4 May 2021 Corporates

Lyse AS
Norway, Utilities

SCOPE BBB+ STABLE

Corporate profile

Lyse AS is a Norwegian utility company, fully owned by a group of 14 municipalities in south-western Norway. The company operates in three business areas: energy production, power grids and telecommunications. Lyse's hydropower assets have over the past 10 years generated a mean production output of around 6.1TWh. This will increase to an annual power production capacity of 9.5TWh from 2021, following the transaction with Hydro's RSK assets. Lyse Kraft DA is 74.4% owned by Lyse and 25.6% by Hydro and is the third largest hydropower producer in Norway. Within its monopolistic grid segment, Lyse operates and maintains the regional and district electricity grid, and has more than over 150,000 customers. In telecoms, Lyse has a long history of fibre optic cables for high- speed digital services. Today, Lyse provides network and content services to around 700,000 customers across Norway and Denmark via different brands and partnerships (i.e. Altibox).

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover	7.6x	6.8x	9.6x	10.0x
Scope-adjusted debt (SaD)/EBITDA	3.5x	4.9x	3.3x	3.2x
Scope-adjusted funds from operations/SaD	14%	13%	25%	20%
Free operating cash flow/SaD	-3.7 %	-10.2%	2.0%	0.9%

Rating rationale

Scope Ratings GmbH (Scope) has affirmed its BBB+/Stable corporate issuer rating on Norwegian utility Lyse AS along with the BBB+ senior unsecured debt rating and the S-2 short-term rating.

The issuer rating is supported by Lyse's diversified business model, with operations in energy production, power distribution and telecommunications. Over time, Lyse has seen an increasing share of its group EBITDA generated by a combination of robust infrastructure segments, such as monopolistic power distribution and fibre optic television and broadband services. Combined, we estimate that these segments will represent most of the company's normalised EBITDA contribution over time. The more volatile energy-producing segment has increased in size and improved its asset diversification, following the establishment of Lyse Kraft DA together with Hydro Energi AS. This segment is supported by a low-cost hydro portfolio and a relatively large hydro reservoir capacity, which helps to optimise production and sales.

Lyse's financial performance and credit metrics deteriorated in 2020 due to lower power prices and continued heavy investment into the company (mainly telecoms-related). Nevertheless, our base case indicates that this is temporary, as FY 2021 is already expected to generate positive free operating cash flow (FOCF) and a reduced leverage ratio. We expect leverage (SaD/EBITDA) to decrease back to the 3-4x range this year, based on our recent update on expected achieved power prices for Lyse. Early 2021 has seen higher power prices and increased volume, combined with stable telecoms and grids profitability, allowing the financial risk profile assessment of the company to improve again.

Ratings & Outlook

Corporate issuer rating	BBB+/Stable
Short-term rating	S-2
Senior unsecured rating	BBB+

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Related Methodologies

European Utility Methodology

Corporate Rating Methodology

Government Related Entities Methodology

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Bloomberg: RESP SCOP

The Stable Outlook reflects our expectation that Lyse will maintain its diversified business model (generation, grids and telecoms) and a strong liquidity that fully covers both shorter-term debt maturities and the current investment programme. We also assume that the main credit metrics in 2021 will improve from 2020, exemplified by SaD/EBITDA returning to the 3-4x range in the short to medium term. The Outlook also reflects our expectation that Lyse's ownership structure will remain unchanged.

A rating upgrade could be warranted if cash flows proved higher than our estimates, due to consistently higher achieved power prices or lower capex, which would translate into sustainable positive FOCF, deleveraging, and an improved financial risk profile exemplified by a SaD/EBITDA of below 3.0x on a sustained basis.

A negative rating action is possible if Lyse's financial risk profile weakens due to lower wholesale prices or debt-financed transactions or investments, resulting in leverage of over 4.0x for a prolonged period.

Rating drivers

Positive rating drivers	Negative rating drivers
• Robust and diversified business model, given its monopolistic structure in power transmission, profitable telecoms business, and the power generation portfolio's advantageous position in the merit order system • Profitable and environmentally friendly hydropower production with a large reservoir capacity • Long-term, supportive and committed municipality owners, justifying one notch of uplift as a government-related entity	• Telecoms business currently in a relatively large investment phase, which puts pressure on FOCF generation • Volatility of achievable prices in its power generation segment • Limited diversification by geographical pricing markets

Rating change drivers

Positive rating-change drivers	Negative rating-change drivers
• Improved credit metrics through reduced investments, asset disposals and positive FOCF • SaD/EBITDA of below 3x on a sustained basis	• Large debt-financed acquisition of other businesses or significantly lower prices, resulting in a weakened financial risk profile (i.e. SaD/EBITDA of above 4x) on a sustained basis • Loss of status as a government-related entity

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021F**	**2022F**
EBITDA/interest cover	7.6x	6.8x	9.6x	10.0x
Scope-adjusted debt (SaD)/EBITDA*	3.5x	4.9x	3.3x	3.2x
Scope-adjusted funds from operations/SaD	14%	13%	25%	20%
Free operating cash flow/SaD	-3.7 %	-10.2%	2.0%	0.9%
Scope-adjusted funds from operations in NOK m	**2019**	**2020**	**2021F**	**2022F**
EBITDA	3,244	2,853	4,460	4,740
less: cash interest	-390	-430	-417	-426
less: cash tax paid	-1,211	-652	-263	-1,094
Other items*	-4	40	-168	-180
Scope-adjusted funds from operations	**1,639**	**1,810**	**3,611**	**3,041**
Scope-adjusted debt in NOK m	**2019**	**2020**	**2021F**	**2022F**
Reported gross financial debt (including leasing)	15,967	17,924	17,651	18,063
*Of which, subordinated shareholder loan***	1,900	1,800	1,700	1,600
less: cash and cash equivalents	-4,718	-4,106	-3,361	-3,134
add: cash not accessible	94	97	95	95
add: pension adjustment	65	104	105	105
add: other provisions	11	18	18	18
Other adjustments	-	-	-	-
Scope-adjusted debt	**11,420**	**14,036**	**14,507**	**15,146**

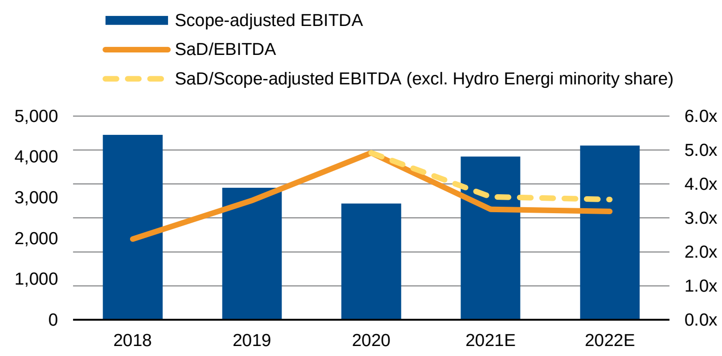
* as EBITDA include the fully consolidated Lyse Kraft DA, the SaD/EBITDA (excluding the estimated minority portion of Hydro) is slightly higher

** The company also has another subordinated loan (YE 2020: NOK 121m), which is not directly from the Lyse's direct municipality owners, and thus excluded in this line, but included in the line above

FY 2020 results and the effects from the Hydro Energi transaction

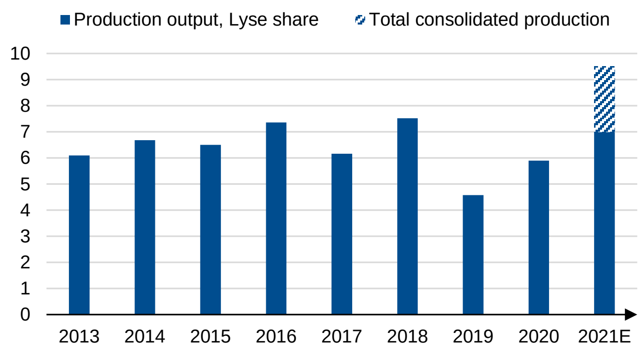
Lyse's overall financial performance in 2020 did not fully meet our expectations due to slightly lower-than-expected contribution from its hydropower production. Although Lyse was negatively affected by the low power prices last year, it was helped by its active use of its flexible hydropower resources and reservoirs, and by its hedging programme. Further, the company also increased its hydropower production volume, up from 4.6TWh in 2019 to 6TWh in 2020. The other business segments developed largely in line with our expectations, with both telecoms and grid segments showing healthy and strong EBITDA growth.

Figure 1: Scope-adjusted leverage development (NOK m)



Source: Company, Scope

Figure 2: Hydro-power production output level (TWh)



Source: Company, Scope

The agreement between Hydro and Lyse effective 31 December 2020 merged part of their respective hydropower production in southern Norway into a joint hydropower company called Lyse Kraft DA. Lyse's hydropower production segment has now increased its size and improved its asset diversification. The number of power plants owned (or partly owned) by the new production company is now 33 (up from 24), which reduces the potential vulnerability of specific power plants. The new company is owned 74.4% by Lyse and 25.6% by Hydro Energi AS.

Lyse Kraft DA is expected to have an annual mean production of over 9.5 TWh, which is comparable to the previous 6TWh standalone production volume Lyse had before. With the ownership agreement, Lyse is expected to get 750GWh new output without any increase in debt. This was achievable for Lyse in the agreement with Hydro thanks to the valuation of the assets and was further driven by the Norwegian Waterfall Rights Act framework. In addition, we also expect cost and efficiency improvements in the new company in years to come (i.e. economies of scale and more efficient operations), and therefore see the transaction as positive for Lyse's credit metrics.

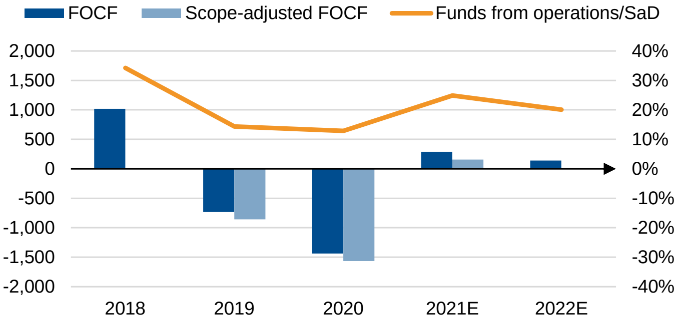
Updated Scope forecast

We have updated our financial forecast for Lyse following the release of the FY 2020 numbers and taken into account that from 2021, Lyse will have new hydro production capacity from the recent deal with Hydro and the Røldal-Suldal Kraft (RSK) assets. In addition, we have applied the new forward power price expectations, given the current market conditions and prospects.

Overall, we forecast notably higher profitability in 2021 than in 2020, driven not only by the rebound in its power production segment, but also the continued EBITDA growth in the telecoms segment. Over time, we also expect to see higher profitability from the grids segment, as new and higher investments should enable higher revenues in the future. Given these expectations, we consider that the Scope-adjusted EBITDA margin is likely to go above 40% again this year.

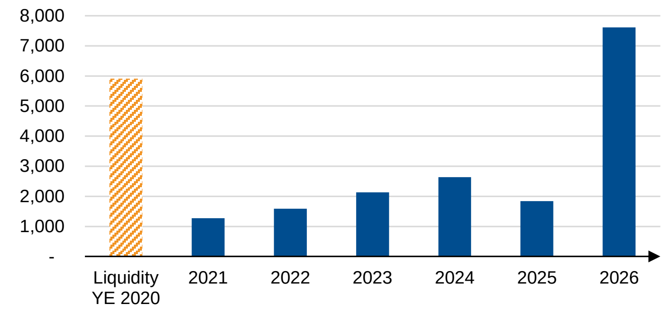
Despite continued high telecoms-related growth investments, we expect that Lyse will be able to cover its capex investment with operational cash flow this year, following two years of negative FOCF. Our projections assume that power prices will be notably higher this year, but we have applied a more conservative level than market prices showed during the strong Q1 2021. Although Lyse has hedged a decent portion of anticipated production this year, there is still some price risk embedded in our medium-term forecast.

Figure 3: Cash flow development (NOK m on LHS)



Source: Company, Scope

Figure 4: Liquidity and debt maturity, YE 2020 (NOK m)



Source: Company, Scope

Summary of business and financial risk profiles

Our BBB+ business risk profile assessment of Lyse remains stable, supported by the large share and importance of stable cash flow from its telecoms and grid segments. With the recent volatile hydro power prices, business risk profile continues to highlight the importance of a diversified organisational structure.

We assess the company's business risk profile as more favourable than its financial risk profile. Lyse's financial risk profile was under some downward pressure in 2020 due to negative FOCF generation, which increased the leverage ratio and worsened other credit-related ratios. Still, with the improvement expected this year, the financial risk profile of the company is no longer under pressure, as long as dividends and capex remain at a sufficient level.

Supplementary rating drivers

We continue to use our bottom-up approach to analyse Lyse's parent support, and the one-notch uplift assigned for municipality ownership has not changed. Although we note that the reduction of municipality ownership in Lyse Produksjon occurred as a consequence of the Hydro ASA ownership, it does not trigger any change in the overall supplementary government-related-entity rating adjustment for Lyse AS, which is still 100% owned by 14 municipalities. The owners are seen as one group, with a long-term, supportive and committed ownership.

We make no adjustment for financial policy. However, we note positively that management targets a minimum credit rating of BBB+ and is thus implicitly aware of the credit ratios it needs to maintain. In addition, management's liquidity strategy includes the stated ambition that cash should cover operational and investment activities as well as debt maturities and dividends in the next six months.

Long-term and short-term debt ratings

The BBB+ senior unsecured debt rating is in line with the issuer rating. We have also affirmed the S-2 short-term rating, still reflecting sufficient short-term debt coverage, and the good access to both bank loans and debt markets.

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