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Credit Opinion: Enexis Holding N.V.

Global Credit Research - 28 Aug 2013

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.**

	12/31/2012	**12/31/2011**	**12/31/2010**	**12/31/2009**	**12/31/2008**
Adjusted Interest Cover Ratio	**7.1x**	**7.2x**	**5.5x**	**9.8x**	**3.0x**
(FFO + Interest) / Interest Expense	**6.8x**	**6.7x**	**5.3x**	**8.2x**	**3.0x**
Net Debt / Fixed Assets	**40.8%**	**35.7%**	**33.5%**	**37.3%**	**57.7%**
FFO / Net Debt	**24.7%**	**28.8%**	**25.5%**	**33.1%**	**15.2%**
RCF / CAPEX	**0.9x**	**1.1x**	**0.8x**	**1.4x**	**1.3x**

[1] All ratios are calculated using Moody's Standard Adjustments.

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

Opinion

Corporate Profile

Enexis Holding N.V. is a holding company of Enexis B.V., which owns and manages the gas and electricity distribution networks in several Dutch regions. Enexis B.V. generates more than 95% of the group's revenue and represents 99% of group assets and liabilities. Moody's rates both Enexis Holding N.V. and Enexis B.V. (together "Enexis"), both having ratings of Aa3 stable. 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 135,000 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

DRAFT REGULATORY TARIFF RELEASED

Enexis's regulator, the Authority for Consumers and Markets (ACM), released a draft of the regulatory framework for the upcoming tariff period 2014-2016. The regulatory principles are expected to remain consistent with the existing structure, however some components may be materially revised.

Most notably, ACM has indicated an update of the allowed return as derived from a notional weighted average cost of capital (WACC). The calculation, based on reviewed market parameters, indicates a pre-tax WACC of 3.6% in real terms, and is materially lower than the existing 6.2% allowance.

The final outcome is expected in Q4 2013 and at this stage it is not clear if there will be other mitigating factors and therefore what the full impact on Enexis's financial position will be. Given the company's existing headroom in its rating category, we expect the lower return to be commensurate with its current rating but that the headroom will be substantially reduced in the event that the draft regulatory return is implemented.

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 and transparent Dutch regulatory framework. The company has historically maintained a conservative financial position relative to European peers, however we anticipate a decline from 2014 if the proposed tariff is implemented.

Rating Drivers

When assessing Enexis's BCA, we apply our Rating Methodology for Regulated Electric and Gas Networks, published in August 2009, which identifies drivers of 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.

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 the existing negative X-factor, set by the Dutch regulator for the fifth regulatory period (2011-13), that allows a gradual increase in tariffs and by extension, cash flow generation, as evidenced by Enexis's operating financial results. However, we have maintained Enexis's A score for the "Cost and Investment Recovery" sub-factor, as the existing X-factor reflects the regulator's recognition of the needs of network operators to cover their growing investment costs. It is likely that the revised X-factor will revert to a value that assumes continued efficiencies of operating costs. Furthermore, our A score also reflects the fact that Enexis opted for only a marginal increase in its 2013 tariffs of 2.2%, despite having regulatory approval to increase these to a maximum of 6.7%. 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. A side effect of this may be that a reduction in the regulatory return will be less evident on Enexis's income in subsequent years.

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, gross investments (excluding contributions from third parties) grew 13% to EUR504 million in 2012 (EUR229 million for 1H 2013) and is expected to remain at this level in 2013, Enexis scores Baa under the "Scale and Complexity of Capital Programme" sub-factor.

RATING FACTOR 3 - Stability of Business Model and Financial Structure

Enexis is primarily focused on its core regulated distribution activities, resulting in an A score for the "Targeted Proportion of Profit outside Core Regulated Activities" sub-factor. Less than 10% of revenues are earned outside of the regulated businesses, these include: public lighting; the Fudura energy services business; and traffic management services (the latter has been separated into a joint venture with neighbouring distribution company Alliander (Aa3 stable)). The 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 initial negotiations for an acquisition of RENDO, although the latter was cancelled. 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 financial performance in 2012 was stable across operating measures, however the group's financial position deteriorated somewhat. Operating profit was stable at EUR401 million reflecting (1) mild revenue growth year-on-year of 4% to EUR1.37 billion and (2) growth across the cost base, most significantly in staff salaries and pension costs due to a greater number of employees. At the same time, the balance sheet has been levered up during 2012 funding growth in capital expenditure (capex) and dividend payments, combined with working capital cash requirements. Cash flow from operations (CFO) of EUR541 million was largely consumed by the EUR504 million of capex, before dividends of EUR115 million were distributed.

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 6.7%, 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 2.2% for 2013. 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 remains fully owned by 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 has historically been 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), although this measure was negative in 2012. Nevertheless, the company's liquidity position is further supported by a EUR450 million back-up revolving credit facility (RCF) maturing in 2015 and a manageable repayment profile of outstanding shareholder loans, with the next EUR500 million tranche due in 2014.

In 2012 the company successfully issued its first bonds under a new euro medium-term note (EMTN) programme, a EUR300 million and EUR500 million in January and November, respectively. These enabled Enexis to prefinance the first tranches of the shareholder loans ahead of maturity (tranche A in January 2012 and tranche B expected in September 2013) and further extend the overall debt maturity profile. As a result of its 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 RCF.

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 last CBL, existing as part of the acquisition of Intergas, was terminated in 2012.

Structural Considerations

The shareholder loan, provided to Enexis Holding N.V. through a special-purpose vehicle, 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. Current and future bond issues, aimed at refinancing the shareholder loan upon the maturity of its tranches, are positioned at the Enexis Holding N.V. level, with the proceeds on-lent to the operating company via a back-to-back intercompany loan. We also note that Enexis's committed RCF is also at the Enexis Holding N.V. level. On the basis of these funding policies, we regard the risk of structural subordination for lenders at the holding level as low, hence the rating of Enexis Holding N.V. and Enexis B.V. are the same. Furthermore, the last tranche of the shareholder loan, payable in 2019, could be converted into equity in case of a deterioration in 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%)						
a) Adjusted Interest Cover Ratio (3 Year Avg)	6.6x					
b) (FFO + Interest) / Interest Expense (3-Year Average)		6.2x				
c) Net Debt / Fixed Assets (3 Year Avg)		36.8%				
d) FFO / Net Debt (3 Year Avg)		26.3%				
e) RCF / CAPEX (3 Year Avg)					0.9x	
Rating:						
a) Indicated BCA from Grid factors 1-4			a1			
b) Impact from Rating Uplift	0					
c) Indicated Rating from Grid			a1			
d) Actual BCA Assigned			a2			

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

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2012

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