Research Update:

Finnish Network Operator Caruna Networks Oy Ratings Affirmed Despite Pressure From Increasing Shareholder Distributions

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Rating Action Overview

- We expect Caruna Neworks Oy's funds from operation (FFO) to reach €250 million by 2022, up from €230 million in 2019, driven by increasing regulatory allowed returns from its growing regulatory asset base.
- Despite increasing FFO, we expect a slight increase in debt over 2020-2021, since cash flow won't likely cover outflows from capex and shareholder distributions that are increasing to €140 million -€150 million in 2021 from €75 million in 2019. We therefore expect debt to EBITDA will remain in the lowest end of the threshold for the rating.
- We are affirming our ratings on Caruna, including our 'BBB+' long-term issuer rating, as we don't expect credit ratios to decline further.
- The stable outlook reflects our expectation that FFO to debt will remain above 9% and debt to EBITDA close to 8x, and that we expect stable operations and no significant changes to the regulatory framework during the current 2020-2023 period.

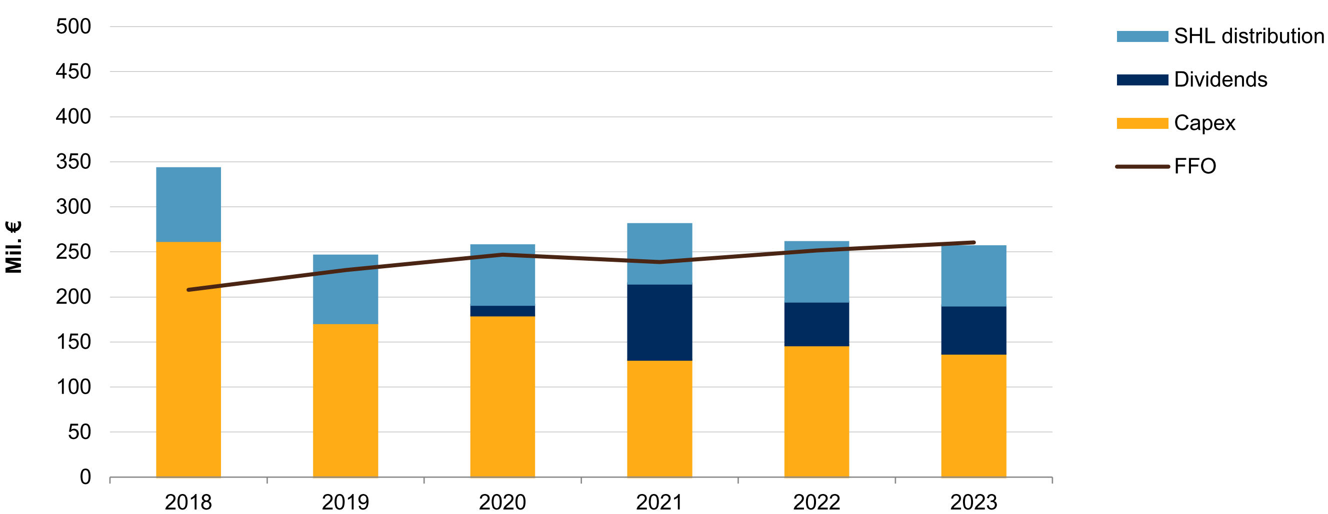
Rating Action Rationale

Credit metrics are expected to remain stable thanks to a stable regulatory environment. The company operates in a favorable operational environment in Finland, and because Caruna's earnings are derived fully from regulated activities, we believe that its cash inflows should remain stable and predictable. We forecast that funds from operations (FFO) over 2020-2022 at €235 million-€255 million, the improvement stemming mainly from increased regulatory remuneration as the regulatory asset base gets larger, which allows for higher allowed regulatory return. This is despite a decreasing weighted average cost of capital (WACC) related to the regulatory framework; WACC for 2020 is 5.73% and 5.35% in 2021, compared with 6.20% in 2019. Over 2020-2021 we expect debt to EBITDA just above 8x but with a downward sloping trend toward 7.8x-8x in 2022. Hence, we view the rating headroom to be limited.

Net cash flow remains negative despite a lower capital expenditure (capex) program, as its shareholder distribution is increasing heavily. Caruna's capex has been large over the past few years, totaling €1.4 billion invested from 2012-2018, as investment in underground cabling has been required to increased security of supply. We believe this should decrease the exposure to storms and interruptions, as overhead lines are more exposed. As the company has progressed well in its underground cabling rate, reaching 56% by end of 2019, investments will now decrease to about €140 million-€150 million on average compared to peak investments of almost €300 million during 2017. Underground cabling has decreased outages and increased security of supply, but at the same time has increased debt. We expect that debt will stabilize between €2.5 billion-€2.6 billion in the coming years. The company plans to increase its shareholder distributions in terms of interest paid on shareholder loans, but also dividends. Shareholder remuneration of about €140 million-€160 million is planned in 2021 and about €105 million-€125 million in 2022, up from €75 million in 2019, which we view as an aggressive increase as it is expected to consume more than 60% of FFO in 2021. That said, we expect Caruna will show flexibility in shareholder distributions to maintain credit metrics commensurate with the rating. The company appears committed to maintaining FFO to debt above 9% and debt to EBITDA at about 8x.

Chart 1

Funds From Operations Do Not Fully Cover Investments And Dividends



Source: S&P Global Ratings.

Caruna benefits from low risk, stable network operations within a framework we view as credit supportive. We view Finland's regulatory framework for the fifth regulatory period (2020-2023) as stable and predictable. The methodology for calculating allowed profit has been in place since 2005, with only minor adjustments. The regulator implemented positive modifications in 2016, resulting in a higher WACC and stronger cost recoverability. The WACC is now linked to the higher of the 10-year average or previous year's (April-September) average of the Finnish government's

10-year bond. For 2020-2023, the regulatory methods are the same, although some parameters were updated--for example, the debt premium was adjusted to 1.26% from 1.40%. The risk-free rate is reset annually. WACC for 2020 is 5.73% and 5.35% in 2021, compared with 6.20% in 2019. Although we expect a gradual decline in the current period, because the risk-free rate is declining and the WACC resets annually, we believe the framework is supportive and allows for good cost recoverability. The government is considering changes to the Electricity Market Act, but they have not yet been sent to for approval in parliament. According to the Energy Authority, changes under consideration mainly concern three factors--unit prices, WACC, and incentives--and could enter into force in 2022, which would be the middle of a regulatory period. If changes are imposed in the middle of the period and result in a significant cut in remuneration, it could lead to a negative rating action. However, at this stage we expect the potential changes to have only a limited effect. Nevertheless, changes to the ongoing regulatory framework run contradictory to our view of regulatory stability.

Outlook

The stable outlook on Caruna reflects our expectation that its EBITDA and FFO will continue to increase, driven by higher allowed regulatory return during the regulatory period that started in 2020, despite decreasing WACC. We expect FFO to debt comfortably over 9% and debt to EBITDA at about 8x, including connection fees, which we consider commensurate with a 'bbb+' stand-alone credit profile.

Downside scenario

Rating downside could emerge if Caruna's shareholder renumerations continue to consume a large part of its cash flow, leading to negative discretionary cash flow and implying weaker credit ratios, FFO to debt below 9% without signs of recovery, or debt to EBITDA sustainably above 8x and increasing including connection fees, and would result in negative rating pressure. This could also materialize if Caruna's operating performance is weaker than we anticipate due to material acquisitions, or larger shareholder returns or capex than expected.

The rating could also come under pressure if the regulator imposes and implements a substantial change to the regulatory framework during the ongoing period (2020-2023) that would result in significantly lower remuneration, for example changing the risk-free rate component, and resulting in a lower WACC.

Upside scenario

We believe that ratings upside is remote within the next two years. We believe that ratings upside would require a change in financial policy that supports stronger credit ratios. We could upgrade Caruna if FFO to debt is 12% or above and if debt to EBITDA remains lower than 7x, including connection fees.

Company Description

Caruna is a Finnish power distribution system operator (DSO) that was founded in 2014 as a spin-off from Fortum. Caruna is the largest power DSO in Finland, with 22.7% market share of power distribution, followed by Elenia (BBB+/Stable/--) with 17.5% in 2019 in terms of network length. Caruna distributes electricity to about 700,000 customers (about 1.5 million people) in its respective geographical areas.

Caruna is composed of Caruna Oy and Caruna Espoo Oy, which together operate 87,400 kilometers of network in Finland (56% of which is underground cable). Caruna Espoo Oy operates in urban areas with a high number of consumers, while Caruna Oy operates in mostly rural areas requiring high investments due to larger network to repair. At year-end 2019, the average cabling rate for Caruna was 56% (54% for Caruna Oy and 76% for Caruna Espoo Oy).

Caruna is mostly owned by infrastructure funds (80%) and Finnish Employment Pension Companies (20%).

Our Base-Case Scenario

We make the following assumptions in our base case scenario for 2020-2022:

- Finland's GDP declines about 6% in 2020, increasing 2.5% in 2021 and 1.5% in 2022.
- Very limited impact from COVID-19 and related lockdowns.
- Stable contribution from predictable DSO activities, with the next regulatory reset date in 2024, i.e., no major changes to the framework in the existing period.
- Pre-tax WACC at 5.35%, 4.99%, and 4.76% for the years 2021, 2022, and 2023. Annual capex of about €180 million in 2020 and averaging €140 million onwards
- Annual connection fees of €12 million-€15 million.
- No material acquisitions.

Table 1

Caruna Networks Oy--Key Metrics*

	2018a	2019a	2020e	2021f	2022f
EBITDA (mil. €)	288	302	305-315	310-320	325-335
FFO (mil. €)	208	230	240-250	235-245	245-255
Shareholder distributions (mil. €)§	81	75	65-85	140-160	105-125
Debt (mil. €)	2,369	2,513	2,500-2,600	2,500-2,600	2,500-2,600
FFO to debt (%)	8.8	9.2	9.5-10.0	9.0-9.5	9.5-10.0
Debt to EBITDA (x)	8.2	8.3	7.8-8.2	7.8-8.2	7.5-8.0
EBITDA margin (%)	63.4	64.7	63-68	63-68	63-68
DCF to debt (%)	(9)	(3.5)	(0.5)-0	(2.5)-(2.0)	(0.5)-0

*All figures adjusted by S&P Global Ratings. §Shareholder distributions including: interest paid on shareholder loans and dividends. FFO--Funds from operations. DCF--Discretionary cash flow. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess Caruna's liquidity as strong. We anticipate that available liquidity sources will exceed expected cash outflows by 2x. We also expect that the sources will cover uses even if EBITDA declined 30% compared with our base case, and that Caruna will retain significant headroom under the financial covenants. The company has no debt maturities until 2023 when its benchmark bond of €500 million is due. Additionally, the company has a conservative average total debt to maturity of about 12 years. In our assessment of liquidity, we also factor in our view of Caruna's solid relationship with banks as recently proven with extending its revolving credit facility (RCF) facility in November this year.

Principal liquidity sources include:

- €11 million cash available as of Sept. 30, 2020;
- €320 million available under its RCF and liquidity facility maturing in more than 12 months; and
- Our expectation that Caruna will generate cash FFO of about €240 million.

Principal liquidity uses include:

- Working capital outflows of €7 million in the next 12 months, €2 million in the subsequent 12 months;
- Annual capex of about €140 million;
- No debt maturities over the coming 12-24 months; and
- Annual shareholder distribution of about €120 million-€130 million including interests on shareholder loan.

Covenants

Although we do not rate Caruna under our structurally enhanced debt criteria, the company has a number of protective covenants. Caruna continues to comply with the debt restriction covenants stipulated in its documentation and as per our analysis below.

The documentation also includes lock-up covenants for shareholder distributions, which are:

- FFO to interest on senior debt of at least 1.7x (12 months backward and forward);
- FFO to senior debt of at least 5% (12 months backward and forward); and
- FFO to senior debt of at least 5.5% (36 months forward).

Caruna's financing structure includes the following financial covenants for events of default:

- FFO to interest on senior debt of no less than 1.7x; and
- FFO to senior debt of no less than 5%.

As of Dec. 31, 2019, the ratios were 9.2% and 5.1x, respectively, showing significant headroom at both covenant levels. We forecast that Caruna will maintain significant headroom under the financial covenants. In addition, the lock-up covenants prohibit shareholder distributions if FFO to debt drops below 5% or if FFO to interest falls below 1.7x. Furthermore, a breach of the financial covenants will not automatically mean a payment default. Instead, there will be a 12-month standstill period, during which there will be no enforcement of security and the 12-month liquidity facility should cover scheduled payments.

Ratings Score Snapshot

Issuer credit rating: BBB+/Stable/--

Business risk: Excellent

- Country risk: Very low
- Industry risk: Very low

Competitive position: Strong

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/portfolio effect: Neutral
- Capital structure: Neutral
- Liquidity: Strong
- Financial policy: Neutral
- Management and governance: Satisfactory
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012

- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Ratings Affirmed	
Caruna Networks Oy	
Issuer Credit Rating	BBB+/Stable/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.