

Research Update:

Alectra Inc. Downgraded To 'A-' On Elevated Business Risk, Outlook Stable

May 27, 2022

Rating Action Overview

- Since Alectra Inc.'s 2021 acquisition of non-utility power restoration company, Holland Power Services Inc. (HPS), its higher risk non-utility business has grown disproportionately and we now expect it to consistently account for about 10% of the company's consolidated EBITDA.
- We are revising downward our comparable rating analysis modifier to neutral from positive to reflect the company's increasing exposure to its higher-risk non-utility businesses and our expectation that its financial measures will generally trend towards the lower end of the range for its financial risk profile category.
- We lowered our issuer credit rating on Alectra to 'A-' from 'A' and our issue-level rating on its senior unsecured debt to 'A-' from 'A'.
- The stable outlook incorporates our expectation that the company's regulated utility business will consistently account for about 90% of its consolidated EBITDA. We also forecast that Alectra's consolidated financial measures will be at the lower end of the range for the significant financial risk profile category, including funds from operations (FFO) to debt of 13%-15% through 2024.

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Rating Action Rationale

We downgraded Alectra to reflect the increased contribution from its non-utility business.

Following the first year of operations by HPS--which the company acquired in January 2021--and management's strategic shift to expand its non-utility business, we now expect that non-utility operations will consistently contribute about 10% of Alectra's consolidated EBITDA through 2024. Prior to the HPS acquisition, we expected the non-utility businesses to account for closer to 5% of the company's consolidated EBITDA. We assess HPS as higher risk than the regulated utility business because its business is heavily dependent on storm activity and restoration work, which will increase the volatility of Alectra's financial performance.

We assess Alectra's financial risk profile as significant using our medial volatility financial benchmark table. We believe that Alectra's strategic decision to disproportionately expand its higher risk non-utility businesses has increased its business risk, which we incorporate by using more stringent benchmarks to assess its financial risk profile. Previously, we assessed the company's financial risk using our low volatility financial benchmark table. The change in benchmark tables does not affect our significant assessment of the company's financial risk profile.

The stable outlook indicates our expectation that the company's regulated business will contribute about 90% of its consolidated EBITDA through 2024. This reflects our expectation that Alectra will not pursue a further expansion of its non-utility business and that its financial measures will remain consistent with the significant financial risk profile category, including FFO to debt of 13%-15% through 2024. Additionally, even if it expands the non-utility businesses at a marginally faster rate than the utility business, we expect its utility operations to provide ratings stability assuming the non-utility business does not approach 15% of the company's consolidated EBITDA.

We assess Alectra at the higher-end of the range of the excellent business risk profile category. This is predicated on the company's lower-risk regulated electric distribution utility business that comprises a large (over 1 million customers) and mostly residential customer base, which provides it with cash flow stability. We view Ontario's regulatory construct as generally constructive, with a fixed-base return on equity and revenue decoupling for residential customers.

Outlook

The stable outlook on Alectra reflects our expectation that its regulated utility business will consistently contribute about 90% of its consolidated EBITDA. Our base-case forecast through 2024 assumes FFO to debt of 13%-15%.

Downside scenario

We could lower our ratings on Alectra over the next 12-24 months if its financial performance weakens, such that its FFO to debt remains consistently below 13%, or we believe its business risk has increased. This could occur if the company disproportionately grows its non-utility businesses, such that it approaches about 15% of its consolidated EBITDA, or if our assessment of Ontario's regulatory environment weakens.

Upside scenario

We could raise our rating on Alectra over the next 12-24 months if its financial measures improve, including FFO to debt of consistently above 18%, without any further increase in its business risk. We could also raise our rating if its non-utility businesses' contribution to its consolidated EBITDA decreases such that it approaches 5%.

Company Description

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

Our Base-Case Scenario

- Gross margin grows by an average of about 6% annually through 2024 due to the company's continued use of regulatory mechanisms, such as the incremental capital module, as well as an expansion in its unregulated business;
- Modest load growth;
- Operation and maintenance expenses rise by an average of about 6% per year through 2024;
- The company begins to recover previously unrecovered energy costs starting in 2023;
- Capital spending averaging C\$380 million per year through 2024;
- Negative discretionary cash flow after dividends of about C\$100 million in 2022, with minimal deficits in 2023 and 2024; and
- All debt maturities are refinanced.

Liquidity

We assess the company's liquidity as adequate because we believe its liquidity sources will likely be more than 1.1x its uses over the next 12 months and meet its cash outflows even if its EBITDA declines by 10%. Our assessment also reflects the company's generally prudent risk management, sound relationships with banks, and generally satisfactory standing in the credit markets.

Principal liquidity sources:

- Cash and liquid investments of about C\$40 million;
- Estimated cash FFO of about C\$400 million; and
- Credit facility availability of C\$700 million.

Principal liquidity uses:

- Debt maturities, including outstanding commercial paper, of about C\$345 million;
- Capital spending of about C\$420 million; and
- Dividends of about C\$75 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

- Alectra's capital structure comprises about C\$2.3 billion of unsecured debt.

Analytical conclusions

- We rate Alectra's senior unsecured debt at the same level as our issuer credit rating because its

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priority debt does not exceed 50% of its consolidated debt, after which point we would likely consider its debt to be structurally subordinated.

Ratings Score Snapshot

Issuer Credit Rating: A-/Stable/--

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: Neutral (no impact)

Stand-alone credit profile: a-

- Likelihood of government support: Low (no impact)

ESG credit indicators: E-2; S-2; G-2

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: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global

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Corporate Issuers, Dec. 16, 2014

- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

Downgraded; Outlook Action

| | To | From |
|----------------------|--------------|---------------|
| Alectra Inc. | | |
| Issuer Credit Rating | A-/Stable/-- | A/Negative/-- |

Issue-Level Ratings Lowered

| | | |
|---------------------|----|---|
| Alectra Inc. | | |
| Senior Unsecured | A- | A |

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