

Research Update:

# Dutch DSO Stedin Holding Affirmed At 'A-/A-2' On Regulatory Visibility And Financial Policy; Outlook Stable

November 8, 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.
- Our revised forecasts show a downward trajectory in Stedin's credit metrics due to the materially lower regulatory returns, although already expected in the draft documentation. We now project Stedin will have no headroom under the current credit rating with average funds from operations (FFO) to debt just above 11% in 2021-2023.
- We understand the group is actively working on different credit remedy measures, including the use of equity-like instruments in order to protect its balance sheet, in line with the company's firm commitment to the 'A-' rating. We are therefore affirming our 'A-/A-2' long- and short-term ratings on Stedin.
- The stable outlook captures our view that, despite significant lower regulatory returns over the 2022-2026 regulatory period, the company will have enough shareholder support to preserve FFO to debt above 11% over the medium term.

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## Rating Action Rationale

**The finalized regulatory remuneration framework for Dutch power and gas distributors over 2022-2026 has caused us to revise down our credit metric forecasts for Stedin.** We updated our forecasts for Stedin based on the final method published by the Dutch regulator, the Authority for Consumers and Markets (ACM), in September 2021. The regulator confirmed a significant decline on the real pretax weighted-average cost of capital (WACC) to 0.99% by the end of the regulatory period from 1.3% in 2022 for power and gas distribution. However, the final decision on regulatory WACC for electricity grid has been revised and is now calculated as real WACC plus 50% of inflation expectations, declining to 1.9% from 2.2%. In addition, the regulatory return for the gas grid is now based on a nominal WACC that will decline to 2.2% from 3% over the 2022-2026 period.

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, ACM's decisions have an overall negative impact on Stedin (though less than we forecast in July 2021), leading to a progressive decline in expected revenues. Stedin, along with the rest of the Dutch distribution system operators (DSOs), already faced a regulatory WACC declining to 2.8% in 2021 from 4.5% in 2016. This drop, coupled with increasing capex needs to adapt the grid to new decentralized renewable power capacity, will put significant pressure on Stedin's credit metrics.

We revised downward our EBITDA forecast for 2022 and 2023 by about €20 million-€30 million per year. This reflects our assumptions of higher energy prices paid for network losses and the changed timing and higher magnitude of revenues on TenneT costs, which will be recovered without a lag on the upcoming regulatory period (compared with a two-year lag under the current period). It also incorporates the negative impact of regulatory decisions to benchmark operating performance incentives on a historical sector-based operating costs benchmark, under which Stedin underperformed.

**We expect Stedin's financial performance to remain aligned with its 'A-' rating over 2021-2023, albeit with very limited headroom left for the current rating.**

Lower returns coupled with incremental capex will result in substantially negative free cash flows, which will pressure its metrics over the medium term, with no headroom left under the current rating. We forecast Stedin's FFO to debt just below 11% in 2021 and increasing above 11% in 2022 and 2023. The company also expects close to €7 billion in capex in 2020-2030 related to connecting green projects to Stedin's grid, mirroring the Dutch government's efforts to move to a greener energy mix with renewables to account for 70% of total power produced by 2030. While we take a favorable view of the stimulus to Stedin's core operations and its increased relevance as a DSO amid the energy transition, the high capex plan puts additional pressure on the rating on Stedin. We expect higher capex and sustained dividends to result in negative discretionary cash flows of €200 million-€230 million in 2021 and €250 million-€300 million for 2022.

**We view the group's unchanged financial policy, with a firm commitment to the current rating level, as supportive and as a cornerstone of the 'A-' rating.**

Stedin's unchanged financial policy of preserving a minimum 'A-' rating requires maintaining FFO to debt of 11%-13%, which we believe the company has strong incentives to comply with, as per the Dutch regulatory framework design. We believe that the company's shareholders are supportive of this goal and we expect Stedin will make use of different instruments to protect its credit metrics over the next regulatory period as pressure will increase over the years. Stedin has appealed to its shareholders for €750 million-€1 billion of equity to fund capex of about €7 billion over 2020-2030. We expect equity support will cover a material part of these needs. The company received €200 million in 2021 by issuing preferred shares that we treated as having 100% equity content, resulting in FFO to debt just above 11% on average until 2023. However, Stedin will require additional measures to preserve the 'A-' rating, and we believe the company could have recourse to various protective balance sheet measures. These could include exhausting Stedin's hybrid capacity or the provision of more equity from new or existing shareholders. We did not include any additional equity injection in our base case and we will closely monitor the decision-making process on potential shareholder support and the type of instruments used over the next six months.

## **Outlook**

Our stable outlook on Stedin captures the company's financial policy of retaining at least an 'A-' rating, and our view of shareholders' supportiveness of this goal. We believe Stedin will require additional capital to fund an average of €700 million in capex per year over the next regulatory period, but expect the company to take decisions regarding further credit remedy measures over the next six months, to maintain FFO to debt of at least 11% over the regulatory period. These measures include additional shareholder equity support, new hybrid capital, or new capital.

It also reflects our expectation that Stedin's cash flow generation will remain stable and predictable on the back of solid operational performance in the supportive Dutch regulatory framework, and despite more pressure from increasing capex needs combined with lower regulatory returns.

As a result, we expect Stedin to post average FFO to debt close to 11% over the next two years.

## **Downside scenario**

We could downgrade Stedin if FFO to debt declined and remained below 11%. This could happen over the course of the next regulatory period if shareholder support is less than what we foresee and we do not see any additional support to fund the company's large investment needs. We would closely monitor progress made in deciding upon the remedy tools over the next six months as we consider that a lengthy decision-making process could weigh negatively on the rating as the group has no rating headroom.

## **Upside scenario**

An upgrade in the short term is unlikely given pressure stemming from higher capex and lower regulatory returns. We also believe that Stedin's financial policy will lead the company's FFO to debt to remain within the 11%-13% range. However, we could consider an upgrade if Stedin were to post FFO to debt sustainably above 15%.

## **Company Description**

Stedin Group was formed on Feb. 1, 2017, from the unbundling of Eneco Holding N.V. into an energy company of the same name and a network company, Stedin Holding N.V.

Stedin Group, through its Stedin and Enduris subsidiaries, is the third-largest electricity and gas grid operator in Netherlands. It operates as a monopoly in a large part of the province of South Holland, Utrecht, and Zeeland, and in parts of North Holland and Friesland. As a grid operator, Stedin provides energy to more than two million customers.

In addition, Stedin offers electricity and gas infrastructure services under the name DNWG Infra. It also offers the realization and maintenance of energy infrastructure, other than gas and electricity, through its subsidiary NetVerder. We expect the company's unregulated business, DNWG Infra and NetVerder, to only represent a minimal part of consolidated EBITDA over the next few years.

Stedin is owned by 44 Dutch municipalities, the largest of which is the City of Rotterdam, followed by The Hague. By law, Stedin must be owned by a public entity.

## Our Base-Case Scenario

### Assumptions

- Regulatory real pretax WACC decreasing to 3.00% in 2021 from 3.50% in 2019, marking the end of the regulatory period.
- Over the next 2022-2026 regulatory period, nominal pretax WACC for the gas grid declining to 2.8% from 3% and inflation-adjusted pretax real WACC for electricity grid declining to 1.9% from 2.2%.
- Close to 100% of Stedin's EBITDA coming from purely regulated activities.
- TenneT fees and smart metering profits tariff discounts resulting in around a €50 million negative effect on EBITDA in 2021. From 2022, revenues over TenneT transport costs will be based on estimates of costs for the next year, resulting in less pre-funding versus the previous two-year lag.
- Stedin's efficiency program, which started in 2018, to realize €140 million-€150 million cumulative savings by 2022.
- Increased working capital needs over 2021-2023 due to tariff deviation, the rise in TenneT transmission costs, and network losses.
- Investments increasing over the next decade due to grid reinforcements, new connections, and metering. We expect capex of about €690 million in 2021, increasing to €700 million in 2022 and €750 million in 2023.
- Customer contributions netting capex of around €110 million per year.
- We assume no equity injection.
- Dividend payout ratio of about 50% of previous year's recurring net income.

### Key metrics

(Mil. €)	--Fiscal year ended Dec. 31--				
	2019a	2020a	2021e	2022f	2023f
EBITDA	489	463	460-470	490-500	520-530
Capital expenditure	640	610	680-700	690-710	740-760
Free operating cash flow	(275)	(213)	(320)-(300)	(220)-(200)	(240)-(220)
Dividends	40	46	10-30	0-20	20-50
Discretionary cash flow	(315)	(259)	(350)-(330)	(220)-(200)	(280)-(260)
Debt§	3.2	3.4	3.4-3.6	3.6-3.8	3.9-4.0
Debt to EBITDA (x)	6.5	7.3	7.3-7.6	7.3-7.6	7.4-7.7
FFO to debt (%)	12.3	12.0	10.3-10.6	11.5-11.8	11.2-11.5

\*All figures adjusted by S&P Global Ratings. §2020 year-end debt consists of net financial debt of €3.1 billion with key adjustments being €250 million of hybrid debt content and €10 million in pension. a--Actual. e--Estimate. f--Forecast.

## Liquidity

We assess Stedin's liquidity position as adequate, reflecting our expectation that its liquidity sources will exceed uses by 1.1x over the next 12 months, as of Sept. 31, 2021. We also assume that sources would cover uses even if forecast EBITDA dropped by 10%. Stedin has access to an undrawn committed credit facility of €600 million maturing in July 2024, which supports the group's liquidity position.

Moreover, our assessment also considers Stedin's satisfactory standing in the credit markets, prudent risk management, and proven access to diverse sources of funding.

Principal liquidity sources for the 12 months from Sept. 31, 2021, are:

- Cash and short-term investments of €110 million;
- Committed credit line of €600 million maturing 2024, 100% of which is unused; and
- Cash FFO of about €400 million-€410 million.

Principal liquidity uses over the same period are:

- Debt maturities of €600 million;
- Working capital outflows of €60 million; and
- Capex, net of customer contributions, of €590 million.

## Covenants

A part of Stedin's loans are subject to various financial covenants, including a ratio of net debt to total equity lower than 70%, and an interest-coverage ratio greater than 3.0x. Stedin complied with both tests as of year-end 2020.

## Compliance expectations

We forecast that Stedin's interest coverage will remain consistently above 5x and net debt to total equity at 55%-58% over our forecast scenario, implying significant headroom.

## Issue Ratings - Subordination Risk Analysis

### Capital structure

As of Dec. 30, 2020, Stedin reported €2.9 billion of interest-bearing debt. Out of this debt, €1.8 billion correspond to Eurobond financing, around €590 million correspond to private placements, €81 million to lease liabilities, and the rest to other type of senior debt. We add €250 million to this debt, corresponding to 50% of the company's perpetual subordinated bond loan, because we view this instrument as having intermediate equity content.

### Analytical conclusions

Except for Stedin's hybrid capital securities, we rate its public debt at the same level as the issuer credit rating, since we perceive no subordination risk that could result in a material credit disadvantage for bondholders.

We rate Stedin's subordinated capital securities two notches below the issuer credit rating: one notch for contractual subordination to other senior debt within the group and an additional notch due to the optional deferability of interest payments.

## **Ratings Score Snapshot**

Issuer 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**

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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 | General: The Treatment Of Non-Common Equity Financing In

Nonfinancial Corporate Entities, April 29, 2014

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

## Related Research

## Ratings List

### Ratings Affirmed

#### Stedin Holding N.V.

Issuer Credit Rating	A-/Stable/A-2
Senior Unsecured	A-
Junior Subordinated	BBB
Commercial Paper	A-2

#### Stedin Netbeheer B.V.

Issuer Credit Rating	A-/Stable/--
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