Stockholm Exergi Holding AB (publ)

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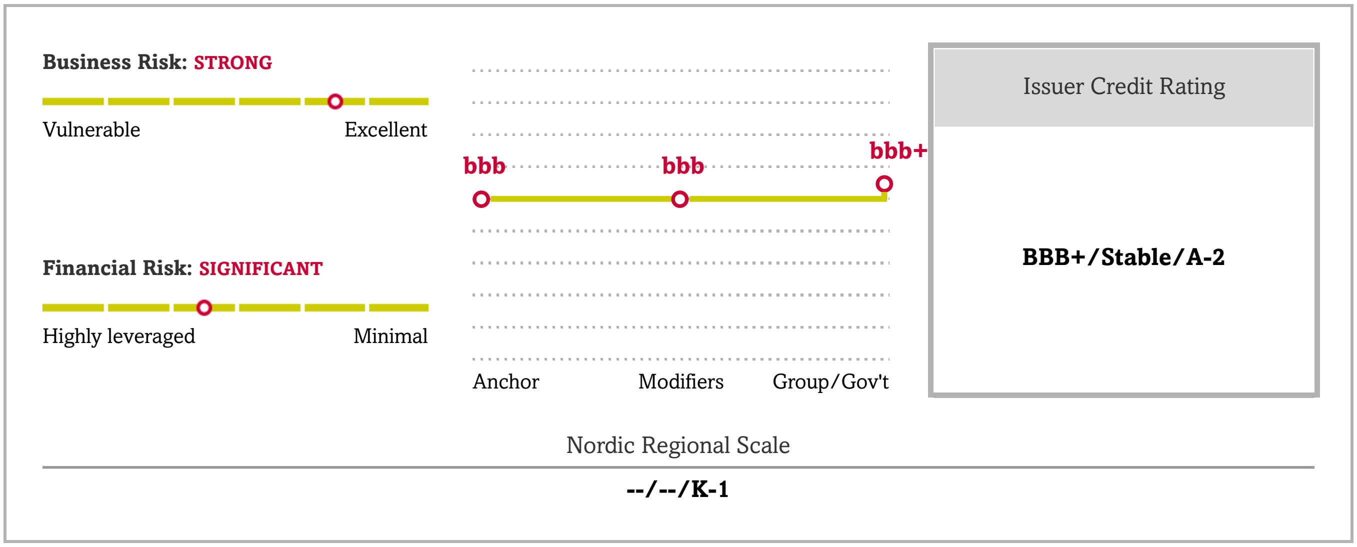


Credit Highlights

Overview

Key Strengths	Key Risks
Stable district heating business accounting for about 85% of operations.	Large fuel consumption related to the combined heat and power (CHP) plants creates exposure to volatile commodity prices, such as for biomass and coal.
Key provider of heat in the Stockholm area, with a stable and dominant market position.	Upcoming large capital expenditure (capex) to finance a new CHP plant and the transition to 100% renewable fuels by 2030.
Support from the city of Stockholm, which has a 50% stake.	Limited geographic diversification, with all operations in the Stockholm region.

S&P Global Ratings regards Stockholm Exergi's district heating business as predictable and relatively stable. About 85% of EBITDA stems from district heating business, which we view as an efficient way to produce heat and electricity, with some flexibility to increase/decrease electricity generation when favorable. We view district heating as a regulated activity, mainly due to its monopoly-like features, although there is no formal regulatory framework.

We expect Stockholm Exergi to maintain its strong local position. Stockholm Exergi is a key provider of heat in Stockholm, and has about an 80% market share in its operating area, with a diverse customer base. In 2018, about 95% of new properties in the Stockholm area chose Stockholm Exergi as the heating provider.

Significant fuel price increases weighed on profitability last year. In 2018, biomass prices spiked because of delivery disruptions caused by wet weather conditions in the Baltics, and coal prices were roughly 40%-60% higher than in 2017. These factors resulted in significantly lower profitability, with our adjusted EBITDA margin at 39%, about 5.5 percentage points lower than we previously forecast. In our view, Stockholm Exergi has notable exposure to volatile fuel prices, since the tariff model could absorb volatile costs in the medium term but not in the short term.

The new SEK5 billion heat plant will likely lead to additional debt. In December 2018, the company decided to construct a new heat plant, likely to be commissioned in 2024, to replace an old less efficient and fossil-fueled power plant. We expect that the new plant, alongside Stockholm Exergi's already ambitious capex plan, will add about SEK2 billion of debt in the coming three years.

Part ownership by the government of Stockholm enhances the company's stand-alone credit profile. Stockholm Exergi is 50% owned by the city of Stockholm and 50% by Fortym Oyj, with equal voting rights. Our 'BBB+' long-term rating on Stockholm Exergi includes one notch of uplift because we believe the city would support the company if it faced difficulties outside the ordinary course of business. We consider a change in ownership support to be unlikely.

Outlook: Stable

Our outlook is stable because we expect Stockholm Exergi's stable heating operations will continue to support its operating cash flows. We believe the company's financial risk profile will likely stay well in line with our parameters for the current ratings. We forecast that Stockholm Exergi's credit metrics will remain at about the current levels in the coming three years, with FFO to debt at 18%-22%, comfortably above our 15% threshold. In addition, we forecast debt to EBITDA will stay below 4.5x over the same period.

Downside scenario

We could consider a negative rating action if Stockholm Exergi's credit metrics were to deteriorate substantially, with FFO to debt below 15% with limited prospects for a swift recovery. This could result, for example, from any significant further debt-funded investment, or operational underperformance as a result of significantly higher fuel prices. In addition, we could lower the ratings if the city of Stockholm's ownership stake decreased, because this could lead us to revise down our assessment of the likelihood of extraordinary support.

Upside scenario

We could consider an upgrade if Stockholm Exergi's financial policy supported a sustainable improvement of its financial position to a level we view as commensurate with an intermediate financial risk profile. This could materialize, all else being equal, if the company's adjusted FFO-to-debt ratio were to exceed 23% on a sustainable basis.

Our Base-Case Scenario

Assumptions

- Revenues decreasing by about 2% annually over the coming three years, owing to lower electricity generation, and no new added capacity over that period. Annual tariff increases of about 2.5% are expected to be offset by capacity adjustments.
- Efficiency program and new business activities will improve EBITDA margins to 44%-46% by year-end 2021 from about 39% in 2018.
- Capex of about SEK1.80 billion in 2019 in line with previous years, and increasing toward SEK2.9 billion annually through 2021.
- An increase in debt of about SEK2.0 billion in the coming three years due to the large capex program. We forecast net debt at roughly SEK14 billion at year-end 2021.
- Dividend payouts of about SEK850 million annually, a small increase from SEK 800 million last year.
- We expect that the increased tax on carbon dioxide and fossil fuels, with expected implementation in August 2019, will have only a minor effect on EBITDA, although may reduce revenues because of lower electricity generation.

Key Metrics

	2018a	2019p	2020-2021e
EBITDA margin (%)	39	40-42	44-46
EBITDA (bil. SEK)	2.8	2.8-3.0	3.0-3.2
Debt (bil. SEK)	12.0	12.1-12.3	13.0-14.0
FFO/Debt (%)	20	20-22	18-20
Debt/EBITDA (x)	4.3	4.2-4.3	4.2-4.4
FFO cash interest coverage (x)	16	15-16	12-14

* Figures are S&P Global Ratings adjusted. a--Actual. p--Projected. e--Estimate. FFO--Funds from operations.

Base-Case Projections

We expect an efficiency- program to limit the effect of debt-funded capex growth in 2021-2023. The expected increase in capex in 2020 (by about SEK1.4 billion) relates to new electricity generation business, and back-up capacity used only for peak periods in the Stockholm area. In 2021, the debt increase of about SEK1 billion relates mainly to the construction of the new CHP plant. We forecast debt to EBITDA will remain below 4.5x in our base case.

Company Description

Stockholm Exergi (formerly Fortum Varme) is the largest provider of district heating in the Stockholm region and has a roughly 80% market share in its operating area, with reported EBITDA of about €270 million. In 2018, it generated sales totaling roughly SEK6.8 billion. The company is 50% owned by the city of Stockholm and 50% by Fortum Oyj.

Stockholm Exergi provides heating for over 800,000 people in and around Stockholm and the district heating network is made up of 2,900 kilometers of underground pipes. Of the 10,400 individual customers, roughly 5,000 are apartment building associations. Stockholm Exergi also provides cooling to about 400 customers.

Business Risk : Strong

In our view, Stockholm Exergi has stable and predictable district heating operations, with monopoly like features. Around 85% of revenues comes from district heating, 10% from electricity production, and 5% from district cooling. District heating also account for about 85% of the company's and EBITDA.

Although there is no defined regulatory framework for district heating in Sweden, Stockholm Exergi is the sole district heating network operator in its area, with implicit oversight from the Swedish Competition Authority. We view the current market-based framework for district heating as predictable, which brings stability to the business.

Stockholm Exergi's business risk profile is also supported by its diverse customer base. These consist mainly of real estate companies and housing associations, which generally exhibit more stable demand than industrial customers. The company also benefits from a diverse fuel mix, which enables it to react, to some extent, to prevailing fuel prices by switching between different fuel types.

The company is, however, exposed to geographic concentration because all of its operations are in the City of Stockholm region. This is partly mitigated by the region's very strong and dynamic local economy. However, the stable operating environment is partly offset by volume and fuel price risks related to district heating. Warmer or colder winters lead to unpredictable demand and volatile fuel prices, as seen in 2018 when coal and biomass prices increased substantially.

The absence of a defined tariff regulation for cost cover means there is no guarantee that the company can recover costs linked to volatility. However, its operating profit has historically been relatively stable, and completion of the new plant should support operating efficiency and flexibility. The Värtaverket plant in Stockholm, commissioned in 2016, is one of Europe's largest urban CHP plants and has the possibility to adjust its heat and electricity production.

Peer comparison

Although there is no rated counterpart to Stockholm Exergi with district heating as the main activity in the Nordics, we have included the two Swedish multi-utilities with significant district heating operations, Kraftringen Energi AB and Tekniska verken i Linköping AB (TvAB) as peers.

Compared with Kraftringen and TvAB, we view Stockholm Exergi's business as slightly stronger because district heating represents the majority of its operations. By contrast, these peers conduct multiple activities, including regulated electricity distribution activities, and what we view as weaker activities such as retail and generation businesses. We also regard peers as having greater asset concentration, since they rely more heavily on individual power plants than Stockholm Exergi.

Nevertheless, Stockholm Exergi's financial risk profile is the weakest. We forecast TvAB's FFO to debt at 45%-50% in 2019 and 2020, compared with Kraftringen at 23%-25%, and Stockholm Exergi at 18%-22%. Stockholm Exergi's projected leverage (debt to EBITDA) is also in a weaker category, at 4.2x-4.4x, compared with 1.8x-2.2x for TvAB and 3.3x-3.7x for Kraftringen.

Table 1

Stockholm Exergi Holding AB (publ)--Peer Comparison			
Industry sector: Combo			
	Stockholm Exergi Holding AB (publ)	**Kraftringen Energi AB (publ)**	**Tekniska verken i Linkoping AB**
	--Fiscal year ended Dec. 31 2018--		
(Mil. SEK)			
Revenues	7,149.0	3,146.8	5,509.0
EBITDA	2,778.5	645.2	1,461.5
FFO	2,405.0	583.0	1,400.6
Interest Expense	193.5	52.0	49.9
Cash Interest Paid	157.5	54.5	50.9
Cash flow from operations	2,240.0	607.8	1,249.6
Capital expenditures	1,548.0	487.5	914.0
Free operating cash flow	692.0	120.2	335.6
Discretionary cash flow	(108.0)	5.1	181.6
Cash and short-term investments	0.0	176.4	141.0
Debt	12,011.1	2,415.3	2,034.4
Equity	12,355.0	3,134.7	5,289.0
Adjusted ratios			
EBITDA margin (%)	38.9	20.5	26.5
Return on capital (%)	5.6	8.2	12.3
EBITDA interest coverage (x)	14.4	12.4	29.3
FFO cash interest coverage (x)	16.3	11.7	28.5
Debt/EBITDA (x)	4.3	3.7	1.4
FFO/debt (%)	20.0	24.1	68.8
Cash flow from operations/debt (%)	18.6	25.2	61.4
Free operating cash flow/debt (%)	5.8	5.0	16.5
Discretionary cash flow/debt (%)	(0.9)	0.2	8.9

FFO--Funds from operations. SEK--Swedish krona.

Financial Risk: Significant

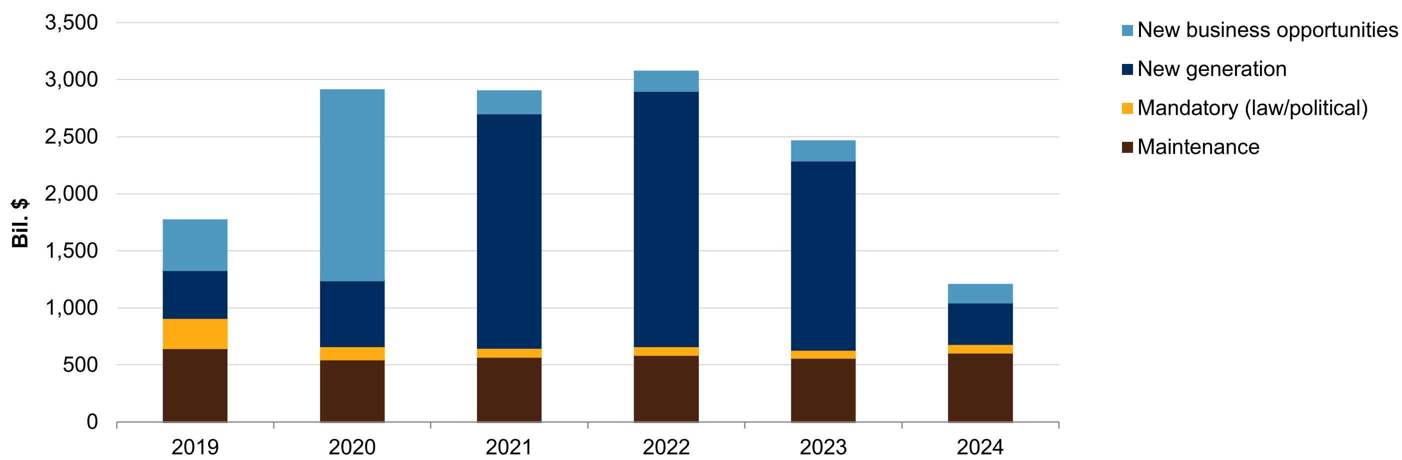
Stockholm Exergi generates stable cash flows. The new plant commissioned in 2016 has improved the efficiency of its heating operations, with increasing cash flows through additional electricity production. That said, Stockholm Exergi is vulnerable to volatile fuel prices, with its profitability weakening when both biomass and coal prices increase rapidly.

Tariff adjustments, even with flexible heat and electricity production, do not fully cover the effect of volatile fuel prices. Despite increased electricity prices last year, with an annual average Nord Pool system price of about €44 per megawatt hour (/MWh) up from about €29/MWh in 2017, Stockholm Exergi was not fully able to maintain its earnings and margins in 2018 compared with previous years.

The company has updated its capex plan for the coming six years, mainly to build a new plant, decommission an old plant from the 1960s, and convert existing heat plants to use renewable fuels. The updated capex plan results in an investment peak in 2020-2023, with annual capex of about SEK2.9 billion, compared with SEK1.6 billion in 2018.

Chart 1

Stockholm Exergi's Capex Will Remain High Until 2022



Source: S&P Global Ratings.

We expect that Stockholm Exergi will partly fund its additional investments, resulting in an increase of net debt of SEK2.0 billion by year-end 2021 and total debt of SEK14.0 billion compared with SEK12.0 billion in 2018. We expect the investments together with the ongoing cost-savings program, will lead to an improved EBITDA margin higher than 44% by the end of 2020, compared with 39% in 2018.

Based on this, we expect:

- FFO to debt of about 20% in 2019 and 2020, giving comfortable headroom versus our downside threshold of 15%.
- Debt to EBITDA at 4.2x to 4.4x in the coming three years.
- FFO cash interest coverage decreasing toward 12x.

Financial summary

Table 2

Stockholm Exergi Holding AB (publ)--Financial Summary					
Industry sector: Combo					
	--Fiscal year ended Dec. 31--				
	2018	**2017**	**2016**	**2015**	**2014**
(Mil. SEK)					
Revenues	7,149.0	6,788.0	6,746.0	6,323.0	6,654.0
EBITDA	2,778.5	3,022.0	2,799.0	2,824.5	2,892.0
FFO	2,405.0	2,640.4	2,584.2	1,961.7	2,265.9

Table 2

Stockholm Exergi Holding AB (publ)--Financial Summary (cont.)

Industry sector: Combo

	--Fiscal year ended Dec. 31--				
	2018	**2017**	**2016**	**2015**	**2014**
Interest Expense	193.5	181.6	183.8	618.8	317.1
Cash Interest Paid	157.5	168.6	158.8	631.8	355.1
Cash flow from operations	2,240.0	2,714.4	2,296.2	1,958.7	2,195.9
Capital expenditures	1,548.0	1,795.0	1,593.0	2,520.0	3,100.0
Free operating cash flow	692.0	919.4	703.2	(561.3)	(904.1)
Discretionary cash flow	(108.0)	519.4	303.2	(961.3)	(1,304.1)
Cash and short-term investments	0.0	0.0	0.0	0.0	0.0
Gross available cash	152.0	149.0	123.0	1.0	60.0
Debt	12,011.1	11,785.9	12,291.1	13,060.1	12,359.7
Equity	12,355.0	11,969.0	11,236.0	10,430.0	10,065.0
Adjusted ratios					
EBITDA margin (%)	38.9	44.5	41.5	44.7	43.5
Return on capital (%)	5.6	7.0	6.8	7.1	7.9
EBITDA interest coverage (x)	14.4	16.6	15.2	4.6	9.1
FFO cash interest coverage (x)	16.3	16.7	17.3	4.1	7.4
Debt/EBITDA (x)	4.3	3.9	4.4	4.6	4.3
FFO/debt (%)	20.0	22.4	21.0	15.0	18.3
Cash flow from operations/debt (%)	18.6	23.0	18.7	15.0	17.8
Free operating cash flow/debt (%)	5.8	7.8	5.7	(4.3)	(7.3)
Discretionary cash flow/debt (%)	(0.9)	4.4	2.5	(7.4)	(10.6)

FFO--Funds from operations. SEK-Swedish krona.

Liquidity: Adequate

We view Stockholm Exergi's liquidity as adequate, reflecting that available liquidity sources should exceed forecast near-term cash outflows by 1.1x. We also expect that sources will exceed uses even if EBITDA declines by 10%. We believe that the company has sound relationships with banks, generally prudent risk management, and no restrictive financial covenants in its loan documentation.

Principal Liquidity Sources	Principal Liquidity Uses
(For the 12 months started Jan. 1, 2019) • Cash FFO of about SEK2.60 billion. • About SEK150 million in cash and marketable securities. • Access to undrawn committed revolving credit facilities totalling SEK3 billion, maturing in 2021. • We do not reflect in our liquidity calculation an additional SEK500 million facility due December 2019, since it does not mature beyond the next 12 months.	(For the 12 months started Jan. 1, 2019) • Debt maturities of about SEK2.30 billion, predominantly outstanding bonds. A SEK1.50 billion bond maturing in December 2019 is expected to be refinanced with a green bond by the end of 2019. SEK300 million relates to bank commercial paper and the remainder to loans. • Capex of about SEK1.80 billion in 2019 and about SEK2.90 billion in 2020. • Expected dividend of about SEK850 million annually.

Covenant Analysis

Stockholm Exergi's credit facilities have no financial covenants.

Environmental, Social, And Governance

The utilities industry, which includes district heating providers, faces short- and long-term risks from environmental factors, but also societal issues in terms of pollution and governance risk related to political decisions affecting the industry, for example targets for carbon dioxide emissions.

Environmental risks are a significant factor for Stockholm Exergi because of its fuel consumption related to the heat and CHP plants, and carbon dioxide discharge. Stockholm Exergi has reduced its carbon dioxide footprint by about 65% since 2002, mainly thanks to a shift from fossil fuel to biofuels and more efficient technology.

Although the company is still one of Stockholm's largest dischargers of carbon dioxide and emissions increased in 2018 compared with 2017, it intends to phase out coal by the end of 2022 and be environmentally neutral by 2030. These targets have resulted in a significant investment plan in the coming years, for example conversion to renewable fuels in existing and new plants, as well as technology to filter the emissions.

Stockholm Exergi and its main coal supplier were mentioned in reports of the Swedbank money laundering scandal. Its main coal supplier had suspected ties to sanctioned individuals, according to Swedish broadcaster SVT's investigation. This could potentially lead to fines or a loss of customers for Stockholm Exergi if the allegations turn out to be true. We do not expect this to result in consequences that will materially affect our credit rating on Stockholm Exergi.

Government Influence

In accordance with our criteria for government-related entities, we see a moderate likelihood of extraordinary support for Stockholm Exergi from the city of Stockholm, based on our assessment of the company's:

- Strong link to the city, which owns 50% of the company. We believe the city of Stockholm has no plans to reduce its stake in Stockholm Exergi. The remaining 50% is owned by Fortum Oyj, and the two shareholders have equal voting rights and board representation; and
- Limited importance for the city. Although Stockholm Exergi provides the majority of heating in Stockholm, we consider that, given the company's part ownership by Fortum, the city of Stockholm is primarily interested in Stockholm Exergi's operations and that its services could be provided by a private-sector entity.

Issue Ratings - Subordination Risk Analysis

Capital structure

Stockholm Exergi's debt structure consists of senior unsecured debt.

Analytical conclusions

We rate Stockholm Exergi's debt 'BBB+', the same level as the issuer credit rating, because no significant elements of subordination risk are present in the capital structure.

Reconciliation

Table 3

Reconciliation Of Stockholm Exergi Holding AB (publ) Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. SEK)

	--Fiscal year ended Dec. 31, 2018--							
Stockholm Exergi Holding AB (publ) reported amounts								
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Capital expenditure**
Reported	11,779.0	12,353.0	2,801.0	1,382.0	169.0	2,778.5	2,228.0	1,549.0
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	(216.0)	--	--
Cash taxes paid - Other	--	--	--	--	--	--	--	--
Cash interest paid	--	--	--	--	--	(133.0)	--	--
Operating leases	384.1	--	36.5	23.5	23.5	(23.5)	13.0	--
Accessible cash and liquid investments	(152.0)	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	1.0	(1.0)	(1.0)	(1.0)
Nonoperating income (expense)	--	--	--	1.0	--	--	--	--
Noncontrolling interest/minority interest	--	2.0	--	--	--	--	--	--
EBITDA - Derivatives	--	--	(59.0)	(59.0)	--	--	--	--
Total adjustments	232.1	2.0	(22.5)	(34.5)	24.5	(373.5)	12.0	(1.0)
S&P Global Ratings' adjusted amounts								
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Capital expenditures**
Adjusted	12,011.11	12,355.00	2,778.50	1,347.48	193.48	2,405.02	2,240.02	1,548.00

SEK--Swedish krona.

Ratings Score Snapshot

Issuer Credit Rating

BBB+/Stable/A-2

Business risk: Strong

- **Country risk:** Very low
- **Industry risk:** Very low
- **Competitive position:** Satisfactory

Financial risk: Significant

- **Cash flow/Leverage:** Significant

Anchor: bbb

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : bbb

- **Related government rating:** AAA
- **Likelihood of government support:** Moderate (+1 notch from SACP)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, Aug. 14, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	**Significant**	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	**bbb**	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of June 3, 2019)*

Stockholm Exergi Holding AB (publ)		
Issuer Credit Rating		BBB+/Stable/A-2
Nordic Regional Scale		--/--/K-1
Senior Unsecured		BBB+
Issuer Credit Ratings History		
03-Apr-2014		BBB+/Stable/A-2
03-Apr-2014	*Nordic Regional Scale*	--/--/K-1

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.