

Research Update:

# Alectra Inc. Outlook Revised To Negative On Revised Business Strategy, Weakened Financial Measures; 'A' Rating Affirmed

June 9, 2021

## Rating Action Overview

- Alectra Inc. recently acquired power restoration company Holland Power Services Inc. (HPS) for C\$52 million, net of C\$28 million of working capital, using mostly debt to fund the transaction. This acquisition is consistent with the company's revised strategy to expand its unregulated business segment, thereby weakening the business risk profile.
- Alectra management indicated the revised strategy includes growth of unregulated operations, which is beyond the traditional strategy of focusing on regulated utility amalgamations within the Ontario jurisdiction.
- In addition to the revised strategy, we expect financial measures to weaken compared with our previous forecasts. The existing financial measures reflect higher deferral and variance account balances. Alectra also experienced lower distribution revenue resulting from the negative effect of the COVID-19 pandemic on load consumption, particularly from commercial and industrial customers. Financial measures could weaken further if the Ontario Energy Board (OEB) adopts a proposal that would limit the recovery of related incremental costs.
- We revised our outlook on Alectra to negative from stable and affirmed our 'A' long-term issuer credit rating.
- The negative outlook incorporates our expectation that the recent acquisition of HPS and Alectra's revised strategy will increase the EBITDA contribution from higher-risk unregulated operations, resulting in a somewhat weaker business risk profile. In addition, Alectra's financial measures will remain weaker for 2021 and 2022 from the negative cash flow impact of the COVID-19 pandemic. This includes our expectation that Alectra's funds from operations (FFO) to debt will be in the 11%-12% range through 2023.

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## Rating Action Rationale

**The negative outlook on Alectra reflects a weakening business risk profile due to the higher contribution from unregulated operations, especially after the acquisition of HPS.** In January 2021, Alectra acquired HPS for C\$52 million, net of C\$28 million of working capital, using mostly debt. HPS is a power restoration business that contracts with public and private utilities in the eastern U.S. and Canada. HPS' financial performance is volatile since it depends heavily on storm activity and restoration work. We expect HPS to add C\$15 million-C\$20 million per year to Alectra's EBITDA. Following the acquisition, we forecast the overall contribution from higher-risk unregulated operations to be about 10%, weakening Alectra's business risk profile. In addition to HPS, the company's unregulated operations include contracted solar, a submetering business, consulting services, and street lighting businesses. Alectra's revised strategy in pursuit of growth beyond regulated operations and expansion into unregulated and competitive operations increases the likelihood of higher EBITDA contributions from riskier unregulated operations, resulting in increased business risk.

**We expect Alectra's financial measures to remain lower for 2021 as the utility absorbs the negative effects of the COVID-19 pandemic, assuming OEB adopts its staff proposal.** OEB staff issued a proposal regarding guidelines for rate recovery of incremental costs incurred during the COVID-19 pandemic. To assess if a utility should be given recovery of these COVID-19-related costs, the staff recommends that only if incremental costs incurred during the COVID-19 pandemic result in a utility's authorized return on equity declining by at least 300 basis points, the utility would be allowed to recover up to 50%. On a case-by-case basis, if the utility demonstrates that its financial viability would still be compromised if the recovery was only limited to 50%, the OEB could consider a higher recovery rate. Based on the OEB staff's proposal, there is a high degree of uncertainty regarding the recovery of incremental costs.

## Outlook

The negative outlook reflects S&P Global Ratings' assessment that Alectra's business risk profile has weakened from growth in unregulated businesses. Our baseline forecast for the next 24 months assumes Alectra's adjusted FFO to debt to be in the 11%-12% range.

## Downside scenario

We could lower the ratings on Alectra if its financial performance weakens such that its adjusted FFO to debt remains consistently below 12% or its business risk weakens further from an increase in its riskier unregulated operations.

## Upside scenario

We could revise our outlook on Alectra to stable if its financial measures strengthen including FFO to debt remaining consistently at or above 12% with no further weakening of the business risk profile.

## Company Description

Alectra is a municipality-owned electric distribution utility operating in Ontario, Canada.

## Our Base-Case Scenario

- Continued costs recovered through annual filings and incremental capital module riders;
- Modest customer growth in its service territory;
- Gross margin additions averaging about C\$17 million annually through 2023;
- Total capital spending of about C\$320 million–C\$430 million per year through 2023;
- Dividends averaging about C\$75 million annually;
- Negative discretionary cash flow indicates external funding needs; and
- All debt maturities are refinanced.

## Liquidity

We assess the company's liquidity as adequate because we believe its liquidity sources are likely to cover uses by more than 1.1x over the next 12 months and meet cash outflows even with a 10% decline in EBITDA. The assessment also reflects the company's generally prudent risk management, sound relationship with banks, and a generally satisfactory standing in credit markets.

Principal liquidity sources

- Cash and liquid investments of about C\$30 million;
- Estimated cash FFO of about C\$315 million; and
- Credit facility availability of C\$700 million.

Principal liquidity uses

- Debt maturities of about C\$165 million;
- Capital outflows of about C\$3 million;
- Capital spending of about C\$405 million; and
- Dividends of about C\$75 million.

## Environmental, Social, And Governance

Alectra's exposure to environmental risk is limited given that its operations are entirely in lower-risk electric distribution operations without commodity exposure. As such, from an environmental perspective, Alectra is better positioned than its counterparts with generation assets across North America. Social and governance factors have not had a material effect on the rating and are generally in line with that of peers.

## Issue Ratings - Subordination Risk Analysis

### Capital structure

Alectra's capital structure consists of about C\$2.4 billion of unsecured debt.

### Analytical conclusions

We rate Alectra's senior unsecured debt at the same level as our long-term issuer credit rating because priority debt does not exceed 50% of the company's consolidated debt, after which point Alectra's debt could be considered structurally subordinated.

### Ratings Score Snapshot

Issuer Credit Rating: A/Negative/--

Business risk: Excellent

- Country risk: Very low
- Industry risk: Very low
- Competitive position: Strong

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: Positive (+1 notch)

Stand-alone credit profile: a

Likelihood of government support: Low (no impact)

### Related Criteria

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

## Ratings List

### Ratings Affirmed; Outlook Action

	To	From
<b>Alectra Inc.</b>		
Issuer Credit Rating	A/Negative/--	A/Stable/--

### Issue-Level Ratings Affirmed

<b>Alectra Inc.</b>		
Senior Unsecured	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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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