Research Update:

Dutch Energy Network Enexis Outlook Revised To Stable On Fudura Sale, Expected State Support; Affirmed At 'A+/A-1'

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Rating Action Overview

- On Aug. 4, 2022, the European Commission approved the Dutch energy distribution network operator Enexis Holding's disposal of its unregulated energy services subsidiary Fudura for €1.3 billion with closing expected in third-quarter 2022.
- Proceeds from the sale will support 2022 credit metrics and partially mitigate short-term pressure caused by higher energy costs and accelerated capital expenditure (capex).
- Moreover, the Dutch government has publicly announced its willingness to financially support network operators with their investment plans by year-end 2023.
- We therefore revised our outlook on Enexis to stable from negative and affirmed our 'A+' long-term and 'A-1' short-term issuer credit ratings.
- The stable outlook captures our view that funds from operations (FFO) to debt will likely stay above 18% on average over 2022-2024 thanks to the Fudura sale, despite a dip in the ratio in 2023 owing to higher energy prices, and that we expect financial support from the state to be implemented within the next 24 months.

Rating Action Rationale

Fudura sale proceeds will help relieve short-term pressure on Enexis' credit metrics with FFO to debt on average above 18% over 2022-2024. As part of the first-half 2022 results, Enexis announced it will receive €1.3 billion from the sale of the 100% stake of its energy services business Fudura, valued at €1.3 billion, to a consortium of DIF Capital Partners and not-for-profit cooperative pension fund PGGM by year-end 2022. We view this sale as a positive for Enexis' credit risk, both from a business and financial perspective, because we consider Fudura as noncore to Enexis' electricity and gas network operations and these nonregulated activities were seen as riskier than the regulated part of the business (90% of EBITDA before the Fudura sale). With an EBITDA of about €40 million, the sale price of Fudura was higher than we expected, and we expect most of the proceeds will be kept to fund Enexis' general corporate expenses and investments, in line with its shareholders' track record of supportive financial policy. The sale was decided as an exceptional remedy measures to support Enexis' credit metrics, which are being negatively impacted by downward remuneration throughout the new 2022-2026 regulatory period and gradual increase in investment to upgrade the Dutch network to meet the country's energy transition targets.

We now expect FFO to debt to be about 30% in 2022, versus 18% in our previous forecast. Average S&P Global Ratings-adjusted FFO to debt will be close to 20% in 2022-2024, above our trigger of 18% for the current rating level, as opposed to 16% in our previous forecast. Even if the group's stated financial policy of maintaining FFO to debt above 16% is too loose for the current rating level at 'A+', we recognize the sale demonstrates a supportive financial policy. In addition, we believe Enexis has a flexible dividend policy and could resort to various protective balance sheet measures, such as hybrid issuance. We note that the group's remaining hybrid capacity stands at about €700 million as of year-end 2021.

We now see financial support from the Dutch government as increasingly needed for the network operators and likely to happen by 2024, greatly supporting credit metrics and our 'A+' rating on Enexis. We consider the Dutch government's likelihood to render timely financial support as a cornerstone of the current rating on Enexis in the absence of further remedy measures by its shareholders. The energy transition is of crucial importance to the sovereign, and the government's participation in funding Enexis' capex plan is needed and likely to happen by 2024. We view positively the Dutch government's publicly stated willingness to participate in funding Dutch grid companies' investment plans, including Enexis', and we now expect financial support to arise before 2024, given a decision should be taken in the first half of 2023 (see "Dutch Government's Willingness To Support Is Mildly Credit Positive For Energy Distributors", published July 25, 2022, on RatingsDirect). Discussions are ongoing and while we understand such financial support would take the form of a capital contribution, uncertainties remain over the size and timing of such support. We will closely monitor the decision-making process on potential state support and the type of instruments used over the next 12 to 24 months.

We expect a sharp deterioration of free cash flow generation in 2023, due to the spike in energy costs. Higher energy costs will impact Enexis' profit margins, mainly in 2023, because we reflect updated assumptions in gas and electricity market prices to which Enexis has long exposure to cover its network losses. The company has a prudent hedging policy in place, and we expect 2022 network losses to be relatively immune to market price volatility given that 100% of expected volumes have been hedged, as shown in the first-half 2022 results. However, only 60% of budgeted network losses are hedged in 2023, and we forecast a sharp deterioration in S&P Global Ratings-adjusted EBITDA to approximately €420 million-€450 million, from €600 million-€630 million in our previous forecasts that reflected those higher costs. This would translate into negative free cash flows after capex and dividends of €690 million in 2023. We expect that Enexis will recover those exceptional costs through the next regulatory period starting 2027. Discussions are ongoing with the Dutch regulator, the Authority for Consumers and Markets (ACM), to anticipate recovery of these costs in the current regulatory period so that the operators don't bear the mismatch between remuneration and costs. However, uncertainties remain over the final decision and timing. Our current forecast does not incorporate any upside from extra remuneration of commodity prices in the current regulatory period.

Increasing investment needs to support the Dutch energy transition will deepen the large negative free cash flows after capex over 2022-2024. 2022 is the first year of the new Dutch regulatory period that will usher in lower returns, coupled with incremental capex, resulting in substantially negative free cash flow. Investments has risen by about €150 million-€180 million over our previous forecast because Enexis' investment needs for the upgrade of its network increased with cost inflation and accelerated development of renewable energy sources and their integration within the grid. We now forecast approximately €1 billion capex annually from 2023. The need for additional infrastructure amid the energy transition in the Netherlands raises Enexis' financing needs to an estimated €800 million-€900 million of annual capex needs until 2030, notably to expand the electricity grid capacity by about 1 gigawatt every year from 2022. We assume that electricity grid investment will increase over the next two to three years, reflecting the acceleration in infrastructure deployment to facilitate the energy transition. Over 2022-2024, we expect continuous high capex (average annual €900 million) and sustained dividends (yearly average of €85 million-€90 million) to result in yearly average negative discretionary cash flows of €300 million-€400 million over the period.

The 2022-2026 regulatory period shows a significant decline on the real pre-tax weighted-average cost of capital (WACC) to 1% by the end of the regulatory period, from 1.3% in 2022 for power and gas distribution. This is partially mitigated by the new regulatory WACC for electricity being calculated as real WACC plus 50% of inflation expectations, declining to 1.86% from 2.04% currently. Moreover, over the 2022-2026 period, the regulatory return for the gas grid will be based on a nominal WACC, which will decline to 2.2% from 3.0% currently. Because the return on investment for a distribution system operator (DSO) is a function of its regulatory asset base growth and of its WACC, the downward revision is causing a steady decline in expected earnings. Enexis, along with the Dutch DSOs, already faced the regulatory WACC declining to 2.8% in 2021 from 4.5% in 2016. This drop, coupled with increasing capex needs to adapt the grid to new decentralized renewable power capacity, will put significant pressure on Enexis' credit metrics.

Outlook

The stable outlook on Enexis reflects our expectation that the company will post average FFO to debt levels at 20% on 2022-2024, despite a dip to 16% in 2023 because of high energy prices. Although Enexis has incremental debt needs due to an intensive capex program as part of the Dutch government's energy transition plan, we expect financial support from the government to be implemented in the next 24 months that will help the company to maintain some financial headroom above the 18% threshold for the current rating. We expect that the effects of higher energy costs will be manageable for Enexis in the long term, thanks to the hedging in place and cost recovery throughout the regulatory framework.

Downside scenario

We would downgrade Enexis if the company's FFO to debt were to decline and remain below 18%. It could stem from:

- Less willingness from the Dutch government to support the company;
- Any material delay in support implementation and without any additional remedy measure from Enexis' shareholders; or

- A higher-than-expected increase in debt and shareholder distributions or decrease in operating margins resulting from higher-than-expected price volatility.

Upside scenario

Given the substantial investment needs in the coming decade to support the energy transition in the Netherlands, we see rating upside as remote. We could raise the rating if we thought 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.

Company Description

Enexis engages in the installation, maintenance, operation, and development of distribution grids for electricity and gas in the Netherlands. Through its main subsidiary, Enexis Netbeheer B.V., the company's electricity grid covers 144,200 kilometers (km) with 2.9 million connection points, while its gas grid covers 46,200 km with 2.3 million connection points, making it the second-largest Dutch DSO, only behind Alliander. Through its network, the company provides electricity and gas in the Dutch provinces of Groningen, Drenthe, Overijssel, Noord-Brabant, and Limburg. After the Fudura sale, less than 5% of Enexis' revenue is derived from other utility services. These nonregulated businesses are complementary to the core activities.

Enexis is owned by the Provinces of Noord-Brabant (30.8%), Overijssel (19.7%), Limburg (16.1%), and Groningen and Drenthe (9%), and the rest is owned by other 88 smaller municipalities.

Our Base-Case Scenario

Assumptions

- Real GDP growth in the Netherlands of 3.2% in 2022, 2.1% in 2023, and about 1.8%-2.0% over 2024-2025. We expect limited impact of the GDP decline over Enexis' activities, due to its regulated nature.
- Over the 2022-2026 regulatory period, nominal pre-tax WACC for the gas grid declining to 2.8% from 3% and inflation-adjusted pretax real WACC for electricity grid (tariff based on 50% nominal WACC and 50% real WACC) declining to 1.86% from 2.04% currently.
- We forecast tariff increase and revenue growth of around 6% in 2022 and in 2023, mainly due to corrections in inflation, efficiency target, transportation costs, and sufferance taxes that result in electricity and gas tariff increases. We do not incorporate any upside from extra remuneration of commodity prices in the current regulatory period.
- The rise in energy prices for grid losses completely hedged for 2022 and only 60% hedged thereafter with a material impact on 2023 EBITDA level.
- We expect Enexis' net capex to average €850 million per year in 2022-2024. This compares with an average of €600 million per year over 2015-2021.
- Increased investments should lead to a higher regulatory asset base over the 2022-2026 regulatory period, partially mitigating WACC-related pressure.

- Lower headroom to overperform regulated cost of debt as the allowed cost of debt continues to decline.
- A dividend payout ratio of 50% on an annual basis and contained exceptional dividends following the Fudura sale.
- No financial support from the Dutch government and no additional remedy measures from Enexis shareholders. We acknowledge that the Dutch government has expressed a willingness to provide support, but the amount and timing are currently uncertain.

Key metrics

Enexis Holding N.V.--Key Metrics*

	--Fiscal year ended Dec. 31--				
(Mil. €)	2020a	2021a	2022e	2023f	2024f
EBITDA	622	732	660-700	430-470	600-630
Net capital expenditure	738	763	800-820	880-920	880-920
Free operating cash flow	(127)	(154)	(100)-(200)	(350)-(450)	(250)-(350)
Dividends	106	80	100-150	200-300	0-100
Discretionary cash flow	(233)	(229)	(200)-(300)	(600)-(700)	(300)-(400)
Debt§	2,684	3,036	2,000-2,300	2,600-3,000	3,000-3,300
Debt to EBITDA (x)	4.3	4.1	2.8-3.2	6.0-6.5	4.9-5.1
FFO to debt (%)	20.3	20.7	28.0-31.0	14.0-17.0	16.0-19.0

*All figures adjusted by S&P Global Ratings. §2021 year-end debt consists of net financial debt of €3.3 bil. with key adjustments being €250 mil. of Shareholder loan debt content and €5 mil. in guarantees . a--Actual. e--Estimate. f--Forecast.

Liquidity

We continue to assess Enexis' liquidity as adequate, based on our expectation that the company's sources will exceed its uses by more than 1.1x over the 12 months started June 30, 2022, despite increasing capex needs and debt maturities of €375 million, mainly of commercial papers. We also believe that the company could withstand a 10% drop in EBITDA. In addition, we believe that Enexis will absorb cash flow mismatches from higher energy costs, transportation fees, and any delayed capex realization.

Our assessment captures qualitative factors such as Enexis' prudent risk management, reflected in the refinancing of its maturities well in advance, and its diverse sources of funding. We also believe that Enexis has a high standing in the credit markets. For instance, in April 2021, the company achieved its lowest ever coupon at 0.375%, and longest tenor in 12 years in the issuance of its €500 million bond.

Principal liquidity sources for the 12 months started June 30, 2022:

- Unrestricted cash and short-term marketable securities of €20 million as of June 30, 2022.
- Access to an undrawn committed revolving credit facility of €850 million, €164 million maturing December 2024, and €686 million maturing December 2025.

- Projected cash FFO of €530 million.
- €1.3 billion proceeds from the disposal of Fudura.

Principal liquidity uses over the same 12-month period:

- Debt maturities of about €370 million over the next 12 months and €500 million over the following 24 months.
- Capex of about €850 million.
- Dividend distributions of about €280 million, including a special dividend following proceeds received from the Fudura sale.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of Dec. 31, 2021, Enexis reported total interest bearing liabilities of €3.3 billion, of which €2.5 billion corresponded to euro medium-term notes and €500 million to a convertible shareholder loan. The remainder comprised short-term debt, lease liabilities, and debt issued under the company's euro commercial paper program.

Analytical conclusions

We rate Enexis' debt at the same level as the issuer credit rating, at 'A+', reflecting our view that subsidiary debt does not represent a subordination risk that could result in credit disadvantages to bondholders.

Ratings Score Snapshot

Issuer 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 (low volatility table)

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 rating analysis: Neutral (no impact)

ESG Credit Indicators: E-2 S-2 G-2

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- 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
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, 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

Related Research

- Dutch Government's Willingness To Support Is Mildly Credit Positive For Energy Distributors, July 25, 2022
- Enexis Holding Affirmed At 'A+/A-1' On Regulatory Decision; Outlook Negative On Constrained Metrics, Dec. 13, 2021

Ratings List

Ratings Affirmed		
Enexis Holding N.V.		
Senior Unsecured	A+	
Ratings Affirmed; CreditWatch/Outlook Action		
	To	**From**
Enexis Holding N.V.		
Issuer Credit Rating	A+/Stable/A-1	A+/Negative/A-1
Enexis Netbeheer B.V.		
Issuer Credit Rating	A+/Stable/--	A+/Negative/--