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Research Update:

Dutch Energy Distribution Network Operator Enexis Affirmed At 'A+/A-1' On Stable Operating Performance; Outlook Stable

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Research Update:

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Overview

- We continue to expect Enexis will generate predictable cash flow and earnings, supported by a transparent regulatory framework and its low-risk business.
- Enexis' cost of capital continues to align with regulatory assumptions to set rates, but the regulator's low allowed return on capital and high efficiency targets continue to pressure revenue growth.
- We are affirming our 'A+' long-term and 'A-1' short-term corporate credit ratings on Enexis.
- The stable outlook reflects our expectation that Enexis will report stable revenues and credit metrics, with funds from operations at 22%-23%.

Rating Action

On Sept. 27, 2017, S&P Global Ratings affirmed its 'A+' long-term and 'A-1' short-term corporate credit ratings on Dutch energy distribution network operator Enexis Holding N.V. and the 'A+' long-term corporate credit rating on its subsidiary Enexis B.V. (jointly Enexis). The outlook on both entities is stable.

The 'A+' rating on Enexis' senior unsecured debt was affirmed.

Rationale

The affirmation and the stable outlook reflect our continued expectation of predictable cash flow and earnings. Although we have reassessed Enexis' liquidity profile to adequate from strong, our assessment is neutral for the rating. We also no longer see Enexis as a government-related entity (GRE) despite being owned by local and regional governments (please see "Five Dutch Regulated And Unregulated Utilities No Longer Classified As Government-Related Entities; Ratings Affirmed," published today on RatingsDirect). This is also neutral for the rating.

At year-end 2016, Enexis posted revenues of €1.376 billion and EBITDA of €687 million. The low-risk regulated operating environment for its electricity and gas distribution network businesses and its high-quality assets support the company's excellent business risk. Our assessment also takes into consideration the good visibility over the regulatory period. However, the regulator's efficiency targets for the 2017-2021 regulatory period and the declining weighted-average cost of capital (WACC; real, pretax) to 3.0% from 4.0% put pressure on revenue growth.

Enexis' updated strategy announced in April this year will also support the company through the energy transition, in our view. The strategy's focus is on improving technology and increasing efficiency through a cost-savings program. Cost savings will augment expected synergies from the integration of the Endinet distribution system operators, which was the result of an asset swap in January 2016 with Dutch peer distribution network operator Alliander to better align the servicing areas for the respective operator and drive efficiencies.

In our base case, we assume that Enexis' credit metrics will support an intermediate financial risk profile, including funds from operations (FFO) to debt of about 22%-23% over the next two years. We benchmark the ratios against the low volatility table (see "Corporate Methodology," published Nov. 19, 2013), as Enexis derives the majority of operating cash flow from regulated activities and enjoys a strong regulatory advantage.

FFO to debt was 25.5% in 2016 and we expect it to decrease in 2017 toward 22.0%. This is a result of the constraints on revenue growth in the new regulatory period. These constraints will likely be partially offset by the reduction of the cost of debt, which is now about 0.5% below the regulator's target, mainly due to the refinancing of expensive shareholder loans. In 2016, Enexis refinanced €500 million of its tranche C shareholder loans, lowering the cost of debt to 0.9% from 4.7%. Out of the original shareholder loans, only the €350 million tranche D remains, with a 7.2% interest rate. There is however no early redemption on the loan maturing in 2019. We continue to expect elevated annual gross capital expenditures (capex) of about €620 million-€630 million as the roll-out of smart meters extends to 2020, and annual dividends of about €100 million. This, together with constrained revenue growth has led us to reassess Enexis' liquidity to adequate from strong, which we consider neutral for the overall rating, however.

In our base case, we assume:

- Modest revenue growth of 0%-3% over 2017-2019, constrained by a downward trending WACC to 3% from 4% and ambitious efficiency targets in the new regulatory period.
- Average EBITDA margin of 47%-48% in 2017-2019.
- Net capex of €550 million-€560 million annually until the completion of the roll-out of smart meters in 2020.
- Annual dividends of about €100 million, equivalent to the 50% payout policy of net income.
- An average cost of debt of less than 3% over the next two years

Based on these assumptions, we arrive at the following credit measures:

- Adjusted FFO to debt of 22.0%-23.0% over 2017-2019, down from 25.5% in

2016.
- Negative discretionary cash flow over 2017-2019.

Liquidity

We assess Enexis' liquidity as adequate, supported by our view that Enexis' liquidity sources will exceed its funding needs by over 1.1x in the next 12 months. Furthermore, Enexis has well-established and solid relationships with banks, generally high standing in the credit markets, and typically very prudent risk management, in addition to our view that it could withstand the stress of a 15% drop in EBITDA.

Principal liquidity sources on June 30, 2017, include:
- Unrestricted cash and short-term marketable securities of close to €32 million.
- Access to an undrawn €600 million committed credit facility expiring in June 2020, which we will reduce in our calculations to €545.45 million expiring in June 2021. Annual FFO of about €520 million.

Principal liquidity uses as of the same date include:
- Our estimate of €550 million in net fixed capex.
- Debt maturities of €100 million over next 12 months.
- Payment of €59.1 million for the municipality of Weert's gas and electricity grid in July 2017.
- Dividend payments of about €99 million.

Enexis currently has no financial covenants on its debt or committed RCF.

Outlook

The stable outlook reflects our expectation that Enexis will sustain S&P Global Ratings-adjusted FFO to debt of about 22%-23% in 2017-2019 as it continues to lower its cost of debt. This should mitigate the declining WACC used by the regulator to determine tariffs.

Downside scenario

We could lower the rating if we expected FFO to debt to decline and remain below 18%. In our view, this is unlikely, but could occur either through further distribution network consolidation or a debt-financed extraordinary dividend.

Upside scenario

We could raise the rating if we thought it likely that Enexis could sustain adjusted FFO to debt comfortably above 23% with no deterioration in business risk. This could result from an increase in return on capital allowed or a change in management's financial policy.

Ratings Score Snapshot

Corporate Credit Rating: A+/Stable/A-1

Business risk: Excellent
- Country risk: Very low
- Industry risk: Very low
- Competitive position: Excellent

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: a+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Issue Analysis

Subordination risk analysis

Capital Structure
- Enexis' capital structure consists of senior unsecured debt issued at the parent level.

Analytical Conclusions
- Enexis' debt is rated 'A+', the same as the corporate credit rating, as no significant elements of subordination risk are present in the capital structure.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013

- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Five Dutch Regulated And Unregulated Utilities No Longer Classified As Government-Related Entities; Ratings Affirmed, Sept. 27, 2017
- State of The Netherlands Ratings Affirmed At 'AAA/A-1+'; Outlook Stable, May 19, 2017
- Why Do We View The Dutch Electricity And Gas Networks Regulatory Framework As Supportive?, March 2, 2016

Ratings List

Ratings Affirmed

Enexis Holding N.V.	
Corporate Credit Rating	A+/Stable/A-1
Senior Unsecured	A+
Enexis B.V.	
Corporate Credit Rating	A+/Stable/--

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