

## Research

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### Summary:

## Alliander N.V.

#### Primary Credit Analyst:

Beatrice de Taisne, CFA, London (44) 20-7176-3938; [beatrice.de.taisne@spglobal.com](mailto:beatrice.de.taisne@spglobal.com)

#### Secondary Contacts:

Nicole D Martin, London (1) 416-507-2560; [nicole.martin@spglobal.com](mailto:nicole.martin@spglobal.com)

Alf Stenqvist, Stockholm (46) 8-440-5925; [alf.stenqvist@spglobal.com](mailto:alf.stenqvist@spglobal.com)

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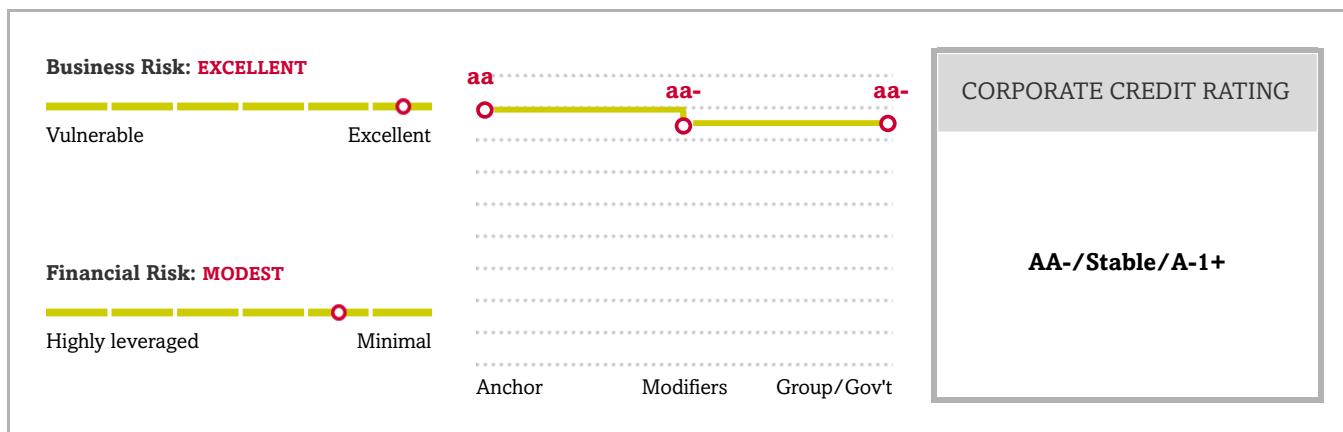
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## Summary:

# Alliander N.V.



## Rationale

Business Risk: Excellent	Financial Risk: Modest
<ul style="list-style-type: none"> <li>Netherlands-based monopoly owner and operator of regulated electricity and gas distribution regional networks.</li> <li>Predictable cash flow and earnings supported by transparent regulatory framework and low-risk business.</li> <li>Good operating performance.</li> </ul>	<ul style="list-style-type: none"> <li>Predictable operating cash flows within regulatory periods.</li> <li>Conservative financial policy and strong debt coverage ratios.</li> <li>Cost of capital largely aligned with regulatory assumptions used to set rates.</li> </ul>

## Outlook: Stable

Our outlook on Dutch electricity and gas distribution network operator, Alliander N.V., is stable. We expect Alliander will be able to sustain S&P Global Ratings-adjusted funds from operations (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 capital expenditure (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 discretionary cash flows (DCF), and given plans to allow the recovery of surcharge tax paid to municipalities (about €130 million per year) proceeds.

### 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 them to occur, factors that could potentially trigger this in the next two years include a decision by the company to recapitalize its balance sheet closer to its publicly stated financial policy (minimum requirement of FFO to debt of 20%) or a material decline in margins.

### Upside scenario

We consider an upgrade highly unlikely in light of 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 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.

## Our Base-Case Scenario

We anticipate a modest weakening in Alliander's credit metrics during the five-year regulatory cycle to 2021 due to the declining allowed weighted-average cost of capital in tariffs, and higher-than-average capex, resulting in moderately negative DCF. However, we expect that ratios will remain commensurate with the modest financial risk profile in the next two years. In our opinion, Alliander has a conservative financial policy with specific minimum ratio thresholds that also supports the company's adequate liquidity position.

Assumptions	Key Metrics				
<ul style="list-style-type: none"> <li>After a slight increase in 2016, we expect FFO to debt to decline between now and 2021 despite the recovery of sufferance tax (municipal tax for use of public land).</li> <li>Negative DCF after capex and dividends resulting in gradually rising debt levels.</li> <li>Alliander has affirmed its dividend policy, of 45% pay-out of previous year's net income, with no minimum set amount.</li> <li>Weighted-average cost of capital (WACC) of 4% in 2017, declining to 3% in 2021.</li> </ul>		<b>2015A</b>	<b>2016F</b>	<b>2017F</b>	<b>2018F</b>
	EBITDA margin (%)*	40.1	45-50	38-42	40-45
	Debt/EBITDA (x)*	3.0	2.0-3.0	2.7-3.0	2.7-3.3
	FFO/debt (%)*	26.0	25-35	25-30	25-30
	DCF/debt (%)*	(5.1)	(10)-(15)	(5)-(10)	(5)-(10)
Debt/(debt+equity)(%)*	35.8	30-35	30-35	35-40	
<p>*S&amp;P adjusted figures. A--Actual. F--Forecast. FFO--Funds from operations. DCF--Discretionary cash flow.</p>					

## Business Risk: Excellent

Alliander benefits from a natural monopoly in its low-risk regulated electricity and gas distribution network businesses, and high-quality network assets, serving about 3 million customers in its licensed areas. The company had total reported debt of €1.7 billion as of Sept. 30, 2016.

We view the regulatory framework in The Netherlands as transparent and supportive of stable cash flows. Regulated tariffs are set with cost recovery in mind. There is a 15-year track record of successive regulatory cycles with a consistent, published, and formula-based tariff setting methodology. In its more recent decision, the regulator lengthened the review cycle to five years from three, which we view as a positive for predictability. The tariffs are based on grid capacity not consumption and, as such, revenue is not exposed to volume risk linked to variability in energy consumption. Furthermore, we believe the risk of privatization is minimal given the legal framework in place which mandates government ownership of utilities.

Regulated utilities under the oversight of the 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. We think the company should be able to meet the efficiency target for this regulatory cycle, aided by synergies resulting from the recent asset swap with Enxsis. The swap reduced the number of noncontiguous customers for both utilities. This cycle's efficiency target is also much reduced from the previous regulatory cycle given Alliander's actual performance is closer to the regulator's benchmark target.

These strengths are partly offset by regulatory tariff reset risk every fifth year and exposure to incentive-based regulation that can impose challenging efficiency requirements. The real pre-tax WACC allowed for in tariffs remains among the lowest in Europe -- in 2014 the allowed WACC was almost halved to 3.5% from 6.2%. During the current regulatory period (2016 to 2021) the allowed WACC begins at 4% and declines over the five years to 3%.

## Financial Risk: Modest

Adjusted FFO-to-debt and debt-to-EBITDA ratios stood at about 26% and 3.0x, respectively, at the end of December 2015. The company has alleviated stress on credit metrics, such as FFO to debt, by bringing its debt costs largely in line with market rates and maintaining a relatively strong balance sheet (about 35% debt to equity) compared to some other jurisdictions. Higher-than-average capex (about €600 million per year) due to the mandatory rollout of smart meters for the next several years will result in negative DCF. The company has consistently maintained its cash flow debt coverage at levels higher than its minimum financial policy target of 20% FFO to debt. We expect it will continue to do so.

## Liquidity: Adequate

Although in our base-case we expect Alliander's liquidity sources will exceed its funding needs by more than 1.5x over the next 24 months, we continue to view the company's liquidity as adequate given that the utility does not have a track record of maintaining strong liquidity. We estimate Alliander's liquidity sources over the next 12 months at about €1.3 billion, while uses will be about €820 million under our base-case scenario.

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> <li>Unrestricted cash and short-term marketable securities of about €130 million.</li> <li>Access to an undrawn €600 million committed credit facility expiring in July 2021. The credit facility contains no financial covenants.</li> <li>Annual FFO of about €490 million in the next 12 months.</li> </ul>	<ul style="list-style-type: none"> <li>Capex of about €600 million.</li> <li>Debt repayments of €100 million.</li> <li>Dividend payments of €100 million or more.</li> </ul>

## Government Influence

Alliander is 100% owned by local regional governments (LRG), primarily by Gelderland (45%), Friesland (13%), Noord-Holland (9%), and the municipality of Amsterdam (9%). There is no uplift in the rating outcome on Alliander given that we view the overall credit quality of the majority of the shareholders as lower than that of Alliander.

Although we would not expect any single shareholder to provide extraordinary support out of proportion to its ownership position, our view is that there is a moderate likelihood that the shareholders would provide timely and sufficient extraordinary support in the event of financial distress at the utility based on our assessment of Alliander's:

- Important role, given its strategic importance to the provinces and municipality owners, as the monopoly provider of gas and electricity distribution services in its license areas; and
- Limited link to the owners, given the dispersed ownership structure. Nevertheless, most of the smaller shareholders, primarily municipalities, have historically been connected to the provinces, which are the larger shareholders, in

terms of geography and administration.

We also believe the utility would survive our stress test of an LRG default (deep recession, 6%-10% output decline in one year) without credit degradation. As a result, our view of the credit quality of the LRG shareholders does not constrain the rating on Alliander. Our LRG default stress test could lead to modestly lower energy consumption in the affected region but is not likely to affect Alliander's credit quality given diverse owners, no volume risk exposure in the tariff design, a stable residential customer base, and that Alliander is providing an essential service. Furthermore, in our view, in the event of an LRG default, we believe regulated tariffs would continue to be based on cost recovery and we would expect the utility to recover, in a timely manner, any additional taxes imposed.

## 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)
- **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-

- **Likelihood of government support:** Moderate (no impact)

## Related Criteria And Research

### Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25,2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013

- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 1, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

### Related Research

- Dutch Energy Company Alliander 'AA-' Ratings Affirmed as Liquidity Score Revised to Adequate from Strong, Outlook Stable Nov. 26, 2015

Business And Financial Risk Matrix						
Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

### Additional Contact:

Industrial Ratings Europe; Corporate\_Admin\_London@spglobal.com

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