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Credit Opinion: Enexis Holding N.V.

Global Credit Research - 11 Sep 2012

Rosmalen, Netherlands

Ratings

Category	**Moody's Rating**
Outlook	Stable
Issuer Rating -Dom Curr	Aa3
Senior Unsecured -Dom Curr	Aa3
Enexis B.V.	
Outlook	Stable
Issuer Rating -Dom Curr	Aa3

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Key Indicators

[1]**Enexis Holding N.V.**

	LTM 6/30/2012	**12/31/2011**	**12/31/2010**	**12/31/2009**
(FFO + Interest) / Interest Expense	**6.59x**	**6.66x**	**5.30x**	**8.15x**
Net Debt / Fixed Assets	**31.40%**	**31.12%**	**33.48%**	**37.27%**
FFO / Net Debt	**32.28%**	**33.17%**	**25.53%**	**33.14%**
RCF / CAPEX	**0.93x**	**1.11x**	**0.85x**	**1.44x**

[1] All ratios are calculated using Moody's Standard Adjustments. Source: Moody's Financial Metrics TM

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Corporate Profile

Enexis Holding N.V. (Enexis), a holding company of Enexis B.V., owns and manages the gas and electricity distribution networks in several Dutch regions. Enexis B.V. generates more than 90% of the group's revenue and represents 99% of group assets and liabilities. Enexis is one of the three largest electricity and gas network operators in the Netherlands responsible for the maintenance, management and development of the medium-voltage electricity and gas distribution grids. It operates around 133,000 km of electricity cable and 45,000 km of gas pipelines, delivering electricity to approximately 2.6 million customers and gas to 2.1 million customers. Enexis is fully owned by Dutch provinces and municipalities, with the largest owners being Noord Brabant (31%), Overijssel (19%), Limburg (16%), Groningen (6%) and Drenthe (2%). The remaining 26% share is owned by one other small province and approximately 120 municipalities where Enexis provides its network services.

Recent Developments

ACQUISITION OF NV RENDO POSTPONED

Although Enexis and N.V.RENDO (RENDO) have postponed the acquisition negotiations, Enexis is keen to resume the negotiations with RENDO later this year or at the beginning of next year. RENDO is the owner and operator of a gas and electricity distribution network in Drenthe and Overijssel comprising a total of approximately 103,000 gas connections and 32,000 electricity connections. Enexis expects the acquisition negotiations with RENDO to resume in 2013. We recognise that the RENDO acquisition could offer synergies as (1) Enexis is already responsible for the transportation of gas and electricity in the other areas in this region; and (2) the acquisition is in line with Enexis's strategy of becoming one of the leaders in the long-term development of the Dutch regional network sector. Given the relatively small size of RENDO and Enexis's solid financial position supported by its cash reserve, we believe that Enexis would be able to absorb the potential acquisition without its current rating position being materially threatened.

Rating Rationale

Given its 100% ownership by Dutch provinces and municipalities, Enexis falls within the scope of our rating methodology for government-related issuers (GRIs). In accordance with the methodology, Enexis's Aa3 rating incorporates a two-notch uplift to its standalone credit assessment, which we express as a baseline credit assessment (BCA) of a2.

Enexis's a2 BCA, representing the company's credit quality before taking into account any support from its owners, is characterised by the low risk of its domestic electricity and gas distribution operations, which generate more than 90% of its earnings and cash flows, supported by a well-defined, transparent and cost-efficient Dutch regulatory framework. The efficiency X and quality Q factors, applied to a Consumer Price Index (CPI)-adjusted revenue cap, are based on an industry average mechanism that encourages companies to improve profitability by outperforming the industry through enhanced efficiency and increased quality.

Rating Drivers

When assessing Enexis's BCA, we apply our Rating Methodology for Regulated Electric and Gas Networks, published in August 2009, which identifies key areas of focus for assessing the relative fundamental credit quality of regulated electric and gas network companies. The methodology focuses on the assessment of the regulatory environment, ownership model, operational performance, stability of business model and key credit metrics. Based on historical financial performance, the methodology grid indicates a BCA of a1 for Enexis, reflecting Enexis historically strengthened capital structure as a result of a EUR600 million shareholder and strong debt protection metrics. Any positive pressure on the BCA, narrowing the difference between the methodology grid outcome and the actual BCA of a2, would also depend on Enexis's ability and willingness to adjust its increasing investment and acquisition activity, in order not to constrain the company's financial performance in the medium term.

RATING FACTOR 1 - Regulatory Environment and Asset Ownership Model

Currently in its fifth regulatory period, the Dutch regulatory framework, applied since 2001, allows the country's electricity and gas distribution companies to earn a return on their regulated asset base, adjusted for CPI and an efficiency incentive X factor. The regulation incorporates incentives based on a "yardstick" mechanism, which defines the efficiency X and quality Q factors based on industry averages and encourages network companies to improve profitability by outperforming the sector through improved efficiency and increased quality. The solid score (Aa) for the "Stability and Predictability of Regulatory Regime" sub-factor reflects the consistent application of transparent regulatory methodologies by the Dutch regulator.

We view positively that the negative X-factor, set by the Dutch regulator for the fifth regulatory period (2011-13), allows a gradual increase in tariffs and positively affects the financial profile of the distribution network operators through strengthened cash flow generation, as already evidenced by Enexis's financial results in 2011. However, we have maintained Enexis's A score for the "Cost and Investment Recovery" sub-factor, as the mechanism of setting the X-factor has not changed and the fact that it is negative for 2011-13 reflects the regulator's recognition of the needs of network operators to cover their growing investment costs. Furthermore, our A score also reflects the fact that Enexis opted for only a marginal increase in its 2012 tariffs of 2.5%, despite having regulatory approval to increase these to a maximum of 6.2% . Although such a move could limit the extent to which Enexis is able to strengthen its financial profile in future, it reflects the company's strong strategic focus on providing its customers with cost-efficient and affordable electricity and gas distribution services.

The regulatory mechanism based on the revenue cap model and a gradual introduction of capacity-based payments reduces the exposure of network companies to volume volatility risk, thus resulting in Enexis scoring Aa

for the "Revenue Risk" sub-factor. We assign the same score to Enexis for the "Asset Ownership Model" sub-factor, given the company's full ownership of the network assets under a licence.

RATING FACTOR 2 - Efficiency and Execution Risk

Enexis's overall score for Factor 2 is supported by the high technical operating performance of Dutch networks, which is generally solid compared with European peers. Enexis's low average annual outage time reflects the extremely high reliability of the company's network assets. The Baa score reflects Enexis's strong focus on cost efficiency and performance in line with regulatory benchmarks. To improve its score under the "Cost Efficiency" sub-factor, Enexis would need to build a strong track record of outperforming the regulator's benchmarks across regulatory periods. Given its annual investment plan, which stood at EUR445 million in 2011 and is expected to remain at this level in the medium term, Enexis scores Baa under the "Scale and Complexity of Capital Programme" sub-factor.

RATING FACTOR 3 - Stability of Business Model and Financial Structure

With the exception of the public lighting and traffic management services, which have been separated into a joint venture with neighbouring distribution company Alliander (Aa3 stable) and do not exceed 10% of Enexis's revenues, the company strategically focuses on its core business of regulated activities based on its distribution network assets, resulting in a solid A score for the "Targeted Proportion of Profit outside Core Regulated Activities" sub-factor. Enexis's A score for the "Ability and Willingness to Pursue Opportunistic Corporate Activity" sub-factor might weaken over the time, as the company plans to play an active role in the long-term strategy to consolidate the Dutch distribution network sector. This is evidenced by the company's executed acquisition of Intergas and negotiated acquisition of RENDO. Although the scope, timing and funding of Enexis's potential future acquisitions within the envisaged consolidation is not certain, the Baa score for the "Ability and Willingness to increase Leverage" sub-factor incorporates our expectation that the company would need to increase its leverage to finance such acquisitions.

RATING FACTOR 4 - Key Credit Metrics

Enexis's strengthened financial performance in 2011 was supported mainly by (1) higher tariffs, made possible by the negative X-factor set by the regulator for the 2011-13 regulatory period; (2) the successful integration of Intergas, which brought positive synergies; and (3) Enexis's ongoing cost management efforts, which prevented increases in its operating costs despite its growing asset base. Enexis's debt coverage metrics remain safely within the company's financial policy targets and our ratio guidance for the current BCA category (funds from operations (FFO)/interest coverage ratio above 4.0x and a FFO/net debt ratio above 20%). Although the negative X-factor permits a maximum annual increase in tariffs of 6.2%, we expect Enexis's performance and financial profile to remain stable, as the company has decided not to utilise the full regulatory allowance and has instead raised its tariffs by only 2.5% for 2012. Furthermore, we caution that the positive impact of higher tariffs on Enexis is dependent on the company's continuing successful execution of its cost efficiency measures and might be constrained by a need to finance potential future acquisitions of smaller network operators, as envisaged within the overall strategy for consolidation of the Dutch distribution network segment. Together with restricting the increase in its tariffs, the need to fund its growing investment programme could limit the extent to which Enexis is able to strengthen its financial profile in future, especially if installation of smart meters is expedited compared with the company's expectations.

OTHER GRI FACTORS

Following unbundling, Enexis retained the same shareholding structure, i.e., 100% ownership by a number of Dutch regional and local governments, with public ownership of the networks required by the current legislation. Therefore, in assessing Enexis we apply our GRI methodology. Our assumption of strong systemic support in the event of need reflects Enexis's strategic importance as a pure network company, and the high reputation risk to its owners. Although ownership of Enexis is relatively fragmented among approximately 125 provinces and municipalities, we perceive the shareholders to be capable and willing to act in conjunction with one another. In determining the probability of systemic support as "strong", we have also taken into account the 72% ownership share of the four largest provinces and their historically proven ability to reach consensus in event of need. Furthermore, in our view, the legal and political mechanisms established in the Netherlands, including the legal requirement for public ownership of distribution network assets, increase the probability of systemic support being provided to a strategically important network operator in the event of extraordinary need.

Our assessment that there is a "very high" level of dependence (i.e., degree of exposure to common drivers of credit quality) between Enexis and the Government of Netherlands reflects our expectation that Enexis, like its

owners, will continue to derive almost all of its revenues from domestic sources.

Liquidity Profile

Enexis's excellent liquidity position is supported by strong cash flow generation and solid cash reserves that are sufficient to cover the planned investments and return to shareholders (dividend payout ratio agreed at 50% of net income). The company's liquidity position is further supported by a EUR450 million back-up overdraft facility maturing in 2015 and a comfortable repayment profile of the shareholder loan, with the next EUR500 million tranche due in 2015. Furthermore, in the beginning of 2012, the company successfully issued its first bond (EUR300 million due in 2022) under a newly set-up euro medium-term note (EMTN) programme, which enabled it to refinance the first tranche of the shareholder loan well ahead of its maturity and further extended the company's overall debt maturity profile. As a result of its prudent financial strategy, Enexis's liquidity position and capital structure strengthened over the past several years, providing comfortable headroom under both the regulatory minimum ratio requirements and financial covenants included in the company's back-up overdraft facility.

CROSS-BORDER LEASE AGREEMENTS

Enexis has successfully managed to terminate all of its cross-border lease agreements (CBLs). These were signed on network assets by Enexis's predecessor and represented significant financial exposure in the event of early termination. The company's exposure to CBLs is currently limited to that taken over as part of the acquisition of Intergas and is at an immaterial level in relation to Enexis's size.

Structural Considerations

The shareholder loan, provided to Enexis Holding through a special-purpose vehicle (SPV), Vordering op Enexis B.V, which is fully owned by Enexis's shareholders, was on-lent to the operating company (Enexis B.V.) via an inter-company loan under essentially the same terms as the shareholder loan. We understand that the bond issuances, aimed at refinancing the shareholder loan upon the maturity of its tranches, are positioned at the Enexis Holding level, with the proceeds on-lent to the operating company via a back-to-back intercompany loan of the same amount and with the same conditions and maturity as the bond issuance. We also note that Enexis's committed revolving overdraft facility is also at the Enexis Holding level. On the basis of these funding policies, we currently regard the risk of structural subordination for lenders at the holding level as low. Furthermore, the last tranche of the shareholder loan, payable in 2019, could be converted into equity in case of adverse development Enexis's financial profile, which we perceive as a material credit positive.

Rating Outlook

The stable outlook reflects our expectation that Enexis will remain a pure electricity and gas distribution network operator that derives most of its revenues and cash flow from regulated activities. Furthermore, we would expect Enexis to continue to follow its conservative financial policy, building on the successful developments of the unbundling process.

The outlook on Enexis's ratings remains stable despite our decision to change the outlook on the rating of the Government of Netherlands to negative from stable, as announced on 23 July 2012. This reflects our view that even a significant downgrade in the rating of the Government of the Netherlands would not cause an adjustment to the uplift for potential extraordinary support incorporated into Enexis's ratings. This reflects our assumption of "strong" systemic support from the government in the event that this was required.

What Could Change the Rating - Up

We could upgrade the rating if Enexis's (FFO)/interest coverage ratio increased sustainably above 4.0x and its FFO/net debt ratio sustainably above 20%, Although the negative X-factor enables Enexis's tariffs and revenues to gradually grow over the current regulatory period, we note that in order to exceed the credit metrics set out above, Enexis would also need to manage its growing investment programme, thereby sustainably strengthening its financial profile. Furthermore, any positive pressure on Enexis's BCA and rating in the future could be constrained by potential acquisitions of other smaller distribution networks, as these could require external funding and therefore result in increased leverage.

What Could Change the Rating - Down

For Enexis to remain safely positioned within its current BCA of a2, we would expect the company to exhibit on a sustainable basis the following minimum credit metrics: an FFO/interest coverage ratio at or above 3.5x and an

FFO/net debt ratio above 15%. If the company's debt protection metrics decline substantially below these levels, mainly due to an increase in indebtedness above the forecast levels and/or weakening of cash flow generation, the BCA and rating could come under downward pressure.

Rating Factors

Enexis Holding N.V.

Regulated Electric and Gas Networks [1][2]	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B**
Factor 1: Regulatory Environment & Asset Ownership Model (40%)						
a) Stability and Predictability of Regulatory Regime		X				
b) Asset Ownership Model		X				
c) Cost and Investment Recovery			X			
d) Revenue Risk		X				
Factor 2: Efficiency & Execution Risk (10%)						
a) Cost Efficiency				X		
b) Scale and Complexity of Capital Programme				X		
Factor 3: Stability of Business Model & Financial Structure (10%)						
a) Ability and Willingness to Pursue Opportunistic Corporate Activity			X			
b) Ability and Willingness to Increase Leverage				X		
c) Targeted Proportion of Operating Profit Outside Core Regulated Activities			X			
Factor 4: Key Credit Metrics (40%)						
b) (FFO + Interest) / Interest Expense (3-Year Average)		6.20x				
d) Net Debt / Fixed Assets (3 Year Avg)		32.89%				
e) FFO / Net Debt (3 Year Avg)	30.46%					
f) RCF / CAPEX (3 Year Avg)					0.98x	
Rating:						
a) Indicated BCA from Grid factors 1-4			a1			
d) Actual BCA Assigned			a2			

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment	a2
b) Government Local Currency Rating	Aaa/NEG
c) Default Dependence	Very High
d) Support	Strong

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 6/30/2012. Source: Moody's Financial Metrics

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