Research Update:

Alliander N.V. 'AA-' Ratings Affirmed On Solid Financial Performance; Outlook Stable

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Rating Action Overview

- Alliander N.V. continues to generate most of its earnings from its fully regulated electricity and gas distribution activities in the Netherlands, providing good visibility over its cash flows streams.
- Despite challenging regulatory returns, we forecast that the company will continue posting stable funds from operations (FFO) because of efficient operations and a relatively stable cost structure.
- We are therefore affirming our 'AA-' rating on Alliander.
- The stable outlook reflects our expectation that the company will post FFO-to-debt comfortably above 25% over the next 24 months despite incremental debt and a scheduled decline in the regulatory weighted-average cost of capital (WACC).

Rating Action Rationale

We expect Alliander to post solid results, despite declining regulatory returns over the next two years. About 90% of Alliander's EBITDA benefits from regulatory returns, modulated by a regulatory WACC, which, according to the revised method decision, we observe declining from 4.10% in 2017 to 2.83% in 2021, which marks the end of a five-year regulatory period. While a lower WACC means lower allowed revenues, we expect pressure on profits will be alleviated through a continuous increase in its regulated asset base thanks to constant investments in its grid. Moreover, we see a high degree of stability in the regulatory framework for Dutch electricity and gas distribution system operators (DSOs).

This is because of well-developed tariff-setting procedures and a low risk of political interference. We believe Alliander will recover all costs and earn a return on its RAB alongside low volatility of cash flows despite regulatory pressure and ever increasing efficiency requirements. In addition, we expect developed cost management strategies and operating efficiencies will allow the company to retain an FFO-to-debt ratio of 27%-29% over the next two years, well above our 23% rating for the category.

Large capital expenditures are one challenge of the energy transition. The Dutch Climate Agreement stipulates that the Netherlands aims to generate 70% of its electricity through renewable sources by 2030. Alliander is a key stakeholder in adapting the grid to these changes. As a result, the company is facing an increasing workload to keep up with the energy transition, which is a key component of its business strategy. Capital expenditure (capex) related to the Climate Agreement is €1.3 billion, deployed in electricity infrastructure until 2030, which translates into €130 million of additional capex per year for Alliander.

Most of the company's capex will serve to strengthen the electricity grid. In addition, Alliander will connect new wind and solar parks to the network, but also smartening the grid. On the other hand, we expect investments in the gas grid to decline consistently, on the back of energy policy incentives to phase out natural gas from all residential buildings by 2050. We believe that this is already resulting in capex optimization within the sector and particularly in Alliander's gas grid, with expansion and replacement capex decreasing to represent about 25% of its total capex over 2019 and 2020.

Our forecast of total capex at €720 million for 2019 and €660 million for 2020 will result in negative discretionary cash flow over at least the next two years. This will increase Alliander's funding needs. That said, this capex is fully regulated and the company operates under the Dutch regulatory framework, which we assess as supportive and has a track record of allowing operators to recover the total of its capital investments and operating costs.

Workload feasibility is an operating burden for the industry, including Alliander. We understand that the shortage of technical personnel represents an increasing challenge for the sector. For instance, Alliander is facing about 7x the level of heavy-duty connections it typically has to deal with in a given year. Because all DSOs in the Netherlands have an 18-week mandate to connect a project, increasing work volume and lack of technically skilled labor are becoming issues. In addition, government incentives for renewables are allowing for projects in land, which is difficult to reach for DSOs and complicate its connection to the network.

These issues could curb Alliander's capex. However, the company is intensifying its planning and synchronization with relevant stakeholders to coordinate the placement of new renewable capacity. In addition, the company has programs to recruit and train new engineers to cope with its increasing workload, in addition to use innovation to optimize work deployment. We expect these factors to partially ease Alliander's workload feasibility.

District heating could represent new sources for growth. Close to 90% of Dutch households are heating with gas. In line with the country targeted gas phase out, the Dutch Climate Agreement targets 1.5 million additional district heating connections by 2030 and 2.9 million by 2050. Alliander is developing district heating capabilities through its Firan subsidiary in its aim to be a facilitator of the heat transition. We understand that the district heating market organization, and price regulation, will be disclosed in the upcoming Heat Act 2.0, which will amend the Heat Act that will take effect in January 2020. We don't expect the Heat Act 2.0 to come into force before 2022. If, because of the new legislation, district heating becomes a fully regulated activity with a sustainable tariff scheme, it could represent additional growth opportunities for Alliander over the medium term.

The new regulatory period may be adapted to fit into new energy legislation. We understand that the period for formal consultation for the next regulatory period was released in September 2019 by the ACM. We expect this process to remain open until the end of 2020 and the regulator to

come up with a final decision in 2021. Although the final conditions for the regulatory period starting in 2022 are still in consultation, we believe that the regulatory returns will continue to decline due to a protracted period of lower interest rates and therefore lower regulatory cost of debt. In addition, we believe the span of the regulatory period could go back to three years from five years in the current regulatory period. Typically, this would reduce the level of visibility over a regulatory period; however, in this case, it would allow the company to prevent cost mismatches and better align the regulatory period with new energy legislation, which is unlikely to be approved before 2022.

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 comfortably above 25% over the next 24 months, thanks to higher regulatory electricity and gas revenues and efficient operations that translate into a stable cost structure. We also believe that investments related to the energy transition in the Netherlands will support Alliander's regulated asset base.

Downside scenario

The ratings could come under pressure if our forecast FFO-to-debt fell below 23% with no immediate likelihood of recovery. Although we don't expect this to happen, factors leading to such a deterioration over the next two years include a decision by the company to recapitalize its balance sheet closer to its minimum internal requirement of FFO-to-debt of 20%, or a material decline in EBITDA margins.

Upside scenario

We consider an upgrade unlikely at this time, given ongoing predictable, but declining, tariffs set by the regulator, alongside the company's capital expenditure (capex) plan and dividend policy. However, we would consider an upgrade if, all else equal, Alliander were to achieve and sustain FFO-to-debt above 30%.

Company Description

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

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 of the group, focuses on developing sustainable technologies and intelligent energy infrastructures. Lastly, Kenter is a metering company that delivers innovative solutions for metering energy and energy management. As of Dec. 31, 2018, about 90% of the group's EBITDA came from Liander, while Qirion and Kenter together represent the balance.

Alliander is 100% owned by 77 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

We use the following assumptions in our analysis:

- Although Alliander's activities do not directly correlate to GDP growth due to its regulated nature, we believe that Dutch GDP growth of 1.7% and 1.3% in 2019 and 2020 will set favorable business conditions in the country
- We forecast a real regulatory WACC of 3.48% in 2019, declining to 3.16% in 2020
- We expect flat revenues in 2019 and about 1.8% growth in 2020 due to increased regulated electricity and gas revenues
- We expect higher costs from the inclusion of operating costs at the 450Connect level to lead to slightly weaker profitability in 2019. However, we expect margins to recover to about 40% in 2020
- Sufferance tax will increase in parallel with the company's grid in municipalities that levy these taxes. We expect that sufferance taxes will be fully compensated for in tariffs, although with some time mismatches
- We expect that extraordinary charges made to the Dutch electricity TSO, TenneT, will be fully compensated for in tariffs, although with some delay
- Capital expenditures will be about €720 million in 2019, declining to €660 million in 2020. Capex will mainly be destined for expanding Alliander's electric grid (connecting new renewable projects to the grid) as well as grid replacement. We expect that only about 25% of the total capex will be deployed in gas networks, reflecting the country's energy policy to phase out gas
- We expect a dividend payout ratio of 45% the of previous year's net income, according to Alliander's policy
- We forecast that higher capex coupled with sustained dividends will lead to cash flow deficits, and will translate in an increase in gross debt of €200 million in 2019 and €100 million in 2020

We arrive to the following credit metrics for 2019 and 2020, respectively:

- FFO to debt: 27.1% and 29.0%
- Debt to EBITDA: 2.9x and 3.1x
- Free operating cash flow to debt: negative 0.4% and positive 3.1%

Liquidity

We are revising our liquidity score on Alliander to adequate from strong, reflecting higher capex needs and an upcoming €482 million debt maturity in 2020. We estimate that the company's liquidity sources will exceed its funding in the next 12 months by more than 1.1x.

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

Alliander's principal liquidity sources include:

- Cash and near-term investments of €397 million as of Sept. 30, 2019
- A committed credit facility of €600 million maturing in 2023
- Cash FFO of about €730 million over the next 12 months
- Modest working capital inflows of €5 million-€10 million

Principal liquidity uses include:

- Debt maturities of €482 million over the next 12 months
- Capital expenditures of €675 million
- Dividends of about €104 million

Issue Ratings--Subordination Risk Analysis

Capital structure

As of June 30, 2019, Alliander's reported debt totaled €2.44 billion, of which €1.7 billion consisted of euro medium-term notes, €300 million of which will mature in December 2019. In addition, €300 million corresponds to a European Investment Bank loan, and €150 million corresponds to a short-term euro-commercial paper. The rest is related to finance lease liabilities and other smaller bank loans.

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

Analytical conclusions

We rate the company senior unsecured debt at the level of its 'AA-' 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.

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 'AA-' 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: 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)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile : aa-

Related Criteria

- 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 | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed	
Alliander N.V.	
Issuer Credit Rating	AA-/Stable/A-1+
Senior Unsecured	AA-
Junior Subordinated	A

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.