Småkraft AS

Full Rating Report

LONG-TERM RATING
BB

OUTLOOK
Stable

SHORT-TERM RATING
N4

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EDITOR'S NOTE (1 Sep. 2023): Text in the Issue Rating section was updated to improve clarity.

RATING RATIONALE

Our 'BB' long-term issuer rating on Norway-based small-scale hydropower producer Småkraft AS reflects the company's comparatively high financial gearing, volatile margins and weak credit metrics. The rating is also constrained by the company's volatile operating environment, with large exposures to spot prices, limited diversity of pricing areas, and lack of reservoirs in its run-of-river plants, subjecting the company to additional hydrological risks. However, these factors are partly offset by the company's business model, which includes a high proportion of volume-dependent costs.

We see the company's position within the merit order system of power generation as a credit strength, with essentially no risk of having to limit production capacity and an ability to generate high margins at low system prices. We view the company's cost flexibility, generation of green energy, low impact on the natural environment and low carbon emissions as positive. The rating is supported by the company's strong committed owners and their willingness to provide equity funding for growth initiatives. We believe that the company can operate at higher leverage than industrial companies due to the asset intensity of the power industry, the liquidity of the company's power plants and its strong owners.

STABLE OUTLOOK

The outlook is stable, reflecting our view that the company will refinance upcoming maturities at funding costs in line with our forecast. We expect Småkraft's margins to improve due to higher than historical system prices and cost-efficient operations, enabling it to offset some of the impact from increased funding costs. We expect owners to continue to support the company by providing equity for its acquisitions and for Småkraft to maintain its diverse funding structure with a high proportion of fixed-interest arrangements.

POTENTIAL POSITIVE RATING DRIVERS

- Improved credit metrics, with NCR-adj. FFO/net debt above 15% and NCR-adj. EBITDA/net interest above 3.5x over a protracted period.
- Increased scale, stabilising profit margins.

POTENTIAL NEGATIVE RATING DRIVERS

- Increased financial gearing, with NCR-adj. FFO/net debt below 5% or NCR-adj. EBITDA/net interest below 2.0x over a prolonged period.
- Deteriorating operating conditions, with low energy prices and lower power generation.
- Changes in ownership, negatively affecting risk appetite.

Figure 1. Småkraft key credit metrics, 2019–2025e

EURm	2019	2020	2021	2022	2023e	2024e	2025e
NCR-adj. revenues*	40	21	39	80	94	121	124
NCR-adj. EBITDA	17	6	17	37	50	73	77
NCR-adj. EBITDA margin (%)	43.2	28.2	43.2	46.3	53.7	60.5	62.3
NCR-adj. FFO	9	4	14	43	32	42	42
NCR-adj. net debt	196	271	283	319	399	489	570
Total assets	491	518	712	936	1,074	1,229	1,358
NCR-adj. net debt/EBITDA (x)	11.4	44.8	16.6	8.6	7.9	6.7	7.4
NCR-adj. EBITDA/net interest (x)	3.4	1.2	2.6	4.7	3.4	2.7	2.5
NCR-adj. FFO/net debt (%)	4.3	1.5	4.8	13.4	8.1	8.5	7.4
NCR-adj. FOCF/net debt (%)	-0.3	-22.2	-34.6	-17.0	-32.9	-28.2	-20.5

Based on NCR estimates and company data. e–estimate. FFO–funds from operations. FOCF–free operating cash flow. All metrics adjusted in line with NCR methodology. *Adjusted for realised hedging losses on energy derivatives

ISSUER PROFILE

Småkraft is a Norway-based small-scale hydropower producer with annual generation of around 2 Twh (terawatt-hours) as of 31 Dec. 2022. The company operates plants in both Norway and Sweden, where it has about 95% and 5% of its production capacity, respectively. Småkraft was founded in 2002 and was acquired by Dutch state pension fund APG, a reputable insurance company in Germany and an infrastructure fund managed by Aquila Capital in 2015, when it had 40 power plants and 440 Gwh in annual generation capacity. Under this ownership, the company's generation capacity increased almost five-fold by 2023. The company develops, operates and invests in small-scale plants in cooperation with landowners, which carry out maintenance and supervision of the plants. Småkraft mostly operates run-of-river plants with low impact on local biodiversity.

BUSINESS RISK ASSESSMENT

Business risk assessment 'bbb-'

Our business risk assessment reflects Småkraft's volatile operating environment, with both generation and pricing variability. It also considers the company's lower impact on local ecological systems and biodiversity than its peers, balanced by a lack of reservoirs and ability to fine-tune production in its run-of-river plants. The company has limited scale relative to peers but has a business model that results in significant cost flexibility and high profitability margins, which we believe offset some risk.

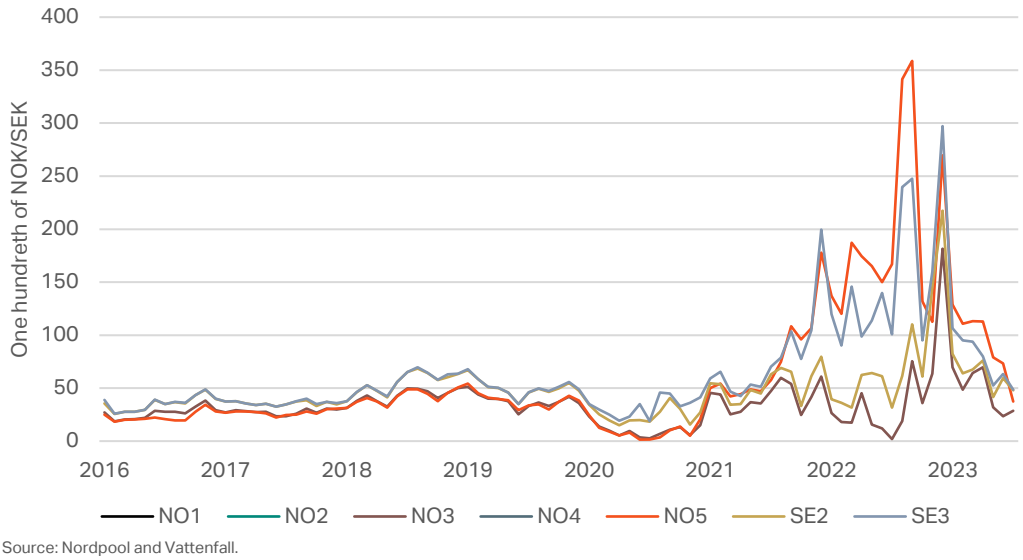
Volatile spot prices and variable production constrain operating environment

Operating environment 'bb'

We consider the company's renewable electricity generation and pricing to be volatile, as they depend on weather and hydrological conditions. In 2022, Norway's electricity generation consisted of 88% hydropower, 10% wind power, with 2% from other sources. Power to meet electricity balance is imported from other countries if necessary.

The Norwegian power market is split into five pricing regions, with prices typically being higher in the south when import volumes are required to maintain the electricity balance. The price differential between pricing regions has historically been minimal. However, in 2021 and 2022 prices in southern price regions NO1, NO2, and NO5 skyrocketed, while prices in the north, where demand is lower, were more stable. Sweden experienced a similar difference between its southern (SE3 and SE4) and northern (SE1 and SE2) pricing regions over the same period.

Figure 2. Spot prices for different pricing regions in Norway (NO) and Sweden (SE), 2016–Jul. 2023



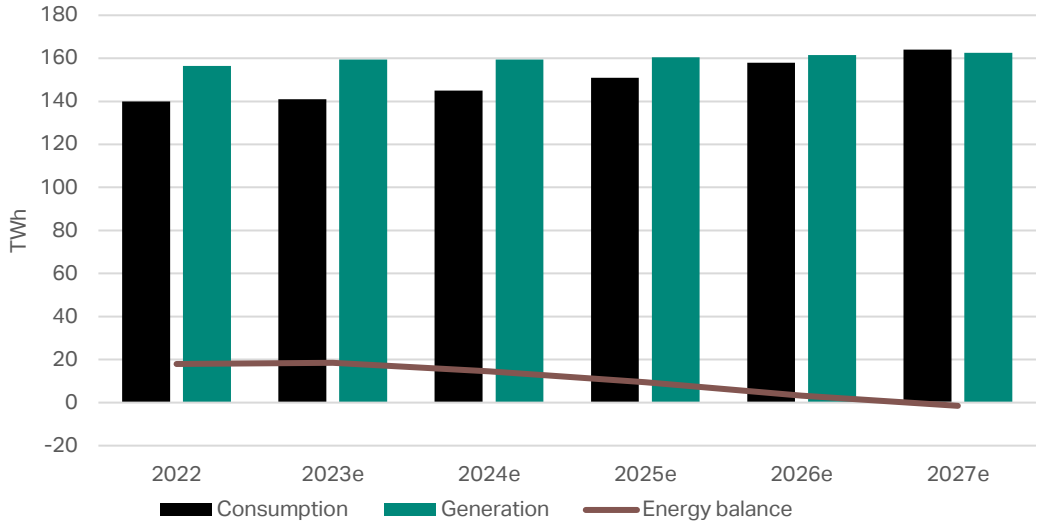
Source: Nordpool and Vattenfall.

The price spike was caused by new interconnectors and increased transmission capacity with continental Europe, alongside bottlenecks within the domestic transmission system. This resulted in historically low Nordic electricity prices converging with those of continental Europe and the UK, which rose significantly as a result of the reduced supply of Russian gas following the invasion of Ukraine. Prices have fallen from their peaks in 2022, and intensified efforts to reduce dependence on Russian gas in continental Europe, which has a higher marginal cost of production, is likely to result

in lower energy prices than 2022. However, the structural difference is expected to remain between pricing regions. We anticipate that prices will remain highly volatile, due to increased electrification of industries and time-consuming progress towards a larger renewable generation fleet with low marginal cost.

Norway is heading for an energy deficit in 2027, as new generation capacity cannot keep pace with increased demand, driven by industrial development and electrification of social infrastructure. The deficit is expected to be greater in the southern part of the country, and less low-price energy will be exported from northern regions when demand increases, which could drive further price differences between the pricing regions. An energy deficit would improve Småkraft's profitability, as more energy would have to be imported at higher cost to the pricing regions where the company operates.

Figure 3. Norwegian electricity consumption and generation balance, 2022–2027e



Source: Statnett. e–estimate.

Electricity accounts for more than half of the energy consumed by Norwegian households, with a high proportion of electricity being used for heating, which results in markedly seasonal consumption patterns with higher demand in the winter. In our opinion, this seasonality provides greater benefits for producers with large reservoir capacities than for operators of run-of-river plants like Småkraft. Norway accounts for about half of Europe's reservoir storage capacity, and about 75% of the country's generation capacity is flexible.

Market position constrained by lack of reservoirs in run-of-river plants

Market position 'bb+'

We believe that Småkraft has a strong market position within its niche, but consider that the company is more subject to hydrological risks than its peers because of its large proportion of run-of-river plants, as it has no reservoirs. We see this as a technological disadvantage to peers, especially those that can adapt generation to optimally navigate pricing or meet contracted volumes. On the other hand, Småkraft's plants have less impact on the natural environment and biodiversity than those of peers with plannable hydropower, as they take advantage of the topography. Småkraft's plants can withstand minor flooding without damage, as the natural water flow is pushed above the turbine.

Småkraft has signed land lease agreements with over 700 landowners, granting the company the right to build and operate hydropower plants on landowners' properties. Typically, at the end of contracts, landowners have the option to acquire the plant or to extend the lease. As of 31 Dec. 2022, the average remaining lease term was 50 years. At the same time, perpetual lease rights accounted for about 20% of the company's contracts, with no land lease payments over the term of the contract.

Electricity prices are set on a marginal basis, with the most expensive power plants required to meet demand in the pricing region determining the prices for all suppliers. New capacity comes online according to a merit order system, with capacity from energy sources with the lowest marginal cost of generation coming online first. Hydropower is favourably positioned in the merit order system, owing to its low marginal cost of production relative to other generators, leading to high profits in periods of

high prices and the ability to remain competitive in periods of low market prices. Hydropower is essential for meeting energy demand in Norway and Sweden, and we see low risk of substitution by other energy sources for the foreseeable future, due to the low marginal cost of generation relative to other generation technologies. We believe, however, that competitive pressure could be exerted through an expansion of Nordic and European renewable energy infrastructure, resulting in price erosion.

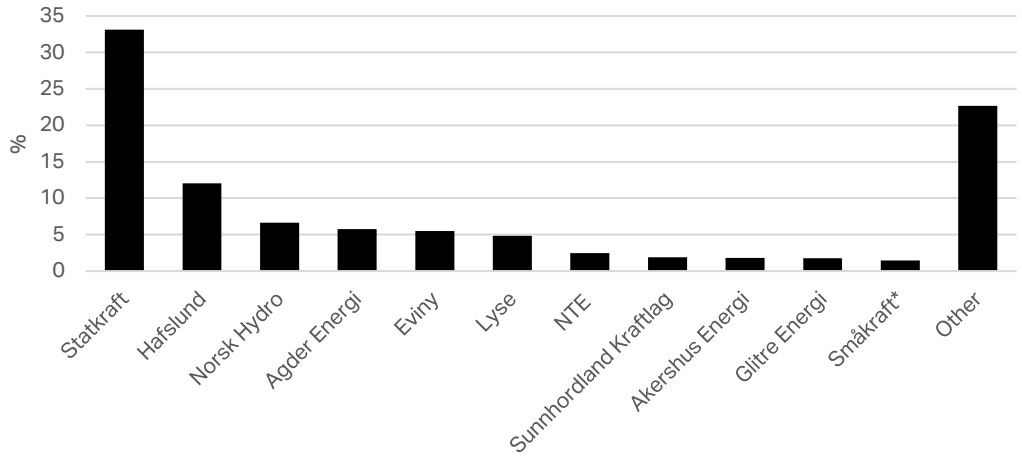
The company's portfolio of modern assets, with an average age of 18 years, requires low capital expenditure over the first 40 years of its lifetime. We assess that the company has a good track record of constructing new plants, with a higher success rate in applications than peers, which has supported its rapid expansion. All of the company's power plants, aside from the Holmen plant, are exempt from the Norwegian resource tax on energy companies, as this only applies when the effect of individual plant exceeds 10 megavolt amperes.

High diversity of power plants offset by limited scale

Size and diversification
'bb+'

The company's operating portfolio has generation capacity of about 2Twh annually, representing about an 8.3% market share of small-scale hydropower in Norway and Sweden but about 0.6% of total generation in those countries. Småkraft is a small-scale producer in relation its regional peers, although it is among the 15 biggest energy suppliers in Norway. The company is growing quickly, and we expect it to grow rapidly through new expansion initiatives in Norway and Sweden, increasing its size relative to other producers. We consider that the company has the capacity the expand to other countries, but that it would require critical mass to justify costs. To some extent, expansion through new projects is limited by high connection fees to distribution grids. We expect the company to grow through greenfield projects, in addition to the acquisition of operational power plants, increasing its scale and diversity.

Figure 4. Normalised share of hydropower generation in Norway, 1991–2020



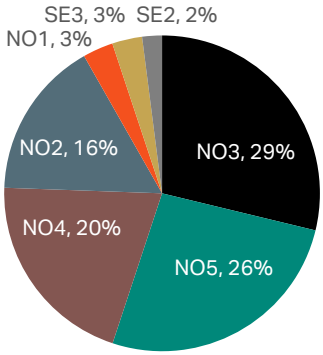
Source: the Norwegian Water Resources and Energy Directorate (NVE). *Generation as of 31 Dec. 2022.

We take a positive view of Småkraft's asset diversity, with 219 hydropower plants as of 31 Dec. 2022 spread across all of Norway's five pricing regions and two of Sweden's. The company has low reliance on individual power plants, with the 10 largest plants accounting for 17% of annual generation capacity. We believe that the regions and plants are hydrologically diverse, but that droughts or floods could impact power generation negatively. However, given the share of hydropower in Norway, spot prices tend to increase in periods of weak hydrology, which could limit the impact if only a proportion of assets are affected.

We take a negative view of the company's concentration of energy sources on run-of-river hydropower. This is because it increases sensitivity to hydrological conditions relative to a broader portfolio of renewable energy sources and plannable hydropower. Larger regional and international peers generally have significant presence in multiple locations, greater diversity of generation technologies and operate in multiple segments due to a high degree of vertical integration, reducing volatility compared with Småkraft's monoline income stream.

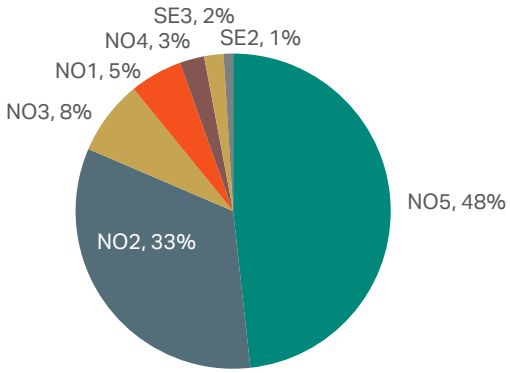
A significant difference in system prices across Norway in 2022 resulted in southern pricing regions NO5 and NO2 accounting for 71% of revenues while only representing 42% of the company's generation capacity (see Figure 2). We expect more balanced exposure going forward, due to improved pricing on transmitted capacity to southern pricing regions from continental Europe and the UK.

Figure 5. Småkraft generation capacity by pricing area, 31 Dec. 2022



Source: company.

Figure 6. Småkraft revenue by pricing area, 31 Dec. 2022



Source: company.

Slim organisation with flexible cost base results in strong margins and efficiency

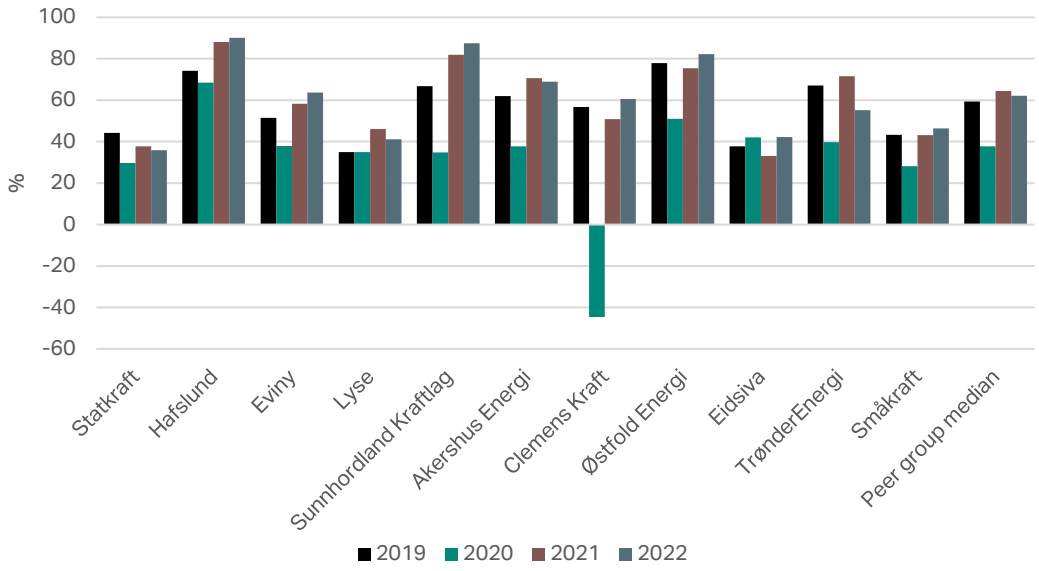
Operating efficiency 'a'

We take a positive view of the company's almost completely variable cost structure, in which about 80% of the company's lease counterparties are compensated based on the revenues or profits of each plant and a large proportion of other costs incurred based on generation volumes. When constructing new sites, the company typically accrues a claim on the landowner, under which future profits will offset the deficit until the balance has been repaid.

The low complexity of the company's plants enables a slim organisation, as most plants do not require an operator on site and can be monitored remotely through Småkraft's control centre. Close collaboration with local subcontractors enables rapid responses to unplanned downtime, improving cost efficiency. Repairs and maintenance are carried out on hourly contracts, as needed.

Negatively, most of the company's plants do not have reservoirs, which limits the flexibility of power generation to take advantage of price differences in a volatile market. On the other hand, the company's flexible cost structure and energy hedging contracts at fixed prices offset some risk. The company aims to hedge 20–30% of its average generation volume. At year-end 2022, the company's fixed-price contracts represented about one-quarter of expected production volumes for 2023 and 2024. The market for longer contracts is constrained due to a lack of buyers.

Figure 7. Småkraft peer group NCR-adj. EBITDA margins, 2019–2022

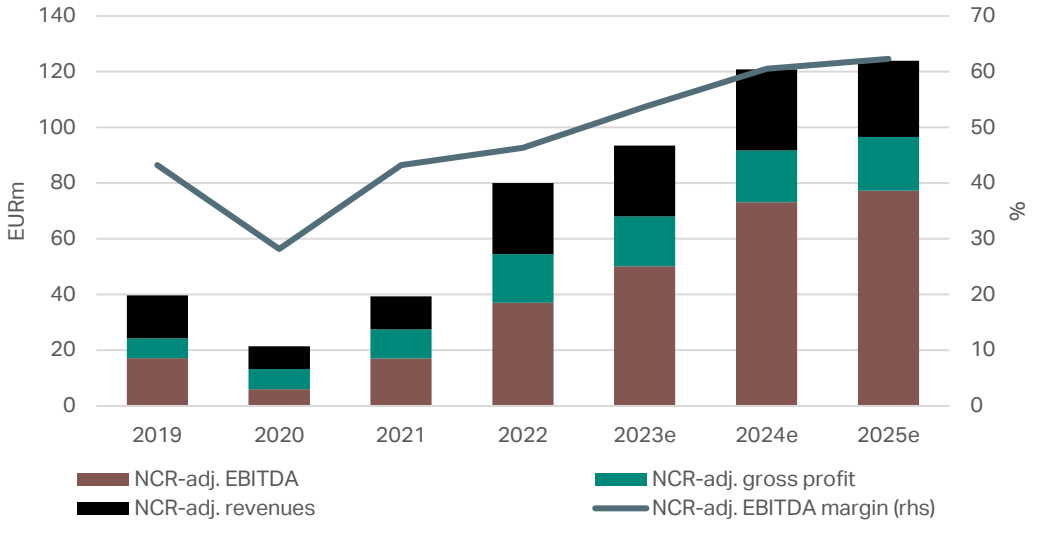


Based on company data.

Over the past four years, the company's NCR-adjusted EBITDA margins have been relatively stable, aside from margins in 2020, which stood at 28% compared with over 43% in the other years. In our opinion, the strength of Småkraft's operating model was highlighted during 2020 when the company managed to obtain high margins despite a price collapse in the Nordic power market, with system prices falling by more than 70% from 2019 levels. Many of the company's closest peers experienced a sharper decline, with a median decline in margins of 19.3%. We expect Småkraft's margins to remain high in relation to an international peer group with a broader portfolio of generation technologies, but below the average of its group of regional hydropower peers, which have very high margins versus other technologies. If the company's leasing rights were capitalised according to IFRS 16, its margins would be about 15pp higher than reflected in the EBITDA margin.

Our forecast assumes that the company's NCR-adjusted EBITDA margins will be between 54% and 62%, driven by higher than historical (pre-2022) electricity prices and the phasing out of legacy hedging contracts entered into at lower prices, resulting in realised hedging losses. It also reflects an expansion of the company's portfolio without a proportional need for overhead staff. Maintenance expenditure and working capital requirements are expected to be low, which improves financial flexibility.

Figure 8. Småkraft NCR-adj. revenues, gross profit, EBITDA and margins, 2019–2025e



Based on NCR estimates and company data. e–estimate.

FINANCIAL RISK ASSESSMENT

Financial risk assessment 'b+'

Our financial risk assessment reflects Småkraft's high financial leverage and ambitious expansion plans with some execution risk, which elevates the company's risk appetite. It also reflects the company's volatile credit metrics, due to generation and pricing variability. In our opinion, the ownership structure, with the Dutch pension fund APG as majority owner, is a strong contributor to reducing financial risk, due to its history of providing equity to the company.

Ratio analysis 'b'

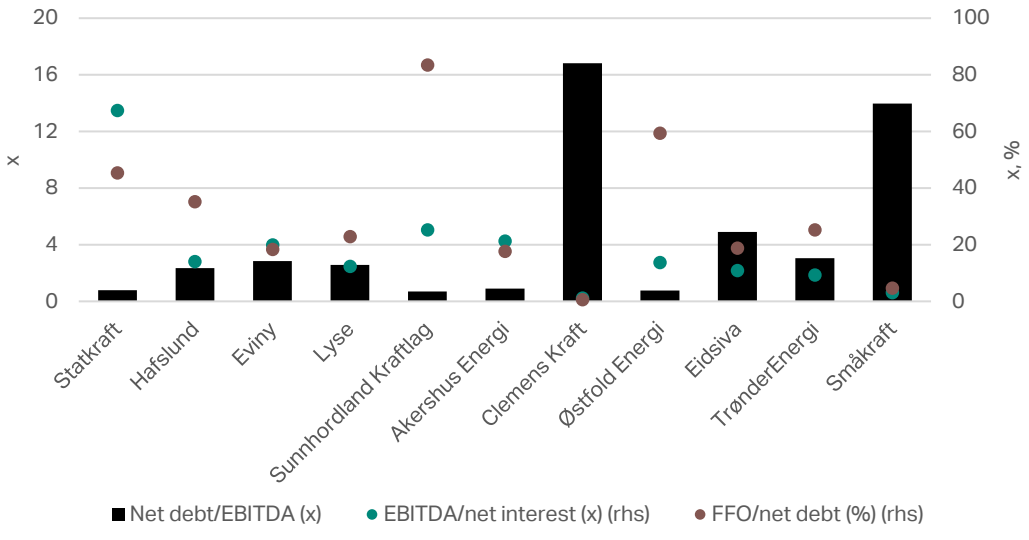
Volatile credit metrics and high financial gearing relative to peers

We expect Småkraft to mainly grow by acquiring operational small-scale hydropower plants and that it will undertake new construction projects when the opportunity arises, as connection fees to local grids could prohibit a profitable project. Our forecast sees prices declining from their elevated levels in 2022 and developing in line with the forward curves for the different pricing regions, resulting in more evenly distributed profit across pricing areas. We expect new energy contracts to be entered into at higher levels and realised losses on energy contracts to decline through our forecast period. We expect EBITDA margins to improve significantly when one-quarter of the company's energy contracts, which were entered into at a lower rate, are replaced with contracts at higher levels.

The company's leasing contracts with landowners are exempt from being recognised on the balance sheet under IFRS 16 because of their characteristics. We treat landowner leases as cost of goods sold because the leasing costs are dependent on production volumes and revenues generated, as they are variable rather than fixed. In addition, landowners have the option to purchase power plants under the contractual terms. If the company's lease liabilities were more similar to capital investments and fixed cost in nature, we would expect them to be recognised as lease liabilities under IFRS 16. The company has some minor leasing arrangements that qualify for IFRS 16 treatment, which are included in our calculations of net debt and in interest payments.

We consider the key credit metric of funds from operations (FFO)/net debt to be more representative of the company's financial gearing than net debt to EBITDA, which does not capture Småkraft's tax advantage over its larger peers, which are subject to resource rent tax. Even including this metric, the company has high leverage on an absolute basis and relative to peers.

Figure 9. Småkraft peer group four-year median key credit metrics, 2019–2022



Based on company data.

Our base case forecast of Småkraft's financial ratios through 2025 assumes:

- expansion of generation capacity, normalised annual generation and prices in line with market forward prices, resulting in a revenue decline of 10% in 2023, growth of 15% in 2024, and a decline of 6% in 2025;
- fluctuating total costs and replacement of old hedging contracts, resulting in unadjusted EBITDA margins between 43% and 61% through 2025;

- an effective tax rate of about 22% through 2025, reflecting the fact that the company only has one power plant that is subject to the resource rent tax, resulting in a lower tax burden;
- an average interest rate of 3.1% in 2023, 4.8% in 2024 and 4.9% in 2025, reflecting our expectations of higher financing costs;
- acquisitions and capital spending of EUR 160m in 2023, EUR 180m in 2024 and EUR 162m in 2025, funded by 50% debt and 50% equity from owners; and
- dividends paid of EUR 28m in 2023, EUR 42m in 2024 and EUR 45m in 2025, corresponding to cash flow from operations.

On the basis of these assumptions, we estimate the following metrics for 2023–2025:

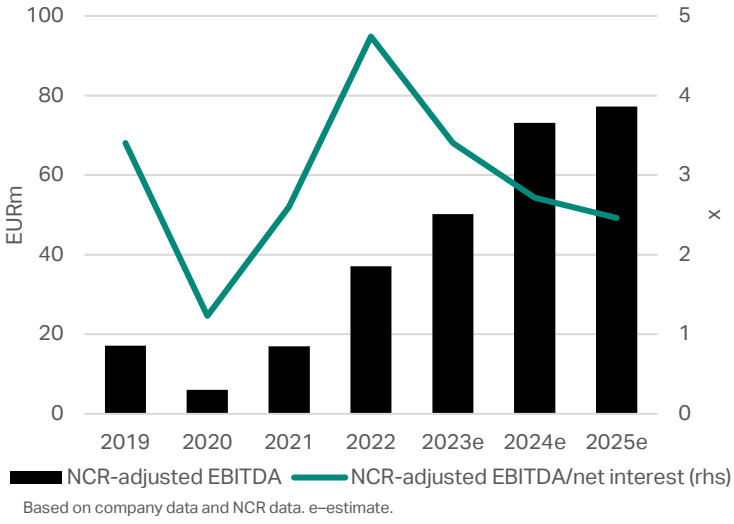
- NCR-adjusted net debt/EBITDA of 6.7–7.9x;
- NCR-adjusted EBITDA/net interest of 2.5–3.4x; and
- NCR-adjusted FFO/net debt between 7.4% and 8.5%.

Figure 10. NCR's adjustments to Småkraft's credit metrics, 2019–2025e

EURm	2019	2020	2021	2022	2023e	2024e	2025e
EBITDA*	17	6	17	39	52	75	79
Share of profit in associated companies			-0	-1	-1	-1	-1
NCR-adj. EBITDA	17	6	17	37	50	73	77
Net interest, including leasing	-5	-5	-7	-8	-15	-27	-31
NCR-adj. net interest	-5	-5	-7	-8	-15	-27	-31
NCR-adj. EBITDA	17	6	17	37	50	73	77
NCR-adj. net interest	-5	-5	-7	-8	-15	-27	-31
Current tax	-4	3	3	13	-3	-5	-4
NCR-adj. FFO	9	4	14	43	32	42	42
NCR-adj. FFO	9	4	14	43	32	42	42
Changes in working capital	-1	1	5	11	-5	0	3
Capital spending (including acquisitions)	-8	-66	-116	-108	-159	-180	-162
NCR-adj. FOCF	-1	-60	-98	-54	-131	-138	-117
Cash and cash equivalents	51	20	44	115	115	115	115
NCR-adj. cash and equivalents	51	20	44	115	115	115	115
Gross interest-bearing debt	247	291	325	434	514	604	685
Lease liabilities	0	0	3	1	1	1	1
NCR-adj. cash and equivalents	-51	-20	-44	-115	-115	-115	-115
NCR-adj. net debt	196	271	283	319	399	489	570

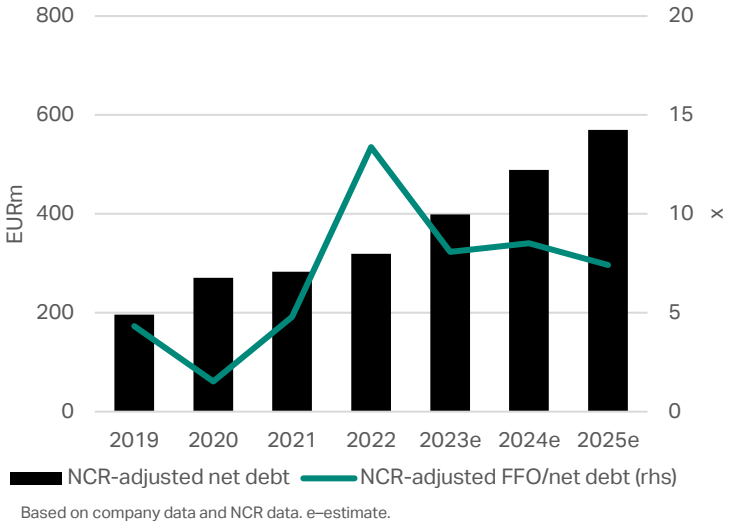
Based on NCR estimates and company data. e–estimate. FFO–funds from operations. FOCF–free operating cash flow. *Excludes unrealised fair value changes relating to energy derivatives.

Figure 11. Småkraft NCR-adj. EBITDA and NCR-adj. EBITDA/net interest, 2019–2025e



Based on company data and NCR data. e–estimate.

Figure 12. Småkraft NCR-adj. net debt and FFO/net debt, 2019–2025e



Based on company data and NCR data. e–estimate.

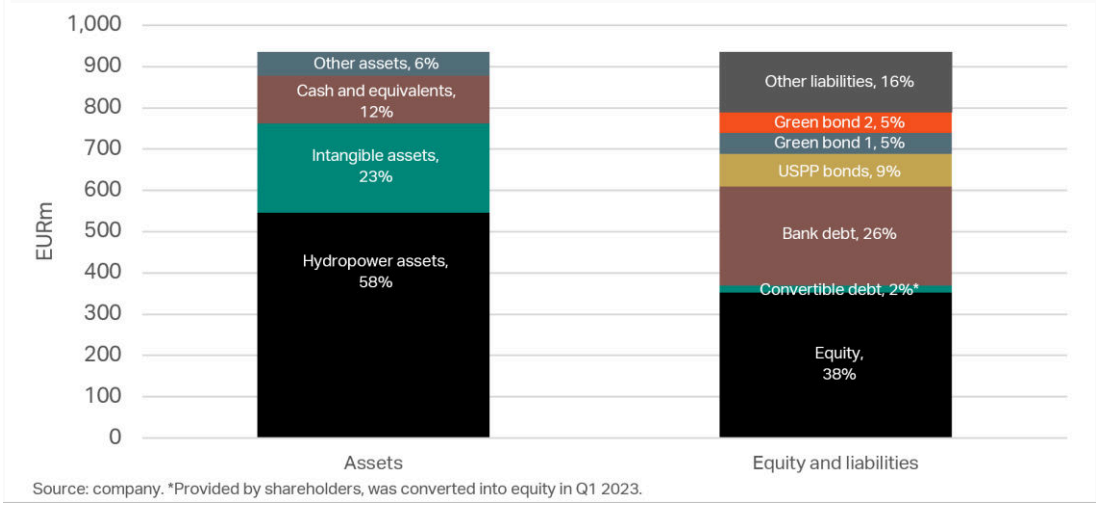
Risk appetite 'bb'

Risk appetite limited by high financial leverage and volatile metrics

We assess the company's financial risk appetite to be more prudent than reflected in by financial ratios, which is largely attributable to the company's strong majority owner, the Dutch pension fund APG (a subsidiary of Europe's largest pension fund, Stichting Pensioenfonds ABP). Together with co-investors, APG has provided over EUR 700m in equity to the group since acquisition. We expect increased explicit commitments from the owners to enable Småkraft's expansion plans through 2025 and the expansion to be contingent on new equity funding.

The company has a track record of paying dividends to its owners despite the rapid expansion. We expect any surplus to be returned to the owners, but consider that the company could cancel dividends and receive new equity from owners if necessary. Typically, when the company acquires power plants or undertakes greenfield projects, the owners provide 100% of the funds, which are refinanced at a later stage to steer the company's capital structure towards its target of 50% loan to value (LTV) in new transactions. The company's shareholders are committed to providing at least 50% for investments, improving the flexibility to undertake acquisitions without assuming more debt.

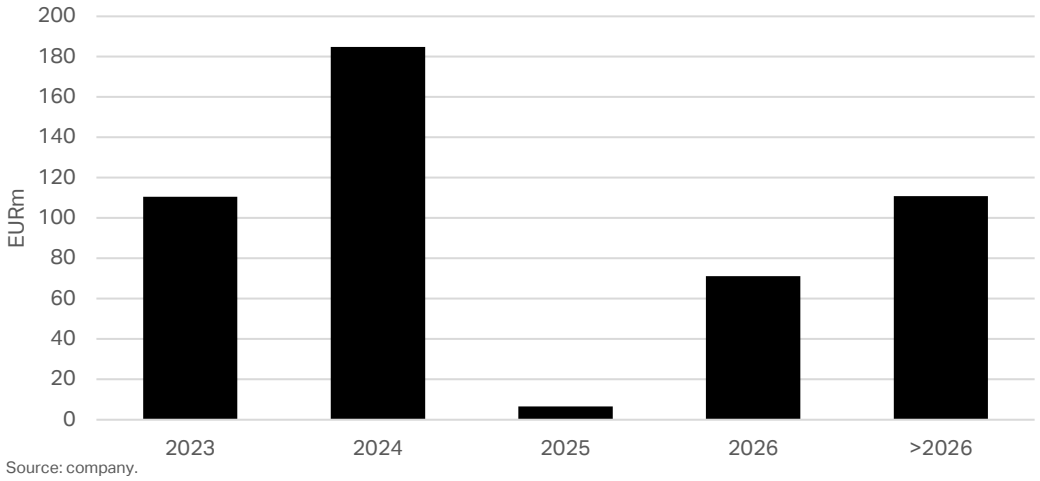
Figure 13. Småkraft capital structure, 31 Dec. 2022



Source: company. *Provided by shareholders, was converted into equity in Q1 2023.

We take a positive view of the company's diverse funding structure and access to green financing, which comprises a mix of bank financing, bonds and US private placements (USPP). The company targets a capital structure with an average debt maturity between three and five years. As of 31 Dec. 2022, the company's debt maturity profile was front-loaded, but we expect it to become more balanced when maturing debt is refinanced.

Figure 14. Småkraft debt maturity structure, 31 Dec. 2022



Source: company.

Most of the company's borrowing is incurred in EUR, its reporting currency, while operational costs are largely incurred in NOK, and to a minor extent in SEK. Payment of the company's contracts is priced in EUR, although these are likely to follow domestic Norwegian power prices. We see currency risk as limited, since the group hedges most currency exposures through financial instruments to ensure the lock-in of investment returns for its owners. The company aims to have at least 50% fixed-interest financing, both using swaps and fixed-rate borrowing. As of 31 Dec. 2022, about 70% of the company's interest rates were fixed, which we see as positive for reducing exposure to interest rate rises.

We see a risk of generation volatility, price volatility and fair value changes relating to derivative contracts resulting in deteriorating financials and increasing the risk of a covenant breach. Weak hydrological conditions could amplify the effect on financial performance, as the company has a low proportion of power plants with reservoirs. However, given Norway's reliance on domestic hydropower, prices would likely increase due to imports from other countries in periods of weak hydrology.

The company's bonds and loans are governed by financial covenants relating to equity ratio, debt service ratios and liquidity. We expect the company to comply with its financial covenants.

Figure 15. Småkraft financial covenants and reported metrics

Metric	Financial covenants	Reported 31 Dec. 2022
Equity ratio	≥30%	38%
Debt service covenant[1)]	≥1.1x	Not relevant[3)]
Liquidity coverage	Liquidity ≥ 6m interest payments[2)]	16.0x[4)]

Source: company. 1) (Adj. EBITDA – taxes paid – change in working capital)/(interest payments and net change in borrowings). 2) Limited to a maximum of EUR 5.0m. 3) Net proceeds from borrowings result in an irrelevant metric as the denominator is negative. 4) Estimated by Nordic Credit Rating.

ADJUSTMENT FACTORS

Adjustment factors neutral

Adjustment factors are assessed as neutral and have no effect on the rating.

Liquidity

Liquidity adequate

Our 12-month liquidity analysis is based on a stressed scenario under which the company cannot access the capital markets or extend bank loans, and therefore has to rely on internal or committed external funding sources to cover its liquidity needs.

We assess Småkraft's liquidity position as adequate, supported by net sources/uses of EUR 69m (1.3x coverage) for the 12 months from 31 Dec. 2022. In a stressed scenario, we expect the company's strong owners to provide full equity funding for committed capital spending and for meeting upcoming debt maturities. The company could also suspend dividends, if necessary.

We estimate the following primary liquidity sources totalling EUR 388m:

- NCR-adjusted cash and equivalents of EUR 115m as of 31 Dec. 2022;
- EUR 24m in FFO, equalling 75% of the estimated NCR-adjusted FFO over the period;
- EUR 159m in committed equity from owners, equalling committed capital spending; and
- EUR 40m in proceeds from borrowings since 31 Dec. 2022.

This compares with the following uses of liquidity totalling EUR 270m:

- Repayment of borrowings of EUR 111m; and
- Committed capital spending of EUR 159m.

ESG factors adequate

Environmental, social and governance factors

Småkraft's environmental, social and governance (ESG) policies support our view of the company's overall business and financial risk. All the company's generation comes from hydropower, the renewable energy source with the lowest CO_2 emissions, which supports the transition to green energy and a low-carbon economy.

We consider Småkraft's ESG efforts to be better than its peers, largely due to the company's run-of-river plants having a low environmental impact, as they take advantage of the topography and do not block streams, unlike plants with reservoirs. The company is required by regulators to maintain a minimum water flow to limit potential damages to local biodiversity. The company performs an annual biodiversity audit of all its plants. Småkraft's operating model encourages the use of local subcontractors and stimulates small rural economies, which helps ensure that the company maintains its licence to operate.

We assess that climate change could impact the hydrological situation as a result of more frequent droughts or floods. Generation could be negatively affected if precipitation patterns change. The impact, however, would not necessarily be negative. The company might benefit from climate change if winters become milder and summers become wetter, as this would imply increased generation at its plants and less seasonal volatility. However, storm Hans in August 2023 brought heavy rain, which had a significant negative effect on spot prices and near-term forward prices, and also caused some damage to two power plants (which were insured).

We take a positive view of the company's access to green funding. It has a green financing framework rated 'Dark Green' in a second opinion from climate research agency CICERO. The company currently reports on sustainability matters according to the standards of the Task Force on Climate-related Financial Disclosures and is expected to align with the EU taxonomy on sustainable investments, which we see as positive for accessing a broader investor base.

The main ESG issues that could impact our overall assessment are factors that could contribute to revenue losses, cost increases, higher capital spending or deteriorating financing terms.

Figure 16. Småkraft ESG considerations

Issue	Risk	Mitigating efforts	Result
CO_2 emissions	Increased costs due to regulatory and/or taxation changes.	The company only operates hydropower plants, which aside from construction, generate the lowest CO_2 equivalents of any energy source over their lifespan. The focus on run-of-river plants further reduces CO_2 emissions. The company aims to eliminate Scope 1 emissions by 2030.	The company reports Scope 1–3 emissions, which have decreased by 9% from 2019 to 2022, with CO_2 emissions of 32.6 tonnes. The company aims to reduce CO_2 emissions to 13.2 tonnes of CO_2e by 2030. The company purchases carbon credits from South Pole to offset its emissions.
Impact of climate change on operations	Loss of revenues and/or increased capital spending. Increased insurance premiums.	Production planning and materiality analysis of impact from floods. Action to prohibit the consequences of extreme flooding and use of contracted local repair and maintenance personnel to decrease downtime.	Applications for new production plants have greater discharge capacity, making them more resilient to floods.
Increased environmental focus on financial markets	Adverse effect on financing possibilities or higher financing costs due to slow transition to lower CO_2 emissions.	Efforts to increase energy efficiency and reduce CO_2 emissions. Overall sustainability and focus on low impact on biodiversity throughout operations.	Established a green bond framework with a 'Dark Green' second opinion from CICERO. Most of the company's funding is considered green.
Community relations and regulatory compliance	The company's concessions and operations hinge on relations with landowners and the socioeconomic benefits of its generation.	The company's business model shares economic benefits with landowners, operators, local construction companies and municipalities. The company monitors minimum water levels.	No physical or financial displacement of residents. Plants are built on the land of 870 owners and the company has 191 local supervisors on contract for daily maintenance of plants. Investments of over NOK 1bn directly benefitting communities in 2022.

Source: company. See ESG factors in corporate ratings.

OWNERSHIP ANALYSIS

Ownership neutral

Småkraft is owned by Dutch state pension fund APG, German insurance company Gothaer Group and an infrastructure fund managed by Aquila Capital, which also manages the assets. The owners have provided more than EUR 700m in committed equity to the company since the acquisition in 2015. We believe the owners will contribute more capital for Småkraft to pursue its growth plan. We view the owners as supportive of the company's development and have reflected these benefits in our assessment of the company's financial risk profile.

Figure 17. Småkraft ownership structure, 31 Dec. 2022

Owner	Share of capital and votes
APG	62%
Gothaer Group	15%
Aquila Capital European Hydropower Fund (14 investors)*	23%

Source: company. *Largest investor has an indirect stake in Småkraft of 6%.

ISSUE RATINGS

We rate Småkraft's senior secured bonds 'BBB-', two notches above the company's 'BB' long-term issuer rating. This reflects senior secured creditors' first-ranking pledge on the security packages at low LTV ratios, typically below 40%, resulting in our expectations of material recovery prospects for senior secured debtholders in the event of a financial default. If Småkraft issues senior unsecured bonds, we expect these to be rated at the same level as the issuer rating, based on recent transaction multiples indicating meaningful recovery prospects for unsecured creditors.

METHODOLOGIES USED

(i) Corporate Rating Methodology, 8 May 2023.
(ii) Rating Principles, 24 May 2022.
(iii) Group and Government Support Rating Methodology, 18 Feb. 2022.

Figure 18. Småkraft key financial data, 2019–2022

EURm	2019	2020	2021	2022
INCOME STATEMENT				
Revenue	44	13	59	135
Cost of goods sold	-15	-8	-12	-26
Selling, general & admin. expenses	-11	1	-30	-71
EBITDA*	17	6	17	39
Net financial items	-3	-17	12	-19
Pre-tax profit	14	-13	-20	-84
Net profit	10	-10	-16	-71
BALANCE SHEET				
Property, plant and equipment	353	384	480	546
Intangible assets and goodwill	51	85	163	216
Total non-current assets	431	485	663	809
Cash and cash equivalents	51	20	44	115
Total current assets	61	33	48	127
Total assets	**491**	**518**	**712**	**936**
Total equity	209	218	339	352
Long-term interest-bearing loans	76	82	316	333
Total non-current liabilities	78	84	333	385
Total current liabilities	204	216	40	199
Total equity and liabilities	**491**	**518**	**712**	**936**
CASH FLOW STATEMENT				
Pre-tax profit	14	-13	-20	-84
Operating cash flow	80	99	149	175
Cash flow from investing activities	-33	-56	-115	-109
Cash flow from financing activities	2	27	117	143
Cash and cash equivalents beginning of the year	71	51	20	44
Cash flow for the year	**-20**	**-31**	**25**	**71**
Cash and cash equivalents at the end of the year	51	20	44	115

*Excludes unrealised fair value changes relating to energy derivatives.

Figure 19. Småkraft rating scorecard

Subfactors	Impact	Score
Operating environment	20.0%	bb
Market position	10.0%	bb+
Size and diversification	10.0%	bb+
Operating efficiency	10.0%	a
Business risk assessment	50.0%	bbb-
Ratio analysis		b
Risk appetite		bb
Financial risk assessment	50.0%	b+
Indicative credit assessment		**bb**
Liquidity		Adequate
ESG		Adequate
Peer calibration		Neutral
Stand-alone credit assessment		**bb**
Support analysis		Neutral
Issuer rating		**BB**
Outlook		Stable
Short-term rating		**N4**

Figure 20. Capital structure ratings

Seniority	Rating
Senior secured	BBB-

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