Creditreform corporate rating update

Eandis System Operator cvba (Group) based on Eandis Economic Group

Creditreform Rating Agentur

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Rating object	Rating information	
Eandis System Operator cvba (Group) based on Eandis Economic Group	Rating: **A+**	Outlook: **stable**

Creditreform ID:	0477445084
Incorporation:	March 30th, 2006
(Main) Industry:	Operating company of seven DSOs
Management:	Walter Van den Bossche, CEO

Prepared on:	**January 17th, 2018**
Monitoring period until:	January 16th, 2020
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Rating methodology:	Corporate ratings Government-related companies
Rating history:	www.creditreform-rating.de

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Abstract

Company

Eandis System Operator cvba (Group[1]) (*Elektriciteit, Aardgas, Netten en Distributie* - ESO) is the Belgian operating company of seven Flemish distribution system operators[2] (DSOs). They constitute together the Eandis Economic Group (EEG - the Group). The Group owns and operates 2.7 million access points for electricity and 1.8 million access points for gas in a territory comprising 229 Flemish and 4 Walloon cities and municipalities. ESO was established in 2006 and is responsible for the distribution of the electricity and gas to private households and SMEs (low or medium voltage/pressure). As ESO operates on a cost-price basis on behalf of the seven DSOs, which are the network owners, and given that the seven DSOs provide a guarantee for all debt obligations incurred by ESO, we considered EEG as a whole in order to assess the creditworthiness of ESO.

EEG employed an average of 4,210 people (2015: 4,480 people) in 2016 and is thereby by far the largest DSO group in Belgium. The Group (IFRS) achieved consolidated revenues of EUR 2,723.2 million in 2016 (2015: EUR 2,618.6 million) and a net profit of EUR 282.9 million (2015: EUR 284.4 million). EBIT grew by 1.1% to EUR 618.8 million in 2016. The Group is currently facing major changes with the restructuring of the Flemish energy distribution sector.

Rating Result

The current rating attests a high level of creditworthiness to ESO, which represents a low default risk for the company in comparison with the sector and the overall economy.

The ultimate shareholders of the DSOs are the municipalities of the Flemish Community, who own 100% of the DSO's share capital. This has a positive impact on our rating assessment. The sub-methodology "government-related companies" has been applied. We thereby assume that the local authorities would give systemic support to the Group if needed. Any change in the sovereign rating of Belgium (CRA rating AA stable as of July 28, 2017) or to the Flemish Region could therefore have an impact on ESO's corporate rating.

The EEG disposes of a legally-based regional monopoly in a sector that provides essential services to the population and is therefore of strategic importance for the Flemish region. Even though allowed returns for the regulatory period 2017-2020 are lower than in the former regulatory periods, the Flemish regulatory framework is supportive (e.g. recuperation of historical tariff deficits, arrangement regarding stocks of unsold green energy and cogeneration certificates) and allows EEG to generate strong predictable cash flows. The effects of the current restructuring of the energy distribution sector in Flanders remain to be seen. We hold the view that the merger of Eandis and Infrax into Fluvius may result in a greater integration of the sector, structures simplification, reduc-

[1] Eandis System operator cvba and its consolidated subsidiaries: De Stroomlijn cvba, Atrias cvba, Synductis cvba. Non-consolidated subsidiaries: Warmte@Vlaanderen cvba and Fluvius cvba.

[2] Gaselwest, IMEA, Intergem, Imewo, Iveka, Iverlek and Sibelgas.

tion of costs and the realization of several synergies. Moreover, we expect a strengthening of the equity ratio and financial results of EEG if the expected split-up of the financing associations[3] and their integration into the DSOs takes place.

Outlook

The yearlong outlook of the rating is stable. This appraisal takes into account the low business risk profile of the company and the moderate financial risk profile given the guarantee of the DSOs and the assumed support of its ultimate shareholders in the event of distress. The impacts of the current restructuring and recent developments in the Flemish energy distribution sector remain to be seen.

Relevant rating factors

Financial ratios' extract Basis: consolidated annual statement per 31.12 (IFRS)	Standardized annual financial statement (Eandis Economic Group)	
	2015	2016
Turnover	EUR 2,315.7 million	EUR 2,454.3 million
EBITDA	EUR 945.3 million	EUR 947.8 million
EBIT	EUR 612.1 million	EUR 618.8 million
EAT	EUR 284.4 million	EUR 282.92 million
Total assets adj.	EUR 9,618.8 m	EUR 9,521.8 million
Equity ratio adj.	24.4%	25.8%
Capital lock-up period	42.3 days	31.8 days
Short-term capital lock-up	62.6%	54.8%
Return on investments	4.9%	5.0%
Net Debt / EBITDA	7.3	7.2
Ratio of interest expenses to debt	2.9%	2.9%

General rating factors

+ Government-related company
+ Strategic importance of the company for the region - crucial market player in the energy distribution sector in Flanders
+ Transparent and supportive regulatory framework
+ Predictable revenues and cash flows
+ Low business risk profile of the DSOs with a legally based regional monopoly for gas and electricity distribution
+ Probable and assumed support by the local authorities (ultimate shareholders) if necessary
+ Guarantee of the DSOs for debts taken by ESO (in proportion of its capital share in ESO)

- Ongoing investments required
- Capital-intensive business, high fixed costs
- Limited upside potential given the revenue cap

Current factors (rating 2018)

+ Increased equity ratio, revenues and EBIT in 2016
+ Significant reduction of historical stocks of unsold green and cogeneration certificates
+ Recuperation of the regulatory assets/liabilities (tariff under-recovery in 2010-2014) over a 5-year period from 2016 until 2020
+ Successful refinancing of expiring bond with lower financing costs
+ Good liquidity position

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[3] Finiwo, Ika, Finea, Fingem, Figga and Finilek.

- High gearing and net debt / EBITDA ratio
- Concentration risk of turnover on a few customers

Prospective rating factors

+ Manageable capex in the infrastructure
+ Expected synergies and economies of scale through integration with Infrax
+ Strengthening of the EEG balance sheet through partial integration of FICs' participations and corresponding liabilities

- Relatively high pay-out ratio although commitment of stable dividend payments until 2019
- Integration risks and costs

Best-case scenario

Best-case scenario: AA-

In our best-case scenario for one year, we assume a rating of AA-. Provided that the merger with Infrax and the partial integration of the FICs are successfully implemented as well as assuming that the business further develops cost-efficiently, a rating update could be expected.

Worst-case scenario

Worst-case scenario: A

In our worst-case scenario for one year, we assume a rating of A. It is assumed that the restructuring leads to an unexpected deterioration of financials due to increased integration costs. The rating could also be downgraded if the assumed support from the ultimate shareholders lowers.

Note:

The scenarios are based on the information available at the time of the rating. Within the forecast horizon, some circumstances could occur that would lead to a rating change out of the indicated range.

Business development

During the year 2016, the Eandis Economic Group achieved revenues amounting to EUR 2,454 million (2015: EUR 2,316 million), of which 94.5% were generated by the distribution of electricity and gas; 3.0% by the direct sale of energy to households that have difficulties finding an energy provider (public service obligation); and 2.5% by construction work for other parties. We identified a concentration risk given the fact that the two largest customers of EEG for the segment electricity together represented 60% of the turnover, and the three largest customers of the segment for gas together represented 63% of the turnover in 2016.

The nominal capital of EEG slightly decreased by EUR -15.7 million as of December 31st, 2016 following the exit of Frasnes-lez-Anvaing, the province East-Flanders and the province Antwerp. The province of West-Flanders will withdraw by the end of 2018 **(**Decree on Intermunicipal Cooperation). Dividends paid amounted to EUR 165.8 million in 2016 (2015: EUR 185.6 million) in accordance with the dividend commitments until 2019.

In 2016, Eandis created two joint-ventures together with Infrax: Fluvius, in order to foster the smart metering project and Warmte@Vlaanderen cvba, which is active in district heating. Infrax is a distribution operator for natural gas, electricity, cable television and sewerage in the Flemish region.

On December 20th, 2016, the Flemish regulator Vlaamse Reguleringsinstantie voor de Elekriciteits- en Gasmarkt (VREG) approved the new tariffs for 2017 based on the 2017-2020 tariff methodology, which is based on an ex-ante "revenue cap-oriented" system[4]. The tarification principles cover exogenous costs and non-exogenous costs and foresee a fair capital remuneration for the shareholders (RAB*WACC). ESO stand-alone performs all operations at cost (without profit or loss) for the inter-municipalities. The new methodology includes the recuperation of the regulatory assets/liabilities for the period 2010-2014 over a period of 5 years (until 2020) from 2016 onwards. These transfers amounted to EUR 397.6 million as of June 30th, 2017 (EUR 587.2 million as of

[4] The cap determines the maximum revenue a DSO can collect from the grid users in a given period, with the exclusion of so-called "exogenous costs" beyond the DSOs' control, which are not subject to the revenue cap and are included in the tariffs.

December 31st, 2016). The regulatory balances from 2015 will be recuperated via the tariffs based on the tariff methodology 2017-2020.

Overall, even though allowed returns for the regulatory period 2017-2020 are lower than in the former regulatory periods, the eligible income 2017 increased in comparison with 2016 due to the increasing exogenous costs (for the green energy certificates and the processing of the regulatory balances). In the first half of 2017, revenues increased by 7.2% to EUR 1,340.1 million in comparison with H1-2016, reflecting again the increased tariffs decided by the VREG. The operating margin was 18.5% (H1-2016: 20.4%). Due to a decrease of EUR 35.9 million in financing costs, EAT for the period increased by 20.5% and amounted to EUR 129.4 million (H1-2016: EUR 118.5 million).

The Flemish energy distribution sector is currently evolving and restructuring. It foresees a full unbundling between generation (a commercial activity), transmission, distribution (both regulated activities) and supply (a commercial activity). Considering the major challenges in the energy sector, the industry is seeking more efficiency, transparency and structural simplifications (including a reduction in the number of political mandates). Therefore, the two operating companies of the Flemish DSOs, Eandis System Operator cvba (RAB 2016: EUR 7,902 million) and Infrax cvba (RAB 2016: EUR 1,792 million), are planning to merge and to integrate into Fluvius. Infrax stand-alone achieved revenues of EUR 12.4 million in 2016 (2015: EUR 10.1 million) and a net profit of EUR 0.2 million (2015: EUR 0.2 million). EBIT decreased by 7.1% at EUR 0.3 million in 2016.

The integration of the two companies should be realized on July 1st, 2018 with a retroactive effect (fiscal and accounting) on January 1st, 2018. A gradual reduction in the number of employees is also foreseen and the full integration of the employees (ESO had 3,967 employees and Infrax 1,546 employees as of December 31st, 2016) should be completed in 2020. Frank Vanbrabant will become the CEO of Fluvius after the integration of the two companies. This could generate significant synergies and economies of scale. Moreover, a potential merger of the DSO IMEA (Eandis) and IVEG (Infrax) is contemplated. We expect Fluvius to publish accounts for the Economic Group Fluvius, i.e. for the operating company Fluvius (= merged Eandis/Infrax), its subsidiaries and the DSOs of both current groups from 2018 onwards.

Furthermore, a split-up of the financing associations (FICs) is being considered in Flanders. All balance sheet items of the FICs as of December 31st, 2017, both assets and liabilities, should be split up and transferred to either the DSOs or to Zefier cvba, a newly constituted company, at a 1-to-1 ratio without any revaluation. This would lead the DSOs to take over the public sector's participations in Elia (through Publi-T) and Fluxys (through Publigas). As such, this transaction should improve the DSOs' balance sheets, given the high equity ratio of the FICs, with an indirect impact on the balance sheet solidity of the EEG. The current FICs are expected to cease to exist as of April 1st, 2018. At that time, the split-up will be executed retroactively as of January 1st, 2018 from an accounting point of view.

Regarding the green power and cogeneration certificates, which weighted on the balance sheet of Eandis, the Flemish system has been changed and will allow the DSOs to reduce their stock of unsold certificates. A "services of general economic interest" (DAEB) arrangement has been found, including the buy-in of certificates by the Flemish Energy Agency (VEA), which are then to be destroyed. The arrangement is valid for a period of 10 years until 2026. The net decrease of the receivables linked to the certificates is significant: from EUR 546.1 million as of December 31st, 2016, the company estimates the certificate stock at EUR 24.8 million as of December 31st, 2017.

The investment program 2018-2022 of Eandis requires on average EUR 433 million every year. During the year 2016, EEG invested EUR 427.6 million (13.3% below the 2015 level), of which EUR 291.6 million in electricity grid infrastructure and EUR 136.0 million in gas. EEG has invested EUR 5.8 million in 2016 for the project smart metering.

As of December 31st, 2017 and based on internal information, EEG's total long-term debt amounted to EUR 5,468 million (initial amount: EUR 6,641 million). In this amount, bonds represent an amount of EUR 3,470 million (EMTN program and retail bonds together) and bank loans represent EUR 1,997 million. Average interest rate of long-term financing is 2.93%, which is lower than the cost of debt in allowed income (3.04% in the new VREG methodology 2017-2020). All long-term bonds of ESO are guaranteed by each of the DSOs in proportion to their participation in the share capital of the company as of the date of entry into the financing arrangements. In June 2017, Eandis successfully issued a new retail bond amounting to EUR 200 million with an 8-year maturity (until June 23rd, 2025) and an interest rate of 2.0% p.a. This new issue has been primarily used to refinance the 2010-2017 bond (4.0% p.a. – EUR 150 million until June 20th, 2017). In the second part of December 2017, the Board of Directors of Eandis decided to convert two swapped loans into non-swapped loans with a fixed interest rate, leading to costs savings.

The company disposes of a good liquidity position with cash amounting to EUR 31.4 million as well as liquidity facilities amounting to EUR 1,222 million, which are undrawn as of December 31st, 2017. All short-term loans are subscribed by Eandis System Operator in the name and on behalf of the Distribution System Operators that stand surety for their part and act as joint co-debtor except for the bank overdrafts.

The current organizational and share capital structure of the Group is subject to changes given the expected merger of ESO and Infrax as well as of the partial integration of the FICs.

Also under the current restructuring of the Flemish energy distribution sector, we assess the Group as having a low business risk profile as the company is system-relevant and benefits from a supportive regulatory framework from the VREG, generating predictable cash flows. We see the merger of Eandis and Infrax as a significant move towards more integration, an increased regulated asset base and monopolistic position in the Flemish region, the realization of economies of scale and efficiency gains (savings on expenses for operations and investments). Nevertheless, the planned synergies remain to be implemented. We hold the view that the split-up of the FICs should have a positive impact on the consolidated balance sheet of the Group. The impact of the partial integration of the FICs on the operating result and on the resulting financials of the Group remains to be seen.

We assess the financial risks of EEG as moderate and lower than in other industries. The joint debt guarantee from all the DSOs has a positive impact on our rating assessment. We furthermore assume that it is very likely that the local authorities will support EEG if needed. The Group currently disposes of a good liquidity position and has the necessary financial instruments and capital market access to finance its further developments. Nevertheless, the credit risk position of EEG may deteriorate if total debts increase following the planned integrations and restructuring.

Annex

Regulatory requirements

After having prepared an unsolicited rating of the company on November 2016, the management of Eandis System Operator cvba commissioned Creditreform Rating AG with the preparation of the rating (solicited rating) on December 7th, 2016 (standing order).

The rating is based on qualitative and quantitative analysis of relevant factors as well as on an estimation of sector-specific influencing factors. The quantitative analysis is primarily based on the annual report for 2016, intermediate reports and press releases of the company as well as supplementary information provided by Eandis.

The rating was prepared by analysts Marie Watelet (lead analyst) and Rudger van Mook (co-analyst).

The information and documents meet the requirements and are in accordance with the published Creditreform Rating AG's rating methodology. An electronic version of our rating methodology can be found on our website www.creditreform-rating.de.

A Rating Committee of highly qualified analysts of Creditreform Rating AG was called on January 17th, 2018. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant risk factors, the Rating Committee arrived at a unanimous rating decision.

The rating result and the present rating report have been communicated to Eandis on the same day. A rating certificate has also been provided to the company.

The rating will be monitored until January 16th, 2020. During this period, rating updates may occur. After the expiration of this term, a follow-up rating will be needed in order for the rating to remain valid.

A complete description of the rating methodology of Creditreform Rating AG is available on our website www.creditreform-rating.de.

In 2011 Creditreform Rating AG was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG (CRA) is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

Conflict of Interests

No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks.

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Rules on the Presentation of Credit Ratings and Rating Outlooks

The approval of credit ratings and rating outlooks follows our internal policies and procedures. In line with our policy "Rating Committee," all credit ratings and rating outlooks are approved by a rating committee based on the principle of unanimity.

To prepare this credit rating, CRA has used following substantially material sources:

1. Annual Report

2. Website

3. Internet research.

There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRA website. Furthermore CRA considers satisfactory the quality and extent of information available on the rated entity. In regard to the rated entity Creditreform Rating AG regarded available historical data as sufficient.

Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

The “Basic data” information card indicates the principal methodology or version of methodology that was used in determining the rating, with a reference to its comprehensive description.

In case where the credit rating is based on more than one methodology or where reference only to the principal methodology might cause investors to overlook other important aspects of the credit rating, including any significant adjustments and deviations, Creditreform Rating AG explains this fact in the credit rating and indicates how the different methodologies or these other aspects are taken into account in the credit rating. This information is integrated in the credit rating report.

The meaning of each rating category, the definition of default or recovery and any appropriate risk warning, including a sensitivity analysis of the relevant key rating assumptions, such as mathematical or correlation assumptions, accompanied by worst-case scenario credit ratings as well as best-case scenario credit ratings are explained.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the “Basic data” card as a “Rating action”; first release is indicated as “initial rating”, other updates are indicated as an “update”, “upgrade or downgrade”, “not rated”, “confirmed”, “selective default” or “default”.

In the case of a rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within „Basic data“ information card.

In accordance to Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available at the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of Creditreform`s default rates are available in the credit rating methodologies disclosed on the website.

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