

Research Update:

Vygruppen AS Upgraded To 'A-' On Eastern Norway Contracts Award; Outlook Stable

September 22, 2023

Rating Action Overview

- Contrary to S&P Global Ratings' expectations, on June 30, 2023, the Norwegian Railway Directorate awarded both the Eastern Norway 1 (EN1) and Eastern Norway 2 (EN2) direct purchase contracts to state-owned transportation group Vygruppen AS (VY) until December 2033.
- In our view, the award supports VY's scale and competitive position, because we expect rail operations will generate about 65% of the group's EBITDA, and we see the rail business as more stable and profitable than bus services. It also confirms VY's important role for the government.
- We expect the group will maintain funds from operations (FFO) to debt at about 28%-29% over the next three years, with debt only represented by leasing obligations. The new contracts will provide a supportive regulatory framework, which, alongside solid traffic, will help mitigate the effects of traffic risk or inflation on cost structure, in our view. In addition, capital expenditure (capex) will be fully covered over the life of the contract by the Norwegian Railway Directorate.
- We raised our long-term issuer credit rating on VY to 'A-' from 'BBB+' and affirmed the short-term rating at 'A-2'. Our long-term rating includes three notches of uplift from our 'bbb-' assessment of VY's stand-alone credit profile (SACP) because we see a high likelihood of extraordinary government support from the Norwegian government (AAA/Stable/A-1+).
- The stable outlook indicates that VY will be able to maintain FFO to debt comfortably above 25%, supported by a favorable regulatory framework under newly agreed railway contracts and solid traffic.

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Rating Action Rationale

We see the award of both Eastern Norway packages to VY as a positive credit factor for the group. Contrary to our expectations, on June 30, 2023, the Norwegian Railway Directorate awarded VY both the Eastern Norway 1 (EN1) and Eastern Norway 2 (EN2) direct purchase contracts to state-owned transportation group VY, running from mid-December 2023 to December 2033. Given the size of the contracts (both represent about 74% of VY's train revenue in 2022), we

see the award as supporting the group's scale and competitive position in the country, as well as its important role to the government.

The government's decision to award both eastern Norway contracts to VY confirms our view of a high likelihood that the Norwegian state would provide extraordinary support to VY if required, with VY continuing to represent a dominant share of total traffic passenger in the country.

Newly renewed contracts comprise a total of 12 lines, of which two are heavy commuter lines, while the rest is split between regional and regional-express trains. The EN2 contract also includes the integration of the Airport Express service from February 2028.

The total amount of public purchases agreed is Norwegian krone (NOK) 21 billion (NOK14 billion of this is for EN1), which the company will receive over the 10-year contract. We expect this amount will represent about half of the group's train revenue in 2023, even though we anticipate that revenue will decline over the planning horizon, as traffic increases alongside cost efficiencies pursued by VY.

We expect train operations will continue to drive about 65% of the group's EBITDA as a result of eastern Norway contracts. In our view, the awards are credit supportive, because we consider train operations to be more stable and profitable than bus services. We see the direct award of both eastern packages as supportive of VY's credit quality because it protects the group from competition on those rail lines until December 2033, with other train contracts in the portfolio not expiring before 2028-2029, and with no additional tenders expected over the next three to four years.

Compared with rated peers, VY is more exposed to competition on the rail segment, with the group losing both northern and southern rail packages to other operators in 2018-2019 since the liberalization started in Norway. The exposure to bus services in terms of EBITDA is therefore higher than peers' (about 40% in 2022). We view bus operations as an inherently more volatile, lower-margin businesses characterized by higher competition, although protected from traffic risk (about 85%-90% of contracts currently held by VY in this segment are represented by gross, inflation-linked agreements, with no exposure to passenger risk).

While we incorporate into our forecast about NOK3.5 billion in lease-funded capex over the next three years for expansion in the bus segment, we think rail activities will continue to drive most EBITDA generation beyond 2025. That said, we expect the group will continue expanding its bus services in Norway and Sweden.

The new contracts provide a supportive regulatory framework for train operations, including mitigating mechanisms against downside risks. The EN1 and EN2 contracts include one-to-one compensation for specific costs, including lease payments. Under the new contracts, the price risk for energy costs will be borne by the Railway Directorate, while the risk on deviations from power consumption forecasts and on remaining cost items (i.e., personnel) will be retained by VY.

While we expect capital spending will still be financed under leasing contracts, we understand that any increase in capex will be entirely covered by the Norwegian Railway Directorate through public purchase revenues over the life of the contract.

We think that the passenger revenue sharing mechanism will give the group protection against downside risk on train turnover, with VY entitled to additional compensation from the government for 67% of revenue losses higher than 4% compared with the base-case estimates. We understand that such a mechanism does not fully insulate VY against pandemic-like market disruptions, and that it requires VY to share with the government 67% of revenue above the 8%

threshold compared with the base-case estimate.

Finally, an ex-post profit-sharing mechanism is set out in the contracts to ensure that VY is not overcompensated by the Railway Directorate. We understand that this mechanism is cumulative over the years.

The upgrade also reflects our view that solid traffic and flexibility in tariff-setting mechanisms will support VY's credit metrics, with cash-flow generation mitigating higher lease debt and dividend distribution. We forecast FFO to debt over the next three years at about 28%-29%, with debt to EBITDA estimated at about 3x. The expected decline compared with 2022 levels (FFO to debt: 41.6%) mainly stems from the significant increase in lease debt, because of the lease-funded capex plan that VY will have to complete in 2023 following the award of the eastern Norway contracts.

We expect traffic recovery to support credit metrics, because we anticipate that train passengers' numbers will almost reach pre-pandemic levels in 2023, thanks to commuters now seeming more inclined to return to the office compared with the previous year, as well as discount initiatives. With public purchases indexed to the Consumer Price Index (CPI), we assess positively the flexibility VY retains under railway contracts to increase ticket prices in line with expected inflation, because we think CPI in Norway will remain high in 2023 and 2024, at 5.4% and 3.2%, respectively. With VY exposed to operating cost risk--in particular, staff costs--we believe such flexibility will help mitigate inflation's adverse impact on margins.

Finally, we expect cash flow generation to compensate for the lease-funded capex plan on both the railway and bus segments (more than NOK10.8 billion over the next three years), as well as for the dividend distribution resumption, which we assume will start from 2023.

Outlook

The stable outlook on VY indicates that FFO to debt will be about 28%-29% over 2023-2025, supported by a favorable regulatory framework and solid traffic, and we expect the company will continue to generate most cash flow from rail operations.

Downside scenario

We could lower the rating by one notch if VY cannot maintain FFO to debt sustainably above 25%. This could happen if, for instance, its margins are weaker than anticipated or if lease-funded investments for its bus and train businesses lines are materially higher than expected.

Upside scenario

We could raise our rating on VY if the group is able to maintain FFO to debt sustainably above 35%. This could happen if, for instance, lease obligations are lower than expected or margins and cash flow generation under the new contracts are materially higher than expected.

Company Description

VY (formerly Norges Statsbaner) is a Norway-based, 100% state-owned group that provides passenger and freight transportation services. Until the COVID-19 pandemic, it derived about 50% of its earnings from railway business in Norway, and the remainder from tourism and bus business

in Norway and Sweden.

Our Base-Case Scenario

Assumptions

- Revenue growth of close to 7%-8% in 2023 and about 1% in 2024, supported by traffic recovery and new tenders in the bus segment.
- Public purchases of about NOK4.3 billion in 2023 and NOK3.9 billion in 2024.
- Adjusted EBITDA margin improving to about 18%-19% over 2023-2024, and about 16% in 2025.
- Investments (primarily lease-funded) of about NOK7.7 billion in 2023, as result of the award of both eastern Norway packages. In 2024 and 2025, we assume investments of around NOK1.5 billion each year.
- No additional lending debt. The only obligations for VY will comprise financial leases, which we expect to be about NOK12.4 billion in 2023 and NOK12.3 billion in 2024, decreasing thereafter to about NOK12.0 billion in 2025. We also include finance lease payments of NOK2.8 billion-NOK2.9 billion in 2023 and NOK1.9 billion-NOK2.0 billion in 2024 and 2025.
- Dividend distribution of 50% of annual net profit, starting from 2023.

Key metrics

Vygruppen AS--Forecast summary

Industry sector: Railroads

(Mil. NOK)	--Fiscal year ended Dec. 31--						
	2019a	2020a	2021a	2022a	2023e	2024f	2025f
Revenue	17,065	14,506	15,289	17,631	18,955	19,098	19,284
EBITDA (reported)	3,038	1,608	1,254	2,689	3,522	3,366	3,129
Plus/(less): Other	(59)	(24)	26	(12)	--	--	--
EBITDA	2,979	1,584	1,280	2,677	3,522	3,366	3,129
Less: Cash interest paid	(180)	(171)	(181)	(238)	(374)	(369)	(361)
Less: Cash taxes paid	(192)	(4)	1	(4)	(160)	(144)	(94)
Funds from operations (FFO)	2,607	1,409	1,100	2,435	2,989	2,853	2,675
Debt (reported)	15	13	23	16	15	14	13
Plus: Lease liabilities debt	6,903	8,251	9,490	7,506	12,429	12,267	12,004
Plus: Pension and other postretirement debt	1,166	985	1,069	423	423	423	423
Less: Accessible cash and liquid Investments	(4,764)	(2,859)	(2,503)	(2,089)	(2,337)	(3,028)	(3,259)
Debt	3,320	6,390	8,079	5,856	10,530	9,677	9,181
Cash and short-term investments (reported)	1,395	3,038	2,658	2,662	2,814	3,505	3,736
Adjusted ratios							
Debt/EBITDA (x)	1.1	4.0	6.3	2.2	3.0	2.9	2.9

Vygruppen AS--Forecast summary (cont.)

FFO/debt (%)	78.5	22.1	13.6	41.6	28.4	29.5	29.1
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All figures are adjusted by S&P Global Ratings, unless stated as reported. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess VY's liquidity as strong, with sources exceeding uses by more than 1.5x over the 12 months from June 30, 2023, and more than 1.0x in the following 12 months. As a government-related entity, VY has sound relationships with banks and generally prudent risk management, which supports our liquidity assessment.

We expect principal liquidity sources over the 12 months from June 30, 2023, will include:

- Cash and cash equivalents of close to NOK2.3 billion;
- The undrawn overdraft facility of NOK400 million; and
- Our FFO estimate of about NOK840 million over the next 12 months, after taking into account finance lease payments.

We expect principal liquidity uses over the same period will include:

- Minimal debt maturities;
- Cash capex of about NOK172 million; and
- Estimated dividends of about NOK245 million

Environmental, Social, And Governance

Environmental factors are a positive consideration in our credit rating analysis of VY. It has a principal role in helping Norway reduce emissions by 50% by 2030. Considering the increasing use of electric passenger and freight trains, as well as renewable energy buses, we believe the group is financially well positioned to advance its green objectives. Social risks are overall a neutral consideration. This balances the key social mandate of the group, which is reflected in a high likelihood of extraordinary government support if needed. The group also plays an important role in servicing Norway's unprofitable lines to more remote destinations.

Ratings Score Snapshot

Issuer Credit Rating	A-/Stable/A-2
Business risk:	Satisfactory
Country risk	Very Low
Industry risk	Intermediate
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage	Intermediate

Issuer Credit Rating	A-/Stable/A-2
Anchor	bbb-
Modifiers:	
Diversification/Portfolio effect	Neutral/Undiversified
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Strong
Management and governance	Satisfactory
Comparable rating analysis	Neutral
Stand-alone credit profile:	bbb-
Group credit profile	bbb-
Likelihood of government support	High (+3 notches 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 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
- 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: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded

	To	From
Vygruppen AS		
Issuer Credit Rating	A-/Stable/A-2	BBB+/Negative/A-2

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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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at <https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceld/504352>. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.

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