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Transaction Update: Dwr Cymru (Financing) Ltd.

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Transaction Update: Dwr Cymru (Financing) Ltd.

Rationale

None

Business Risk	Financial Risk
<ul style="list-style-type: none">• Mainly focused on low-risk, U.K.-water regulated monopoly activities.• Transparent, credit supportive regulatory framework that results in financial stability during regulatory periods.• Low regulatory reset risk because the current regulatory period (AMP6) runs until March 31, 2020.• Adequate performer under the range of regulatory measures set and monitored by Ofwat.• Relatively weak although improving profitability compared with peers'.	<ul style="list-style-type: none">• Relatively weak cash flow ratios.• Declining leverage and a new tighter company target of 60% adjusted debt to regulatory capital value (RCV).• Various structural features designed to increase cash flow certainty for debtholders.

Outlook

The stable outlook on U.K.-based Dwr Cymru (Financing) Ltd. reflects Standard & Poor's Ratings Services' view that utility company Dwr Cymru Cyfyngedig (Welsh Water) will continue to reduce leverage, maintain headroom according to its new internal policy, and generate close to neutral discretionary cash flows on average for the current regulatory period ending in March 2020. Dwr Cymru (Financing)'s debt, which we rate, is backed by future cash flows generated by Welsh Water's fully regulated and relatively low-risk water assets.

The outlook also reflects that we expect Welsh Water to continue to deliver adequate operational performance and a good track record as an asset operator in both the short and medium term.

Downside scenario

We could lower our rating on the debt if we see weaker operational performance, which could lead us to revise our assessment of the company's business risk profile to strong from excellent. We would also consider lowering the rating if we see any evidence of pressure to increase balance-sheet leverage, or if the company's financial metrics are more aggressive than we expected.

Upside scenario

At this stage, we consider that there is limited scope for a higher rating on the outstanding debt because the financial covenants in the documentation for the medium-term note program allow the group to operate with high leverage. However, if the company's commitment to substantially reduce leverage translates into sustainably stronger credit metrics throughout the regulatory period, we would view this as supportive of underlying credit quality.

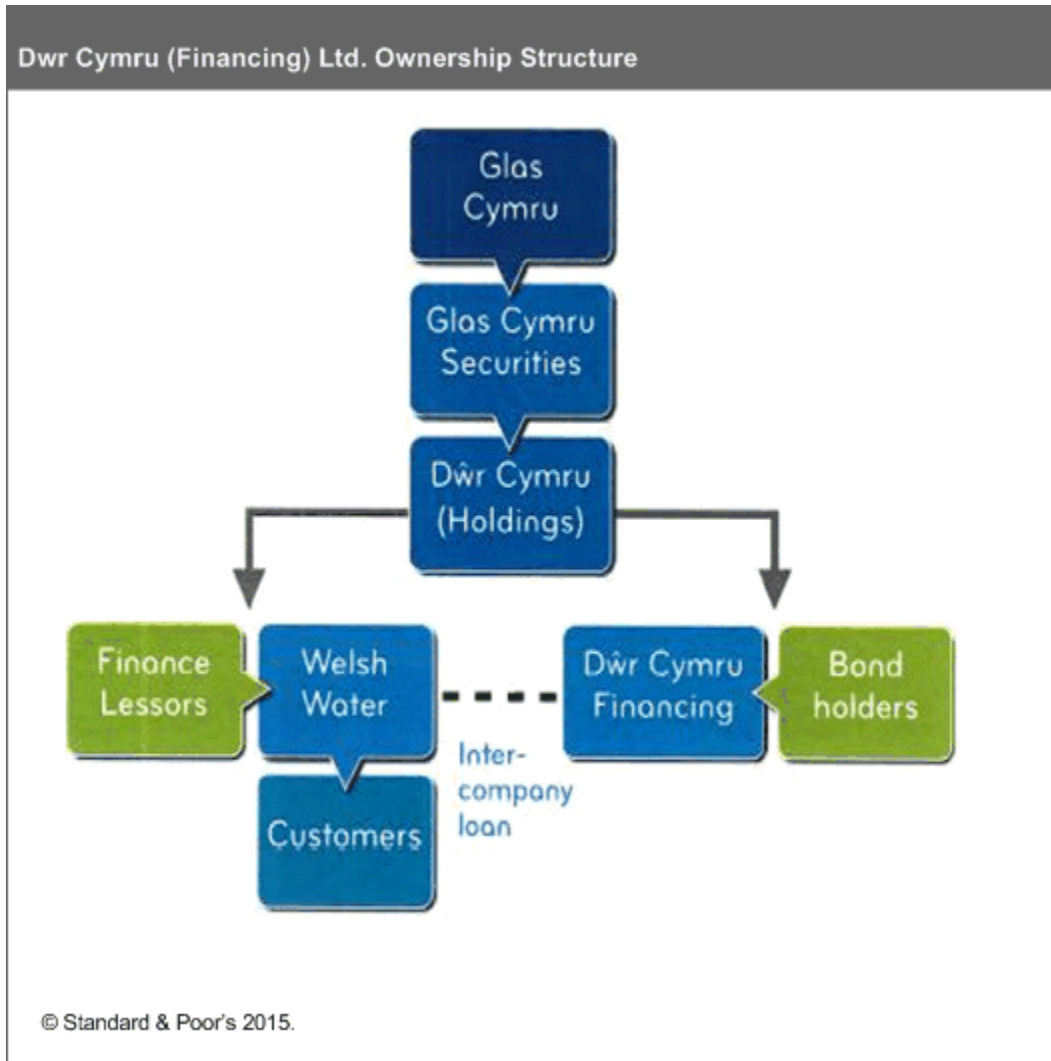
Standard & Poor's Base-Case Scenario

Assumptions	Key Metrics				
<ul style="list-style-type: none"> Revenues declining by 1%-1.5% in 2015-2016 and low-single digit growth during the current regulatory period (AMP6) from 2015 to 2020, based on a combination of real price declines and our retail price index (RPI) assumption. Adjusted EBITDA margins of 49%-52% in 2015-2016 and during AMP6. Capital expenditure (capex) of about £300 million-£350 million in 2015-2016. Limited outperformance against an already tight total expenditure allowance, as per the company's track record. An operational target of debt to RCV of 60% (down from 70%) as per the company's new internal policy. 					
		2015e	2016f	2017f	2018f
	EBITDA margin (%)	49.9	49-52	49-52	49-52
	FFO/Debt (%)	8.4	7-9	7-8	7-8
Debt/EBITDA (x)	7.9	8.0-9.0	8.0-9.0	8.0-9.0	
e--Estimate. f--Forecast. FFO--Funds from operations.					

Company Description

Welsh Water is the sixth largest of the 10 regulated water and sewerage companies in England and Wales, according to the RCV (regulatory capital value), which was £4.83 billion as of March 31, 2015. It supplies water and wastewater services to 1.3 million properties across most of Wales and some adjoining areas of England.

Dwr Cymru (Financing) is a financing vehicle that is ultimately owned by Glas Cymru, a Welsh nonprofit company (see chart). Glas Cymru is controlled by members with no financial interest in the company. The financial beneficiaries of outperformance are primarily the customers and, to a lesser extent, investors, although the latter also bear some underperformance risk. This unique ownership structure distinguishes Glas Cymru from other U.K. water utilities because it eliminates pressure to pay dividends and other shareholder returns.



Structural Features

The debt Dwr Cymru (Financing) has issued is backed by the future cash flows of Welsh Water's fully regulated and relatively low-risk water assets. Dwr Cymru (Financing) has lent the proceeds of its debt issuance to Welsh Water. Our ratings on the debt reflect our assessment of Welsh Water's underlying credit quality within the ring-fenced group.

We rate Dwr Cymru (Financing)'s long-term senior secured debt, the subordinated debt on its medium-term note program, the class A debt guaranteed by MBIA U.K. Insurance Ltd., and the outstanding class B debt. Under our criteria, the rating on monoline-insured debt reflects the higher of the rating on the monoline insurer and Standard & Poor's underlying rating (SPUR). Therefore, the rating on the class A bonds guaranteed by MBIA U.K. Insurance Ltd. reflects the higher SPUR (see table 1).

Table 1

Dwr Cymru (Financing) Ltd. Supporting Ratings	
Institution/role	Rating
Lloyds Bank PLC as swap counterparty	A/Stable/A-1
BNP Paribas as liquidity facility provider	A+/Negative/A-1
HSBC Bank PLC as swap counterparty and liquidity facility provider	AA-/Stable/A-1+
National Australia Bank Ltd. as liquidity facility provider	AA-/Stable/A-1+
JP Morgan Chase Bank N.A. as liquidity facility provider	A+/Stable/A-1
Royal Bank of Scotland as a swap counterparty	BBB+/Stable/A-2
MBIA U.K. Insurance Ltd. as guarantor of Class A debt	B/Stable/--

The ratings on the debt also reflect various structural features (see table 2). These are designed to increase cash flow certainty for debtholders, including restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable Dwr Cymru to manage temporary cash flow shocks. In particular, debtholders benefit from:

- Ring-fencing of the financing entity, which is achieved through Dwr Cymru (Financing)'s special-purpose status; significant independent representation on the Dwr Cymru board (six of the nine members); and some business, legal, and regulatory restrictions.
- Three levels of financial covenants (a restricted payment condition, trigger events, and events of default) and an automatic 18-month standstill period after an event of default. These provide creditors with significant control over Dwr Cymru at an early stage of financial or operational difficulty or following material changes in business circumstances. The covenants minimize the probability of default and create an additional credit cushion.
- Liquidity facilities of £135 million available to cover a standstill, provided by suitably rated counterparties (see table 1). These facilities are sufficient to cover finance charges, and are dedicated to drawings if the company enters a standstill. The facilities remain undrawn and the amounts available are unchanged.
- A strong covenant package, including limitations on additional debt, a defined cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on distributions.
- Subordination of the class C debt, the nonpayment of which cannot create an event of default for the class A debt. Currently Dwr Cymru (Financing) has no outstanding class C debt.

Table 2

Dwr Cymru (Financing) Ltd. Key Features Of The Debt	
Closing date	May 10, 2001
Collateral	Dwr Cymru (Financing) Ltd.'s debt is secured by first fixed and floating charges on assets to the extent permitted by the Water Industry Act 1991 and Welsh Water's Instrument of Appointment. Security includes Welsh Water's accounts receivable, contracts, bank accounts, and all assets except protected land. In addition, the other entities in the Glas Cymru structure--Glas Cymru, Dwr Cymru (Holdings) Ltd., and Glas Cymru (Securities)--guarantee Welsh Water's obligations.
Country of origination	U.K.
Financial covenants	Senior and class C RAR: 95.0%
	Senior interest cover ratio: 1.6x
Trigger events	Senior interest cover ratio: 2.0x
	Senior post-maintenance interest cover ratio: 1.0x
	Senior and Class C RAR: 90%
Liquidity facility size (mil. £)	135

Table 2**Dwr Cymru (Financing) Ltd. Key Features Of The Debt (cont.)**

Revolving credit facility (mil. £)	120
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RAR--Regulated asset ratio.

Business Risk

Our assessment of Welsh Water's business risk profile as "excellent" reflects the stable and predictable revenue and cash flow streams from the low-risk regulated water and wastewater businesses, Welsh Water's natural monopoly in its service area, and a generally supportive and transparent regulatory framework. The strength of the Water Services Regulation Authority (Ofwat) and its framework is reflected in our assessment of Ofwat providing a "strong" regulatory advantage (see "Why U.K. Utilities' Regulatory Frameworks Merit A "Strong" Regulatory Advantage Assessment," published Dec. 11, 2013, on RatingsDirect).

In our opinion, Welsh Water's operational performance remains weaker than its peers', based on the level of profitability. This is mainly attributable to the retail business, which has higher-than-average costs to service. That said, the company successfully achieved tough efficiency targets set in the previous regulatory period. Furthermore, we expect this trend to continue and the company to comply with even tighter AMP6 requirements. Welsh Water has also performed well against regulatory key performance indicators, particularly in terms of customer service, where the company now ranks No. 3, on par with Northumbrian Water. Nevertheless, there remain significant improvement needs, as demonstrated by supply interruptions.

Like all water companies, Welsh Water is exposed to regulatory reset risk every five years. In December 2014, Ofwat announced the final determination for Welsh Water. Although Welsh Water's business plan was not fast tracked in the price review process, it was in line with the regulator's expectations (except for the retail business) and benefited from early draft determination in May 2014. Based on the published determination for the regulatory period 2015-2020 under AMP6 and Welsh Water's business plan, we believe the targets and incentives are achievable and unlikely to have a negative impact on the company's business or financial risk profiles. However, we do not factor into our base case potential outcome delivery incentives as we consistently do for Welsh Water's peers.

S&P Base-Case Operating Scenario

- Our assumption of RPI inflation of 1.1% in 2015 and 2.8% in 2016 resulting from a 1% premium over the cost price index. We assume 2.5% RPI inflation thereafter.

Peer comparison**Table 3****Dwr Cymru (Financing) Ltd. Peer Comparison****Industry Sector: Water**

	Dwr Cymru (Financing) Ltd.	Yorkshire Water Services Finance Ltd.	Anglian Water Services Financing PLC
Issue rating on senior secured debt as of Sept. 3, 2015	A/Stable/--	A/--/--	A/--/--

Table 3

Dwr Cymru (Financing) Ltd. Peer Comparison (cont.)			
(Mil. £)	--Average of past three fiscal years--		
Revenues	734.1	943.4	1,171.7
EBITDA	364.6	552.8	701.1
Funds from operations (FFO)	207.7	292.5	319.4
Net income from continuing operations	25.6	176.4	301.8
Cash flow from operations	228.8	413.2	435.9
Capital expenditures	256.0	376.9	393.4
Free operating cash flow	(27.2)	36.2	42.5
Discretionary cash flow	(27.2)	(125.6)	(192.8)
Cash and short-term investments	6.7	0.7	8.2
Debt	2,834.0	4,508.9	5,310.3
Equity	7.5	2,439.2	1,010.3
Adjusted ratios			
EBITDA margin (%)	49.7	58.6	59.8
Return on capital (%)	6.7	5.7	8.3
EBITDA interest coverage (x)	2.2	2.0	2.0
FFO cash int. cov. (X)	3.0	2.7	2.9
Debt/EBITDA (x)	7.8	8.2	7.6
FFO/debt (%)	7.3	6.5	6.0
Cash flow from operations/debt (%)	8.1	9.2	8.2
Free operating cash flow/debt (%)	(1.0)	0.8	0.8
Discretionary cash flow/debt (%)	(1.0)	(2.8)	(3.6)

Financial Risk

Our rating on Dwr Cymru (Financing)'s debt is constrained by Welsh Water's relatively weak although improving credit metrics. In particular, we expect adjusted funds from operations (FFO) to debt to be at about 7% on average throughout the current regulatory period under the weight of relatively low profitability and the negative impact of RPI inflation on index-linked debt.

That said, Welsh Water has relatively lower balance-sheet leverage than peers. Debt represented less than 60% of the company's RCV at the end March 2015, whereas that of peers is about 80%. This is the result of the nonprofit ownership by Glas Cymru, which eliminates pressure to increase leverage through shareholder distributions. This, combined with the moderately large capital investment program at the beginning of AMP6, should result in discretionary cash flows after capex and dividends that are marginally negative, on average.

S&P Base-Case Cash Flow And Capital Structure Scenario

- Adjusted FFO to debt of 7%-9% over 2015-2016.
- FFO to cash interest coverage of 3x-4x over 2015-2016.
- Increasing debt, but total leverage (debt to RCV) remaining at about 60%.

Financial summary

Table 4

Dwr Cymru (Financing) Ltd. Financial Summary					
Industry Sector: Water					
(Mil. £)	--Fiscal year ended March 31--				
	2015	2014	2013	2012	2011
Revenues	752.5	735.1	714.6	693.8	676.0
EBITDA	381.2	368.4	344.2	338.4	371.4
Funds from operations (FFO)	232.5	207.4	183.2	147.1	193.0
Net income from continuing operations	(80.1)	155.3	1.6	(104.0)	138.5
Cash flow from operations	252.4	230.5	203.5	180.7	224.4
Capital expenditures (capex)	275.5	260.1	232.3	149.2	189.4
Free operating cash flow	(23.1)	(29.6)	(28.8)	31.5	35.0
Dividends paid	0.0	0.0	0.0	0.0	0.0
Discretionary cash flow	(23.1)	(29.6)	(28.8)	31.5	35.0
Debt	2,910.7	2,821.2	2,770.1	2,729.0	2,674.2
Preferred stock	0.0	0.0	0.0	0.0	0.0
Equity	(4.9)	101.2	(73.9)	(77.5)	46.1
Debt and equity	2,905.8	2,922.5	2,696.2	2,651.5	2,720.3
Adjusted ratios					
EBITDA margin (%)	50.7	50.1	48.2	48.8	54.9
EBITDA interest coverage (x)	2.5	2.2	2.0	1.7	2.0
FFO cash int. cov. (x)	3.1	3.0	2.9	2.4	2.5
Debt/EBITDA (x)	7.6	7.7	8.0	8.1	7.2
FFO/debt (%)	8.0	7.4	6.6	5.4	7.2
Cash flow from operations/debt (%)	8.7	8.2	7.3	6.6	8.4
Free operating cash flow/debt (%)	(0.8)	(1.0)	(1.0)	1.2	1.3
Discretionary cash flow/debt (%)	(0.8)	(1.0)	(1.0)	1.2	1.3
Net cash flow/capex (%)	84.4	79.7	78.8	98.6	101.9
Return on capital (%)	6.6	6.9	6.6	6.5	7.8
Return on common equity (%)	(171.2)	1,213.3	(2.1)	666.7	(624.9)
Common dividend payout ratio (un-adj.) (%)	0.0	0.0	0.0	0.0	0.0

Liquidity: Strong

We assess Dwr Cymru's liquidity position as "strong" under our criteria, supported by our view that liquidity resources will exceed the company's funding needs by more than 1.5x in the next 12 months. Our liquidity assessment is further underpinned by Dwr Cymru's high standing in the capital markets and its good relationship with banks.

Principal Liquidity Sources

- A cash balance of about £147 million as of March 31, 2015;
- FFO of about £270 million; and

- Access to £190 million of undrawn credit facilities comprising a loan from the European Investment Bank and the operating and maintenance reserve.

Principal Liquidity Uses

- Expected capital spending of approximately £325 million;
- Upcoming short-term debt maturities of approximately £21 million;
- Working capital outflows of approximately £17 million; and
- Flexible return to customers in line with management's commitment to maintaining debt to RCV at 60%.

Covenants

In addition, the company must maintain a liquidity facility that will be available if it goes into default and is also unable to pay interest charges. This facility amounted to £135 million as of March 31, 2015, equivalent to the next 12 months of cash interest payable. Drawing on the liquidity facility results in a distribution lock-up.

If the short-term ratings on the liquidity facility providers are lowered to below 'A-1', the providers must be replaced within 30 calendar days or the funds available under the facility must be fully drawn.

Debt maturities

Table 5

Dwr Cymru (Financing) Ltd. Debt Maturity Schedule	
Year*	(Mil. £)
2015-2016	21
2016-2017	97
2017-2020	77
After 2020	2,685

*Fiscal year end is March 31.

Covenant Analysis

Dwr Cymru continues to comply with the debt-maturity limitations stipulated in the documentation. The next significant maturity is that of £325 million of class B notes in 2021. There are no mandatory break clauses in the index-linked swaps. Dwr Cymru does not have any outstanding class C bonds.

Dwr Cymru has continued to perform well under the covenants and improve the headroom since the debt transaction closed on May 10, 2001. On March 31, 2015, the senior and class C regulated asset ratio was 59.7%, well within the trigger level of 90%. This has been helped by consistently high inflation in the U.K. Although the same factor makes meeting interest cover ratio covenants more difficult, because pay-as-you-go swaps are settled in cash each year, Dwr Cymru has still managed to maintain lower ratios than the trigger level during periods of higher inflation (see table 7). The covenants are calculated on a consolidated basis at the level of Glas Cymru, the ultimate parent company.

Table 6

Dwr Cymru (Financing) Ltd. Key Covenants				
Financial covenant	Restricted payment condition*	Actual performance March 31, 2014	Actual performance March 31, 2015	Forecast performance March 31, 2016
Senior and class C regulated asset ratio (%)	90	63	60	60
Senior ICR (x)	2.0	3.6	3.8	3.7
Senior PMICR (x)	1.0	2.1	2.4	2.1

*For ICR ratios, trigger event covenant is displayed. ICR--Interest cover ratio. PMICR--Post-maintenance interest cover ratio.

Other Credit Considerations

Welsh Water's underlying credit quality is underpinned by its nonprofit ownership structure and no pressure to increase balance-sheet debt, which is lower than peers'.

Reconciliation

Table 7

Reconciliation Of Dwr Cymru (Financing) Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. £)

--Fiscal year ended March 31, 2015--

Dwr Cymru (Financing) Ltd. reported amounts							
	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	3,027	(6)	381	202	148	381	259
Standard & Poor's adjustments							
Interest expense (reported)	--	--	--	--	--	(148)	--
Interest income (reported)	--	--	--	--	--	3	--
Current tax expense (reported)	--	--	--	--	--	(0)	--
Postretirement benefit obligations/ deferred compensation	24	2	1	1	--	3	(7)
Surplus cash	(141)	--	--	--	--	--	--
Capitalized interest	--	--	--	--	6	(6)	--
Non-operating income (expense)	--	--	--	3	--	--	--
Total adjustments	(116)	2	1	4	6	(148)	(7)
Standard & Poor's adjusted amounts							
	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	2,911	(5)	381	206	154	233	252

Related Criteria And Research

Related Criteria

- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Methodology For Considering Pre-Insolvency Structural Protections In Europe, Dec. 13, 2012

Related Research

- Why U.K. Utilities' Regulatory Frameworks Merit A "Strong" Regulatory Advantage Assessment, Dec. 11, 2013

Ratings Detail (As Of September 3, 2015)

Dwr Cymru (Financing) Ltd.

Senior Secured	A
Senior Secured	A/Stable
Subordinated	BBB+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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