

Tear Sheet:

VR Group

January 25, 2024

S&P Global Ratings thinks Finnish rail operator VR Group's improved performance on the long-distance segment will more than offset the lower volumes on the freight business, VR Transpoint, over the next two years. We expect the long-distance rail passenger segment will represent 32%-33% of the total group revenue over 2024-2025, supported by annual traffic growth of 1.3%-1.5%, in line with our forecasts for Finland's GDP growth. The group--currently the sole operator of long-distance rail services in the country--surpassed pre-pandemic passenger journey levels by 5%-6% in 2023. We expect this will compensate for VR Transpoint's reduced freight volume, which stemmed from the discontinued traffic on the eastern route following the onset of the Russia-Ukraine conflict. We estimate that VR Transpoint's will contribute about 25% to group revenue in 2023, down from 33% in 2022. We anticipate freight volumes to pick up from 2024, capturing lower inflation and supportive economic conditions.

We expect the commuting business, VR City Traffic, to acquire new contracts over the coming years but we anticipate some revenue pressure in the short term. The group's Swedish operations face the maturity of three contracts in the next 18 months, two of which are on the train segment. We expect this will cause VR City Traffic's revenue to shrink 3%-5% each year over 2024-2025. This segment's revenue should resume growth in 2026, however, thanks to new contract awards stemming from management's plans to expand VR City Traffic in both Finland and Sweden, where there is a good base of tenders. As such, we expect bus transportation will continue to represent only 10%-15% of total group EBITDA over 2023-2026.

Improved adjusted EBITDA margins will support VR's credit metrics, but we project the large capex plan will reduce funds from operations (FFO) to debt to 44%-46% over 2025-2026 from about 68% expected in 2023. We expect the group will post an adjusted EBITDA margin of 21%-23% over the next three years, versus 12.4% in 2022, mainly driven by positive traffic performance on the long-distance segment. In fact, we expect the company will focus on passenger growth over the coming years, with fares increasing slower than the country's inflation, even though the long-distance segment's open-access model gives the company full flexibility to set tariffs. We also think cost efficiencies and indexed contracts at the freight business will strengthen EBITDA margins, with energy price increases passing through to fares. Delayed contract indexation and one-off costs related to the Arriva Sweden acquisition weighed on VR City Traffic's profitability, with a reported EBITDA margin of 4.9% in 2022 and 6.4% for the first nine months of 2023. Although we anticipate further improvements in the coming years, this segment's margins should remain much lower than that of Long Distance (38.4% for the first nine months of 2023) and freight business (14.3%). In fact, contract structures under the commuting business are typically characterized by lower margins, even though they are protected (either fully or at least partially) against volume and inflation risk, thereby supporting cash flow predictability. Over 2024-2026, we expect adjusted debt will increase because of an estimate of €940 million in capex over the same period, mainly for fleet investments. Still, we expect the company will continue to adjust dividends and spending, benefiting from its flexible balance sheet. Although the new long-term financial targets approved last March raised the

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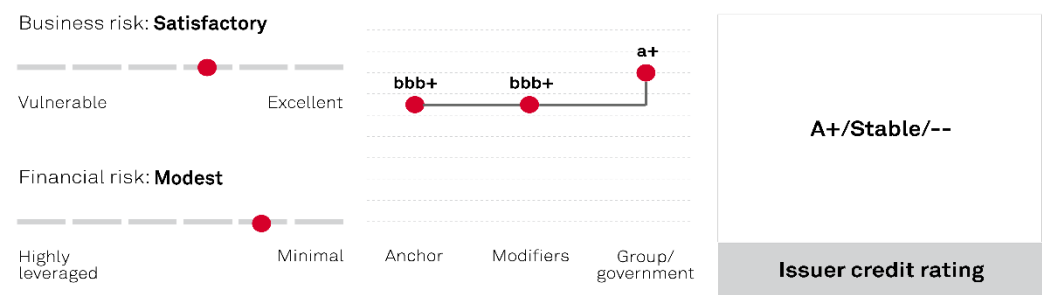
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group’s target net debt to EBITDA to 3x from 2x, VR will maintain S&P Global Ratings-adjusted leverage well below the threshold over 2024-2026.

Ratings Score Snapshot



Recent Research

- Industry Credit Outlook 2024: Transportation, Jan. 9, 2024
- Industry Credit Outlook 2024: Transportation Infrastructure, Jan. 9 2024
- Research Update: Finland 'AA+/A-1+' Ratings Affirmed; Outlook Stable, Oct. 27, 2023
- Tear Sheet: VR Group, Dec. 21, 2022

Company Description

VR Group is the national rail transport operator in Finland, providing long-distance and commuter rail services, in addition to buses. It is 100% owned by the Finnish government, and it is currently the sole operator in the long-distance passenger rail segment. VR Group also operates on both rail and road freight under the name VR Transpoint and has retained more than 95% of the rail freight market even though the sector was opened to competition in 2007.

In 2022 VR expanded its presence to the commuting business in Sweden, notably to the bus segment, with the acquisition of Arriva Sweden. The acquisition consisted of seven contracts, including three bus, two rail, and two multimodal agreements.

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. However, in the face of weaker-than-expected traffic recovery or higher-than-expected inflation that is not mitigated, we also expect the group will control its shareholder distributions and capital spending, such that adjusted FFO to debt remains above 35% over 2023-2025.

Downside scenario

We could lower the rating if FFO to debt deteriorated below 35% without signs of recovery, which could result from materially slower traffic volume recovery than anticipated. We could also lower the rating if we believed 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 materially increase. 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 weakened significantly following the potential entry of new players in the market and profitability materially declined.

Upside scenario

We currently see an upgrade of VR Group as unlikely. We may revise upward our assessment of VR Group's stand-alone credit profile (SACP) if the group demonstrates its ability to maintain a solid competitive position despite the liberalization of rail passenger services and the bus operations continue to contribute 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 require a three-notch improvement of the SACP, which we see as unlikely.

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

Key Metrics

VR-Yhtymä Oyj--Forecast summary

Period ending	Dec-31-2019	Dec-31-2020	Dec-31-2021	Dec-31-2022	Dec-31-2023	Dec-31-2024	Dec-31-2025	Dec-31-2026
(Mil. EUR)	2019a	2020a	2021a	2022a	2023e	2024f	2025f	2026f
Revenue	1,034	822	884	1,160	1,288	1,267	1,280	1,401
EBITDA (reported)	431	126	129	149	245	260	283	326
Plus/(less): Other	(211)	(2)	(4)	(5)	--	--	--	--
EBITDA	220	124	125	144	245	260	283	326
Less: Cash interest paid	(10)	(15)	(9)	(6)	(11)	(11)	(16)	(22)
Less: Cash taxes paid	(21)	(1)	(4)	6	(11)	(24)	(19)	(27)
Funds from operations (FFO)	189	108	112	144	223	226	247	277
EBIT	97	(26)	(26)	(22)	49	91	81	111
Interest expense	13	9	9	10	11	11	16	22
Cash flow from operations (CFO)	196	100	138	180	228	229	251	281
Capital expenditure (capex)	177	152	152	167	215	243	359	338
Free operating cash flow (FOCF)	19	(52)	(14)	13	13	(14)	(108)	(57)
Dividends	123	--	100	40	--	46	45	36
Discretionary cash flow (DCF)	(104)	(52)	(114)	(27)	13	(60)	(152)	(93)
Debt (reported)	--	34	33	327	299	299	599	599
Plus: Lease liabilities debt	283	252	271	288	258	235	212	194
Less: Accessible cash and liquid investments	(290)	(199)	(66)	(274)	(229)	(145)	(270)	(158)
Plus/(less): Other	37	--	--	--	--	--	--	--
Debt	30	88	238	341	328	389	541	634
Equity	1,336	1,274	1,279	1,246	1,273	1,283	1,283	1,309
Interest expense (reported)	13	9	9	10	11	11	16	22
Adjusted ratios								
Debt/EBITDA (x)	0.1	0.7	1.9	2.4	1.3	1.5	1.9	1.9

VR-Yhtymä Oyj--Forecast summary

FFO/debt (%)	620.5	123.8	47.1	42.2	67.9	58.0	45.7	43.7
FFO cash interest coverage (x)	19.6	8.5	13.0	24.8	21.3	22.2	16.2	13.6
EBITDA interest coverage (x)	16.9	13.4	14.0	14.7	21.9	24.1	17.2	14.7
Annual revenue growth (%)	(20.6)	(20.5)	7.5	31.3	11.0	(1.6)	1.0	9.5
EBITDA margin (%)	21.3	15.0	14.2	12.4	19.0	20.5	22.1	23.3

All figures are adjusted by S&P Global Ratings, unless stated as reported. a--Actual. e--Estimate. f--Forecast. EUR--euro.

Financial Summary

VR-Yhtymä Oyj--Financial Summary

Period ending	Dec-31-2017	Dec-31-2018	Dec-31-2019	Dec-31-2020	Dec-31-2021	Dec-31-2022
Reporting period	2017a	2018a	2019a	2020a	2021a	2022a
Display currency (mil.)	EUR	EUR	EUR	EUR	EUR	EUR
Revenues	1,269	1,302	1,034	822	884	1,160
EBITDA	230	224	220	124	125	144
Funds from operations (FFO)	204	169	189	108	112	144
Interest expense	18	20	13	9	9	10
Cash interest paid	12	12	10	15	9	6
Operating cash flow (OCF)	192	164	196	100	138	180
Capital expenditure	120	117	177	152	152	167
Free operating cash flow (FOCF)	72	46	19	(52)	(14)	13
Discretionary cash flow (DCF)	(120)	(54)	(104)	(52)	(114)	(27)
Cash and short-term investments	176	214	290	199	66	274
Debt	134	78	30	88	238	341
Adjusted ratios						
EBITDA margin (%)	18.2	17.2	21.3	15.0	14.2	12.4
EBITDA interest coverage (x)	13.1	11.0	16.9	13.4	14.0	14.7
FFO cash interest coverage (x)	17.8	14.9	19.6	8.5	13.0	24.8
Debt/EBITDA (x)	0.6	0.3	0.1	0.7	1.9	2.4
FFO/debt (%)	152.2	217.0	620.5	123.8	47.1	42.2

Peer Comparison

VR-Yhtymä Oyj--Peer Comparisons

	VR-Yhtymä Oyj	NS Groep N.V.	Vygruppen AS
Foreign currency issuer credit rating	A+/Stable/--	A/Stable/--	A-/Stable/A-2
Local currency issuer credit rating	A+/Stable/--	A/Stable/--	A-/Stable/A-2
Period	Annual	Annual	Annual
Period ending	2022-12-31	2022-12-31	2022-12-31
Mil.	EUR	EUR	EUR
Revenue	1,160	3,341	1,674
EBITDA	144	434	254
Funds from operations (FFO)	144	420	231
Interest	10	14	25
Cash interest paid	6	14	23
Operating cash flow (OCF)	180	896	185
Capital expenditure	167	438	16
Free operating cash flow (FOCF)	13	458	169
Discretionary cash flow (DCF)	(27)	458	169
Cash and short-term investments	274	1,141	198
Debt	341	1,162	556
Equity	1,246	2,309	339
EBITDA margin (%)	12.4	13.0	15.2
EBITDA interest coverage (x)	14.7	31.0	10.2
FFO cash interest coverage (x)	24.8	31.0	11.2
Debt/EBITDA (x)	2.4	2.7	2.2
FFO/debt (%)	42.2	36.2	41.6

Environmental, Social, And Governance

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 from the 2019 level. Positively, the group's entire fleet of passenger trains is 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, supported by its government owner.

Rating Component Scores

Foreign currency issuer credit rating	A+/Stable/--
Local currency 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+
Diversification/portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	bbb+

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

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