

# Dwr Cymru (Financing) Ltd

## Update

### Ratings

#### Foreign Currency

Class A bonds senior secured	A
Class B bonds senior secured	A
Class C bonds senior secured	BBB+

### Outlooks

Class A bonds senior secured	Stable
Class B bonds senior secured	Stable
Class C bonds senior secured	Stable

### Financial Data

#### Dwr Cymru Cyfyngedig

	31 Mar 14	31 Mar 13
Revenue (GBPm)	736.5	716.4
Operating EBITDA (GBPm)	445.1	421.4
Operating EBITDA margin (%)	60.4	58.8
Pension adjusted net debt (class A and B) (GBPm)	2,821	2,756
RAV (GBPm)	4,648	4,367
Pension adjusted net debt/RAV (%)	60.7	63.1
PMICR (x)	1.7	2.0

### Key Rating Drivers

**Conservative Financial Policies:** The ratings reflect Dwr Cymru Cyfyngedig's (Welsh Water) sound regulatory and operational performance, the low debt levels of the group and its not-for-profit business model. The rating forecast also takes account of the material reduction in earnings expected for the upcoming regulatory period from April 2015 to March 2020.

Dwr Cymru (Financing) Ltd is the debt-raising vehicle of Welsh Water, the water and sewerage company in Wales.

**Assumptions for the Forecast:** In terms of outcome delivery incentives, the financial rewards and penalties in the draft determination for Welsh Water are skewed towards the downside. Therefore, Fitch Ratings assumed for purposes of the rating forecast that the company will earn the cost of capital of 3.85% and no premium or penalty, before factoring in negative GBP52.1m of revenue adjustments relating to the previous price control period (ie service incentive mechanism (SIM), capital incentive scheme (CIS) and revenue correction mechanism).

**Financial Flexibility Mitigates Interest Cover:** Fitch forecasts pension-adjusted net debt/regulatory asset value (RAV) below 60% for the combined class A and class B debt for the period to March 2020, materially lower than the ratio guideline of the low 70s for the existing rating. Post-maintenance and post-tax interest cover (PMICR) is expected to range between 1.3x and 1.5x (1.4x being the five-year average), slightly lower than the ratio guideline of minimum 1.5x.

In addition, considering the cash-flow dynamics of the group, ie that the company will be free cash-flow neutral before potential customer rebates or additional capital projects for the benefit of customers, financial flexibility in terms of gearing compensates for the low interest cover. Therefore, the Outlook on the ratings remains Stable.

**Sound Regulatory Performance:** In the year ending 31 March 2014, Welsh Water met leakage targets, improved pollution incident performance and maintained a service incentive mechanism (SIM) score of 84. The company reported stable asset serviceability for all asset categories. However, as part of the draft determination, Ofwat assessed water infrastructure to be marginal for the whole price control, given that the company revised its data for the DG3 measure (less than 12 hours supply interruption) as part of the business plan submission.

### Rating Sensitivities

**Upgrade Currently Unlikely:** Given the ample financial flexibility in terms of gearing and tight interest cover, the following combinations could lead to a downgrade: gearing in the mid-70s and PMICR below 1.5x; gearing above 67.5% and PMICR below 1.4x; gearing above 60% and PMICR below 1.3x. In addition, a marked deterioration in operating and regulatory performance or adverse changes to the regulatory framework could result in a negative rating action.

### Liquidity and Debt Structure

**Adequate Liquidity into 2016:** As of 31 March 2014, Welsh Water had GBP92m in cash and cash equivalents available as well as GBP140m of undrawn, committed bank facilities against debt falling due over the next two years of GBP56m. This funding position will provide for sufficient liquidity for capital expenditure and operating requirements into 2016. In accordance with transaction documentation, the group also maintains a GBP135m reserve liquidity facility that would be available in times of financial distress.

### Related Research

[Fitch Affirms Dwr Cymru's Senior Secured Debt at 'A' \(July 2014\)](#)

[UK Water Sector Faces Material Reduction in Earnings \(February 2014\)](#)

[Fitch Revises UK Water Sector Outlook to Negative on Ofwat's Guidance \(January 2014\)](#)

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Peer Group

Issuer	Country
<b>Class A bonds:</b> <b>'A'<sup>a</sup></b>	
Yorkshire Water Services	UK
Bradford Finance Limited <sup>b</sup>	
Dwr Cymru (Financing) Ltd <sup>c</sup>	UK
<b>Class B bonds:</b> <b>'A'<sup>a</sup></b>	
Dwr Cymru (Financing) Ltd <sup>c</sup>	UK
<b>Class B bonds:</b> <b>'BBB+'<sup>a</sup></b>	
Yorkshire Water Services	UK
Bradford Finance Limited <sup>b</sup>	
<b>Class C bonds:</b> <b>'BBB+'<sup>a</sup></b>	
Dwr Cymru (Financing) Ltd <sup>c</sup>	UK

<sup>a</sup> Senior secured bond ratings  
<sup>b</sup> Financing vehicle for Yorkshire Water Services Limited  
<sup>c</sup> Financing vehicle for Dwr Cymru Cyfyngedig (Welsh Water)

Senior Secured Rating History Dwr Cymru (Financing) Ltd

Date	Class A <sup>a</sup>	Class B/C
17 July 2014	'A' St.	'A'/BBB+' St.
14 Mar 2013	'A' St.	'A'/BBB+' St.
21 Mar 2012	'A' St.	'A'/BBB+' St.
23 Mar 2011	'A' St.	'A'/BBB+' St.
30 Oct 2009	'A' St.	'A'/BBB+' St.
17 Mar 2009	'A' St.	'A'/BBB+' St.
27 Jun 2008	'A' St.	'A'/BBB+' St.
7 Apr 2008	'AA' Neg.	'A'/BBB+' St.
6 Feb 2008	'AAA' RWN	'A'/BBB+' St.
17 Jan 2008	'AAA' St.	'A'/BBB+' St.
21 Dec 2007	'AAA' RWN	'A'/BBB+' St.
16 Feb 2006	'AAA' St.	'A'/BBB+' St.

"RWN" denotes Rating Watch Negative, "St." denotes Stable Outlook and "Neg." denotes Negative Outlook  
<sup>a</sup> Subject to MBIA bond policy; the rating of MBIA was withdrawn by Fitch on 26 June 2008

Snapshot Profile: Major Issuer-Specific Rating Factors and Trends

Rating factor	Status <sup>a</sup>	Trend
Operations	Average	Neutral
Market position <sup>b</sup>		
Finances	Average	Neutral
Governance	Average	Neutral
Geography <sup>b</sup>		

<sup>a</sup> Relative to peer group  
<sup>b</sup> Not applicable due to regional monopoly status  
 Source: Fitch

Related Criteria

Corporate Rating Methodology (May 2014)

Immediate Peer Group – Comparative Analysis

Sector Characteristics

Operating Risks

Water supplies are under stress in some parts of the country. In order to safeguard the security of supply and protect the environment for the long term, the water sector will need to use all adaptation and mitigation means available. These include using a catchment-based approach to preserve water quality, limiting abstractions from water bodies to sustainable levels, increasing connectivity of supply networks, and employing media campaigns to encourage customers to use water wisely and stop putting unflushables down the sink or lavatory. Also on the government's agenda is to improve the range and quality of services to customers.

Financial Risks

During the current price control period, which comes to an end in March 2015, management teams have mostly been able to manage financial profiles within ratio guidelines for existing rating levels. Companies have been able to procure some efficiencies. However, these have mostly been offset by cost pressures related to doubtful debt and pension deficit repair or unfunded obligations related to the carbon reduction commitment and the adoption of private sewers.

Affordability concerns over water bills have become an important topic for the ongoing price review for the period April 2015 to March 2020. Companies are experiencing pressure from the regulator and the public to keep bills flat. This was reflected in the risk and reward guidance published by the regulator in February 2014, including a weighted average cost of capital at a historical low of 3.85% and little appetite for reopener mechanisms, or scrutiny applied to the outcome delivery incentives for the draft determinations.

Peer Group Analysis

	Welsh Water	Yorkshire Water	Thames Water
<b>Bond ratings operating company</b>	<b>A/BBB+ Stable</b>	<b>A/BBB+ Negative</b>	<b>n.a.</b>
<b>Credit metrics – operating company</b>			
Forecast pension adjusted net debt/RAV (%)	Below 60/ Below 60	73/83	73/83
Forecast PMICR (x)	1.4/1.4	1.4/1.2	1.4/1.1-1.2
<b>Recent performance – operating company</b>			
Leakage targets not met (year)	FY11	FY10 & FY11	
Asset serviceability not stable for FY13	Marginal water infrastructure		Marginal sewerage infrastructure
Asset serviceability not stable for FY14	Marginal water infrastructure		Marginal sewerage infrastructure
Service incentive mechanism FY14 (points)	84/100	82/100	71/100
<b>Fitch view – operating company</b>			
Operational and regulatory performance	Middle -ranking	Middle -ranking	Below average

Source: Fitch, companies, Ofwat (the economic regulator for the water and sewerage industry in England and Wales)

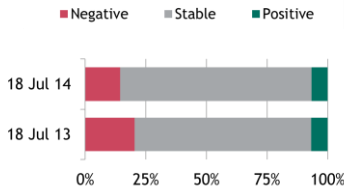
Key Credit Characteristics

For the next price control period, Ofwat has decided to focus more on customer service, bolder incentives and an environmentally sustainable business model. It remains to be seen whether changes in regulation will have a material impact on the business risk of the sector.

Under the revised tariff-setting framework performance related to total expenditure and outcome delivery incentives will have a visible impact on financials/ credit metrics. As a result, operational and regulatory performance as a key rating driver is gaining in importance.

## Distribution of Sector Outlooks

Directional Outlooks and Rating Watches



Fitch's expectations are based on the agency's internally produced, conservative rating case forecasts. They do not represent the forecasts of rated issuers individually or in aggregate. Key Fitch forecast assumptions include:

- forecast broadly based on the revenue building blocks as per the company's draft determination;
- newly raised debt to be priced at 5.25% for class B debt; at present there is no intention to raise new class A or class C debt;
- deposit balances to be remunerated at 1.5%;
- RPI to revert to 2.5% in the medium term.

2013 represents either Dec 2013 or Mar 2014, depending on balance sheet dates of individual companies.

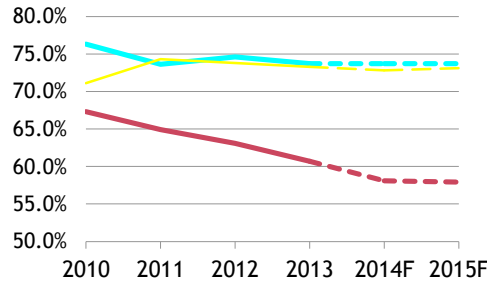
## Definitions

- Leverage: Debt plus lease adjustment minus equity credit for hybrid instruments plus preferred stock divided by FFO plus interest paid plus preferred dividends plus rental expense.
- Interest cover: FFO plus interest paid plus preferred dividends divided by interest paid plus preferred dividends.
- FCF/revenue: FCF after dividends divided by revenue.
- FFO profitability: FFO divided by revenue.
- For further discussion of the interpretation of the tables and graphs in this report see Fitch's "[Interpreting the New EMEA and Asia-Pacific Corporates Credit Update Format](#)" Special Report, dated 25 November 2009 and available at [www.fitchratings.com](http://www.fitchratings.com).

Dwr Cymru: Class A + B — Thames Water: Class A — Yorkshire Water: Class A — Utilities Median — Developed BBB+ Median — Source: Company data; Fitch

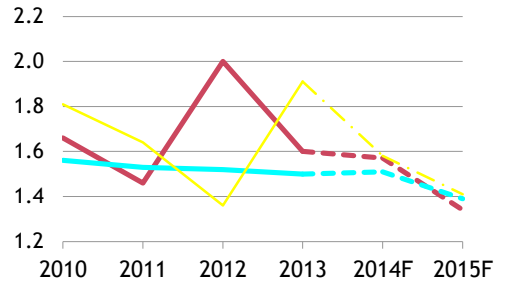
## Pension Adjusted Net Debt/Regulatory Asset Value

including Fitch expectations



## Post-Maintenance and Post-Tax Interest Cover

including Fitch expectations



## Debt Maturities and Liquidity at 31 March 2014

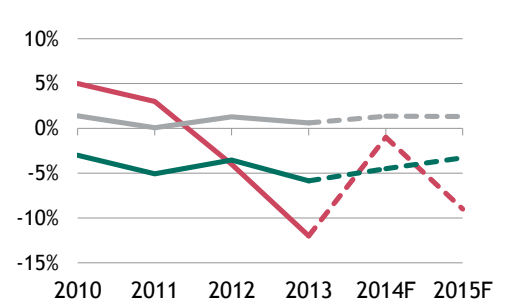
(GBPm)

By March 2015 (year 1)	29.7
By March 2016 (year 2)	26.3
By March 2019 (years 3-5)	214.5
After March 2019	2,596.1
<b>Cash and equivalents</b>	<b>92.0</b>
<b>Undrawn committed facilities</b>	<b>140.0</b>
(maturing between 2016 and 2019)	

Source: Company

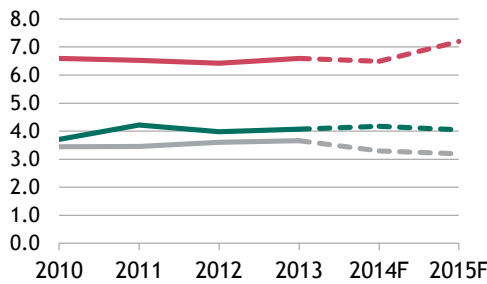
## FCF/Revenues

including Fitch expectations



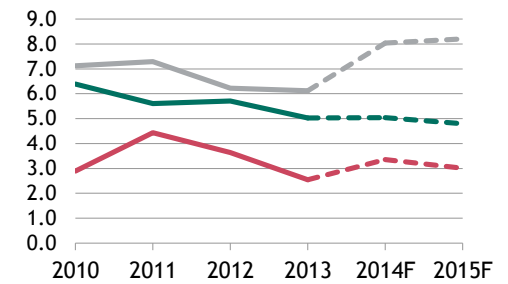
## Leverage

including Fitch expectations



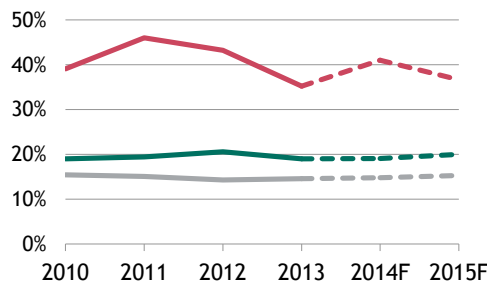
## Interest Cover

including Fitch expectations



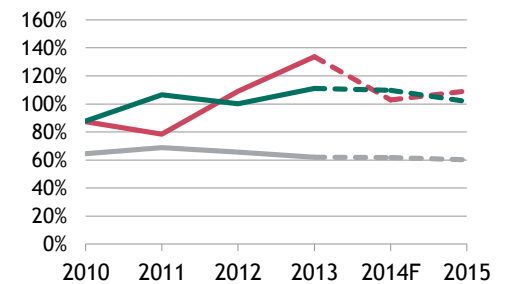
## FFO Profitability

including Fitch expectations



## Capex/CFO

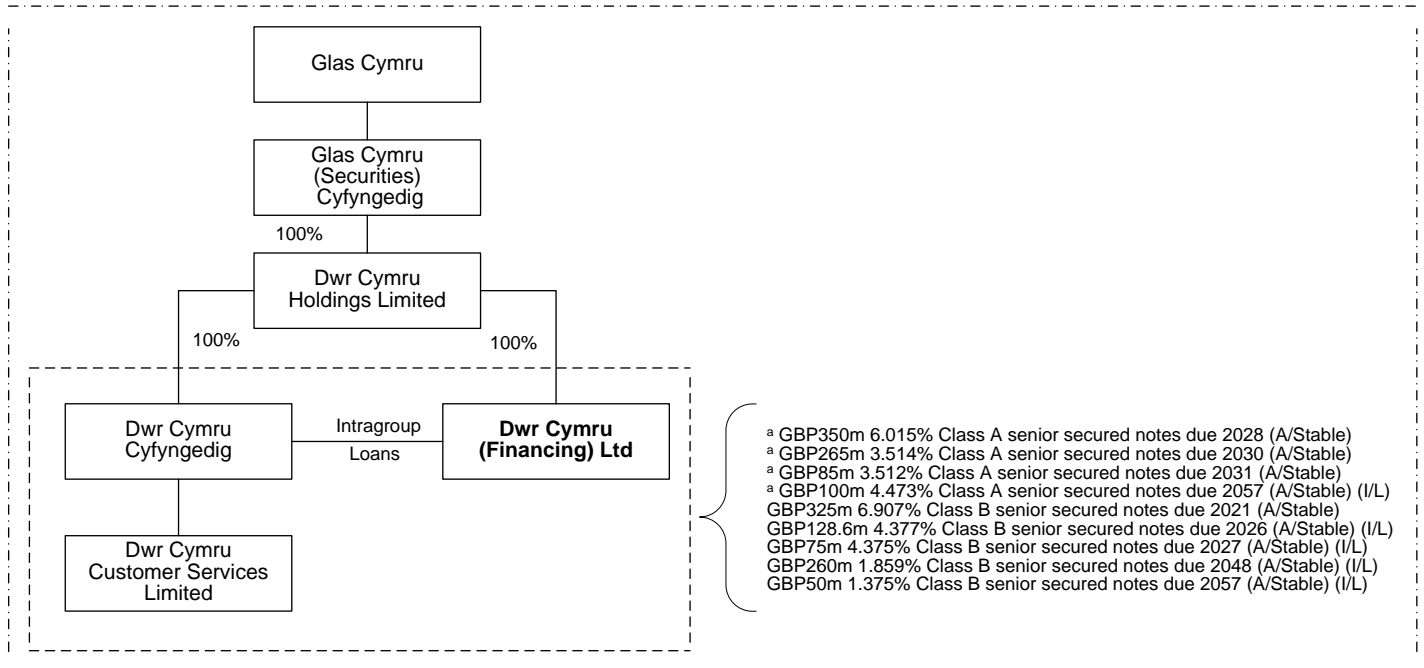
including Fitch expectations



Appendix 1

Figure 1

Group Structure Diagram



- - - - - Regulatory ring-fence  
 - . . . . . Documentation ring-fence  
 I/L – Index-Linked

<sup>a</sup> Notes guaranteed by MBIA  
 Source: Transaction documents – July 2014

**Dwr Cymru Cyfyngedig**  
**FINANCIAL SUMMARY**

	31 Mar 2014 GBPm Year End	31 Mar 2013 GBPm Year End	31 Mar 2012 GBPm Year End	31 Mar 2011 GBPm Year End	31 Mar 2010 GBPm Year End
<b>Profitability</b>					
Revenue	737	716	695	677	688
Revenue Growth (%)	2.81	3.08	2.70	(1.67)	4.72
Operating EBIT	237	221	233	228	258
Operating EBITDA	445	421	423	412	423
Operating EBITDA Margin (%)	60.43	58.82	60.79	60.90	61.39
FFO Return on Adjusted Capital (%)	11.17	11.50	12.12	11.24	11.50
Free Cash Flow Margin (%)	(11.66)	(3.66)	2.95	5.42	(7.45)
<b>Coverages (x)</b>					
FFO Gross Interest Coverage	2.45	3.43	2.86	2.80	3.62
Operating EBITDA/Gross Interest Expense	2.55	3.39	2.92	2.86	3.64
FFO Fixed Charge Coverage (inc. Rents)	2.45	3.43	2.86	2.80	3.62
FCF Debt-Service Coverage	0.43	0.48	0.74	1.09	0.25
Cash Flow from Operations/Capital Expenditures	0.75	0.92	1.27	1.15	0.85
<b>Debt Leverage of Cash Flow (x)</b>					
Total Debt with Equity Credit/Operating EBITDA	6.43	6.78	6.98	6.59	6.79
Total Debt Less Unrestricted Cash/Operating EBITDA	6.22	6.41	6.27	6.36	6.20
<b>Debt Leverage Including Rentals (x)</b>					
Annual hire lease rent costs for long-term assets (reported and/or estimate)	0	0	0	0	0
Gross Lease Adjusted Debt/Operating EBITDAR	6.43	6.78	6.98	6.59	6.79
Gross Lease Adjusted Debt /FFO+Int+Rentals	6.69	6.69	7.14	6.73	6.82
FFO Adjusted Net Leverage	6.47	6.32	6.42	6.49	6.23
FCF/Lease Adjusted Debt (%)	(3.00)	(0.92)	0.70	1.35	(1.79)
<b>Debt Leverage Including Leases and Pension Adjustment (x)</b>					
Pension and Lease Adjusted Debt /EBITDAR + Pension Cost	6.21	6.66	6.72	6.41	6.79
<b>Balance Sheet Summary</b>					
Readily Available Cash	93	156	299	97	248
Restricted/Not Readily Available Cash	0	0	0	0	0
Short-Term Debt	30	80	77	22	144
Long-Term Senior Debt	2,831	2,777	2,872	2,694	2,724
Subordinated debt	0	0	0	0	0
Equity Credit	0	0	0	0	0
Total Debt with Equity Credit	2,860	2,856	2,949	2,716	2,868
Off-Balance-Sheet Debt	0	0	0	0	0
Lease-Adjusted Debt	2,860	2,856	2,949	2,716	2,868
Fitch- identified Pension Deficit	2	25	24	12	6
Pension Adjusted Debt	2,863	2,881	2,974	2,728	2,874
<b>Cash Flow Summary</b>					
Operating EBITDA	445	421	423	412	423
Gross Cash Interest Expense	(175)	(125)	(145)	(144)	(116)
Cash Tax	0	4	3	2	0
Associate Dividends	0	0	0	0	0
Other Items before FFO (incl. interest receivable)	(11)	9	40	(6)	2
<b>Funds from Operations</b>	<b>259</b>	<b>310</b>	<b>320</b>	<b>264</b>	<b>308</b>
Change in Working Capital	(5)	(18)	8	27	(12)
<b>Cash Flow from Operations</b>	<b>255</b>	<b>292</b>	<b>328</b>	<b>290</b>	<b>296</b>
Total Non-Operating/Non-Recurring Cash Flow	0	0	0	0	0
Capital Expenditures	(341)	(318)	(257)	(253)	(347)
Dividends Paid	0	0	(50)	0	0
<b>Free Cash Flow</b>	<b>(86)</b>	<b>(26)</b>	<b>21</b>	<b>37</b>	<b>(51)</b>
Net (Acquisitions)/Divestitures	0	0	0	0	0
Net Equity Proceeds/(Buyback)	0	0	0	0	0
Other Cash Flow Items	19	(24)	(52)	(35)	10
Total Change in Net Debt	(67)	(51)	(31)	2	(41)
<b>Working Capital</b>					
Accounts Receivable Days	24	23	21	21	21
Inventory Days	0	0	0	0	0
Accounts Payable Days	59	59	53	37	33

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