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Ratings

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Summary:
Stedin

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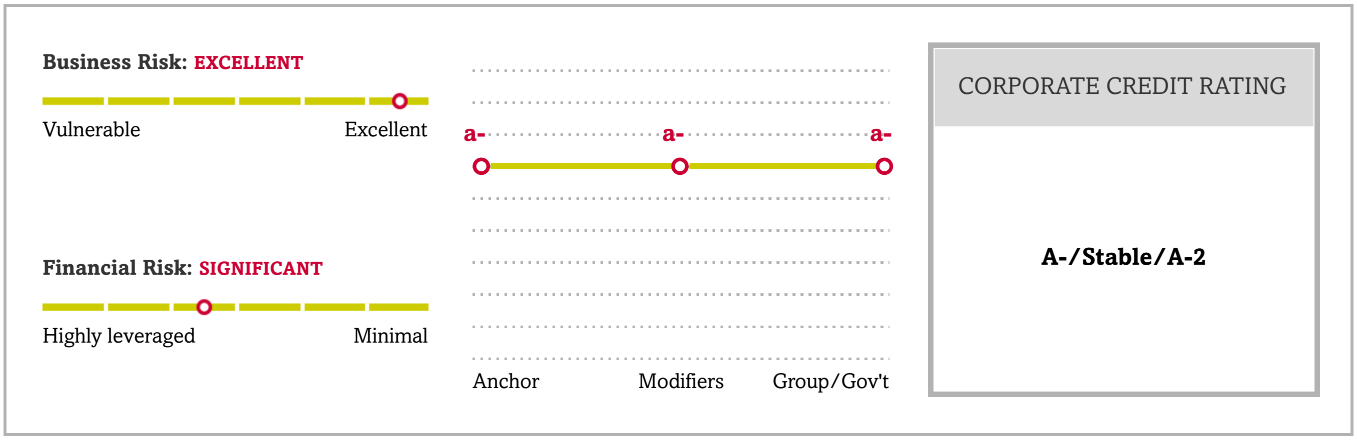
Summary:

Stedin



Rationale

Business Risk: Excellent	Financial Risk: Significant
• Monopoly owner and operator of the Netherlands' third-largest regional electricity and gas distribution network. • Predictable cash flow and earnings supported by transparent regulatory framework and low-risk business. • Stable and predictable earnings from low-risk regulated network activities accounting for 95% of EBITDA.	• Regulatory reset risk every five years. • Low allowed return on capital and high efficiency targets set by the regulator weigh on revenues. • Relatively small scale operations and higher financial risk compared to Dutch peers.

Outlook: Stable

The stable outlook on Stedin Holding N.V. and Stedin Netbeheer B.V. reflects the group's excellent business risk profile and our expectation that Stedin Holding will maintain credit metrics in line with the rating, namely funds from operations (FFO) to debt consistently above 11% (we forecast 11.5%-13.0% over the medium term under our base case). Robust earnings from the stable distribution networks support the current ratings, even though we expect profitability to be affected by additional costs from the unbundling process. We also expect the contribution from unregulated ancillary activities to remain below 10% of the group's total EBITDA.

Downside scenario

We could lower the ratings on Stedin if the group's adjusted FFO to debt fell below 11%, combined with declining profitability. In our view, the regulatory reset risk in the new regulatory period, starting in 2022, poses the main potential uncertainty to profitability. In our view, a negative rating action could also materialize from potential integration risk or additional costs following the acquisition of ZNH.

Upside scenario

We consider an upgrade unlikely in the near term given the company's current leverage. This said, we would consider an upgrade if Stedin Holding maintained FFO to debt sustainably above 15%.

Our Base-Case Scenario

Assumptions

- Allowed revenues of about €1.2 billion-€1.35 billion over 2017-2019.
- Average EBITDA margin of 41%-42% over 2017-2019.
- A weighted-average cost of capital (WACC) for the current regulatory period of 2017-2021 (real pre-tax) starting at 4% and decreasing to 3% in 2021.
- EBITDA of €500 million-€550 million over 2017-2019 supported by volume growth from the acquisition of PZEM N.V. (formerly Delta), Zeeuwse Netwerkholding N.V. and its subsidiaries (together, ZNH).
- Dividend policy to remain consistent with a payout ratio of 50% of net profit (payable in the subsequent year), except in 2017, as a result of the unbundling.

Key Metrics

	2016A	2017E	2018E
FFO to debt (%)	N.M.	11.5-12.5	12.0-13.0
FFO interest cover (x)	N.M.	4.5-5.5	5.0-6.0
DCF to debt	N.M.	(4.0-5.0)	(5.5-6.5)

FFO--Funds from operations. DCF--Discretionary cash flows. A--Actual. E--Estimate. N.M.--Not meaningful.

Business Risk: Excellent

Following the unbundling of the unregulated activities as of Feb. 1, 2017 we expect 95% of Stedin's EBITDA to be generated from stable regulated activities. We view the Dutch regulatory framework for distribution networks as strong based on the good visibility of cash flows over the increased five-year regulatory period from the previous three years. However, the regulator's efficiency targets, together with the decline of the WACC (real pre-tax) from 4% to 3% over the current regulatory period, has put pressure on allowed revenues.

The acquisition of ZNH in June this year is expected to increase the scale of operations by about 10%, offering the company a wider service area. We also foresee potential gains that could emerge as both networks are operating in neighboring areas with the same regulator overseeing the network performance. However, we do not factor in synergies in our base case. Stedin is also currently updating its strategy, which we expect will be supportive through the energy transition with planned cost savings. However, we think there are currently some risks from potential operational issues following the unbundling of unregulated activities. We also anticipate that the integration of the new network could weigh on the company's profitability if it creates additional costs, for example, from integrating IT systems. Stedin remains slightly smaller compared to its Dutch peers Alliander and Enexis but is similar in size to U.K. peer Wessex Water. The ratings do not incorporate a negative adjustment to reflect these weaknesses, however, we remain cautious about the group's ability to effectively operate as a newly created, stand-alone, fully fledged company and to integrate ZNH at the same time.

Financial Risk: Significant

In our base case, we assume that Stedin will maintain a significant financial risk which is higher than its Dutch peers, reflected in FFO to debt of 11.5%-13.0% over the two-year outlook horizon. The slight strengthening primarily reflects expected volume growth after the recent acquisition of ZNH and tariff adjustments. We benchmark the ratios against the low volatility table (see "Corporate Methodology," published on Nov. 19, 2013 on RatingsDirect), as Stedin derives the majority of operating cash flow from regulated activities with a strong regulatory advantage.

Overall, capital expenditures (capex) are expected at elevated levels of about €400 million-€550 million until the roll-out of the smart meters in 2020, which weighs on free operating cash flows (FOCF). We therefore forecast negative FOCF.. After the completion of the rollout, we expect capex to reduce. However, in relation to the regulatory reset risk, we also foresee potential ratings constraints from 2021 as the regulator may offset any surplus profit after the completion of the rollout of smart meters by lowering the tariffs at the start of the next regulatory period in 2022.

Liquidity: Adequate

We assess Stedin Holding's liquidity position as adequate, reflecting our expectation that the company's liquidity sources will exceed uses by 1.1x over the next 12 months. We also assume that sources would cover uses even if forecast EBITDA dropped by 10%. We understand that Stedin Holding has access to an undrawn facility of €600 million maturing in July 2022 and a €200 million bridge maturing in February 2018, both of which are included in our liquidity calculation.

Principal Liquidity Sources	Principal Liquidity Uses
• Access to cash and cash equivalents of approximately €50 million; • Access to €600 million of undrawn committed credit facilities maturing in July 2022 and a €200 million bridge maturing in February 2018; • Forecast FFO of about €400 million; and • Proceeds of about €60 million from the sale of Weert network as of July 1, 2017.	• Debt maturities of approximately €790 million; • Estimated capex of about €390 million; and • Dividend on the perpetual subordinated bond of about €16 million (€12 million after tax)..

Issue Ratings

Subordination risk analysis

Capital structure

- Stedin's capital structure consists of senior unsecured debt issued at the parent level and subordinated perpetual securities.

Analytical conclusions

- Stedin's senior unsecured debt is rated 'A-', the same as the corporate credit rating as there are no significant elements of subordination risk present in the capital structure. The subordinated perpetual securities are rated 'BBB'.

Ratings Score Snapshot

Corporate Credit Rating

A-/Stable/A-2

Business risk: Excellent

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

Financial risk: Significant

- **Cash flow/Leverage:** Significant

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)

Stand-alone credit profile : a-

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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
- 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
- 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

Related Research

- Why Do We View The Dutch Electricity And Gas Networks Regulatory Framework As Supportive?, March 2, 2016

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-

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