

Research Update:

Finnish National Passenger Rail Operator VR Group Affirmed At 'A+'; Outlook Stable

May 16, 2022

Rating Action Overview

- We believe that VR-Vhtyma Oyj (VR-Group PLC) will have sufficient financial headroom to absorb its acquisition of train and bus operator Arriva Sweden for an enterprise value of €80 million, according to our estimates, thanks to meaningful recovery in passenger traffic in 2022 and prudent financial discipline.
- However, the acquisition increases VR Group's exposure to bus operations, which we view as more competitive and lower margin than the group's rail segment. As such, we believe it will weigh on the group's earnings profile.
- Therefore despite our expectation that leverage will remain at similar levels, we revised downward our assessment of VR Group's stand-alone credit profile (SACP) to 'bbb+' from 'a-'.
- Nevertheless, we affirmed our 'A+' rating on VR Group, because we believe it will continue to benefit from a high likelihood of extraordinary government support from the Finnish government in the event of financial distress.
- The stable outlook reflects our expectation that VR Group's capital structure can accommodate a potentially softer operational environment than expected, given its flexibility in shareholder distributions and capital spending, which should ensure adjusted funds from operations (FFO) to debt will remain above 35% over 2022-2024.

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Rating Action Rationale

The acquisition of Arriva Sweden increases VR Group's exposure to bus operations, which are more competitive and generate lower margins. On March 23, 2022, VR Group signed an agreement to purchase Arriva Sweden for an enterprise value of about €80 million, according to our estimates. The acquisition, which we expect will close on July 1, 2022, consists of seven contracts, including three bus, two rail, and two multimodal contracts. The transaction is part of the group's strategy to pursue growth in the bus operation segment in both Finland and Sweden, where there is a good base of tenders.

This acquisition results in a higher share of VR Group's earnings being generated from what we

consider non-infrastructure activities. We now expect bus operations--which we regard as operating in a more cyclical industry--will account for about 20% of total EBITDA over our projection horizon through 2024, up from about 12% in 2021. In our view, bus operations have lower margins, shorter contracts, less predictable earnings, and a more competitive operating environment than the group's rail segment. As such, although we believe the group's leverage will remain at a similar level post acquisition, we believe that even with a recovery in train passenger volumes to 2019 levels in 2023, VR Group's margins could take longer to recover to pre-pandemic levels. In our base case, we project the EBITDA margin will be about 18% by 2023, and about 20% in 2024. This compares with EBITDA margins of about 25% in 2019. As the sole service provider of long-distance passenger rail in Finland, VR Group has enjoyed high margins of about 30%. In contrast, the bus segments in both Finland and Sweden have margins of about 15%-20%. As a result, we revised downward our SACP on the group to 'bbb+' from 'a-'.

However, we believe that VR Group's acquisition will help offset the loss of its Russian-related freight transports. As a result of the Russia-Ukraine conflict, VR Group terminated its contracts related to freight services between Russia and Finland and will also divest its affiliates and subsidiaries in Russia. We expect that this will mainly impact freight volumes in 2022, which we anticipate will be about 10% less than in the previous year, translating to about 7.5% lower EBITDA (about €30 million) for VR Transpoint, the group's logistics services segment. From 2023, there will be no further Russian-related transports.

In this context, we believe VR Group's purchase of Arriva Sweden will help to sustain cash flow. With the exception of one contract that will expire in July 2022, the acquisition will bring cash flows that are contracted until at least 2024. Additionally, most of these contracts fully or partially protect from volume risks, which will provide some predictability to cash flow. For the two contracts that are fully exposed to volume risks, we expect that revenue will nevertheless be protected from the impact of the pandemic in 2022, thanks to separate agreements with passenger transport authorities that will support revenue despite passenger volumes. We project EBITDA from VR Group's new Swedish operations will reach about €30 million-€38 million on over the next two years. In our base case, we only consider contracted cash flows and do not yet anticipate renewal of contracts.

The loosening of Finnish pandemic-related restrictions in recent months will support a stronger rebound in long-distance passenger traffic volumes in 2022. Fuelled by a sharp increase in leisure travel and increasing fuel costs that potentially make car travel more expensive, we believe that VR Group's long-distance passenger traffic could see a faster recovery in 2022. In first-quarter 2022, traffic levels from this segment reached almost 75% of 2019 levels, with April and the first few weeks of May at close to 100% of 2019 traffic volumes. In our base case, we anticipate traffic recovery for long-distance train travel to be about 80% of 2019 levels in 2022 and 90% in 2023.

In contrast, we anticipate that more engrained working-from-home practices and consumer concerns over safety will continue to drag on the recovery path for commuter train travel, despite the loosening of pandemic restrictions. For this segment, we therefore anticipate a slower return to 2019 levels, with traffic volumes about 5% less than our assumptions for long-distance travel over the next two years. That said, VR Group derived 60% of commuter revenue from Helsinki Regional Transport routes, which are protected by long-term fixed contracts without volume and pricing risks. As such, we expect some stability in cash flows from these contracts, despite a slower traffic recovery path than expected.

We believe VR Group's favorable contract structures will help mitigate impact from the high inflationary environment. We believe that the group has limited exposure to the secondary effects from the economic fallout from the Russia-Ukraine conflict, such as inflationary pressures and soaring commodity and energy prices. VR Group's freight and bus contracts benefit from index-linked clauses that allow for the pass-through of inflation on a quarterly (rail freight), weekly (road freight), and monthly (bus) basis. For the group's long-distance train segment, it is free to set its own prices, supported by the company's strong competitive position. Additionally, we anticipate that VR Group will be able to better manage its cost base over the next 12 months having already agreed upon salary increases of about 2% for 2022 with its labor unions, lower than our forecast rate of inflation of about 4.4% for the year.

We also note the group's hedges in place for 2022 and 2023 that will limit the increase of rising electricity and fuel costs. We believe that Finland is also less dependent on Russia for electricity, given that its electricity is mostly generated by hydropower, nuclear, and wind power. As such, unlike for some other European countries, such as Germany, Russian natural gas is not as critical in the Nordics.

With passenger volume recovery underway and good cost control, we believe that VR Group will be able to accommodate its acquisition of Arriva Sweden. We expect FFO to debt will temporarily deteriorate to about 35% in 2022, but recover to above 40% by 2023. This is mainly driven by the timing of the group's Arriva Sweden acquisition in July 2022, which will result in half-year cash flows being recognized for the year, while at the same time the group will incur a full year of debt. These ratios are on average, above our rating threshold for the current rating level. However, given the group's increased exposure to non-infrastructure activities, we would expect the group to operate with higher cash flow coverage ratios to offset a less predictable earnings profile to arrive at the same view of credit quality. In the same vein, if non-infrastructure operations were to increase to more than one-third of total EBITDA, this could also lead us to reassess VR Group's framework for cash flow volatility when determining its financial profile assessment for the rating level.

Ultimately, we expect that VR Group will exercise its flexibility in spending and dividends to maintain leverage in line with the current credit profile. In our base, we consider an annual dividend pay-out of about €40 million. We also anticipate that the group will undertake capital expenditure (capex) of about €256 million in 2022 (including the acquisition of Arriva Sweden), maintaining investments of €240 million–€270 million annually from 2022.

However, in the face of an uncertain recovery path or higher-than-expected cost increases, we believe that VR Group will continue to manage its dividend payments and capital spending to support leverage in line with the rating. Given that about 70% of VR Group's investment program on average is uncommitted, it has flexibility to defer investments to preserve cash in a weaker-than-expected operating environment.

We continue to believe that there is a high likelihood of support from the Finnish government to VR Group if needed, due to the group's role and link with the state. VR Group's government support translates into three notches of uplift that we apply to the group's SACP of 'bbb+', resulting in an issuer credit rating of 'A+'. This reflects that we believe the acquisition of Arriva Sweden has not changed VR Group's relationship with the Finnish government. We continue to believe that VR Group has an important role for the Finnish government, its sole owner, as the country's incumbent provider of passenger rail services and main railway freight operator. In our view, VR Group has maintained a very strong link with the Finnish government based on existing

mechanisms and the government's capacity to provide support to the group. This has been evident during the pandemic, despite VR Group's low leverage. Moreover, we understand that privatization of VR Group is not contemplated in the medium term.

However, VR Group could transform itself through an increased international presence and diversified revenue generation. If market liberalization proves detrimental to VR Group, or the government reclassifies its view of the group's importance, we could reconsider our assessment of the likelihood of extraordinary state support.

Outlook

The stable outlook reflects our expectation that VR Group's capital structure can accommodate to some extent a potentially softer operational environment than we previously expected, given historically low leverage levels. However, in the face of weaker-than-expected traffic recovery or higher-than-expected inflation that is not mitigated, the stable outlook also reflects our expectation that the group will control its shareholder distributions and capital spending, such that its adjusted FFO to debt will remain above 35% over 2022-2024.

Downside scenario

We could lower the rating if FFO to debt deteriorates below 35% without signs of recovery. This could be the result of materially slower traffic volume recovery than anticipated. We could also lower the rating if we believe the group's financial flexibility has deteriorated, for instance if VR Group is obliged to pay dividends or is unable to defer spending to manage inflationary pressures.

We could also lower the rating, by at least one notch, if earnings from operations that are more volatile than passenger rail services. This could be the case, for example, if bus transportation exceeds more than one-third of VR Group's total earnings. Downward pressure on the rating could also materialize if VR Group's competitive position weakens significantly following the potential entry of new players in the market and profitability materially weakens.

Upside scenario

We currently see an upgrade of VR Group as unlikely. We may revise upward our assessment of VR Group's SACP if the group demonstrates its ability to maintain its solid competitive position despite the liberalization of rail passenger services amid bus operations remaining less than one-third of total earnings. However, absent any changes in our assessment of the likelihood of government support, an upgrade of VR Group, would mean a three-notch upward revision of the SACP, which we see as unlikely.

A one-notch upgrade of Finland (AA+/Stable/A-1+) will not impact the rating on VR Group.

Company Description

VR Group is the national rail transport operator in Finland. It is 100% owned by the Finnish government, and currently operates a monopoly in the long-distance passenger rail segment. VR also operates in freight rail under the name VR Transpoint, holding a market share of above 95% even after the sector was opened up to competition in 2007.

Our Base-Case Scenario

In our base case for 2022-2024, we assume:

- Finnish GDP of 1.8%-2.0% over the period.
- The Finnish consumer price index rising 4.4% in 2022, 2.2% in 2023, and 2.0% in 2024.
- Train passenger volumes as a proportion of 2019 levels will be about 75%-85% in 2022, 85%-90% in 2023, and 95%-100% in 2024.
- Revenue growth of about 15% in 2022, driven by a recovery in passenger volumes. In 2023, an uptick in revenue growth of about 20%, supported by the full-year contribution of Arriva Sweden's revenue and continued traffic recovery. From 2024, we expect revenue growth broadly in line with Finnish GDP.
- EBITDA margins to remain weak in 2022 and 2023, at about 15%-18%. As recovery accelerates and inflationary pressures start to ease, we project margins of about 20% from 2024.
- Capex of €256 million in 2022 (including estimated cash payment of Arriva Sweden of €75 million), then maintaining annual investments of €240 million-€270 million from 2023 as the group invests in a new fleet for the freight segment and rolling stock for the passenger services.
- New investments to be funded through debt rather than leases.
- Dividend distributions to the Finnish government of approximately €40 million from 2022.

Key metrics

(Mil. €)	--Fiscal year ended Dec. 31--				
	2020a	2021a	2022e	2023f	2024f
Revenue	822.3	883.6	1,010.0-1,030.0	1,210.0-1,230.0	1,240.0-1,260.0
EBITDA margin (%)	15	14.2	14.5-15.0	17.0-19.0	About 20.0
Funds from operations (FFO)	108.4	112.2	130.0-140.0	200.0-210.0	230.0-240.0
Capital expenditure	151.6	156.2	250.0-260.0	240.0-250.0	About 260.0
Adjusted debt*	87.6	238.1	390.0-400.0	470.0-480.0	540.0-550.0
FFO to debt (%)	123.8	47.1	About 35.0	40.0-45.0	40.0-45.0

*Adjusted debt includes finance leases and net of cash. a--Actual. e--Estimate. f--Forecast.

Liquidity

We view VR Group's liquidity as adequate. We estimate that sources of liquidity in the 12 months to March 31, 2023, will exceed uses by more than 1.2x. We also assume that liquidity sources will exceed uses even if EBITDA were to decrease by 30% and we understand that VR Group's credit facility is free from onerous financial covenants. As a government-related entity, we also view the group as having solid relationships with its banks, despite the COVID-19-related market turmoil. Overall, we view risk management as prudent.

We expect that VR Group's principal liquidity sources for the 12 months to March 31, 2023, will

include:

- Surplus cash and liquid investments of about €53 million;
- Availability of €200 million syndicated revolving credit facility (RCF) that expires in June 2024 and term facility to fund the Arriva Sweden acquisition; and
- Estimated cash flows from operations of about €140 million.

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

- Limited debt maturities of about €30 million;
- Committed capex of about €196 million;
- Estimated cash payment of Arriva Sweden of €75 million; and
- Dividends of €40 million.

Environmental, Social, And Governance

ESG credit indicators: E-1, S-2, G-2

Environmental factors are a positive consideration in our credit rating analysis of VR Group. The group is key in helping Finland achieve its carbon neutral objectives by 2035 and a 50% reduction in emissions by 2030. The group aims to reduce emissions by 15% (per unit of output) over the next four years, against the 2019 level. Positively, the group's entire fleet of passenger trains are already carbon neutral, and the group has operated with 100% renewable electricity since 2008. Social factors have an overall neutral influence, balancing the group's responsibility for meeting national social objectives including wide rail connections across Finland, versus the negative impact from the pandemic. The latter provoked a sharp drop in passenger volumes of more than 30% in 2020. However, the group maintained stronger financial metrics than peers, thanks to very low financial leverage in the capital structure as supported by its government owner.

Ratings Score Snapshot

Issuer Credit Rating: A+/Stable/--

Business risk: Satisfactory

- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)

Research Update: Finnish National Passenger Rail Operator VR Group Affirmed At 'A+'; Outlook Stable

- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+

- Related government rating: AA+
- 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: 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

Ratings List

Ratings Affirmed

VR-Yhtymä Oyj

Issuer Credit Rating A+/Stable/--

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/sourceld/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

Research Update: Finnish National Passenger Rail Operator VR Group Affirmed At 'A+'; Outlook Stable

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