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German Municipal Utilities: Fair to Cloudy Credit Conditions

Scope Ratings

Sobering news from the once-stable Stadtwerke (German municipal utility) sector persists unabated. Deteriorating finances have forced several former municipal earners to reduce or even cancel dividends paid to municipal treasurers. Some have even requested cash injections from municipal shareholders, which could prove dangerous for municipalities already under financial pressure. Scope Ratings (Scope) has monitored the financial development of 30 of the over 1,000 Stadtwerke. Compared to Scope's 2015 industry analysis, the financial risk position of some Stadtwerke remains vulnerable. Nevertheless Scope states that the majority should maintain a solid investment grade. As rating support may be limited due to issues around municipal guarantees, greater importance should be assigned to individual cases based on business and financial risks.

Credit evaluations based on cash flow more important than ever

This update of rating-relevant factors for the 30 Stadtwerke analysed by Scope in October 2015 (see German Municipal Utilities: Financing under Scrutiny) shows that key credit metrics regarding leverage and interest coverage did not deteriorate much more than in former years despite a further rise in external financing. This is due, firstly, to borrowing, and occasionally refinancing, using low-interest bank loans or German promissory note loans (Schuldschein). Secondly, a further deterioration was prevented by curbing unsustainable distribution policies, cutting costs or mothballing loss-making power plants.

On average, financial leverage remains at 3.2x, with interest coverage still at a solid 6.2x. Scope has, however, also observed that cash injections in the form of equity or shareholder loans were at times necessary, if not essential for survival. For those Stadtwerke which display comparatively weak finances, the reasons are complex: the ongoing burdens of the transition to clean energy; the subsidisation of the chronically unprofitable segments of multi-utility Stadtwerke; and structurally weak supply areas. It is, however, not just the unrelenting pressure on many Stadtwerke and municipalities which is hampering lending to certain municipal utilities. In the wake of increasing criticism that municipal guarantees may be in breach of EU state aid law, Scope believes it is more important than ever for lenders to focus on cash flow-based considerations when evaluating the credit quality of individual Stadtwerke.

Credit quality: fair to cloudy credit conditions

Despite the continuing pressure, Scope highlights that the credit quality of Stadtwerke (at holding company level) can still, for the most part, be assigned a solid investment grade (IG). Compared to Scope's analysis from October 2015, 24 of the 30 Stadtwerke continue to achieve an indicative classification of IG on a standalone basis, five of those in the crossover range. The exceptions, i.e. those with lower credit quality, are Stadtwerke that were particularly affected by the cross-subsidisation of unprofitable electricity generation. With regard to the German municipal utility landscape, comprising over 1,000 Stadtwerke, Scope has, however, established that the vast majority (over 90%) which are not exposed to loss-making conventional power plants should continue to stand on solid ground. Overall, Stadtwerke have been less adversely affected by the energy transition than other European utilities, which are implementing a range of strategies to fend off deteriorating credit quality (see Scope's study European Integrated Utilities: From Headwinds to Tailwinds).

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Related Research

German Municipal Utilities: Financing under Scrutiny Oct 2015

Application Study: European Utilities, Apr 2016

European Integrated Utilities: From Headwinds to Tailwinds, Sep 2016

Rating Methodology: European Utilities, Dec 2015

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Greater burden on municipal budgets

Historically, Stadtwerke have largely been able to fulfil their role to i) subsidise chronically unprofitable public services and ii) reliably pay dividends to (predominantly) municipal shareholders; but this mechanism is now failing in certain cases. Indeed, selected cases from the last three years show that municipal shareholders have been forced to bolster their Stadtwerke with shareholder loans or equity injections. Some Stadtwerke were even forced to take out restructuring loans to avoid financial distress. In the worst cases, municipal shareholders had to raise debt themselves in order to support their utility subsidiaries. Despite the low interest rates, these additional burdens on municipal budgets are painful, especially if income contributions are not expected to cover principal and interest payments in the short or medium term. This would, in all likelihood, negatively affect refinancing, should interest rates rise.

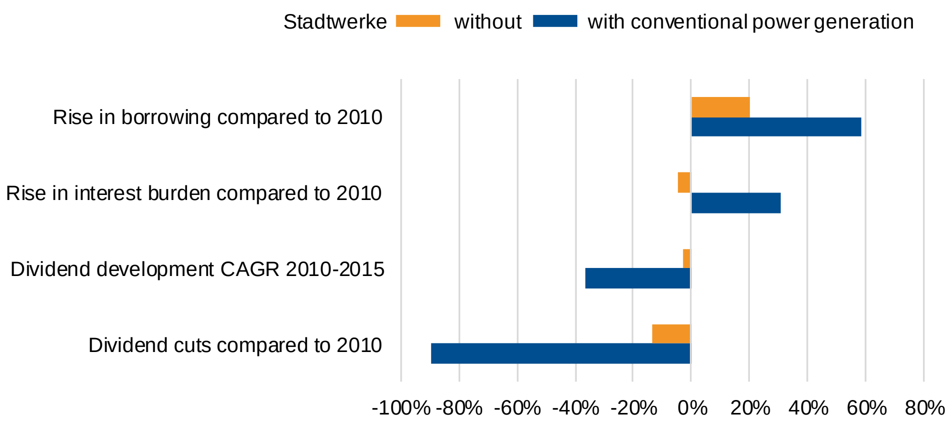
Table 1: Selected examples of Stadtwerke/groups in financial difficulty

Period	Provider	Corporate action
2016	STEAG GmbH	Cancellation of dividends paid to Stadtwerke consortium
2015	SWU Stadtwerke Ulm/Neu-Ulm GmbH	Equity injection from municipal shareholders
Q2 2015	Duisburger Versorgungs- und Verkehrsgesellschaft mbH	Equity injection from municipal shareholders
Q4 2014 Q2 2015	Stadtwerke Völklingen Holding GmbH	Bridge loan and corporate restructuring
Q4 2015	Enervie AG	Financial restructuring with shareholder loan
Q3 2014	Stadtwerke Wanzleben GmbH	Insolvency
Q2 2014	Stadtwerke Gera AG	Insolvency

Significant cuts in dividends

The low distributions/dividends might pose a considerable problem for municipal treasurers, also in cases where municipal companies are not exactly in a precarious financial situation. While total borrowing and interest costs have risen sharply since 2010, dividend distributions have in part been cut significantly (by a median of 20%) or even cancelled (Figure 1). In nine of the 30 cases from Scope's sample, Stadtwerke have cut distributions to shareholders, with the deepest between 2014 and 2015. Further dividend reductions were also announced for 2016. Although this is seen positively from a credit perspective, it is bad news for treasurers, especially if the municipalities affected are also shouldering more debt.

Figure 1: Increase in borrowing costs, decrease in distributions (median)



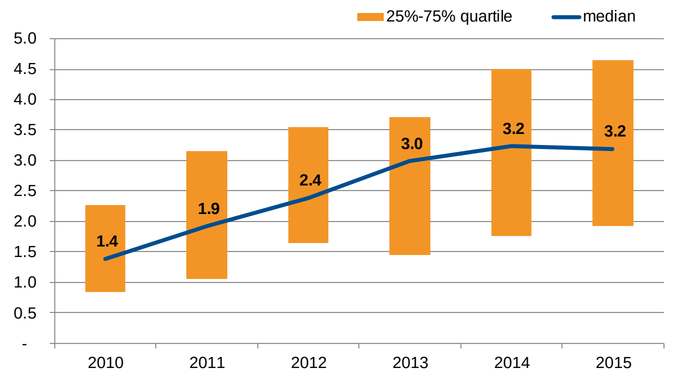
Source: Scope Ratings

Key credit metrics 2015

Key credit metrics for 2015 largely stable

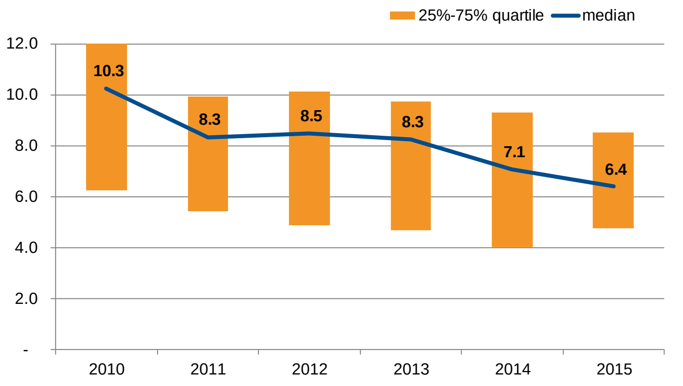
Scope's update of key credit metrics (leverage and interest coverage) for the 30 Stadtwerke analysed in 2015 reveals that the average financial risk profile in the sector did not deteriorate further despite the further rise in external financing. Scope even observed a slight improvement in margins, thanks, in particular, to better results from electricity and gas sales. The net financial leverage in the sample continues to be 3.2x on average (Figure 2), indicating investment grade credit quality in line with Scope's rating methodology for European utilities. Interest coverage has only dropped by a negligible amount, to a median of 6.4x (Figure 3).

Figure 2: Development of (net) financial leverage[1]



Source: Annual reports of 30 Stadtwerke, Scope

Figure 3: Development of interest coverage[2]

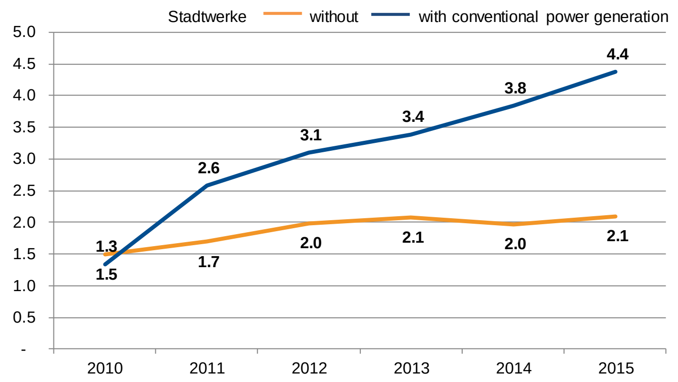


Source: Annual reports of 30 Stadtwerke, Scope

Clear structural divergences

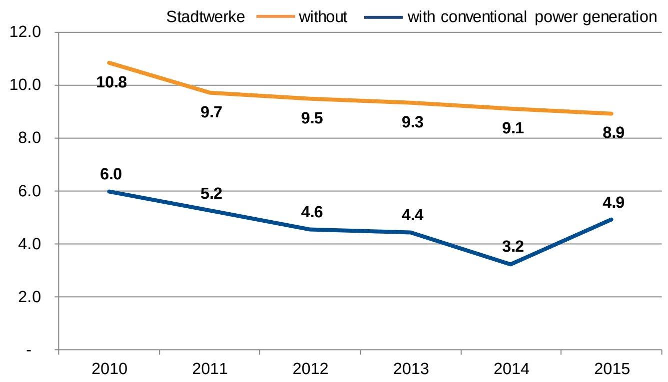
Scope has noted, however, that in 25% of cases, financial leverage is clearly above 4.5x, with an EBITDA interest coverage of under 5.0x (see the 25% and 75% quartiles). Four of the 30 Stadtwerke have maintained interest coverage at 2.0x or below which is commensurate with a B rating category only for a utility's financial risk profile. Rating-relevant credit metrics continue to diverge sharply when differentiating between Stadtwerke that operate conventional power plants and those that do not. While the figures for the Stadtwerke that focus on energy distribution remain very solid, selected Stadtwerke with exposures to conventional power generation saw a further rise in leverage. This is especially alarming if income from debt-financed investments is insufficient to cover principal and interest payments.

Figure 4: Leverage (median) for various Stadtwerke



Source: Annual reports of 30 Stadtwerke, Scope

Figure 5: Interest coverage (median) for various Stadtwerke



Source: Annual reports of 30 Stadtwerke, Scope

[1] Defined as Scope-adjusted debt/EBITDA. Debt = financial debt including shareholder loans + partial consideration of pension provisions + possible obligations for the decommissioning of power plants – available liquidity. EBITDA = EBITDA + income from shareholdings/subsidiaries. No consideration of possible off-balance sheet debts such as municipal pension obligations or guarantees.

[2] Defined as EBITDA/interest expenses

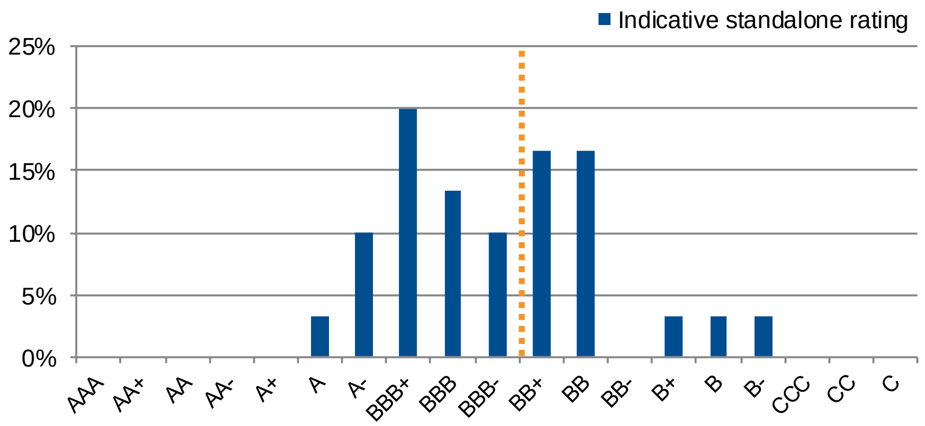
Scope assumes that the majority of the over 1,000 Stadtwerke in Germany will maintain a solid financial footing, as most utilities focus on regulated grid operation and energy sales without having their own power generation capacities. Interestingly, a survey of "Der Neue Kämmerer" among more than 200 municipal treasurers revealed that only a small minority of municipal utilities have faced deteriorating financing conditions from banks[3]. The majority of Stadtwerke continue to have good access to bank financing; with alternative financing sources such as promissory note loans (Schuldschein) or project financing still playing a subordinated role.

Credit quality: fair to cloudy credit conditions

Majority of Stadtwerke maintain solid IG status

According to Scope's rating methodology for European utilities, 60% of the Stadtwerke[4] in Scope's sample continue to achieve an indicative IG rating (using a standalone approach), reflecting their business and financial risks. Around a quarter of the Stadtwerke selected are, however, in the so-called crossover area between investment grade and non-investment grade (BB+/BBB-).

Graph 6: Distribution of indicative ratings (standalone approach)



Source: Scope Ratings

Potential difficulties with shareholder guarantees necessitate cash flow-based rating approach on a standalone basis

The proportion of Stadtwerke in the IG range should rise further if we allow for possible guarantees or guarantor liabilities provided by municipal majority owners. Bearing in mind the role of Stadtwerke as public utilities, and the blow to prestige caused by a financial failure, we can assume that municipal shareholders will almost always take supportive action should the situation become critical, as seen recently with equity injections and new shareholder loans. Scope argues, however, that lenders should focus more strongly on the standalone ratings based on cash flow. This applies especially to Stadtwerke whose municipal majority shareholders are themselves under financial pressure or for which the municipal joint-liability system and the implementation of shareholder guarantees would fail to take effect in a critical situation.

[3] Click **here** to the study title "Kämmerer blicken mit Sorge in die Zukunft".

[4] The indicative rating refers to Stadtwerke holding companies. Indicative ratings for other corporate entities such as grid companies may differ.

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