MOODY'S
INVESTORS SERVICE

# Credit Opinion: Enexis Holding N.V.

Global Credit Research - 22 Sep 2011

*Rosmalen, Netherlands*

## Ratings

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

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## Key Indicators

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

| | 6/30/2011 | 12/31/2010 | 12/31/2009 |
|---|---|---|---|
| (FFO + Interest) / Interest Expense | **6.9x** | **6.2x** | **7.9x** |
| Net Debt / Fixed Assets | **31.2%** | **32.3%** | **36.2%** |
| FFO / Net Debt | **34.4%** | **32.3%** | **35.0%** |
| RCF / CAPEX | **1.2x** | **1.1x** | **1.5x** |

[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) is a holding company of Enexis B.V. that 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 130,000 km of electricity cable and 40,000 km of gas pipelines, delivering electricity to approximately 2.6 million customers and gas to 2 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 1 other small province and approximately 120 municipalities where Enexis provides its network services.

### Recent Developments

ACQUISITION OF INTERGAS ENERGIE BV

On May 31 2011 Enexis bought Intergas Energie BV (Intergas), a gas distribution network owner and operator in the region of 21 municipalities at the western part of the Noord - Brabant province, for an approximate acquisition price of EUR190 million. Intergas distributes gas to approximately 2% of the market in the Netherlands, which represents approximately 150,000 connections and a total annual turnover of around EUR30 million.

Given that Enexis's financial position is supported by its cash reserve, we perceive it as strong enough for the company to absorb the acquisition price of Intergas without its current rating position being materially threatened. We recognise that the Intergas acquisition offers synergies as Enexis already owns and operates the electricity distribution network on Intergas's territory and is in line with Enexis's strategy of becoming one of the leaders in the long-term development of the Dutch regional network sector.

### Rating Rationale

Given its 100% ownership by Dutch provinces and municipalities, Enexis falls within the scope of Moody's rating methodology for government-related issuers (GRIs). In accordance with the methodology, Enexis's Aa3 rating incorporates two-notch uplift to its stand-alone credit assessment, which is expressed by Moody's as a BCA of 6 (on a scale of 1 to 21, where 1 represents the lowest risk and 6 is equivalent to an A2 rating).

Enexis's Baseline Credit Assessment (BCA) of 6, 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 Prices 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, Moody's applies its 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 5 for Enexis, reflecting Enexis historically strengthened capital structure by shareholder loans provided during the unbundling process and strong debt protection metrics. Any positive pressure on Enexis's BCA, narrowing the difference between the methodology grid outcome and the actual BCA of 6 would also depend on the company's ability and willingness to adjust the increasing investments and acquisition activity, in order not to constrain Enexis'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 consumer price index (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 of tariffs and positively impacts the financial profile of the distribution network operators through strengthened cash flow generation, as already evidenced by Enexis's financial results for the first half of 2011. However, we keep the score for the "Cost and Investment Recovery" sub-factor at A, as the mechanism of setting the X-factor has not changed and the negative X-factor rather reflects the regulator's recognition of network operators' needs to cover growing investment costs.

The regulatory mechanism based on the revenue cap model and a gradual introduction of capacity-based payments reduces 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. The low average annual outage time reflects the extremely high reliability of Enexis's network assets. The Baa score, assigned to Enexis for the "Cost Efficiency" sub-factor, has been historically constrained by the relatively higher X-factor compared with the other main Dutch distribution network operators. We might consider improving the score under this sub-factor in the future as Enexis continues to invest significantly in maintenance and upgrade of its network asset base and continues consistently executing efficiency measures. Enexis's annual investment plan, which is expected to gradually increase from its current level of EUR 300 million over the next five years, results in Baa score 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 (rated 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 for consolidation of the Dutch distribution network sector as evidenced by the recent acquisition of Intergas. 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 Moody's expectation that the company would need to increase its leverage to finance such acquisitions.

RATING FACTOR 4 - Key credit metrics

Although Enexis's 2010 financial performance resulted in a slightly weaker financial profile, it'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 4x and a FFO/net debt ratio above 20%). Furthermore, we expect Enexis financial profile to strengthen over the next three years as the negative X-factor, set by the Dutch regulator for the current regulatory period, enables a gradual increase of tariffs resulting in growing revenues and strengthening cash flow generation as already evidenced by strengthened 2011 half-year results. However, we point out that the positive impact is conditioned by the continuing successful execution of the 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. Furthermore, the need to fund the growing invest programme might restrict the future strengthening of Enexis's financial profile especially if the smart metering project gets expedited compared to 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, Enexis is considered a GRI under our methodology. Our assumption of strong systemic support reflects Enexis's strategic importance as a pure network company, and the high reputation risk to its owners. Although the ownership 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 case of need. Furthermore, in our view, the legal and political mechanisms established in 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 case of extraordinary need.

Our assessment of a very high level of dependence (i.e. degree of exposure to common drivers of credit quality) reflects our expectation that almost all of Enexis's revenues will continue to be derived from domestic sources, similarly to those of its owners.

**Liquidity Profile**

As a result of prudent financial strategy the company's liquidity position and capital structure strengthened providing comfortable headroom under both the regulatory minimum ratio requirements and financial covenants included in the company's EUR 450 million back-up overdraft facility. The comfortable maturity profile on the shareholder loan, solid headroom under the overdraft facility and reasonable dividend policy that has been agreed at 50% further support Enexis's solid liquidity position.

CROSS-BORDER LEASE AGREEMENTS

Enexis successfully managed to terminate all of its CBLs. These were signed on network assets by Enexis's predecessor and represented significant financial exposure in the event of early termination. Enexis's exposure to CBLs is currently limited to the CBL taken over within the acquisition of Intergas and is at an immaterial level in relation to the company'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 future bond issuances, aimed at refinancing the shareholder loan at maturity of its tranches, are planned at the Enexis Holding level with the proceeds to be on-lent to the operating company via a back-to-back intercompany loan in the same amount and with the same conditions and maturity as the bond issuance. We also note that Enexis's committed revolving overdraft facility, originally provided directly to the operating company (Enexis B.V.), has been transferred to the Enexis Holding level. On the basis of these funding policies and actions, we currently regard the risk of structural subordination for lenders at the holding level as low.

**Rating Outlook**

The stable outlook reflects Moody's 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 expect Enexis to continue to follow its conservative financial policy, building on the successful developments of the unbundling process.

**What Could Change the Rating - Up**

The rating could be upgraded if (FFO)/interest coverage ratio is likely to be sustainably above 4x and the 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 point out that in order to exceed the credit metrics set out above, Enexis would also need to manage its growing investment programme to allow sustainable strengthening of its financial profile. Furthermore, the future positive pressure on Enexis's BCA and rating might be constrained by potential future acquisitions of other smaller distribution networks that might require external funding and increased leverage level.

**What Could Change the Rating - Down**

To remain safely positioned within its current BCA of 6, Moody's expects Enexis 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 might 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) | | | 4.9x | | | |
| d) Net Debt / Fixed Assets (3 Year Avg) | | 41.7% | | | | |
| e) FFO / Net Debt (3 Year Avg) | | 25.0% | | | | |
| f) RCF / CAPEX (3 Year Avg) | | | | 1.2x | | |
| **Rating:** | | | | | | |
| a) Indicated BCA from Grid factors 1-4 | | | A1 | | | |
| d) Actual BCA Assigned | | | A2 | | | |

| Government-Related Issuer | Factor |
|---|---|
| a) Baseline Credit Assessment | 6 |
| b) Government Local Currency Rating | Aaa |
| c) Default Dependence | Very High |
| d) Support | Strong |

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2010. Source: Moody's Financial Metrics