Q2 2018 Vattenfall AB Earnings Call

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Good morning and welcome to this presentation of Vattenfall's Six-Month Report 2018. This is an audiocast and we will present by starting with Magnus Hall, our CEO; and our CFO, Anna Borg, will follow and then at the end, we will open up for questions.

So with that, Magnus.

Magnus Hall - Vattenfall AB - CEO

Thank you very much, Karin. And also from my side, a warm welcome to this morning's audiocast for the first half and quarter two results for Vattenfall 2018.

We are delivering a stable result for the first half year and the quarter and we see a good development in general in the company. The Swedish increased electricity generation particularly the Swedish hydro contributed strongly to the stable first half year.

If we look to the profit for the period, there was an increase versus last year with a little bit more than SEK1 billion mainly as a result of a revaluation of the holdings in the Swedish Nuclear Waste fund and also the upcoming change in the corporate tax rate.

If we go to the underlying profit, it was stable roughly the same as last year, SEK13.1 billion for the first half year. There we could see increased contribution from both power generation and wind and I will go through every business area and business segment a little bit later and give some more details. But we also had quite a negative development in heat specifically looking at the second quarter where we had a negative result. And I will comment a little bit more on that as well, of course.

We have more growth in Sweden. We had an additional wind park in Sweden. We can see that the Netherlands and other countries are taking their responsibilities in terms of changing their policies for climate change and we can see there is now a phase out plan for fossil fuels in the Netherlands particularly regarding coal that affects the operations in Vattenfall for the future.

We have also had significant strategic partnerships and customer contracts during the period for e-mobility but also in cooperation with industry partners and here I would like to highlight the groundbreaking for the fossil-free steel pilot plant in Lulea, where we're doing this together with LKAB and SSAB and we look forward to continuing that development together.

And finally just as an opening remark, the investments in distribution are continuing and they will have to continue in order to modernize the grid and enable more electrification and connect more data centers and make this energy system possible for the future.

So, we go to the first results, a few details on that. We can see that we did not reach the financial targets. We have a return on capital employed target of 8%; we reached 7.1%. If you look at the underlying result, we were actually above 8%, but if you take the actual definition of the EBIT, we did not.
And if you look at FFO relative to adjusted net debt, we were at 19.4%, which is a decrease versus last year but that's also an expected change so nothing out of the ordinary.

Customer sales is increasing. We can see top line growth in the company from SEK69.4 billion in net sales to SEK76 billion. That's quite a significant increase driven by price increases but also volume increases in customer sales.

And then also followed by good electricity production in the company specifically as I mentioned earlier in hydro power; you can see the difference on this Page 3 down to the right where you can see that we had 19.3 terawatt hours for the first half year this year and versus 16.5 terawatt hours last year.

Going to the next page, Customers and Solutions where we are increasing our customer sales. You can also see here where we have the main thrust of the net sales going out of the company. We showed a significant increase. The underlying profit increased somewhat.

And here we can see that it's supported by both the increased net sales and improved margins. But we also have some higher operating expenses at the same time. This is an area where we really have to keep control over your cost as well in order to be profitable for the future and also we have currently in UK expansion which is costing us a little bit of money.

We have a new supply agreement with two Facebook data centres in Sweden, which we are very proud of and we have since long a good cooperation with Facebook and we are now extending that and we are also continuing to install solar panels. This particular one is with a real estate company in the Netherlands where we have a 9-megawatt installation together with them.

And the e-mobility side is continuing to increase. We are growing in charging infrastructure. We have a new cooperation agreement with Volvo in Sweden and then Tanka which is their filling station, so it goes to the retailers where we have a partnership where we will build and operate charging infrastructure.

And we have also announced that our InCharge network, the platform where everybody can connect and be part of a simple system for finding points to charge your car and connect your charging points, InCharge we call it, we are expanding that into UK.

So, with good growth and good development of Customers and Solutions, power generation coming back to mainly the hydro. The question here I think is a significant question and if you look then to the right and the middle graph which is the hydro balance and the system price, so you can see that it's an inverse relation and we know when there is less water in the system, of course, we have a higher price pressure in Sweden, we can significantly see that now.

With two periods, we actually affected the hydro balance, one being the very cold weather spell during the first quarter; and then in the second quarter, we had very low precipitation, low water inflow into the system which means that the balance continue to become more negative and, of course, that is putting pressure on the prices right now.

And we are reporting an increased profit here from SEK5.6 billion to SEK6.4 billion for the first half year. And I could see that also people around could expect that to be more but we have hedges that is running against this because we do run a long term, I guess, our CFO, Anna Borg, will perhaps comment on that later but we do have a hedge that limits sort of the short term changes in the pricing situation for us.

But we are very happy about the situation we have in power generation and being there now right now with good production in both nuclear and in hydro which is important to us. And here also we are in the trading. In power generation, we also have our trading unit where we have together with Facebook where we had a sales agreement under Customers and Solutions, we also have a balancing services agreement with Facebook to make sure that they are properly connected to the electricity system.

We go to the next page which is wind. And as you know, we are spending a considerable amount of expansion investments into wind. The two areas where we are doing that is actually wind and distribution. I will come back to distribution later, very important part of the Vattenfall operation and also a very important part of how the electricity system works.

And here you can see we have increased net sales but we have also increased underlying profit, mainly as a development of prices. This consists of normally fixed pricing income but also to a certain extent merchant price exposed income and the big part of this change that we can see here is based on higher prices coming in also here.
But it shows that we are on the right direction. And we have also started a construction during the quarter, the Blakliden/Fäbodberget, our biggest wind park in Sweden where we cooperate with Vestas and PKA from Denmark. Vestas is a well-known turbine supplier and PKA is a pension fund, Danish pension fund which we partner with. And we have also connected a long term PPA, a power purchase sales agreement with the Norsk Hydro aluminum producer in Norway.

And so, we're very happy about that. We have also just installed the final turbine in our offshore wind deployment center outside Aberdeen, Scotland where we have deployed the biggest wind turbine, offshore wind turbine so far in commercial operation.

And then we have also just started what you can see on the picture here which is the 22-megawatt battery at our Wales installation Pen y Cymoedd where we have a wind farm of 225 megawatts and then we run this as a combination. And this is to ensure the UK grid stability services that we supply from here. And we have just started operations and we will come back on the experience of that running later in a year or two. So, very happy about the wind development in general.

Heat, there is a strategic direction. Clearly, we see heat is an important part of how we go into a climate-friendly world where renewables will play a bigger and important role. But we also now experience, of course, quite very high prices for fuels on the continent, not only for fuels being coal and gas but also for CO2 emission rights.

And they have compared to last year, they have increased significantly, all of them. And that is actually affecting us negatively and you can see that we are for the first half year and particularly in the second quarter which is not here, but if you look to the other parts of the report, we're actually showing a negative result for the second quarter in heat and it's really a result of a very warm period during the second quarter but also cost increases.

Now, this is something that will balance itself with the years to come but short term we are suffering. You can say of the fact that we don't have the one-offs that we had last year, specific subsidies that were run-offs but we also have cost increases which we now have to take back in one way or another.

Otherwise, this is an interesting part in the development for Vattenfall. We will continue to invest in this as well. We have one development in the Netherlands which I was commenting on in the beginning and we have one big coal-fired power plant in the Netherlands which we will have to close, should close by the latest 2024 and then we will see exactly when we would do that from practical and cost reasons. But now we have some visuals on how that should happen which is positive for the development of the reduction of CO2 in Vattenfall.

We also have just as an example of an energy collaboration where we capture excess heat together with a local coffee producer in Uppsala. It's not big but it's very interesting as a principal thing that we need to use a lot more of excess heat in order to find solutions for the climate change, CO2 emission reductions in the heat side.

And we have as you know, our biggest operation is in Berlin where we have just concluded a long term agreement for supply of heat to the municipal buildings in the city of Berlin, for us a very important development. So, short term, a little bit problematic because of cost increases; long term, a good development possibility for the group.

Distribution. Here, the distribution networks are, of course, an integral part of any electrical energy system to make it work. Vattenfall is operating here two big areas. You can say one is, of course, Sweden where we are the biggest distribution operator in the Swedish market. We operate both sort of local grids but also regional grids. And we also have the Berlin side where we are the operator of the distribution grid there.

And here you can see that we have increased the underlying operating profit a little bit mainly as a result of higher network tariffs in Sweden but also due to increased volumes during the cold weather, a lot more electricity was being bought and the variable cost for that part is coming in as part of the increased net sales that we can see in the picture.

Here, it's a very important question for us to continue to invest. We're increasing our investments quite considerably. The coming five-year period, we will be investing SEK20 billion in the Swedish grid and that equals roughly SEK4,000 for every customer per year so it's significant investments that we are doing in order to secure the grid but also to make it possible to connect new operators. And we see that in many areas in Sweden, urban areas, they are expanding and they need more of grid capacity both locally and regionally and transmissions-wise through the Svenska kraftnät in order to get this delivery of electricity. And here we need to continue to invest.

And, of course, right now we have discussion around the regulation in Sweden and here our message in general is that we have to make sure that we get a long term regulation and it has to give incentives for the investors to actually put money into the needed investments into the grids. This is a very important discussion going forward.
But for us, it means that we are prepared now to increase the investments and we will do that. You might see in the picture here that we are also increasing in terms of customers. We get more connections and you can see to the right that we are also clearly increasing our investments here which is what I just tried to explain.

Short comment on the smart grids, we are also working with digitalization of this side of the business. And one example of that is, of course, that we use low voltage monitoring which means that we can very quickly see if we have a distribution problem, we can act as soon as possible. And we can also monitor the grids in a better way to make sure that we keep the maintenance in the right places. So, there's a significant help of making these grids much smarter than before and we are working quite heavily on that.

So, to finish off, I think we are showing a stable result and I see in general that overall good development in the company where I feel we are taking ourselves in the strategic direction which we have decided where the purpose is to power climate smarter living and to become fossil-free within one generation and everything that we are doing in terms of our development should be in support of this purpose and the way forward.

So, that's the general overview of the situation. With that, I would like to leave the word to Anna Borg, our CFO. So, I will give you the clicker. Anna, please.

Anna Borg - Vattenfall AB - CFO

Thank you, Magnus. Good morning. Let's have a look at the financials for the first half year. Our profit for the period is increasing. We're amounting to SEK7.1 billion, which is SEK1.2 billion higher compared to last year. We also see a net sales increase with SEK6.9 billion amounting to SEK76.3 billion. This is mainly due to our increased sales volume in the Netherlands, in Germany, in France and in the UK. But, of course, it also has to do with the higher wholesale prices and with the strong hydro generation in Nordic that Magnus referred to earlier.

Our underlying EBIT is stable at SEK13.1 billion. We see higher contributions mainly from our power generation and wind areas. That is, however, offset by a lower contribution from our heat business and I will come back to that in a few moments.

We see a return on capital employed at 7.1% to be compared with the same period last year wherein we had a return on capital employed of 4.2%. We do have an impact in this number both from currency effects due to the weaker SEK. But we also have quite steep fair value swings due to the very volatile price movements in the markets. Excluding items affecting comparability, our return on capital employed would be 8.4% for the first half year, which is well above our hurdle rate.

When it comes to our FFO over adjusted net debt, we are at 19.4%. We see a decrease in our FFO mainly due to the decreased EBITDA. We know we have a heavy investment year in 2018 and we also see an impact of some increased provisions we made in relation to nuclear that is according to our normal yearly cycle we are reviewing the interest rates that we are using. And since we are using an average interest rate over a period of time and the interest rates have gone down, so that's the average which means that there is an increase in the provisions.

In general, I would also like to mention that we have a one-time effect in the result for the first six months. That is related to reclassification of the Swedish Nuclear Waste Fund, which is now allowed to invest also in the stock market which means that we are reclassifying it and it will also be shown in our fair value swings going forward. The one-time effect is approximately SEK2 billion for this.

Having a look at our underlying EBIT per business area for the first six months, we can see that in our customers solution business, we have an increased net sales and improved margins but we also have some higher operating expenses in UK, where we are expanding.

In our power generation segment, we clearly see an improvement based on the higher prices and the strong hydro generation, so the result is SEK0.9 billion better compared to the same period last year. However, we do have hedges. We have a hedge ratio of approximately 75% which is, of course, taking away a lot of the price effect so the net effect is the SEK0.9 billion.

Our wind business, we have new capacity on line compared to the same period last year since we are expanding in wind power. But we also see an impact of the higher prices also here.

Our heat business is showing a low result compared to the same period last year. It is due to deteriorating spreads in continental Europe. So the higher fuel prices and the higher CO2 prices and there has not been an increase in the electricity prices to the same extent that we have normally seen in the market. So, the spreads are tighter, which is hitting our heat business.

We do, however, also have a couple of one-off items that showed up last year where we had some additional subsidies that were actually related to 2016, which means that the heat result for the first half year last year was higher than what it should normally have been and that is, of course, also visible in the difference.
In relation to the price movements and especially the prices in CO2, I would like to highlight that those prices are 200% higher right now than they were in the same period last year. So, it’s material swings that we see.

In our distribution business, we see a positive price and volume effect but we also have some higher operating expenses partly related to the improvements and investments that we are making.

Looking at our cash flow development, we have a strong and solid cash flow for the first six months. The cash flow from operating activities is SEK16.5 billion. We have a positive impact from changes in working capital by SEK3.7 billion that is mainly related to margin calls. We also have a timing effect in our investments, so we generally have lower investment levels this first half year than what we will see in the second half year. So, that is the timing effect only and will not be visible in the full year report.

We continue our growth investments and we are doing that mainly in our wind business. And if we look at the investments we made for the first half year, you can see that approximately 80% of those investments are going into climate smart production technologies and into our distribution business as Magnus highlighted also earlier.

That will continue and when it comes to our growth investments, we will continue to focus on wind for the next two years approximately 60% of our growth investments will go into our wind business.

So, looking at the overview, you can see that we all in all have a stable development. We are having more renewable capacity on line compared to last year, so we are delivering on our growth ambitions. We see increased sales volumes in basically all our markets. We have a positive impact of the price increase but we also have some high impact and steep swings in our fair value development due to this same price development.

2018 is as we have indicated before, a heavy investment year for us which is the reason that our FFO over adjusted net debt is lower than last year but that is expected. And when it comes to our return on capital employed, it is higher compared to last year, but slightly below our hurdle rate which is also due to mainly these fair value swings.

If you look at our return on capital employed not taking into consideration the items affecting comparability, we are well above the 8%, so all in all, a stable quarter.

**QUESTIONS AND ANSWERS**

**Karin Lepasoon - Vattenfall AB - Head of Communications**

Very good. Thank you very much, both Anna and Magnus. With this, we open up for questions.

And we do have one question on the web comes from Andrew Moulder from CreditSights.

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**Andrew Moulder - CreditSights - Analyst**

The Netherlands is not phasing out coal plants until 2030, why are you undertaking an early closure in 2024 of your Netherlands coal plant?

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**Magnus Hall - Vattenfall AB - CEO**

Actually, the Dutch government has said that from today, they will abolish coal-fired power plants but they will give five power plants what you call it, some extra room to live. And it's actually depending on how old they are and for us, it's 2024. And then we have to find, actually, it will be depreciated by this time, so we will not take a loss if we do that. And then we just have to plan it to make it fit into our own maintenance schedule at the right time. So, probably earlier than 2024, but at the latest 2024.

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**Karin Lepasoon - Vattenfall AB - Head of Communications**

Good. Thank you. We have another question from Ashley Thomas from London.
Ashley Thomas - Millennium Management

The government has commissioned a report to review Swedish grid regulation to conclude by end October. What do you think the government wants to achieve from this and do you expect it to result in any materials changes?

Magnus Hall - Vattenfall AB - CEO

For the Swedish one, I understand it right.

Karin Lepasoon - Vattenfall AB - Head of Communications

Yes. Yes.

Magnus Hall - Vattenfall AB - CEO

Yes. There is a discussion, I don't know of this exact October question, if this regarding to the grid. But if we look to the distribution networks now, the government has done quite a lot of work on that during the last year. And we expect them to come up with some sort of a proposal either before the election or later, we don't really know because the time plan is a little bit uncertain.

We are fearing that they are looking at a very low level of cost of capital, the applied weighted average cost of capital that is very low. But we don't really know yet. We are trying to argue that we have had during the last six periods in Sweden changes from every regulatory period to the next. Now, we have to try and create a long term stable system and this is what we are arguing around together with the government.

And so, let's see what the outcome will be. But if the WACC becomes too low, again, we are not in a position with the long term development that we need in order to drive investment that we all understand that we need to make into the grids. So, uncertainty on that question, actually.

Karin Lepasoon - Vattenfall AB - Head of Communications

I do believe we have a question on the telephone. Please go ahead with the question from the telephone conference.

Operator

The first question from the phone comes from Jakob Magnussen from Danske Bank. Please go ahead, sir.

Jakob Magnussen - Danske Bank - Analyst

Yes. Hello. A question to FFO to adjusted net debt, is it correctly understood that you will see a peak in your CapEx in 2018 and then it'll go down somewhat in 2019 and that will bring you above the minimum 22% mark.

And also in that connection, why are you paying out this high dividend, obviously, your owner is requiring this. But couldn't you persuade your owner to be more supportive of you to adhere to your minimum FFO to net debt target and thereby maybe postpone the dividend payment.

Anna Borg - Vattenfall AB - CFO

It is correct that we have a heavy investment year in 2018 and that has been known to us for quite some time so that is not a surprise. What kind of investments we will make and what kind of levels of FFO over adjusted net debt we will have going forward, we are not giving any sort of forecasting numbers on that. But we see a solid and strong continuation of the improvements in our business in general.
When it comes to dividend, we paid the dividend early this year relating to last year of SEK2 billion although we did not reach the hurdle rate; we were just below. We have not paid the dividend for the last five years to our owner, but we have managed to do a steep turnaround of the business and showed a strong result for 2017.

So, we think it was a good thing to make a dividend in order to sort of mirror that strong development. Whether there will be any dividends for this year or not, I cannot say, so we will have to wait the full year results and then come back on that.

Karin Lepasoon - Vattenfall AB - Head of Communications

All right. Thank you Anna.

And we have another question on the web from Matthieu Durandeau from LFDE.

Matthieu Durandeau - LFDE

What proportion of electricity does the heat plant in the Netherlands account for compared to total production? And a second question related to that, how much will a closure cost in terms of amount?

Magnus Hall - Vattenfall AB - CEO

I just said that if we go from the back, I just said that we expect the plant to be totally depreciated by the period when we stop it and then exactly what we will have in terms of cost apart from that, we haven't gone out with yet and we haven't even decided for the exact time when we are going to close it. But the cost to close it, it's not a big thing.

The production of the plant is roughly 2%, 3% of the total output of electricity in the company around 3%, I think. So, it's marginal in terms of effect on the total. In the meantime, we are going to increase our wind power development deliveries as well during the period up to 2022-2024 or whatever the exact time will be.

So, in electricity production, I think we will be -- yes, okay, we also have the closures of the Swedish nuclear plants, of course, so we will have a reduction after the closures of the Swedish nuclear plants, but then we will continue to grow again.

Karin Lepasoon - Vattenfall AB - Head of Communications

All right. It appears that we don't have any more questions on the telephone and we have no more questions on the web. So with that, we close this audiocast and we thank you for your attention. Thank you very much.