

Research Update:

# Swedish Power Company Vattenfall Ratings Affirmed At 'BBB+'; Outlook Stable

May 12, 2020

## Rating Action Overview

- Very low power prices in the Nordics over 2020-2021 and a 5%-10% reduction in power demand following the outbreak of COVID-19 will cause a shortfall in earnings for Vattenfall's power generation business.
- However, increased EBITDA generation from certain business units, namely wind and heat, should support Vattenfall's cash flow, although we anticipate cash flow will be negative over 2020-2023 due to high investment levels, resulting in significantly weaker credit ratios.
- Given the volatile market conditions and the potential impact on Vattenfall's working capital, we have revised our liquidity assessment to adequate from strong.
- We are affirming our 'BBB+' rating on Vattenfall.
- The stable outlook reflects our view that management is committed to maintaining the current rating and would implement firm actions if needed to reduce spending and support credit ratios, as well as our assumption that funds from operations to debt will not fall below 20% over a prolonged period.

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## Rating Action Rationale

**Very low power prices and a COVID 19-driven reduction in demand will lead to a shortfall in earnings for power generation in 2020 and 2021.** We therefore expect EBITDA contribution from Vattenfall's power generation business will decline to about Swedish krona (SEK) 14 billion-SEK16 billion in 2021 from SEK19 billion in 2019. Vattenfall has hedges in place that should mitigate most price effects for 2020--65% of production is hedged at €33 per megawatt hour (/MWh). We expect a more material impact on earnings and cash flow in 2021 and 2022, with the hedge ratio declining to 47% and 26% of output respectively. Lower power prices are mostly a consequence of very high water levels in Nordic reservoirs and a mild and windy winter. Power prices in 2020 have fallen such that spot prices stand at below €10/MWh, well below the 2019 average of €39/MWh. We expect power prices in the region will remain depressed over 2020-2023, below €25/MWh on average. This is the primary driver for the decline in Vattenfall's ratios. Additionally, we expect the

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COVID-19 outbreak will lead to a 5%-10% reduction in electricity demand 2020, and will also affect 2021 demand.

**Increasing cash flow from its wind and heat business units will support Vattenfall's ratios, but we anticipate previously expected earnings growth will be delayed.** In response to lower prices, Vattenfall has delayed the start of its nuclear power plant Ringhals for several months after a service shutdown. This will lead to some cost savings in 2020 because fuel can be saved for a later date, and costs won't be covered at current prices. Recent investments in wind and heat should increase EBITDA in 2021-2023, and bring some stability to Vattenfall's EBITDA mix. We expect stable and increasing cash flows from the wind division, thanks to contracted revenue through national support schemes.. Additionally, we expect increasing contribution from the heat division as new assets come online, supported by combined heat and power subsidized generation in Germany. All in all, we forecast annual EBITDA of SEK39 billion-SEK42 billion in 2020 and 2021, not materially different from Vattenfall's S&P Global Ratings-adjusted EBITDA of SEK40 billion in 2019.

**Peaking investment levels in 2020-2023 will lead to a significant debt buildup, because we don't expect operating cash flow will cover capital expenditure (capex) and dividends.** We expect Vattenfall will make significant investments in renewables, in line with its strategy. For 2020 and 2021, Vattenfall's capex program amounts to SEK56 billion, about SEK35 billion of which is dedicated to growth investments, mainly in wind generation. Due to lower EBITDA generation, planned capex and dividends will not be covered by operating cash flows. We anticipate negative free operating cash flow of up to SEK10 billion annually over 2021-2023, although this ultimately depends on working capital movements, which are volatile in the current environment. Investments should lead to improved EBITDA after 2023, because of significant additional capacity. While we understand investment decisions could be postponed to safeguard credit ratios, high investments levels will pressure ratios. In addition, we see higher execution risk during the construction phase of offshore wind projects. In the past, Vattenfall experienced a roughly two year delay in project such as Vesterhav Syd and Nord (350MW). In total, about 2 gigawatts (GW) of wind capacity is under construction, with planned commissioning in 2020-2021. A further 5GW of capacity is under development, mainly within offshore wind. These additions are substantial compared with current capacity of 3.3GW at year-end 2019.

**We expect a material decline in credit ratios, but that they will remain commensurate with the current rating thanks to headroom at year-end 2019.** We expect funds from operations (FFO) to debt will decline during 2020 and again in 2021, to about 20%. We forecast debt to EBITDA of 3.5x-4.5x, and expect debt will increase to about SEK150 billion at year-end 2021 from SEK126 billion at year-end 2019. This is a material decline from the strong ratios at year end 2019, including FFO to debt of about 28%. We view these updated ratios as at the lower end of the range commensurate with the rating, but believe management will actively reduce operating costs and, if needed, take other measures such as delaying investments or disposing noncore assets to support ratios. Additionally, dividends have been lowered by 50% to SEK3.6 billion from what was proposed pre COVID-19, which we view as positive.

## Outlook

The stable outlook reflects our assumption that Vattenfall will manage earning pressure stemming from lower power prices and increasing investment levels such that it will maintain a

financial risk profile in line with our expectations for the rating, namely FFO to debt above 20%. The group's significant share of stable cash flows from electricity distribution and district heating are supportive for the rating. The company's proven flexibility in making dividend payouts might somewhat mitigate potential operating underperformance.

## **Downside scenario**

We could lower the rating if we considered that Vattenfall's position in the power generation business was weakening; for example, if power prices remains subdued or if the planned expansion of the wind portfolio is delayed or unsuccessful. These factors could have negative financial consequences for Vattenfall and, unless countermeasures are implemented, could lead to weakening credit measures such as FFO to debt falling below 20% on a prolonged basis. We could also downgrade Vattenfall if the EBITDA contribution from regulated or semi-regulated operations, for example its distribution system operator and district heating operations, declined materially, or if we saw signs of weakening government support; for example, if the government privatized a significant part of its ownership in Vattenfall. However, we consider this last risk as unlikely over the near-to-medium term.

## **Upside scenario**

We see an upgrade as unlikely given the current market environment and Vattenfall's high capex plan, but it could occur if the financial risk profile strengthened, with FFO to debt increasing toward 25% on a sustainable basis. This could occur if power prices strengthened more than we expect.

## **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 2019, Vattenfall reported sales of about SEK166 billion and EBITDA of about SEK42.4 billion. Vattenfall's business portfolio is a split between liberalized power generation and supply, mainly in Sweden, the Netherlands, and Germany (43% of 2019 underlying EBITDA), electricity distribution networks in Sweden and Germany (18.6%), and heat business in Germany, Sweden, Denmark, and the Netherlands (10%). The company is also expanding its largely subsidized wind generation network (22%).

## **Our Base-Case Scenario**

### **Assumptions**

- Swedish GDP to decline 7% in 2020.
- Continued subdued power prices in the Nordic region, on average at €10/MWh and €15-€20/MWh in 2020 and 2021 respectively.
- Vattenfall's generation segment will hedge approximately 65% at €33/MWh and 47% at €32/MWh in 2020 and 2021 respectively.
- Tough power market conditions in the Nordics and lower power demand due to COVID-19 measures in 2020 and 2021.

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Based upon these assumptions, we arrive at the following S&P Global Ratings-adjusted measures in 2020-2021:

Table 1

### Key Metrics

(Bil. SEK)	2019a	2020e	2021e
EBITDA	40.1	39-42	39-42
Debt	125.8	150-160	165-175
Capex	25.9	24-27	24-27
Dividends	4.1	5-6	6-7
FFO to debt (%)	28.5	20-23	19-22
Debt to EBITDA (x)	3.1	3.5-4.5	3.7-4.7

### Liquidity

We assess Vattenfall's liquidity position as adequate. We expect the group will maintain liquidity sources exceeding liquidity uses of about 1.4x over the next 12 months. We also assume liquidity sources will exceed uses even if EBITDA decreases by 15%, and we understand that Vattenfall's credit facilities are free from onerous financial covenants. We also view Vattenfall as having solid relationships with its banks and a high standing in credit markets, as demonstrated by several issuances--in total SEK10 billion has been obtained in the form of bank or bond debt over the last two month despite the market turmoil stemming from the COVID-19 outbreak. All in all we view risk management as prudent.

According to our calculations, Vattenfall's liquidity sources as of March 31, 2020, comprised:

- Available cash and marketable securities of about SEK27.8 billion;
- Access to committed credit lines of about SEK25 billion. In this figure we include a recent obtained term loan that can be used for general corporate purpose; and
- Forecast FFO of SEK32 billion-SEK35 billion.

Principal liquidity uses as of March 31, 2020 are:

- Reported debt of SEK29 billion due within one year (including refinancing at the quarter end);
- Capex of about SEK25 billion in both 2020 and 2021; and
- Dividends of about SEK3.6 billion in 2020 and SEK5 billion-SEK6 billion in 2021.

### Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/A-2

Business risk: Strong

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

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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

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- 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 | 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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

### Ratings Affirmed

#### Vattenfall AB

Issuer Credit Rating	BBB+/Stable/A-2
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Nordic Regional Scale	--/--/K-1
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#### Vattenfall AB

Senior Unsecured	BBB+
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Junior Subordinated	BB+
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Commercial Paper	A-2
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