FitchRatings

Fitch Revises Dwr Cymru's Outlook to Negative from Stable, Affirms Ratings

Fitch Ratings - London - 04 June 2019:

Fitch Ratings has revised the Outlook on Dwr Cymru (Financing) Ltd's ratings to Negative from Stable. Fitch has affirmed Dwr Cymru's senior secured class A debt and class B debt ratings (both wrapped and unwrapped) at 'A'. The agency has also affirmed the subordinated class C debt of Dwr Cymru's bond programme at 'BBB+'. As there is no class C debt currently in issue the 'BBB+' rating indicates the level at which Fitch would rate prospective class C issuance.

The Outlook revision reflects our forecast of weaker cash flows for the next price control (AMP7) resulting in a post-maintenance interest cover ratio (PMICR) below our negative rating sensitivity and reduced gearing headroom. We will review the Outlook to Stable or downgrade the ratings depending on the final determination for AMP7 and the company's performance on totex and outcome delivery incentives (ODI) at the start of AMP7. We view the company's proposal to substitute issuers as rating-neutral.

Key Rating Drivers

Future Regulatory Challenge: For AMP7 from April 2020, Ofwat sets the cost of capital allowance at 2.3% based on RPI inflation, substantially lower than the 3.5% for the current price-control period, reducing operating cash flow generation. Ofwat also expects a step-change in cost efficiency and will apply tougher benchmarking and cost baselines. For Dwr Cymru, Ofwat has queried GBP450 million of proposed capex, although the plan has customer support and 70% of this is not discretionary. The company hopes to narrow the differences with Ofwat in the draft determination due on 18 July 2019.

Pressure on PMICR: We expect Dwr Cymru to be free cash flow negative for the remainder of AMP6 and the whole of AMP7. An expected reduction in EBITDA in the fiscal year to end-March 2021 (FY21) with AMP7 coincides with a peak in gearing on net debt/RCV at just above 60% compared with our negative rating sensitivity of 65% (revised down from 67.5% reflecting our view of higher business risk in the UK water sector). PMICR depends on totex, ODI and cost of debt performance. As there is no totex, ODI or cost of debt outperformance (Fitch assumes 4.36-4.60%) over AMP7 in our rating case, it will be challenging for PMICR levels to recover to our negative rating sensitivity of 1.5x (revised up from 1.4x).

We may tolerate a slightly weaker PMICR considering the remaining gearing headroom, but a revision of the Outlook back to Stable will depend on the final determination for AMP7 and the company's performance.

Delivery on AMP6: Dwr Cymru's totex continued with outperformance in the fiscal year to end-March 2018 (FY18), although this almost entirely reflects the catch-up on capex compared with the original profiling for AMP6. The company addressed one of the areas of poor regulatory performance, written complaints, but the other outstanding area, reliability of supply, was hit by one-offs in FY18. The company's regulatory performance for FY18 was mostly in the upper quartile. However, an increase in opex based on weather-related issues has negatively affected EBITDA in FY19.

Increase in Customer Distributions: A non-profit organisation with no dividends to shareholders, Dwr Cymru overspent baseline capex, raising regulatory gearing and lowering PMICR in AMP5. The company expects to increase social tariffs during AMP6 by GBP33 million compared with its previous forecast and to reinforce asset resilience and operational sustainability. The company is reviewing distribution policy consistent with gearing on net debt/RCV of 60%. Additionally, Dwr Cymru has creditor approval to invest up to GBP100 million outside the regulatory ring-fence in energy from waste and competitive retail business for business customers in England.

Liquidity & Refinancing: We view the company's new liquidity facility provided on a rolling five-year basis by Assured Guaranty Municipal Corp., and its proposal to substitute issuer as per the STID proposal dated 17 May 2019 as rating-neutral. Dwr Cymru is considering refinancing the 6.91% GBP325 million notes due March 2021, which we assume would reduce its average cost of debt. The capital structure benefits from committed reserve liquidity facilities and enhancements including trigger mechanisms with profit distribution lock-up provisions tied to financial, positive and negative covenants.

Derivation Summary

The rating reflects a lower level of target leverage on net debt/RCV at around 60% and our negative rating sensitivity of 65% compared with peers Yorkshire Water Services Limited (Class A debt rated 'A', Outlook Negative) and Anglian Water Services Financing Plc (Class A debt rated 'A', Outlook Stable), with negative rating sensitivities at 67%. Offsetting this, we expect a PMICR level at around 1.4x to be weaker than for Yorkshire and Anglian. Unlike its peers, Dwr Cymru does not pay dividends to external shareholders, but instead makes discretionary customer distributions impacting PMICR. Also, any discussion around nationalisation applies to the English water companies only.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer

-Allowed weighted average cost of capital in AMP7 of 2.3% (RPI-based) and 3.3% (CPIH-based) in real terms, excluding retail margins;

-Average PAYG rate of 46.3%, average run-off rate of 3.5% for FY21-FY25;

-AMP7 totex of GBP3,546 million (nominal);

-Zero totex outperformance, zero ODI-related rewards in AMP7;

-Retail EBITDA of around GBP15 million a year average during AMP7;

-Average cash interest cost falls from 4.2% in FY20 to 3.6% in FY25;

-65% of total debt is index-linked, average cost of new debt is 3.0%;

-Pension deficit recovery payments of GBP3 million a year in AMP7.

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to an Upgrade

- A sustained reduction in target gearing to below 57% and improvement of PMICR above 1.7x.

Developments that May, Individually or Collectively, Lead to Negative Rating Action

- A marked deterioration in operating and regulatory performance or adverse changes to the regulatory framework.

- A sustained increase in gearing to 65% and decline in PMICR to below 1.5x.

Liquidity and Debt Structure

Sufficient Liquidity: As at 31 December 2018, the company's undrawn credit facilities and cash totalled GBP614 million. This includes revolving credit facilities amounting to GBP170 million. The European Investment Bank loan facility of GBP250 million was fully drawn on 17 December 2018.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Dwr Cymru (Financing) Ltd			
subordinated	LT BBB+ Affirmed		BBB+
senior secured	LT A Affirmed		A

Additional information is available on www.fitchratings.com

FITCH RATINGS ANALYSTS

Primary Rating Analyst
Chris Moore
Director
+44 20 3530 1683
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf
London E14 5GN

Secondary Rating Analyst
Harry Monthen
Senior Analyst
+44 20 3530 1247

Committee Chairperson
Josef Pospisil
Managing Director
+44 20 3530 1287

MEDIA CONTACTS

Adrian Simpson
London
+44 20 3530 1010

adrian.simpson@thefitchgroup.com

Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)

Additional Disclosures

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