

Research Update:

Finnish Power Distributor Caruna Downgraded To 'BBB' On Regulatory Changes Of Asset Value; Outlook Stable

January 27, 2022

Rating Action Overview

- A revision of the framework for Finnish electricity distribution system operators (DSOs) in October includes a weighted-average 17% cut in regulatory asset value (RAV), following changes that reduce DSOs' income by almost 100 basis points (bps), resulting in allowed income being €295 million lower from 2022.
- Consequently, we view the regulatory framework as strong/adequate rather than strong, and therefore also revised upward our ratio thresholds for a 'BBB+' rating.
- We now anticipate that Caruna Networks Oy's funds from operations (FFO) to debt is likely to remain at 9.0%-10%, below the revised threshold of 12% or more for the 'BBB+' rating.
- We are therefore lowering our issuer credit ratings on Caruna to 'BBB' from BBB+, and removing them from CreditWatch negative where we placed them on Oct. 29, 2021.
- The stable outlook indicates that we believe Caruna remains committed to keeping FFO to debt above 9% and will continue with flexible shareholder remunerations to balance its ratios.

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Rating Action Rationale

Caruna's ratios are unlikely to be in line with our new thresholds for a 'BBB+' rating. As a consequence of our reassessment of the Finnish regulatory framework for DSOs in October 2021 to strong/adequate from strong (see "Finnish Power Distributors Elenia And Caruna Ratings Put On CreditWatch Negative On Regulatory Remuneration Cuts," published Oct. 29, 2021), we increased the FFO to debt threshold for Caruna to 10% from 8% for the 'BBB+' rating. The revision of metrics thresholds for Caruna is in our view warranted to compensate for what we perceive as higher business risks; we therefore now place Caruna's business risk profile at the lower end of the excellent category. The regulatory framework is an important component of our assessment of any DSOs' competitive advantage, and its untypical that we see changes in the framework during a regulatory period. In our view this creates uncertainty about the stability of the system, also in the

future. We don't expect any further changes in the current regulatory period but, based upon the regulator's announcement in October 2021, we believe the risk of such intervention has increased. Following our reassessment, we now benchmark the credit metrics for Finnish DSOs against the more demanding medial financial risk table instead of the low volatility table. After our review, which included discussions with Caruna's management, we have concluded that Caruna is unlikely to achieve the ratios commensurate with a 'BBB+' rating. This acknowledges that this would have required a relatively sizable strengthening of the company's balance sheet of about €500 million-, which the owner is unlikely to arrange. Over the past three years, Caruna has paid about €300 million of shareholder remuneration. In the future, we expect Caruna to balance its shareholder remuneration and show flexibility to maintain credit metrics commensurate with the 'BBB' rating. We believe the company remains committed to keeping FFO to debt above 9%, which we see as in line with its 'bbb' stand-alone credit profile.

Despite what we perceive as reduced predictability of the Finnish regulator, Caruna remains one of the most efficient operators in Finland in our view. We believe the regulatory environment for DSOs in Finland has weakened as a result of significant changes to the framework in the middle of the regulatory period. Ultimately, this has led to a significant cut in remuneration, by about €60 million annually in 2022 and 2023 for Caruna. It is highly unusual for frameworks to be amended in the middle of a regulatory period, and this goes against our view of a stable and supportive framework. In our view, introducing a new unit price list that results in a substantial lowering of the RAV by 2022, and also by including investments already made and completed, does not align with our view of a strong regulatory framework. On average, the regulatory assets base, which is the starting point for the reasonable-return calculation, has been reduced by 17% on a weighted-average basis for all DSOs in Finland. We view this as a significant reduction and untypical among other European regulatory frameworks that we assess as strong. We note that DSOs in Finland have made a legal appeal against the changes, but we don't expect an outcome in the near term; moreover, the outcome is highly uncertain. That said, Caruna is one of the largest network operators in Finland. We expect that Caruna will remain one of the most efficient operators, among other reasons due to its advantage from economies of scale and highly competent project management skills, resulting in stable and predictable cash flows. We therefore still regard Caruna's business risk profile as excellent. We expect profitability, as measured by the EBITDA margin, to remain in the 60%-65% range over 2022-2023.

The effect from the cut in remuneration is muted by Caruna's cumulative, regulatory allowed income deficit, implying the group can use income exceeding €300 million from previous periods. Historically, Caruna has not charged the full allowed tariff from its customers, to balance its regulatory allowed income over previous periods. This has resulted in a cumulative regulated allowed income deficit, transferred from previous periods, which amounted to more than €300 million by the end of 2020. As Caruna starts to activate this deficit it will to some extent increase its revenue until the next regulatory period, which is set to start in 2024, thereby somewhat offsetting the impact of the regulatory cut. This also provides a degree of stability to revenue and cash flows, despite the regulatory changes. At this stage is unclear to us whether the next regulatory reset, commencing 2024, will result in further remuneration cuts for Finnish DSOs.

Outlook

The stable outlook reflects our expectation that Caruna's EBITDA and FFO will not decline significantly despite the regulatory changes, since the company can activate cumulative income

deficits from previous years of about €300 million, which should somewhat offset negative effects. Additionally, we expect that Caruna will adjust its shareholder distributions to protect its credit metrics. Therefore, we expect FFO to debt remain comfortably at 9%-10% and debt to EBITDA at about 8x, which we consider commensurate with a 'bbb' stand-alone credit profile.

Downside scenario

We could lower the rating if Caruna's FFO to debt falls below 9% without any signs of recovery, or debt to EBITDA remains above 8x and is increasing. This could occur if:

- The company increased investments or shareholder remuneration beyond our expectations.
- The regulator imposes additional changes to the framework for the 2024-2027 regulatory period that would have a significant negative impact.

Upside scenario

We see a positive rating action as unlikely at this stage, especially since we believe Caruna will use its additional flexibility to either expand its investment pipeline or increase shareholder remuneration.

We could, however, consider an upgrade if Caruna were to commit to deleveraging, resulting in FFO to debt sustainably above 12% and debt to EBITDA below 7x. We view this as unlikely over the remaining regulatory period until end of 2023, given the group's business plan and recently implemented changes to the regulatory framework leading to lower remuneration.

Additionally, we have noted that Caruna, and the vast majority of DSOs in Finland have appealed the changes imposed by the regulator in the middle of the regulatory period. We could consider raising the rating if the appeal is successful. However, we understand that this could be a very lengthy process, and a positive outcome in the magnitude required for the rating to return to 'BBB+' appears low at this stage.

Company Description

Caruna is a Finnish power DSO that was founded in 2014 as a spin-off from Fortum. It is the largest power DSO in Finland, with 20.6% market share of power distribution, followed by Elenia Verkko Oyj with 12.7% in 2020. Caruna distributes electricity to about 700,000 customers (about 1.5 million people) in its geographic 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 operates in urban areas with a large number of consumers, while Caruna Oy operates in mostly rural areas, requiring high investments owing to the larger network. At year-end 2019, the average cabling rate for Caruna was 56% (54% for Caruna Oy and 76% for Caruna Espoo), reaching 58% as of June 30, 2020. Caruna is owned by Finnish mutual pension insurance company Elo (7.5%), as well as international investors KKR (40%), Ontario Teachers' Pension Plan Board (40%), and AMF Pension (12.5 %).

Our Base-Case Scenario

Assumptions

- Finland's GDP to increase by 1.7% in 2022 and 1.5% in 2023.
- Pretax weighted average cost of capital (WACC) of 4.0%, 4.0%, and 4.2% for 2022, 2023, and 2024.
- Utilizing its cumulative regulatory allowed income deficit, totaling about €310 million, to smooth the effect from the cut in RAV and lower WACC.
- Shareholder distributions of €90 million-€115 million annually during 2022 and 2023.
- No material mergers or acquisitions.

Key metrics

Caruna Networks Oy--Key Metrics*

Mil. €	--Fiscal year ended Dec. 31--			
	2020a	2021e	2022f	2023f
EBITDA	304.5	310-330	290-310	300-320
Funds from operations (FFO)	236.3	250-270	230-250	240-260
Dividends§	78.9	140-160	80-100	100-120
Debt	2503.4	2500-2600	2500-2600	2500-2600
Debt to EBITDA (x)	8.2	8.0-8.5	8.5-9.0	8.0-8.5
FFO to debt (%)	9.4	10.0-10.5	9.0-9.5	9.5-10.0

*All figures adjusted by S&P Global Ratings. §Dividends include interests on shareholder loan a--Actual. e--Estimate. f--Forecast.

Liquidity

We view Caruna's liquidity as strong. We believe that available liquidity sources exceed forecast near-term cash outflows by more than 2x in the next 12 months. In our assessment of liquidity, we also factor in qualitative factors, such as Caruna's sound relationships with banks, satisfactory standing in credit markets, and likely ability to absorb high-impact, low-probability events, with no debt maturing until 2023.

We forecast Caruna will have significant headroom over the next two years under the covenants in its debt documentation. We also believe the company has significant flexibility to reduce shareholder distributions even before reaching lock-up covenant levels.

Principal liquidity sources:

- As of Dec. 31, 2021, forecast FFO of €240 million-€250 million.
- Available cash and marketable securities of about €60 million.
- Access to committed credit lines of about €250 million.

Principal liquidity uses:

- As of Dec. 31, 2021, capex of about €140 million over the next 12 months.
- About €90 million-€115 million of shareholder remunerations.
- No debt maturities over the next 12 months.

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 (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Related Research

- Finnish Power Distributors Elenia And Caruna Ratings Put On CreditWatch Negative On Regulatory Remuneration Cuts, Oct. 29, 2021

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Caruna Networks Oy		
Issuer Credit Rating	BBB/Stable/--	BBB+/Watch Neg/--

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.

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