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Research Update:

Dutch Electricity And Gas Utility Enexis Downgraded To 'A+'; Outlook Stable

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Overview

- In our view Dutch electricity and gas distribution network operator Enexis Holding N.V. will need to finance material investments to safeguard the future reliability of the power and gas distribution grids over 2015-2018.
- We believe that Enexis' Standard & Poor's-adjusted credit metrics will deteriorate beyond a "modest" financial risk profile.
- We are therefore lowering our long-term rating on Enexis to 'A+' from 'AA-'.
- The stable outlook reflects our opinion that Enexis will be able to sustain adjusted funds from operations (FFO) to debt in the 20%-23% range over the coming two years.

Rating Action

On Oct. 6, 2014, Standard & Poor's Ratings Services lowered its long-term corporate credit ratings on Dutch electricity and gas distribution network operator Enexis Holding N.V. and its subsidiary Enexis B.V. (jointly Enexis) to 'A+' from 'AA-'. At the same time, we lowered the ratings on Enexis' unsecured debt to 'A+' from 'AA-'. The outlook is stable.

Rationale

The rating action reflects our view that Enexis' Standard & Poor's-adjusted ratio of funds from operations (FFO) to debt will fall below our previous expectation of 25% on a sustainable basis by the end of the current regulatory period in 2016. In our view, this will occur because of the combined effect of material investments necessary to upgrade and maintain the security and the reliability of the power and gas distribution grids in Enexis' service area together with the final determination of the Dutch regulator ACM (Authority for Consumers and Market), which has lowered Enexis' return on capital .

For this reason, we have revised our view of Enexis' financial risk profile to "intermediate" from "modest," which we believe is commensurate with the credit metrics that Enexis will be able to sustain in the future. We now expect Enexis to be able to post adjusted FFO to debt of above 20% on a sustainable basis from 2016.

At the same time, we have removed our negative comparable rating analysis modifier, as we believe that Enexis' credit metrics will be solidly positioned in the "intermediate" financial risk category.

Enexis has a natural monopoly in its license areas, low-risk regulated electricity and gas distribution network businesses, and high-quality network assets. All of these factors feed into our "excellent" business risk profile assessment. The assessment also factors in good visibility on the regulatory framework within the three-year period. Nevertheless, we believe that regulatory tariff reset risk is significant for the Dutch distribution network operator, as demonstrated by the final determination of the ACM. The ACM set relatively ambitious efficiency targets for the 2014-2016 period, but at the same time lowered the weighted average cost of capital (real pre-tax) to 3.6% from 6.2%, which we believe is among the lowest in Europe. In our base-case scenario, we expect Enexis' profitability, which we mainly measure using return on capital, to decline to below 6% from 2016, from an average 8% in 2012-2013.

In our base case, we assume:

- Flat revenues over 2014-2016;
- Average EBITDA margin of 51% over 2014-2016;
- Cumulative capital expenditure exceeding €1.7 billion over 2014-2016;
- Cumulative dividends of approximately €350 million over 2014-2016, equivalent to a 50% payout; and
- Average cost of debt at 4%.

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

- Adjusted FFO to debt falling below our prior expectation of 25% by 2016, the end of the current regulatory period; and
- Negative discretionary cash flow over 2014-2016.

The 'A+' rating on Enexis is based on the company's stand-alone credit profile, which we assess at 'a+', and on our opinion that there is a "moderate" likelihood that Enexis' owners would provide timely and sufficient extraordinary support in the event of financial distress. In accordance with our criteria for government-related entities, our view of a "moderate" likelihood of extraordinary support is based on our assessment of Enexis':

- "Important" role, given Enexis' strategic importance to its province and municipality owners as the monopoly provider of gas and electricity distribution services in its license areas; and
- "Limited" link to its owners, given the dispersed ownership structure. Enexis' owners are the provinces of Noord Brabant (31%), Overijssel (19%), Limburg (16%), Groningen (6%), and Drenthe (2%), as well as other provinces and 116 municipalities in the region.

Liquidity

We assess Enexis' liquidity as "strong" as defined in our criteria, supported by our view that Enexis' liquidity sources will exceed its funding needs by over 1.5x 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.

We estimate that Enexis' liquidity sources over the next 12 months will exceed €1.3 billion, as of June, 2014, including:
- Unrestricted cash and short-term marketable securities of close to €106 million;
- Access to an undrawn €600 million committed credit facility expiring in June 2019. and
- Annual FFO of about €560 million-€570 million.

For the same period, we estimate that liquidity uses will be €600 million, including:
- Almost no short-term maturities,
- Capital expenditures averaging €500 million, and
- Annual dividend payments of about €120 million.

Outlook

The stable outlook reflects our opinion that Enexis will be able to sustain adjusted FFO to debt of above 20% in 2015-2018. We expect Enexis' business risk profile to remain stable, despite the tough 2014-2016 regulatory review that we expect to weigh on the company's profitability.

Downside scenario

We could lower the ratings if we believed that the company's FFO to debt would decline even further and remain below 18%, a level we would no longer consider commensurate with an "intermediate" financial risk profile. In our view, this could occur either through further sector consolidation in the Netherlands or through an extraordinary dividend distribution.

Upside scenario

Given the regulated tariffs through 2016 and the company's capital expenditure program and dividend policy, we believe that rating upside is limited. With this in mind, we could raise the ratings if we deemed it likely that Enexis would be able to sustain adjusted FFO to debt of about 25%, all else remaining equal. However, we consider this scenario unlikely.

Ratings Score Snapshot

Corporate Credit Rating: A+/Stable/--

Business risk: Excellent
- Country risk: Low Risk
- Industry risk: Very Low Risk
- Competitive position: Excellent

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: a+

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

Stand-alone credit profile: a+
- Sovereign rating: AA+/Stable/A-1+
- Likelihood of government support: Moderate

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded

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

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