

# Hydro One, Ltd.: Quality Rating

## Investment Thesis

Hydro One Ltd. (H) continues to capture growth beyond guidance. New transmission lines, outside its joint distribution and transmission regulatory application (JRAP), offer new investment opportunity alongside potential Ontario local distribution company (LDC) consolidation. We expect H's rate base growth to exceed 7% through 2027, rivaled only by peer Emera Inc. H's TTM AFFO yield of ~6% is lower than peers, a function of favourable regulation, growth prospects, and a solidly investment grade balance sheet. We expect H to exceed its allowed ROE by over 100 basis points in 2023, driven by transmission assets entering a first-phase of performance based regulation. An impressive achieved ROE and a distinct funding advantage for growth underpin our outlook for sector-leading returns from H stock through 2027. At H's current share price, we expect impressive average equity returns above 11% through 2027 and maintain a BUY rating.

## Intrinsic Value

We value H at \$42 per share.

## Quality Rating Conclusion ★★★★★

## Accounting & Disclosure ★★★★★

H's accounting and disclosure is above-average with impressive transparency provided on regulatory factors and a more meaningful cash-based non-GAAP metric.

## Adjusted Cash Flows ★★★☆☆

H's cash flow profile is capable of supporting dividend growth of 5%+ per year due to rate base growth, efficiency cost savings and a solid balance sheet.

## The Balance Sheet ★★★★★

H's FFO-to-debt ratio remains solidly investment grade, facilitating accretive growth/development beyond guidance.

## Business Operations ★★★★★

A focus on cost cutting is benefiting cash flow, while the Ontario Energy Board's automatic adjustment mechanism mitigates regulatory lag on price hikes to compensate for higher interest rates. As a pure-play electric utility, transition spending (i.e., electrification) is beneficial.

## Corporate Governance ★★★★★

H is focusing on efficiency to drive system costs down, driving organic improvement in AFFO and debt service metrics.

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*Our analysts rate stocks based on their view of how the stock will perform over the next 12 months relative to their sector of coverage.*

Rating	Description
Buy	Expected to generate a meaningful positive return or outperform analyst's sector coverage over the next 12 months
Reduce	Expected to underperform analyst's sector coverage over the next 12 months
Sell	Expected to generate a negative return over the next 12 months

## Explanation of the Veritas Quality Rating System

*Our Quality Rating System evaluates the key components of our investment recommendations for companies under coverage. We rate each company under the given criteria using a proprietary five-star system versus its sector peers:*

Category	Explanation
Accounting and Disclosure	We compare the quality and transparency of the financial and non-financial information provided to investors in public disclosures.
Cash Flows Sustainability	We evaluate the sources of and sustainability of each company's cash flow to equity investors.
Balance Sheet Exposure	We evaluate the company's asset valuations and consider on and off-balance sheet exposures.
Business Operations Risks	We evaluate the key tenants supporting the sustainability of an organization's business success.
Corporate Governance	We consider each company's management compensation system, its decision-making process and sustainability to evaluate whether management's interests are aligned with those of shareholders.

*We arrive at a conclusion of zero to five stars:*

Stars	Explanation
Zero Stars	Very high risk or deficiency versus sector peers.
★	Significant risk versus sector peers.
★★	Above-average risk versus sector peers.
★★★	Average risk versus sector peers.
★★★★	Below-average risk versus sector peers.
★★★★★	Applies best practices versus sector peers.

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