STANDARD & POOR'S

# FULL ANALYSIS

# Lunds Energikoncernen AB (publ)

**Corporate Credit Rating**

BBB+/Stable/A-2

***Nordic National Scale***

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## *Major Rating Factors*

***Strengths:***

- Significant share of earnings from stable monopoly electricity distribution operations.
- Strong market position in and around the Swedish city of Lund.
- Expectations of "moderately high" likelihood of extraordinary support from its municipal owners.

***Weaknesses:***

- Small scale operations, resulting in business and asset concentration.
- Relatively high cost base due to ineffective generation fleet.
- Comparably lower flexibility to adjust tariffs in district heating and electricity distribution.
- Expected sizable investments in environmentally friendly generation capacity.

## *Rationale*

The ratings on Sweden-based integrated utility Lunds Energikoncernen AB (publ) (LEAB) are based on the company's stand-alone credit profile (SACP), which Standard & Poor's Ratings Services assesses at 'bbb-', as well as on our opinion that there is a "moderately high" likelihood that LEAB's municipal owners will provide timely and sufficient extraordinary support in the event of financial distress. Our opinion is based on our assessment of LEAB's "important" role for its municipal owners and the "strong" link between LEAB and its owners. LEAB is owned by the Swedish municipalities of Lund (82%; AAA/Stable/A-1+), Eslöv (12%; not rated), Hörby (4%; not rated), and Lomma (2%; not rated).

We believe LEAB's SACP is underpinned by its strong market position in and around the city of Lund and its low risk monopoly operations in electricity distribution, which account for a significant share of its EBITDA and generate stable and predictable cash flow. The major supports of the SACP and ratings are partly offset by LEAB's small scale operations and a relatively uncompetitive district heating generation fleet, which is exposed to high marginal costs. They are further offset by our expectations that the company's debt-protection ratios will weaken over the coming years; this is based on a planned debt-funded investment of up to Swedish krona (SEK) 1.9 billion (about €210 million) for a new bio-fuelled combined heating and power (bio-CHP) plant.

***Key business and profitability developments***

The exceptionally cold weather in Sweden at the start and end of 2010 affected LEAB negatively. The low temperatures increased demand of district heating to such an extent that LEAB had to use expensive oil- and natural gas-based peak-load capacity. However, LEAB was unable to pass the higher costs on to its customers. In addition, an outage in a gas turbine at one of its power plants had a further negative effect on the company's operating margins. Although this was partly offset by an increase in the margins of electricity sales from its retail division, LEAB's operating margin decreased to 13.3% for the 12 months ended Sept. 30, 2010, compared with 14.5% for full-year 2009.

We expect LEAB's planned investment in the bio-CHP plant to materialize over the near to medium term. According to the company, a decision from Sweden's environmental court is due in April 2011. We think it unlikely that the project's construction will commence before 2012, however, assuming that the necessary permissions are granted.

LEAB regards the plant as strategically important because it will improve the company's fuel mix and further expand its heat and electricity production using renewable fuel sources. The plant is expected to generate 550 gigawatt hour (GWh) of district heating and 300GWh of electricity annually (compared with 1,200GWh and 200GWh, respectively, of total production for 2010). Such an increase will, in our view, strengthen LEAB's generation portfolio profile. We understand the first phase of the investment is expected to cost about SEK1.9 billion, with the company possibly spending SEK600 million when the second phase is initiated in 2016, at the earliest. We view this as a large investment for a relatively small company such as LEAB, and we think it will add significant project risk exposure to the company's business risk profile. In addition, the investment is likely to tie up capital during the investment phase, which will weigh on LEAB's profitability during construction.

***Key cash flow and capital-structure developments***

The ratio of adjusted funds from operations (FFO) to debt reached 23.1% in the 12 months ended Sept. 30, 2010, compared with 28.7% in the corresponding previous period.

Over the medium term, we expect capital spending requirements to increase significantly if the planned bio-CHP investment materializes. Given our assumption that the investment in the new bio-CHP plant will be debt funded, we expect the company's debt-protection ratios to weaken significantly when the project is implemented. In our base case, the investment would lead to significantly higher debt levels and a decline in the ratio of FFO to debt to less than 20% for two years. Although such a level would be weak for the current ratings, we would nevertheless expect the ratio to stay in the high teens, and for it to climb back to more than 20% as the new plant is commissioned.

***Liquidity***

LEAB's short-term rating is 'A-2' and we perceive its liquidity position to be "adequate". The company has recently issued a SEK500 million bond and extended a SEK500 million committed credit line that was scheduled to mature in August 2011. These actions were necessary for LEAB to keep an adequate liquidity profile, in our view.

As of Dec. 31, 2010, LEAB had SEK48 million in cash and short-term investments and SEK975 million in undrawn committed credit facilities maturing beyond 12 months. This includes SEK500 million related to debt facilities, which together with the recently extended SEK500 million credit line, form a SEK1.0 billion back up to a commercial paper program of the same amount.

These liquidity sources compare with total short-term debt of about SEK1.0 billion as of the same date. This amount was entirely related to commercial paper utilization, which we expect to be rolled over.

We expect LEAB to generate less negative discretionary cash in 2011, at about SEK34 million, compared with an estimated negative SEK92 million during 2010. This was primarily due to lower capital spending in 2010. LEAB's debt facilities require the company to maintain an equity to assets ratio of at least 30%. As of Sept. 30, 2010, the ratio stood at about 54%.

## Outlook

The stable outlook reflects the stability of LEAB's regulated operations and our expectations that the company will post predictable earnings and solid internally-generated cash flow. We expect LEAB to post a ratio of adjusted FFO to debt of about 20% over the cycle. However, we project that the construction of the bio-CHP plant, assuming it commences in 2012 as planned, could pressure cash flow credit metrics. Nevertheless, we expect the company's FFO-to-debt ratio to not fall lower than 17% during construction: a level which we deem adequate for the ratings on a temporary basis.

We could revise the outlook to negative if LEAB's SACP were to come under pressure as a result of, for example, weaker-than-expected preinvestment operating cash flow generation. A negative rating action could also materialize if larger-than-expected debt-funded investments, most likely relating to the bio-CHP project, cause the company's financial risk profile to weaken beyond our current expectations. Although unlikely at this stage, a weakening of actual or prospective shareholder support or the prospect of privatization could further pressure the ratings.

The potential for ratings upside is limited by our expectation that the company's medium-term financial performance will be relatively weak for the ratings. This could, however, be offset by a meaningful capital contribution from the shareholders in order to support the planned bio-CHP project—although we currently view such a scenario as unlikely.

## Business Description

LEAB is a municipality-owned integrated regional utility based in Lund, Sweden. It employs 409 people and supplies energy to approximately 170,000 customers. The company's business activities are spread across the southern part of Sweden. Its activities encompass the production, sale, and distribution of electricity and district heating and cooling, the sale and distribution of natural gas, information-technology communications along its distribution network, and other, related services.

## Rating Methodology

In accordance with our criteria for government-related entities, our view of a "moderately high" likelihood of extraordinary government support is based on our assessment of LEAB's:

- "Strong" ownership link, primarily reflecting its 100% ownership by Kraftringen AB (not rated), a holding company owned by the municipalities of Lund (82%), Eslöv (12%; not rated), Hörby (4%; not rated), and Lomma (2%; not rated). The company's operations are strongly aligned with the interests of the four municipalities, and in particular, the municipality of Lund, which has a strong affiliation with, as well as a controlling influence over, LEAB.
- "Important" role from its owners' perspective, given the focus on providing critical public services, such as electricity and district heating in the region, as well as contributing to the municipalities' environmental agenda.

We believe a private sector entity or another, larger government-related entity could undertake LEAB's operations if the company experienced financial distress or ceased to exist. We understand, however, that there is a broad political and strategic consensus among the owners that LEAB should continue to play an important strategic role within the region, and that it should remain under municipal control, even if it were to come under financial stress. We understand that the owners' view is particularly strong with regards to LEAB's monopoly operations, such as electricity distribution and district heating.

## *Business Risk Profile: High Proportion Of Regulated Earnings Tempered By Uncompetitive Generation Fleet*

The major supports for the "satisfactory" business risk profile are, in our view:

- A high proportion of earnings from low-risk electricity distribution operations. These operations contributed most of LEAB's operating profit in 2010. Electricity distribution in Sweden is fully regulated and should present low operating risk and fairly predictable revenue streams with limited volume exposure, in our opinion. The new ex-ante regulatory model, with four-year tariff periods, being introduced in 2012 increases predictability and transparency compared with the former light-handed regulatory framework (where tariffs were examined ex-post). Although LEAB's tariffs are already comparably high, we expect the company to increase tariffs as the ex-ante framework allows for the additional pass-through of overhead costs.
- Favorable market position. Although operating margins in the electricity retail segment are low, owning its own distribution grid provides the company with a competitive advantage. Customers that have not actively chosen an electricity supplier are automatically directed to a supplier that is decided by the grid owner. This results in strong retail market positions in areas where LEAB is the grid owner. LEAB is the fifth largest grid owner in Sweden and its distribution grid covers a major part of southeastern Sweden.
- Strong service area. LEAB benefits from operating in the prosperous region of Skåne in the southern part of Sweden. Skåne benefits from a rapidly growing population of 1.2 million and a dynamic local economy focused on trade, manufacturing, and public services. Lund municipality, which owns 82% of LEAB and has a strong affiliation with the company, benefits from highly-educated inhabitants, high average incomes, and an unemployment rate well below the national average. This should ensure high payment capacity among customers and long-term demand growth for LEAB's products and services.

We consider these supports to be partly offset by:

- LEAB's small size. This creates significant business and asset concentration, in our view.

- An uncompetitive energy generation fleet with high marginal costs. LEAB's fairly old and relatively ineffective generation fleet pressures profitability in its district heating segment, in our view. Although the company's fuel mix is diverse, its peak-load includes expensive fossil-based inputs such as natural gas and oil. The company is seeking to improve the efficiency of its generation fleet and reduce its dependence on fossil-based fuels. The planned construction of a bio-CHP plant would phase out the use of oil and lower the proportion of natural gas to less than 10%. As a result, renewable sources would account for about 90% of LEAB's fuel mix on completion of the plant.
- Exposure to price and volume risk in electricity retail. LEAB's domestic electricity retail market share is about 3%, with a retail volume of about 2,900GWh in 2010. However, the company's vertical hedge (own electricity generation compared with electricity retail sales) is only about 7%. LEAB's energy purchases amount to about 1,100GWh a year, which exposes it to the volatile Nordic electricity market. To mitigate this risk, LEAB continuously hedges electricity and variable costs in its district heating operations.

## *Financial Risk Profile: Impact Of Planned Investment Partly Offset By Improved Liquidity*

The main weaknesses of the "significant" financial risk profile are, in our view:

- Material investment planned. We expect a significant weakening in the company's financial profile over the short to medium term, given the scale of the planned bio-CHP project and the continued assumption that it will be largely debt funded. The ultimate impact on LEAB's financial profile will depend on any material changes to the project's scale, funding, exchange rates, and costs related to equipment purchases at the time of implementation.
- Below-average financial flexibility. LEAB regularly pays group contributions to the holding company Kraftringen AB to cover its interest expenses. For 2010, such contributions are expected to account for about 60% of net profit. Although the contributions are largely predictable and we expect the owners to accept a lower group contribution to facilitate investments, these contributions could prove to be fairly inflexible under adverse conditions.

These weaknesses are mitigated by:

- Stable credit metrics over the near term. Due to a delay in the planned bio-CHP investment, we expect debt protection ratios to remain largely stable over the near term.
- Improved liquidity and financial policies. LEAB's recent issuance of a SEK500 million bond, combined with an extension of a SEK500 million credit line, has improved its liquidity profile, which we previously considered to be constrained. Besides diversifying its funding sources, the ability to tap the bond markets is important to LEAB because the company plans to fund a large part of the bio-CHP plant with bonds.

## *Financial Statistics/Adjustments*

LEAB reports under Swedish generally accepted accounting principles. We make no major adjustments to the company's accounts.

Table 1

**Reconciliation Of Lunds Energikoncernen AB (publ) Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. SEK)***

| | —Fiscal year ended Dec. 31, 2009— | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Lunds Energikoncernen AB (publ) reported amounts** | | | | | | | | | |
| | **Debt** | **Shareholders' equity** | **Operating income (before D&A)** | **Operating income (before D&A)** | **Operating income (after D&A)** | **Interest expense** | **Cash flow from operations** | **Cash flow from operations** | **Capital expenditures** |
| Reported | 1,460.5 | 1,705.4 | 428.1 | 428.1 | 179.8 | 91.1 | 343.9 | 343.9 | 263.8 |
| **Standard & Poor's adjustments** | | | | | | | | | |
| Operating leases | 15.6 | — | 5.6 | 0.9 | 0.9 | 0.9 | 4.7 | 4.7 | 7.6 |
| Postretirement benefit obligations | 26.7 | (12.0) | — | — | — | 1.5 | 1.2 | 1.2 | — |
| Reclassification of nonoperating income (expenses) | — | — | — | — | 52.1 | — | — | — | — |
| Reclassification of working-capital cash flow changes | — | — | — | — | — | — | — | (27.3) | — |
| Minority interests | — | 10.5 | — | — | — | — | — | — | — |
| Other | — | — | 3.2 | 3.2 | 3.2 | — | — | — | — |
| Total adjustments | 42.3 | (1.5) | 8.8 | 4.1 | 56.2 | 2.3 | 5.9 | (21.4) | 7.6 |
| **Standard & Poor's adjusted amounts** | | | | | | | | | |
| | **Debt** | **Equity** | **Operating income (before D&A)** | **EBITDA** | **EBIT** | **Interest expense** | **Cash flow from operations** | **Funds from operations** | **Capital expenditures** |
| Adjusted | 1,502.7 | 1,704.0 | 436.9 | 432.2 | 236.1 | 93.4 | 349.8 | 322.5 | 271.4 |

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts. SEK—Swedish krona.

Table 2

**Lunds Energikoncernen AB (publ)—Peer Comparison***

| | **Lunds Energikoncernen AB (publ)§** | **Tekniska Verken i Linkoping AB¶** | **Energie AG Oberoesterreich** | **KELAG** | **Acea SpA** |
|---|---|---|---|---|---|
| Rating as of Feb. 28, 2011 | BBB+/Stable/A-2 | A/Stable/A-1 | A/Stable/— | A/Stable/— | A/Negative/A-1 |
| | —Average of past three fiscal years— | | | | |
| **(Mil. €)** | | | | | |
| Revenues | 273.5 | 517.0 | 1,844.0 | 1,091.5 | 2,948.3 |
| EBITDA | 39.7 | 99.2 | 295.1 | 143.7 | 524.8 |
| Net income from cont. oper. | 11.3 | 34.9 | 83.4 | 83.8 | 99.3 |
| Funds from operations (FFO) | 33.1 | 83.8 | 231.0 | 147.5 | 382.8 |
| Capital expenditures | 34.7 | 57.1 | 187.7 | 109.7 | 448.6 |
| Free operating cash flow | (7.4) | 20.5 | 26.1 | 53.3 | (115.5) |

Table 2

**Lunds Energikoncernen AB (publ)—Peer Comparison* (cont.'d)**

| | Lunds Energikoncernen AB (publ)§ | Tekniska Verken i Linkoping AB¶ | Energie AG Oberoesterreich | KELAG | Acea SpA |
|---|---|---|---|---|---|
| Discretionary cash flow | (9.4) | 2.5 | (23.6) | 18.5 | (246.1) |
| Debt | 148.8 | 294.6 | 864.0 | 307.7 | 2,218.4 |
| Equity | 157.5 | 256.4 | 1,565.4 | 546.7 | 1,409.1 |
| Debt and equity | 306.3 | 551.0 | 2,429.4 | 854.5 | 3,627.4 |
| ***Adjusted ratios*** | | | | | |
| Oper. income (bef. D&A)/revenues (%) | 14.7 | 19.2 | 16.2 | 13.2 | 17.9 |
| EBIT interest coverage (x) | 2.3 | 4.5 | 2.8 | 5.0 | 3.3 |
| EBITDA interest coverage (x) | 3.9 | 7.7 | 5.2 | 5.2 | 5.1 |
| Return on capital (%) | 6.8 | 9.4 | 6.5 | 16.9 | 9.4 |
| FFO/debt (%) | 22.4 | 28.6 | 26.7 | 47.9 | 17.3 |
| Debt/EBITDA (x) | 3.7 | 3.0 | 2.9 | 2.1 | 4.2 |
| Total debt/debt plus equity (%) | 48.6 | 53.4 | 35.6 | 36.0 | 61.2 |

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt. ¶Fully adjusted. §Excess cash and investments not netted against debt.

Table 3

**Lunds Energikoncernen AB (publ)—Financial Summary***

| | —Fiscal year ended Dec. 31— | | | | |
|---|---|---|---|---|---|
| | **2009** | **2008** | **2007** | **2006** | **2005** |
| Rating history | BBB/Stable/A-2 | BBB/Stable/A-2 | BBB+/Stable/A-2 | BBB+/Stable/A-2 | -/-/- |
| ***(Mil. SEK)*** | | | | | |
| Revenues | 3,022.3 | 2,841.2 | 2,524.9 | 2,412.7 | 2,126.7 |
| Net income from continuing operations | 98.6 | 150.6 | 100.1 | 101.1 | 78.1 |
| Funds from operations (FFO) | 322.5 | 398.3 | 298.3 | 260.2 | 261.4 |
| Capital expenditures | 271.4 | 469.5 | 331.8 | 448.2 | 187.3 |
| Free operating cash flow | 78.4 | (98.2) | (198.7) | (250.1) | (45.3) |
| Discretionary cash flow | 76.8 | (161.3) | (200.4) | (250.1) | (102.2) |
| Cash and short-term investments | 95.5 | 110.3 | 124.9 | 218.8 | 87.4 |
| Debt | 1,502.7 | 1,594.9 | 1,460.8 | 1,315.7 | 885.2 |
| Preferred stock | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Equity | 1,704.0 | 1,622.3 | 1,500.0 | 1,440.1 | 1,504.6 |
| Debt and equity | 3,206.7 | 3,217.2 | 2,960.8 | 2,755.8 | 2,389.9 |
| ***Adjusted ratios*** | | | | | |
| EBIT interest coverage (x) | 2.5 | 2.2 | 2.3 | 2.6 | 2.8 |
| FFO int. cov. (x) | 4.3 | 4.4 | 3.8 | 4.3 | 5.3 |
| FFO/debt (%) | 21.5 | 25.0 | 20.4 | 19.8 | 29.5 |
| Discretionary cash flow/debt (%) | 5.1 | (10.1) | (13.7) | (19.0) | (11.5) |

Table 3

**Lunds Energikoncernen AB (publ)—Financial Summary* (cont.'d)**

| | —Fiscal year ended Dec. 31— | | | | |
|---|---|---|---|---|---|
| | **2009** | **2008** | **2007** | **2006** | **2005** |
| Net Cash Flow / Capex (%) | 118.2 | 71.4 | 89.4 | 58.0 | 109.2 |
| Debt/debt and equity (%) | 46.9 | 49.6 | 49.3 | 47.7 | 37.0 |
| Return on common equity (%) | 5.9 | 9.5 | 6.7 | 6.8 | 5.3 |
| Common dividend payout ratio (un-adj.) (%) | 1.7 | 39.7 | 65.8 | 85.1 | 72.9 |

*Fully adjusted (including postretirement obligations). SEK—Swedish krona.

**Ratings Detail (As Of 28-Feb-2011)***

| | | |
|---|---|---|
| Lunds Energikoncernen AB (publ) | | |
| Corporate Credit Rating | | BBB+/Stable/A-2 |
| Nordic National Scale Rating | | —/—/K-1 |
| Commercial Paper | | |
| Nordic National Scale Rating | | K-1 |
| Senior Unsecured (1 Issue) | | BBB+ |
| ***Corporate Credit Ratings History*** | | |
| 05-Feb-2010 | | BBB+/Stable/A-2 |
| 16-Dec-2008 | | BBB/Stable/A-2 |
| 02-Oct-2006 | | BBB+/Stable/A-2 |
| 05-Feb-2010 | Nordic National Scale Rating | —/—/K-1 |
| 16-Dec-2008 | | —/—/K-2 |
| 02-Oct-2006 | | —/—/K-1 |
| ***Business Risk Profile*** | | Satisfactory |
| ***Financial Risk Profile*** | | Significant |

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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