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Research Update:

Dutch Energy Distributor Alliander Downgraded To 'A+/A-1' On Regulatory Decision; Outlook Stable

December 20, 2021

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.
- From 2022, we expect lower regulatory returns and a significant increase in capital expenditure (capex) that will lead to weakening credit metrics to below our rating threshold of 23% funds from operations (FFO) to debt, and lower thereafter.
- We anticipate metrics will gradually decline, due to markedly lower regulatory returns over the 2022-2026 regulatory period and increasing investments, but to remain above 18% FFO to debt, thanks to the implementation of remedial measures to counter downward trending metrics.
- We therefore lowered our issuer credit ratings on Alliander to 'A+/A-1' from 'AA-/A-1+', and removed the ratings from CreditWatch negative, where we had placed them on June 4, 2021.
- The stable outlook reflects our expectations for metrics to remain above 21% at least over 2021 and 2022 and sustainably above 18% thereafter, thanks to the implementation of remedial measures to counter downward trending metrics.

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Rating Action Rationale

A gradual-but-clear decline in credit metrics and an updated financial policy have led us to our lower our rating on Alliander to 'A+' from 'AA-'. We expect credit metrics to deteriorate below our rating threshold of 23% FFO to debt for an 'AA-/A-1+' rating in 2022 and lower thereafter. We expect credit metrics to remain in line with an 'A+/A-1' issuer credit rating at least until end of 2022. Alliander has revised its financial policy to adapt to the evolving Dutch energy environment, with a minimum FFO to debt of 15% instead of 20% before. While this is not a target in itself, it signals that the company will now have more leverage tolerance.

Even though timing and magnitude of additional measures has not been defined yet, we expect the company to enact timely and sufficient remedial measures that should, after 2022, counter credit metric deterioration below our rating threshold for the 'A+' rating. We understand

Alliander is currently looking into various measures to support its credit metrics. This is likely to include the conversion of its settled convertible shareholder loan, followed by a combination of further hybrid issuance and capital contributions. We recognize Alliander's track record of prudent financial policy and shareholder support. We will closely monitor the decision-making process on shareholder support and the type of instruments used over 2022.

We expect credit metrics to deteriorate, due to increased investment needs and lower electricity and gas regulated returns once the Dutch regulatory period 2022-2026 begins. The final regulatory decision has some supportive elements, such as a nominal weighted average cost of capital (WACC) and an accelerated depreciation rate for gas assets (1.3x, up from 1.0x the previous regulatory period), in addition to a real WACC for electricity grids incorporating additional 50% of inflation expectations. However, we expect these updates to the remuneration scheme will be insufficient to support Alliander's ability to cope with gross capex increasing to about €1.2 billion per year from an average of €800 million over the 2016-2021 regulatory period. This is because real returns will effectively decline. 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, The decisions for the new regulatory period from the Netherlands Authority for Consumers and Markets will cause a steady decline in expected earnings.

Moreover, we expect Alliander and the sector will have limited flexibility to implement investments in the grid, given that they are necessary to reach the Netherlands' climate ambitions. We expect the magnitude of investments will remain at least constant throughout the decade, with the pace only accelerating, leading Alliander to implement additional capex to protect its creditworthiness.

Outlook

The stable outlook reflects our expectation that, despite incremental debt due to increased capex and a scheduled decline in regulatory WACC, Alliander will post an FFO-to-debt ratio above 21% at least over 2021 and 2022. Over the next 12 months, we also anticipate management, backed by shareholders, will enact remedial measures to counter downward trending metrics, by means of hybrid issuance or capital contributions, to keep them above 18% FFO to debt. Alliander has a track record of managing its rating-relevant credit metrics above the downside trigger and we expect the company will implement remedial measures to counter increasing pressure on metrics.

Downside scenario

The rating could come under pressure if our forecast FFO to debt fell below 18% with no immediate likelihood of recovery. This could result from the company failing to implement a combination of timely and sufficient remedial measures, such as conversion of its recently settled €600 million convertible shareholder loan, capital contributions, and further hybrid issuance.

Upside scenario

We consider an upgrade unlikely at this time, given the predictable ongoing decline of tariffs set by the regulator, alongside the company's capex plan and dividend policy. However, we would consider an upgrade if, all else remaining equal, Alliander were to achieve and sustain FFO-to-debt above 23% backed by company's financial policy.

Company Description

Alliander is a Dutch group mainly devoted to energy distribution in the Netherlands regions of Gelderland, Noord-Holland, Amsterdam, Zuid-Holland, Friesland, and Flevoland.

Through its main subsidiary, Liander, the group provides electricity and gas to about 3.3 million consumers and businesses through its more than 5.7 million connection points. Qirion, another subsidiary, focuses on developing sustainable technologies and intelligent energy infrastructures. Lastly, Kenter is a metering company that delivers solutions for metering energy and energy management.

Alliander is 100% owned by 76 Dutch provinces and municipalities. The Province of Gelderland owns 44.7%, Friesland 12.7%, Noord-Holland 9.2%, and the city of Amsterdam 9.2%. The remainder is owned by other smaller Dutch municipalities.

Our Base-Case Scenario

Assumptions

- Real GDP growth in the Netherlands of 3.1% in 2021, 3.3% in 2022, and about 1.5%-2.0% over 2023-2024. We expect limited impact of the ongoing pandemic on Alliander's activities, due to its regulated nature.
- Over the 2022-2026 regulatory period, nominal pre-tax WACC for the gas grid declining to 2.8% from 2.9%, and inflation-adjusted pretax real WACC for the electricity grid declining to 1.9% from 2.0% in 2022.
- EBITDA margin around 39%-41% over the forecast period of 2021-2024.
- Net capex of about €850 million-€1.10 billion annually, driven by the energy transition target in the Netherlands and the requirement to expand Alliander's electric grid (connecting new renewable projects to the grid) as well as grid replacement. We expect that less than 15% of the total capex will be deployed in gas networks, reflecting the maturity of this business.
- Dividend payout ratio of 45% of the previous year's net income, according to Alliander's policy.
- No acquisitions or sale of assets expected during the forecast period of 2021-2024.

Key metrics

Alliander N.V.--Key Metrics

	2019a	2020a	2021e	2022f
Debt to EBITDA	3	3.6	3.2-3.4	3.7-3.9
FFO to debt (%)	28.7	24.2	24-26	21-23
DCF (mil. €)	(230)	(203)	Negative	Negative

FFO--Funds from operations. DCF--Discretionary cash flow. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess Alliander's liquidity as adequate, reflecting our view that its liquidity sources will exceed its funding in the next 12 months by more than 1.1x.

Further, our liquidity assessment factors Alliander's high standing in the credit markets, as shown by the company consistently outperforming regulated cost of debt. The recent issuance of a green bond and Alliander's well-established and solid relationship with banks further supports our opinion of its liquidity.

Principal liquidity sources as of Sept. 30, 2021:

- Cash and near-term investments of €244 million;
- A committed credit facility of €600 million maturing in 2023; and
- Cash FFO of about €700 million over the next 12 months.

Principal liquidity uses as of the same date:

- Debt maturities of about €140 million over the next 12 months;
- Capex of €1 billion over the next 12 months; and
- Dividends of about €100 million over the next 12 months.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of June 30, 2021, Alliander's interest bearing debt totaled €2.614 billion, of which about €2 billion consisted of euro medium-term notes (€1.2 billion green bond) and €300 million correspond to a loan from the European Investment Bank. The rest relates to other smaller bank and shareholder loans.

Furthermore, we add 50% of the company's 1.625% €500 million perpetual subordinated notes in our calculations of S&P Global Ratings-adjusted debt, because we evaluate this instrument as having intermediate equity content.

Analytical conclusions

We rate the company's senior unsecured debt at the level of its 'A+' issuer credit rating.

Alliander is the holding company of a key operating company and other smaller subsidiaries. All new debt is placed at the Alliander level; and debt at the Liander level, which is small compared with the group's total, will be repaid at the end of 2027 (€167 million).

Besides this factor, we rate Alliander's debt in line with the issuer credit rating, because we consider the company's leverage low enough to limit the possibility of any noteholders being significantly disadvantaged relative to other lenders.

We rate the perpetual notes 'A-', two notches below the 'A+' issuer credit rating on Alliander, reflecting:

- A one-notch deduction because of contractual subordination; and
- An additional one-notch deduction for payment flexibility to reflect that the deferral of interest is optional.

Ratings Score Snapshot

Issuer Credit Rating: A+/Stable/A-1

Business risk: Excellent

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

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

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: E2, S2, G2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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: 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
- Dutch Electricity And Gas Networks: Why We See The Regulatory Frameworks As Supportive, May 15, 2019

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Alliander N.V.		
Issuer Credit Rating	A+/Stable/A-1	AA-/Watch Neg/A-1+
Senior Unsecured	A+	AA-/Watch Neg
Junior Subordinated	A-	A/Watch Neg