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Research Update:

Dutch Energy Network Operator Alliander N.V. Affirmed At 'AA-/A-1+' On Stable Operating Performance; Outlook Stable

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Overview

- We continue to expect that Alliander will generate predictable cash flow and earnings, supported by good operating performance, a transparent regulatory framework, and its low-risk business.
- Alliander's cost of capital continues to align with regulatory assumptions to set financing rates, reflecting its conservative financial policy and strong debt coverage ratios.
- We are affirming our 'AA-' long-term and 'A-1+' short-term corporate credit ratings on Alliander N.V.
- The stable outlook reflects our expectation that Alliander will report growing revenues and a slight strengthening in credit ratios, with adjusted funds from operations to debt of 25% or better.

Rating Action

On Nov. 27, 2017, S&P Global Ratings affirmed its 'AA-' long-term and 'A-1+' short-term corporate credit ratings on Dutch energy distribution network operator Alliander N.V. The outlook is stable.

We also affirmed our 'AA-' rating on Alliander's senior unsecured debt and our 'A' rating on its junior subordinated debt.

Rationale

The affirmation and stable outlook reflect our continued expectation of predictable cash flow and earnings.

Alliander is the largest national network operator in the Netherlands serving about 3 million electricity and 2.5 million gas customers, with EBITDA of €560 million at year-end 2016 and reported debt of €1.9 billion. The low-risk regulated operating environment for its electricity and gas distribution network businesses, its high-quality assets, and its strong operating performance support the excellent business risk profile. Our assessment also takes into consideration the good predictability of revenues over the regulatory period. This strength is partially offset by the regulatory tariff reset risk after five years.

Regulated utilities under the oversight of the Dutch Authority for Consumer &

Markets (ACM) have a long track record of being able to recover their costs and earn a return on their regulated asset base. The ACM adjusts its revenue allowances for the consumer price index and has an efficiency incentive targeting national best-in-class performance. The regulator's efficiency targets for the 2017-2021 regulatory period and the declining weighted-average cost of capital (WACC; real, pretax) to 3.0% from 4.0% have put pressure on revenue growth. However, we believe that Alliander should be able to meet its efficiency targets, which are also much reduced for all the regulated entities compared with the previous regulatory cycle. Alliander has the least punitive efficiency targets, reflecting a one-off full compensation of sufferance taxes (municipal tax for use of public land) levied in previous years.

Alliander has launched cost-reduction initiatives to counter the increase in costs experienced in 2016 due to higher sufferance taxes, transport costs, costs passed on from the transmission network operator TenneT, network maintenance costs, and information and communication technology costs. We expect revenues to grow in the current regulatory period, driven by higher metering tariffs, sufferance tax recovery, and positive final adjustments to the final regulatory methods. We also expect the EBITDA margin to increase slightly and stabilize around 40%.

Adjusted funds from operations (FFO)-to-debt and debt-to-EBITDA ratios weakened slightly year on year to 25% and 3.3x, respectively, at the end of December 2016, primarily driven by lower EBITDA due to increasing costs and lower tariffs. We expect debt to gradually increase over 2018-2019, primarily driven by higher-than-average capital expenditure (capex). We forecast annual capex at about €640 million due to the mandatory rollout of smart meters for the next several years, which will result in negative discretionary cash flows (DCF). However, the company has reduced the impact on credit metrics, such as FFO to debt, by bringing its debt costs largely in line with market rates, which we expect will keep interest expenses stable despite an increase in debt. The company has also maintained a relatively strong balance sheet (about 34% debt to equity) compared with peers in some other jurisdictions. The company has consistently maintained its cash flow debt coverage at levels higher than its minimum financial policy target of 20% FFO to debt.

In our base-case scenario, we assume:

- Revenue growth of about 10% in 2017, 6% in 2018, and 2.4% in 2019, driven by higher metering tariffs, full compensation from sufferance taxes, and positive final regulatory method decisions.
- EBITDA margins to slightly strengthen toward 40% in 2019, supported by cost reduction initiatives, which support a gradual increase in FFO to debt in each forecast year.
- Continued higher-than-average capex of about €640 million, primarily due to the rollout of smart meters.
- Cost of debt will continue to align with regulatory assumptions to set financing rates, which leads to stable interest expenses despite increasing debt.
- Common dividends in line with the 45% payout of the previous year's net income and an additional €16 million dividend on the subordinated hybrid

debt.

Based on these assumptions, we arrive at the following credit measures:
- Adjusted FFO to debt clearly above 25% in 2017-2019.
- Negative DCF, with adjusted DCF to debt of -6.5% to -1.5% over 2017-2019.
- Adjusted FFO to interest cover of 11x-13x over 2017-2019.
- Debt to debt plus equity of about 35.0% over 2017-2019.

Liquidity

We have reassessed Alliander's liquidity as strong, compared with adequate previously, which is neutral for the rating. The short-term rating is 'A-1+'. Our liquidity assessment is supported by our view that Alliander's liquidity sources will exceed its funding needs by more than 1.5x over the next 12 months and remain above 1.0x over the following 12 months.

Alliander's well-established and solid relationships with banks, its generally high standing in the credit markets, and typically very prudent risk management further support our opinion of its liquidity. We estimate that Alliander's liquidity sources over the next 12 months will be close to €1.75 billion, while uses will be around €1.1 billion under our base-case scenario.

Principal liquidity sources:
- Unrestricted cash and short-term marketable securities of about €210 million.
- Access to an undrawn €600 million committed credit facility expiring in July 2022 and access to €225 million from the European Investment Bank. The credit facility contains no financial covenants.
- Annual FFO of about €600 million-€650 million.

Principal liquidity uses:
- Capex of about €640 million.
- Debt repayments of €320 million.
- Dividend payments of about €100 million.

Outlook

Our outlook on Alliander is stable. We expect Alliander will be able to sustain adjusted FFO to debt of 25% or better, given slightly higher-than-expected regulated returns and lower interest expense in the next two years. The weighted-average cost of capital in regulated tariffs will decline each year until 2021 and we expect higher-than-average capex as the company rolls out smart meters. Nevertheless, the company should be able to maintain this level of coverage beyond our outlook period, despite negative DCF, and given plans to allow the recovery of sufferance tax paid to municipalities (about €140 million to €150 million per year).

Downside scenario

We would likely lower the ratings if our forecast credit ratios fell consistently below 23% FFO to debt. Although we don't expect this to occur, factors that could trigger this in the next two years include a decision by the company to recapitalize its balance sheet closer to its minimum requirement of FFO to debt of 20%, or a material decline in margins.

Upside scenario

We consider an upgrade is constrained by the relatively predictable but challenging tariffs set by the regulator, and the company's large capex plan and dividend policy. That said, we would consider an upgrade if we thought Alliander was able to sustain and commit to an adjusted FFO-to-debt ratio of more than 30%, assuming an unchanged business risk profile and no negative impact from Alliander's public sector shareholder ownership.

Ratings Score Snapshot

Corporate Credit Rating: AA-/Stable/A-1+

Business risk: Excellent
- Country risk: Very low
- Industry risk: Very low
- Competitive position: Excellent

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: aa

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: Negative (-1 notch)

Stand-alone credit profile: aa-

Issue Ratings

Capital structure

Alliander's capital structure consists of senior unsecured debt and junior subordinated debt issued at the parent level.

Priority liabilities at the subsidiary level are limited. Due to modest financial risk, we apply no notching to the issue ratings for structural subordination.

Analytical conclusions

Alliander's senior unsecured debt is rated 'AA-', the same as the corporate credit rating. We rate Alliander's junior subordinated debt at 'A', reflecting one notch for subordination and one notch for deferability. We assign intermediate (50%) equity content to the securities.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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 And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 1, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Ratings Affirmed

Alliander N.V.	
Corporate Credit Rating	AA-/Stable/A-1+
Senior Unsecured	AA-

Junior Subordinated	A

Additional Contact:

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