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Summary:
Lunds Energikoncernen AB

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Summary:

Lunds Energikoncernen AB

Credit Rating: BBB+/Stable/A-2

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.

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.

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, a holding company owned by the municipalities of Lund (82%; AAA/Stable/A-1+), 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, with which it has a strong affiliation and which has a controlling influence over LEAB.
- "Important" role from its owners' perspective given its focus of providing critical public services such as electricity and district heating in the region around Lund.

Key business and profitability developments

In the first six months of 2011, LEAB's profitability improved mainly as a result of higher earnings from its electricity networks and electricity sales segments. However, the improvement was partly offset by poor performance in its district heating generation segment which had to use expensive bio oil-fired generation facilities during a cold period at the beginning of the year. In addition, a break-down in a turbine at the Svartisen hydro-power plant further reduced profitability. Nevertheless, the EBITDA margin increased to 15.3% in the 12 months to June 30, 2011, compared with 12.8% in the corresponding period a year earlier.

In June 2011, LEAB received the necessary permission from the Swedish Environmental Court to start the construction of a bio-CHP plant. Although construction is subject to approval by the Supreme Court, we maintain our base-case scenario that it will commence during the first quarter of 2012. The first phase of the project, which we expect to be finalized when the plant is commissioned in mid-2014, is likely to cost about SEK1.9 billion. In addition to this, the company might spend an additional SEK600 million in a second phase which cannot be initiated until 2016 at the earliest. 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 hours (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. However, 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 and debt to EBITDA reached 28.3% and 3.4x, respectively, in the 12 months ended June 30, 2011, compared with 21.6% and 3.6x in the corresponding previous period. The improvement was due to strong cash flow generation in the fourth quarter of 2010 in combination with slightly lower debt levels.

We expect LEAB's capital expenditures to increase significantly in 2012-2014 if the bio-CHP investment materializes as planned. 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

The short-term rating is 'A-2'. LEAB's liquidity is "adequate", in our view. This assessment is based on our expectation that available liquidity resources, including cash, FFO, and facility availability, would cover expected cash outflows by at least 1.2x over the next 12 months with adequate headroom under its covenants and with support from LEAB's sound relationships with banks.

As of June 30, 2010, LEAB had SEK46 million in cash and short-term investments and SEK1.75 billion in undrawn committed credit facilities maturing beyond 12 months. This includes two SEK500 million credit facilities which act as back-up to a commercial paper program of the same amount.

These liquidity sources compare with total short-term debt of about SEK640 million as of the same date. This amount was entirely related to commercial paper utilization, which we expect to be rolled over. LEAB has recently decreased its reliance on short-term funding by issuing two long-term bonds through private placements. We view this as positive as it diversifies the company's funding sources and makes it less vulnerable to sudden adverse changes in credit conditions.

We expect LEAB to generate a low, but positive, discretionary cash flows in 2011 and strongly negative discretionary cash flows in 2012-2014 as a result of increased investment levels due to the construction of the bio-CHP plant. LEAB's debt facilities require the company to maintain an equity to assets ratio of at least 30%. As of June 30, 2011, the ratio stood at about 45%.

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 pre-investment 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.

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