Research Update:

Enexis Holding Affirmed At 'A+/A-1' On Regulatory Decision; Outlook Negative On Constrained Metrics

December 13, 2021

(***Editor's Note:*** *In the original version of this article, published Dec. 13, 2021, we misstated the WACC. A corrected version follows.)*

PRIMARY CREDIT ANALYST

Pauline Pasquier
Paris
+ 33 14 420 6771
pauline.pasquier@spglobal.com

SECONDARY CONTACTS

Claire Mauduit-Le Clercq
Paris
+ 33 14 420 7201
claire.mauduit@spglobal.com

Gerardo Leal
Frankfurt
+ 49 69 33 999 191
gerardo.leal@spglobal.com

ADDITIONAL CONTACT

Infrastructure Finance Ratings Europe
InfrastructureEurope@spglobal.com

Rating Action Overview

- On Sept. 20, 2021, the Dutch regulator published the final remuneration framework for power and gas distribution over the 2022-2026 period.
- Our revised forecasts for Dutch energy distribution network operator Enexis Holding show a gradual decline in credit metrics due to the materially lower regulatory returns from 2022, prompting us to anticipate a progressive erosion of the headroom at the current credit rating absent any countermeasures; funds from operations (FFO) to debt will likely slip from 20% in 2021 to below18% from 2023.
- We therefore affirmed our 'A+' long-term and 'A-1' short-term issuer credit ratings on Enexis and removed the ratings from CreditWatch negative, where we had placed them on June 4, 2021.
- The negative outlook captures our view that, due to markedly lower regulatory returns over the 2022-2026 regulatory period, Enexis is unlikely to sustain FFO to debt above 18% without implementing remedy measures within the next 24 months.

Rating Action Rationale

Enexis will face a deterioration of its credit metrics due to the finalized regulatory remuneration framework for Dutch power and gas distributors over 2022-2026. We updated our forecasts for Enexis based on the final method published by the Dutch regulator, the Authority for Consumers and Markets (ACM), in September 2021. The regulator confirmed 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 1.9% from 2.8%. Also over the 2022-2026 period, the regulatory return for the gas grid will be based on a nominal WACC that will decline to 2.8% from 3.0% currently.

Because the return on investment for a distribution system operator (DSO) is a function of its regulatory asset base (RAB) growth and of its WACC, ACM's decisions for the new regulatory period hurt Enexis (though less than we forecast in July 2021), causing a steady decline in expected earnings. Enexis, along with the Dutch distribution system operators (DSOs), already faced a 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.

Unless Enexis implements a remedial plan, the headroom around its credit metrics will likely diminish, with FFO to debt falling below our threshold for the current rating from 2023. The next regulatory period will usher in lower returns coupled with incremental capex that will result in substantially negative free cash flow. This in turn will squeeze Enexis' metrics over the medium term, causing the eroded headroom from 2023. We forecast Enexis' FFO to debt will reduce from about 20% on 2021 to below 18% in 2023 in the absence of any credit supportive measure. The need for additional infrastructure amid the energy transition in the Netherlands raises Enexis' financing needs to an estimated €700 million-€800 million of annual capex needs until 2030, notably to expand the electricity grid by about 1GW 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. At the same time, other capex will decline, notably smart metering (which is nearing completion of its roll-out). We also note that gas network capex reduced to safety and reliability investments. Although we view favorably the stimulus to Enexis' core operations and its increased relevance as a DSO amid the energy transition, the high capex plan puts additional pressure on the rating on Enexis. Over 2021-2023, we expect continuous high capex (average annual €750 million) and sustained dividends (yearly average of €85 million-€90 million) to result in yearly negative discretionary cash flows of €230 million-€270 million over the period on average .

Although Enexis has a track record of prudent financial management, we think the group will need to roll out exceptional remedy measures to sustain the 'A+' rating. Even if the group's stated financial policy of maintaining an FFO to debt above 16% is too loose for the current rating level at 'A+', we recognize the historically supportive financial policy such as the €500 million shareholder loan issued in two tranches in 2020 (see "Enexis Holding N.V.'s Proposed Fixed-Rate Convertible Shareholder Loan Assigned Intermediate Equity Content," published April 17, 2020, on RatingsDirect). In addition, we believe Enexis has a flexible dividend policy and could have recourse to various protective balance sheet measures, such as hybrid issuance or non-core asset disposals. We note that the group's remaining hybrid capacity stands at about €700 million as of year-end 2020. We will closely monitor the decision-making process on potential shareholder support and the type of instruments used over the next twelve to 24 months.

Outlook

The negative outlook reflects our view that Enexis' revenue and EBITDA will decline gradually but significantly from 2022 as a result of the lower rate of return embedded in the new Dutch gas and electricity regulatory period. We anticipate that Enexis' headroom under the current rating would disappear from 2023 absent any credit remedial measures.

Downside scenario

We would downgrade Enexis if the company's FFO to debt were to decline and remain below 18%. We believe this would happen from 2023 without any additional remedy measure from Enexis' shareholders.

Upside scenario

We could revise the outlook to stable if Enexis implements additional remedy measures such that the company posts FFO to debt sustainably above 18%.

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 142,200 kilometers (km) with 2.9 million connection points, while its gas grid covers 46,300 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. Less than 10% of Enexis' revenue is derived from other utility services. These non-regulated businesses are complementary to the core activities and include the Fudura energy services brand.

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

Our Base-Case Scenario

Assumptions

- Regulatory real pre-tax WACC decreasing to 3.00% in 2021 from 3.50% in 2019, marking the end of the regulatory period.
- 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 declining to 1.9% from 2.2%.
- We forecast revenue growth of around 6% in 2021 and in 2022 mainly due to corrections in inflation, efficiency target, transportation costs, and sufferance taxes that result in electricity and gas tariff increases.
- The rise in energy prices for grid losses completely hedged for 2022 and partially hedged thereafter.
- We expect Enexis' net capex to average €750 million per year in 2021-2023. This compared with an average of €570 million over 2015-2020.
- Increased investments should lead to a higher RAB over the 2022-2026 regulatory period, partially mitigating WACC-related pressure.
- Lower headroom to overperform regulated cost of debt as allowed cost of debt continues to decline.

- Redemption of a €300 million bond in January 2022 already prefunded with issuance of €500 million green bond in April 2021 with a 0.375% interest rate.
- A dividend payout ratio of 50% on an annual basis.

Key metrics

Enexis Holding N.V.--Key Metrics*

	--Fiscal year ends Dec. 31--				
(Mil. €)	2019a	2020a	2021e	2022f	2023f
EBITDA	710	622	680-720	680-720	620-6600
Capital expenditure	638	738	700-800	700-800	700-800
Free operating cash flow	(99)	(127)	(100)-(200)	(100)-(200)	(100)-(200)
Dividends	122	105	70-90	80-100	80-100
Discretionary cash flow	(221)	(233)	(200)-(300)	(200)-(300)	(200)-(300)
Debt§	2,640	2,684	2,900-3,000	3,100-3,300	3,100-3,300
Debt to EBITDA (x)	3.7	4.3	4.1-4.3	4.4-4.7	4.9-5.1
FFO to debt (%)	22.7	20.3	18.0-20.0	18.0-20.0	16.0-18.0

*All figures adjusted by S&P Global Ratings. §2020 year-end debt consists of net financial debt of €2.9 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 Sept. 30, 2021, despite increasing capex needs and debt maturities of €300 million. The €300 million bond maturing in January 2022 has been prefunded through a €500 million green bond issued in April 2021. 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 transportation fees and 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 0.3275%, and longest tenor in 12 years in the issuance of its €500 million bond.

Principal liquidity sources for the 12 months started Sept. 31, 2021:

- Unrestricted cash and short-term marketable securities of €272 million as of Sep 30, 2021.
- 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 €580 million.

Principal liquidity uses over the same 12-month period:

- Debt maturities of about €300 million over the next 12 months and €500 million over the next 24 months.
- Capex of about €750 million.
- Dividend distributions of about €90 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of Dec. 31, 2020, Enexis reported total interest bearing liabilities of €3.0 billion, of which about €2.3 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, 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+/Negative/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: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- 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: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

Related Research

- Ratings On Dutch DSOs Alliander And Enexis Holding Put On CreditWatch Negative; Ratings On Stedin Holding Affirmed, June 4, 2021
- Enexis Holding N.V.'s Proposed Fixed-Rate Convertible Shareholder Loan Assigned Intermediate Equity Content, April 17, 2020

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Enexis Holding N.V.		
Issuer Credit Rating	A+/Negative/A-1	A+/Watch Neg/A-1
Enexis Netbeheer B.V.		
Issuer Credit Rating	A+/Negative/--	A+/Watch Neg/--
Enexis Holding N.V.		
Senior Unsecured	A+	A+/Watch Neg