Research Update:

Stockholm Exergi Holding AB Outlook Revised To Negative On Cost Pressure; 'BBB+' Ratings Affirmed

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Rating Action Overview

- We see a material risk that Swedish district heating utility Stockholm Exergi Holding AB's operating performance will not be able to fully recover from increased biofuel costs, which will weigh on performance in 2023. We now forecast EBITDA of Swedish krona (SEK) 2.2 billion-SEK2.5 billion, down from SEK2.9 billion in 2022.
- As a result, we see a higher risk of financial metrics deteriorating over 2024 and 2025. We anticipate funds from operations (FFO) to debt will decrease to about 13% by 2023 from about 18.5% in 2022, which is below the 15% rating threshold. For 2024 and 2025, we expect a gradual return to about 17%-20%, but this will depend on how successfully Stockholm Exergi passes through the increased fuel prices to its customers and recovers its operating performance.
- In addition, Stockholm Exergi recently changed its financial policy and now intends a dividend payout ratio of 0%-100% of net income after servicing its investment requirements, targeting a minimum rating of investment-grade. While no investment decision has been taken yet, Stockholm Exergi is considering large projects such as a bio-energy carbon capture and storage (BECCS) facility in addition to an already committed SEK750 million investment for its CHP1 project, which is part of a capacity deal entered with Ellevio.
- We revised our outlook to negative from stable because of the heightened risks from the company's need for cost recovery in the coming years, as well as the potential for material investments relating to its BECCS facilities. At the same time, we affirmed our rating on Stockholm Exergi at 'BBB+'.

Rating Action Rationale

Stockholm Exergi could find it difficult to fully pass through increased fuel prices to its customers. The company consumes about 2 million tons of biofuels per year, making biofuels its largest cost component. For 2023, we expect fuel-related costs to increase heavily--about 75% compared with 2022. Because Stockholm Exergi has only has a limited ability to pass such large price increases through to its customers within a year, we forecast EBITDA for 2023 to decrease to about SEK2.2 billion-SEK2.5 billion, from SEK2.9 billion in 2022. With current fuel prices showing higher volatility than in the past, we also see risks arising for Stockholm Exergi's profitability ratios beyond 2023. We understand that Stockholm Exergi, as part of the Swedish Price Dialogue, can only adjust its district heating and cooling prices once a year, effectively creating a one-year time lag that exposes the company to rapid market changes. We therefore expect the company, like other district heating operators, will attempt to increase customers' prices in the coming two to three years, aiming to recover its EBITDA margin to historical levels of about 38%-40% by 2025. For 2023 and 2024, we now expect FFO to debt of 12%-13%, before returning to 18%-20% by 2024, which is a level commensurate with the current rating. If the investment decision is taken on BECCS, those assumptions will be altered, and we would expect to see significantly lower ratios over 2024-2025. The negative outlook reflects our concern that Stockholm Exergi will be unable to fully recover from its significantly increased costs. If this happens, it could change our view of Stockholm Exergi's market position. Nevertheless, we expect Stockholm Exergi's district heating operations, which historically generated about 85% of total revenue, to continue contributing a large share of stable earnings.

We think Stockholm Exergi's revised dividend policy allows for greater flexibility during a period of elevated fuel prices and potentially significant investment, but also increases the risk of a weaker financial risk profile. On April 19, 2023, Stockholm Exergi's management board agreed to revise its dividend policy, which from 2024 allows shareholders to extract more capital. Since the adjustment of the policy, the revised payout ratio now targets 0%-100% of profits after tax, given that the company can service its investment needs and maintain at least an investment-grade rating ('BBB-' or above'). In our view, this is a softening of the previous financial policy, which effectively allows the owners to increase dividends. We understand that the change in policy was mainly taken to increase flexibility during a period of higher investments, and that dividends will be lowered if needed. This would be in line with the prudency of the shareholders and Stockholm Exergi's importance as a critical infrastructure provider for the city of Stockholm. We therefore do not forecast a material deviation in dividend payments from the current average of SEK850 million that the company paid over the past four years. Nevertheless, we see a risk of increased dividend payments, which we will monitor.

In early 2024, we expect increasing visibility on the potential scale of investments covering BECCS, which could significantly raise the investment needs. Management is investigating and preparing to take a final investment decision in early 2024 on the building of a BECCS facility at one of its main facilities close to central Stockholm. As the final investment decision has not yet been taken, we exclude the investment in our base case, but highlight the impact an investment of about SEK6 billion within the project's first three years would have on the company's credit metrics. We see a likelihood that the project will be carried out, given its importance for the city's decarbonization strategy and path toward net-zero. We believe this project would strengthen Stockholm Exergi's importance for the city materially, if it is undertaken. With the help of BECCS, Stockholm Exergi aims to become climate positive as early as year-end 2025, while also able to sell negative emissions at a profit at auctions. However, technological and execution risks will be high, especially because this would be one of the first full-scale BECCS project in Europe. Even in the absence of the BECCS investments, we forecast that capital expenditure (capex) will increase to about SEK2.4 billion as of 2023, from 1.7 billion in 2022, followed by annual investments of about SEK1.7 billion. The material step-up of about SEK750 million of capex in 2023 reflects the company's investments in its CHP1 project, which is part of a capacity deal signed with Ellevio.

Outlook

Our negative outlook reflects our view that higher costs are weighing on Stockholm Exergi's historically stable district heating operations, with a perceived risk that it will not be able to fully pass on the increased costs to consumers over 2024 and 2025. In combination with a potentially more aggressive investment profile over 2024-2026 and higher dividends, this could lead to substantially lower credit ratios for the company.

Downside scenario

We could downgrade Stockholm Exergi if the company is unable to recover its FFO to debt metrics in the coming two years. FFO to debt sustainably below 15% and limited prospects for a swift recovery would likely lead to a downgrade. This could result, for example, from a longer period of weak operational performance because of significantly higher fuel prices, or from a decision to undertake largely debt-funded investments, such as BECCS. A combination of a weaker operating performance, higher investments, and larger dividend payments could result in a one- or two-notch downgrade, depending on the resulting long-term financial risk profile.

In addition, we could lower the rating if the city of Stockholm's ownership stake decreased, because this could lead us to revise down our assessment of the likelihood of extraordinary support. However, we do not view this scenario as likely given the company's importance to the city.

Upside scenario

We could revise the outlook back to stable if we gain clarity on how and to what extent the company is able to recover its operation performance to historical levels--that is, an EBITDA margin of about 38%-40%--and on the investment levels for the next three years.

Company Description

Stockholm Exergi is the largest provider of district heating in the greater Stockholm region, with production capacity of about 5,000 megawatts. More than 90% of its district heating system is based on renewable or recycled energy. It has about an 80% market share in its operating area, and reported EBITDA of about SEK2,950 million in 2022. Stockholm Exergi provides heating for over 800,000 people in and around Stockholm, and the district heating network is made up of 3,000 kilometers of underground pipes. Of its 10,400 customers, about 8,000 are apartment building associations and real estate companies. Stockholm Exergi also provides cooling to about 400 customers.

The company is 50% owned by the city of Stockholm (AAA/Stable) and 50% by Ankhiale, a consortium of mainly pension funds, including APG, Keva, Alecta, PGGM, and AXA. Ankhiale acquired its 50% stake from Fortum in 2021.

Our Base-Case Scenario

Assumptions

- Inflation in Sweden of about 7.6% in 2023 and 3.2% in 2024.
- An increase in revenue to about SEK10 billion by 2023, mainly driven by elevated electricity prices boosting electricity revenue, as well as higher realized prices for district heating customers.
- District heating generation of between 8.1 terawatt-hours (TWh) and 8.3 TWh annually, and electricity generation of about 1 TWh.
- An EBITDA margin of about 22%-26% in 2023, increased to 34%-39% between 2024 and 2025.
- Capex of SEK2.4 billion in 2023, reducing thereafter to SEK1.7 billion annually. We exclude the company's investment in BECCS because the final investment decision has not yet been taken.
- Limited working capital outflows of less than SEK100 million annually, and with a neutral effect on average.
- Annual dividend payouts of about SEK850 million until 2024, transforming into 100% of net profits thereafter.

Key metrics

Stockholm Exergi Holding AB (publ)--Key Metrics

	--Fiscal year ending Dec. 31--				
(Mil. SEK)	2021a	2022a	2023e	2024e	2025e
EBITDA	2,774.0	2,947.0	2,400-2,500	3,300-3,500	3,500-3,800
FFO	2,411.0	2,496.0	1,750-1,850	2,700-2,900	2,800-3,000
Capex	1,363.0	1,684.0	2,350-2,450	1700-1800	1,600-1,700
Dividends	850.0	850.0	850.0	850.0	850-1,500
Debt	12,501.9	13,470.0	14,400-14,600	14,000-14,300	14,300-14,600
FFO to debt (%)	19.3	18.5	12-13	19-20	>19
Debt to EBITDA (x)	4.5	4.6	5.5-6.5	3.5-4.5	<4.5

Note: Metrics for 2022 are based on actual figures, although the analytical adjustments based on audited information were still being updated at the time of publication. SEK--Swedish krona. a--Actual. p--Projected. e--Estimate. FFO--Funds from operations. Capex--Capital expenditure.

Liquidity

We view Stockholm Exergi's liquidity as adequate, reflecting that available liquidity sources should exceed our forecast of near-term cash outflows by about 1.3x. We also expect that sources will exceed uses even if EBITDA declines by 15%. We believe that the company has sound relationships with banks and a high standing in the credit markets. The company also has generally prudent risk management, and no restrictive financial covenants in its loan documentation.

Principal liquidity sources as of Dec. 31, 2022, include:

- Cash FFO of about SEK1.9 billion;
- Access to undrawn committed revolving credit facilities (RCFs) totaling SEK3 billion, which are expected to mature in May 2027; and
- Working capital inflow of SEK134 million.

Principal liquidity uses as of Dec. 31, 2022, include:

- Debt maturities of about SEK2.2 billion, predominantly outstanding commercial papers maturing in the first quarter of 2023;
- Maintenance capex of about SEK700 million in 2023; and
- Expected dividend of SEK850 million annually.

Environmental, Social, And Governance

ESG credit indicators: E-3, S-2, G-2

Environmental factors are a moderately negative consideration in our credit rating analysis of Stockholm Exergi, reflecting its large district heating operations (80% of EBITDA). That said, the company was able to phase out coal from its district heating system two years ahead of schedule and ahead of many peers, and now only uses nonfossil fuels such as biomass. The sustainability of bioenergy is part of an ongoing discussion about the EU Taxonomy. The company also has a carbon capture and storage project that will enable it to shift from reducing carbon-dioxide emissions to negative emissions. Our understanding is that the company could start carbon capture in 2025.

The utilities industry, which includes district heating providers, faces short- and long-term risks from environmental factors. It also faces societal issues in terms of pollution laws and governance risk arising from political decisions affecting the industry; for example, targets for carbon-dioxide emissions.

Governance influence

In accordance with our criteria for government-related entities, we see a moderate likelihood of extraordinary support for Stockholm Exergi from the city of Stockholm, based on our assessment of the company's:

- Strong link to the city, which owns 50% of Stockholm Exergi. We do not expect that the city of Stockholm plans to reduce its stake in Stockholm Exergi. The remaining 50% is owned by Ankhiale, a consortium of mainly pension funds. The two shareholders have equal voting rights and board representation; and
- Limited importance for the city. Although Stockholm Exergi provides the majority of heating in Stockholm, we consider that, given the company's part-ownership by Ankhiale, the city of Stockholm is primarily interested in Stockholm Exergi's operations, and its services could be provided by a private-sector entity.

Ratings Score Snapshot

Issuer credit rating	BBB+/Negative/A-2
Business risk:	Strong
Country risk	Very low
Industry risk	Very low
Competitive position	Satisfactory
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
Stand-alone credit profile:	bbb
Related government rating	AAA
Likelihood of government support	Moderate (+1 notch from SACP)

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 | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Related Research

- Stockholm Exergi Holding AB (publ), May 2, 2022

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Stockholm Exergi Holding AB (publ)		
Issuer Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2
Ratings Affirmed		
Stockholm Exergi Holding AB (publ)		
Issuer Credit Rating		
Nordic Regional Scale	--/--/K-1	
Senior Unsecured	BBB+	

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914