Research Update:

# Swedish Power Company Vattenfall Outlook Revised To Positive On Increased Financial Flexibility; Affirmed At 'BBB+'

**November 26, 2021**

## Rating Action Overview

- Vattenfall's balance sheet has strengthened significantly in 2021, thanks notably to a series of materially positive one-off events, including the German nuclear settlement; the sale of Stromnetz Berlin, a German based distribution system operator (DSO); and the sale of 49.5% of Hollandse Kust Zuid offshore wind farm.
- We now anticipate credit ratios such as S&P Global Ratings-adjusted funds from operations (FFO) to debt in the 30%-35% range in 2022-2023, which is significantly higher than our previous expectations of 20%-25% and gives Vattenfall ample flexibility to deliver on its strategy; we anticipate stronger credit metrics can be sustained despite the group's ambitious investment plan.
- Vattenfall intends to invest SEK57 billion (€5.7 billion) over 2021-2022, up from about SEK48 billion over 2019 and 2020 combined. We expect investments to be elevated through 2023, gradually leading to a rapid increase in the group's share of renewable and distributions earnings.
- As a result, we revised our outlook on Vattenfall to positive from stable and affirmed our 'BBB+' long-term issuer credit rating on the utility.
- The outlook revision reflects the prospects either for a sustained financial risk profile improvement or our expectation that any step-up in investment would result in some improvement in the business risk profile, which could offset additional leverage.

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## Rating Action Rationale

**An improved balance sheet and more favorable pricing led to much stronger-than-anticipated credit metrics.** Vattenfall's credit ratios have improved over the past few years, above our previous expectations. We expect ratios to improve further for fiscal 2021, mostly as the utility will receive compensation for the closure of its German nuclear operations and proceeds from sold

DSO operations in Berlin, as well as disposals of 49.5% in the Hollandse Kust Zuid offshore wind farm. Total proceeds of about SEK37 billion should significantly lower net debt in 2021 and support credit ratios over 2022 and 2023. This will be balanced by increased investment and dividends. In our updated forecast, we assume FFO to debt of 30%-35% in 2022 and 2023, which includes the assumption that the bulky margin calls that Vattenfall received over the first nine months of 2021 will reverse over the coming quarters and that Vattenfall will pay dividends in line with its financial policy. This is despite our expectation that investment will increase, as guided by the company. We view positively the more favorable power prices, which substantially have improved across Europe over 2021. In the Nordic region, Nord pool system spot prices has swiftly improved and averaged €50-€55 per megawatt-hour (/MWh) year to date, a major increase compared with about €11/MWh during 2020. Although we expect Vattenfall's achieved price to remain relatively stable, at €28-€30/MWh in 2021 and 2022, mostly because of the group's prudent hedge policy, fundamentally, we believe the improved pricing environment overall is positive because it should support cash flow over the medium term. We also assume that price volatility will be greater than before. We expect Vattenfall's S&P Global Ratings-adjusted EBITDA to remain relative stable at around SEK40 billion-SEK43 billion over 2021-2022, compared with SEK41.6 billion in 2020, a consequence also from the stability provided by its integrated business model.

**We are mindful about the recent decrease in reported debt, steaming from large marginal call inflow of SEK78 billion in the first nine months of 2021.** This is due to the extremely volatile price environment in 2021, where gas and power prices rose significantly during a very short period of time. In the third quarter, adjusted FFO to debt had increased to above 180% , although excluding the margin call effect, the ratio was in the 35%-40% range, also a very robust ratio compared with the expectation for the rating. In our analysis, we assume that the margin calls will be neutralized over the coming quarters as Vattenfall makes delivery on power and gas contracts and prices normalize. We therefore view this as a temporary peak.

**The current strong balance sheet and balanced financial policy give Vattenfall flexibility to execute its investment.** In its September capital market day, the utility repeated its intention to keep the adjusted FFO to debt in the 22%-27% range and targeted dividend range payment at 40%-70% of net income. It also affirmed its investment plan. We observe that ratios currently are stronger, according to Vattenfall's calculations of FFO to debt, and excluding the impact of margin calls, FFO to debt stood at around 36% in September 2021, up from 28.8% and 26.0% in 2020 and 2019, respectively. Those ratios are already above our threshold for an upgrade, which is still 25% (S&P Global Ratings-adjusted). Even with some sensitivity on dividends, we believe the ratios will remain in the upper end for the rating over the next two years. We expect management to adhere to its financial policy and use its headroom to invest significantly in renewables and networks. This implies that we expect ratios to approach the financial policy range. If that was the case, however, we still see a one-notch potential upside to the rating, because a higher share of earnings will come from wind and regulated assets, which in our view would improve the business risk, although keeping it within the current strong assessment.

**The 2021-2025 strategic plan entails ambitious investment in renewables and networks, bringing credible growth and a gradually more stable cash flow profile.** Vattenfall plan to invests significantly in renewables and its regulated distributions networks. We believe the company is in a good position to transition its generation mix to fossil-free, compared with many peers, because it already has a high share of low-emitting hydro in the portfolio (11.5 gigawatts [GW]). Vattenfall's capex program for the coming period is massive: SEK57 billion [€5.7 billion] has been guided for 2021-2022, a significant increase from previous years. Of this amount, about SEK32 billion will fund growth projects, mainly wind (71%) and distribution operations (14%). We expect this investment should allow the company to expand its wind generation fleet rapidly, from 4 GW installed capacity as of second-quarter 2021, toward 10.5 GW over the next few years (2.6 GW under construction and 4.0 GW under development). We see this as transformational for the generation portfolio. In addition, the planned investment in distribution will broadly double to about SEK7 billion per year, from SEK3.5 billion on average during 2010-2019, which likewise should allow a good growth in the regulated asset base (RAB) and cash flow streams from regulated assets.

**Vattenfall's investment should lead to improved cash flow from wind and regulated assets from 2023-2025.** In 2024, we expect the business unit wind to generate 35%-40% of EBITDA, up from about 20% in 2020. We see this development as positive for the credit profile, improving the business risk. Although wind operations in our view are not akin to regulated operations, they are a source of more stable and predictable cash flow streams because they are typically backed up by power purchase agreement (PPA) solutions or subsidies. Still, it is exposed to wind speed volatility. Key wind investment projects include Hollandse Kust Zuid 1-4, the first global subsidy-free offshore wind farm. Its large size, with 1,500 MW of capacity, should help Vattenfall reach economy of scale, although timely execution and tight budget control will be key to make the project economical. This risk was substantially reduced earlier this year, when the utility sold 49.5% in the project to BASF for €300 million, who also will be responsible for their share of the remaining investment. Earlier this year, Vattenfall completed the 605 MW Kriegers Flak, which is the largest offshore windpark in Denmark.

**We expect Vattenfall to remain an integrated operators, with important contribution from DSO and heat business units (20% and 10% of underlying EBITDA in 2020 respectively).** The strategy to remain an integrated utility is unchanged, which in our view supports the business risk profile because meaningful contributions from stable DSO and heat operations in highly rated countries, namely Sweden and others in northern Europe, will continue to support cash flow. We believe that there is still some uncertainty around the regulatory framework in Sweden, but we continue to view it as strong. The weighted-average cost of capital (WACC) for the 2021-2023 regulatory period is still not final due to a legal matter. It has been decided that DSOs are allowed to carry forward under-recovered amounts for investment from previous regulatory periods under certain conditions. In our view, this signals a broad understanding for the need of increased investment, triggered by the quicker pace of the energy transition.

## Outlook

The positive outlook reflects a one-notch potential upside over the two next years should Vattenfall execute its planned investment, which should lead to a higher share of cash flow from wind and regulated assets combined, while maintaining a strong balance sheet.

### Upside scenario

We see upgrade potential over the next two years should Vattenfall execute its ongoing investment without any significant cost overruns or delays. Should we believe the company could sustain its financial risk profile, with FFO to debt above 25%, this could also lead to a one-notch upgrade.

### Downside scenario

We could revise the outlook to stable should we believe that the financial risk profile is not sustainable, meaning FFO to debt could return to the 20%-25% range without any material improvement in business risk. Any capex delay or major cost overrun could have negative financial consequences for the company and, unless countermeasures are implemented, lead to weaker credit measures than we assume. A lower EBITDA contribution from regulated or long-term contracted operations, for example its distribution system operator and district heating operation declining materially, could also lead to a negative rating action.

In addition, our rating includes a one-notch uplift for government support. We could take a negative rating action if government support weakened--for example, if the government privatized a significant part of its ownership in Vattenfall could lead to downgrade pressure. However, we consider this unlikely over the near-to-medium term.

## Company Description

Vattenfall is one of the largest electricity and heat producers in Europe and is 100% owned by the Swedish state. At year-end 2020, the company reported sales of about SEK158 billion and S&P Global Ratings-adjusted EBITDA of about SEK42 billion. Vattenfall's business portfolio is split between unregulated power generation and supply, mainly in Sweden, the Netherlands, and Germany (43% of 2020 underlying EBITDA); electricity distribution networks in Sweden (20%); heat businesses in Germany, Sweden, and the Netherlands (10%); and the customers and solutions segment (7%). The company is also expanding its largely subsidized wind generation network (21%). The group generated about 112.8 terawatt-hours (TWh) of electricity and sold about 13.8 TWh of heat in 2020.

## Our Base-Case Scenario

### Assumptions

- Swedish GDP to increase 4.0% in 2021, and 3.3% in 2021.
- Power prices in the Nordic region to average €30-€40/MWh in 2021 and €40-€50 per MWh in 2022.
- EBITDA of SEK40 million-45 million in 2021-2023.
- Capex of about SEK58 billion in total over 2021 and 2022.
- Vattenfall's hedged generation segment, with approximately 69% at €28 per MWh and 78% at €29 per MWh in 2021 and 2022, respectively.
- WACC under the Swedish regulatory framework for the DSO at 2.35%.
- No major acquisitions.
- Dividends payments in 2022 of about SEK20-22 billion, and SEK10-12 billion in 2023

## Key metrics

### Vattenfall AB--Key Metrics*

| | --Fiscal year ended Dec. 31-- | | | |
|---|---|---|---|---|
| (Mil. SEK) | 2019a | 2020A | 2021f | 2022f |
| EBITDA | 40,138 | 41,627 | 40,000-45,000 | 38,000-43,000 |
| Funds from operations (FFO) | 35,860 | 36,396 | 32,000-36,000 | 29,000-34,000 |
| Capital expenditure | 25,939 | 21,204 | 25,000-29,000 | 28,000-31,000 |
| Debt | 125,828 | 116,068 | 30,000-50,000 | 90,000-110,000 |
| Debt to EBITDA (x) | 3.1 | 2.8 | 0.5-1 | 2-3 |
| FFO to debt (%) | 28.5 | 31.4 | 80-100 | 28-33 |

*All figures adjusted by S&P Global Ratings. Insert here footnotes highlighting the key debt adjustments. a--Actual. e--Estimate. f--Forecast. SEK--Swedish krona.

## Liquidity

We assess Vattenfall's liquidity position as adequate. We expect the group will maintain liquidity sources will exceed liquidity uses of about 1.45x over the next 12 months. The cash balance is very high, but we expect that working capital outflow relating to margin calls to be high in 2022 due to market price volatility, potentially also with large intrayear movements. We assume liquidity sources will exceed uses even if EBITDA decreases by 15%, and understand that the company's credit facilities are free from onerous financial covenants. We also view Vattenfall as having solid relationships with banks and a high standing in credit markets, as demonstrated by several issuances--in 2020, it could obtain market access despite major market turmoil stemming from COVID-19, and recently the extension of its backup credit facility. We also believe the status as state-owned and the position as the largest utility company in Sweden facilitates market access. All in all, we view risk management as prudent.

According to our calculations, Vattenfall's liquidity sources as of Sept. 30, 2021, comprised:

- Available cash and marketable securities of about SEK115 billion
- Access to committed undrawn credit lines of about SEK20 billion maturing in December 2023, with two one-year extension options.
- Forecast FFO of SEK32 billion-SEK35 billion

Principal liquidity uses as of Sept. 30, 2021, are:

- Reported financial liabilities of SEK9 billion due within one year
- Estimated working capital outflow of SEK40-60 billion, but with large intrayear movements.
- Capex of SEK24 billion-SEK30 billion annually in 2021 and 2022, respectively.
- Dividends of about SEK20 billion-SEK22 billion in 2022 and SEK10-12 billion 2023.

## Ratings Score Snapshot

Issuer credit rating: BBB+/Positive/A-2

Business risk: Strong

- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

Anchor: bbb+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Negative (-1 Notch)
- 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)

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
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- 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

- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Criteria | Corporates | General: Corporate 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
- General Criteria: Methodology: Industry Risk, 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; Outlook Action**

| | To | From |
|---|---|---|
| **Vattenfall AB** | | |
| Issuer Credit Rating | BBB+/Positive/A-2 | BBB+/Stable/A-2 |
| Nordic Regional Scale | --/--/K-1 | --/--/K-1 |
| Senior Unsecured | BBB+ | BBB+ |
| Junior Subordinated | BB+ | BB+ |
| Commercial Paper | A-2 | A-2 |