

## 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+

## Outlook

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 15	31 Mar 14
Revenue (GBPm)	751	737
Operating EBITDA (GBPm)	462	445
Operating EBITDA margin (%)	62	60
Funds from operations (GBPm)	325	259
Cash flow from operations (GBPm)	331	255
Free cash flow (GBPm)	-35	-86
Pension adjusted net debt (GBPm)	2,969	2,821
Pension adjusted net debt/RAV (%)	60	62
Post-maintenance interest coverage ratio (x)	1.7	1.7

## Related Research

[UK Water Sector Flooded by Signalled Reforms \(January 2016\)](#)

[Fitch Affirms Dwr Cymru's Senior Secured Debt at 'A' \(December 2015\)](#)

[2016 Outlook: EMEA Utilities \(December 2015\)](#)

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## Key Rating Drivers

**Company Structure Change:** The ratings on Dwr Cymru (Financing) Ltd's senior secured debt take into account its proposed revision of its holding-company structure. The company wants to add a new holding company (holdco) above the current one, Glas Cymru Cyfyngedig, which sits within the ring-fenced group. The new holdco will be a company limited by guarantee, but sits outside the ring-fenced group.

The Security Trust and Intercreditor Deed (STID) proposal allows the ring-fenced group to pay out dividends totalling only GBP100m, which is easily absorbed within the current rating guidance.

**Good Regulatory Performance:** Fitch Ratings expects that the efficiency targets for total expenditure in the wholesale price controls will leave Dwr Cymru some room for outperformance. Allowances for the retail price controls are challenging and may offset some or all of the savings from the wholesale business. Dwr Cymru will need to improve its regulatory performance to ensure it will meet the current top-quartile levels by the end of the current regulatory period in March 2020.

**Good Financial Flexibility:** Dwr Cymru's financial flexibility relating to its low gearing compared to its peers, compensates for weak interest cover ratios. Fitch forecasts pension-adjusted net debt/regulatory asset value (RAV) at or below 60% and post-maintenance and post-tax interest cover (PMICR) between 1.3x and 1.5x (1.4x being the five-year average), both ratios lower than the guidelines for the rating.

**Revenue Penalties From High Capex:** Dwr Cymru's board of directors opted to pursue capital schemes over and above the regulator's funded baseline in the period to March 2015 in order to support asset resilience and sustainability of operations. This investment is treated as an overspend under the Capital Incentive Scheme (CIS), leading to a material log up of RAV in March 2015 and around GBP50m revenue penalty for the current price control review (AMP6).

## Rating Sensitivities

**Credit Metrics Improvement:** Future developments that could lead to positive rating action include a sustainable reduction in target gearing to below 60% and improvement in PMICR to above 1.6x together with maintenance of top-half regulatory performance. However, at this stage an upgrade seems rather unlikely.

**Weaker Interest Cover:** Given the ample financial flexibility in gearing but 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. Furthermore, a marked deterioration in operating and regulatory performance or adverse changes to the regulatory framework would also be a negative rating factor.

## Liquidity and Debt Structure

**Sufficient Liquidity:** As of 31 December 2015, Dwr Cymru had GBP192m in cash and cash equivalents, GBP150m of undrawn, committed revolving credit facilities (maturing in 2019 and 2020) as well as GBP130m undrawn loans against debt falling due of GBP124m before March 2018. This funding position will provide sufficient liquidity for capex and operating requirements for the next 24 months. In accordance with transaction documentation, it also maintains a GBP135m reserve liquidity facility that would be available in times of financial distress.

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
Anglian Water Services Financing Plc <sup>d</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>	
Anglian Water Services Financing Plc <sup>d</sup>	UK
<b>Class C bonds:</b> <b>'BBB+'<sup>a,e</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)  
<sup>d</sup> Financing vehicle for Anglian Water Services Limited  
<sup>e</sup> Currently no outstanding Class C bonds

Senior Secured Rating History Dwr Cymru (Financing) Ltd

Date	Class A	Class B/C
17 Jul 14	'A' St.	'A'/BBB+' St.
14 Mar 13	'A' St.	'A'/BBB+' St.
21 Mar 12	'A' St.	'A'/BBB+' St.
23 Mar 11	'A' St.	'A'/BBB+' St.
30 Oct 09	'A' St.	'A'/BBB+' St.
17 Mar 09	'A' St.	'A'/BBB+' St.
27 Jun 08	'A' St.	'A'/BBB+' St.
7 Apr 08	'AA' Neg.	'A'/BBB+' St.
6 Feb 08	'AAA' RWN	'A'/BBB+' St.
17 Jan 08	'AAA' St.	'A'/BBB+' St.
21 Dec 07	'AAA' RWN	'A'/BBB+' St.
16 Feb 06	'AAA' St.	'A'/BBB+' St.

"RWN" denotes Rating Watch Negative, "St." denotes Stable Outlook and "Neg." denotes Negative Outlook

Related Criteria

Corporate Rating Methodology (August 2015)

Immediate Peer Group – Comparative Analysis

Sector Characteristics

Operating Risks

Fitch revised the outlook for the UK Water Sector to stable from negative for 2016 following the start of the new five-year regulatory price control review, AMP6, on 1 April 2015. We expect that companies will be able to deliver the minimum outputs set by the regulator within the allowed regulatory revenues and challenging efficiencies embedded in the price control.

Uncertainties surrounding upcoming proposed reforms are, in our view, increasing the business risk of the water sector which we view now as more closely aligned with regulated UK gas and electricity network businesses.

Financial Risks

Key drivers of financial performance will be the cost of capital (at an all-time low of 3.74%) compared to companies' funding costs as well as total expenditure and retail business performance compared to allowances. Fitch believes that total expenditure targets leave some room for manoeuvre, while most licence holders are likely to overspend on retail.

Peer Group Analysis

	Dwr Cymru	Yorkshire Water	Anglian Water
<b>Bond ratings operating company</b>	<b>A/BBB+ Stable</b>	<b>A/BBB+ Negative</b>	<b>A/BBB+ Negative</b>
FY ending March 2014 EBITDA (GBPm)	442	596	762
FCF in the midterm	Negative	Negative	Negative
<b>Credit metrics – operating company</b>			
Forecast pension adjusted net debt/RAV (%)	Below 60/ Below 60	70/81	72/83
Forecast PMICR (x)	1.4/1.4	1.4/1.2	1.5/1.2
<b>Recent performance – operating company</b>			
Leakage targets not met (year)	FY11	FY10 & FY11	FY11
Asset serviceability not stable for FY13	Marginal water infrastructure		Marginal sewerage infrastructure
Asset serviceability not stable for FY14	Marginal water infrastructure		
Service incentive mechanism FY14 (points)	84/100	82/100	87/100
<b>Fitch view – operating company</b>			
Operational and regulatory performance	Middle -ranking	Middle -ranking	Above average

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

Key Credit Characteristics

In addition to a significant reduction in the cost of capital, total expenditure will be benchmarked at the top quartile, representing a more demanding target for capital expenditure. Ofwat is pursuing progressive targets for the retail price controls, eliminating protection from RPI and implementing catch-up efficiency targets using an average cost to serve, which does not fully reflect each company's operating cost base.

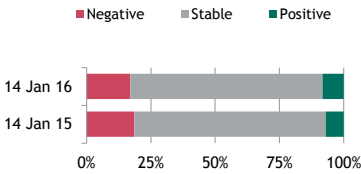
Ofwat is working towards the opening of the retail sector to competition for non-households which is expected to start in April 2017 in England, allowing water companies to compete over the provision of services such as customer care, billing and meter reading. The Welsh government has stated that it will monitor the costs and benefits of the reform in England and inform its future policy for the water companies located wholly or mainly in Wales.

Fitch does not expect the impact of retail competition on the water companies to be significant as only around 1%-2% of the company revenues relate to retail services and because of our expectation that the number of new entrants to the retail segment will be low.

## Distribution of Sector Outlooks

### 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:

- regulated revenues in line with the final determination of tariffs for April 2015 to March 2020, ie, assuming no material over- or under- recoveries;
- no totem out- or underperformance over the five-year price control;
- retail price inflation of 0.75% for FY15, 1% for FY16, 2% for FY17 and 2.5% thereafter;
- no impact on cash-flow generation from outcome delivery incentives, given that financial rewards and penalties will all be taken into account as part of the next price review;
- excess cash flow to be paid as dividend, accelerated capex and/or customer rebates.

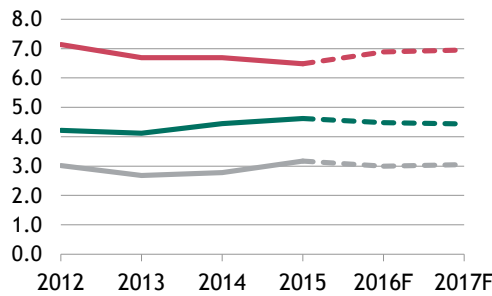
### Definitions

- Leverage:** Gross debt plus lease adjustment minus equity credit for hybrid instruments plus preferred stock divided by FFO plus gross interest paid minus interest received plus preferred dividends plus rental expense.
- Interest cover:** FFO plus gross interest paid minus interest received plus preferred dividends divided by gross interest paid plus preferred dividends.
- 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 Cyfyngedig — Utilities Median — A Median — Source: Company data; Fitch

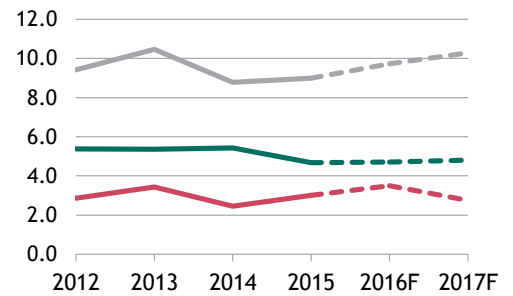
### Leverage

including Fitch expectations



### Interest Cover

including Fitch expectations

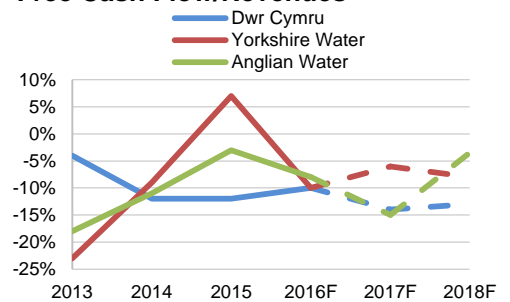


### Debt Maturities and Liquidity at 31 December 2015

Debt maturities	(GBPm)
March 2016	21
March 2017	70
March 2018	32
After March 2018	2,811
<b>Cash and equivalents</b>	<b>148</b>
<b>Undrawn committed facilities<sup>a</sup></b>	<b>280</b>

<sup>a</sup> Including GBP150m RCF and GBP130m committed EIB and KfW loans  
Source: Fitch

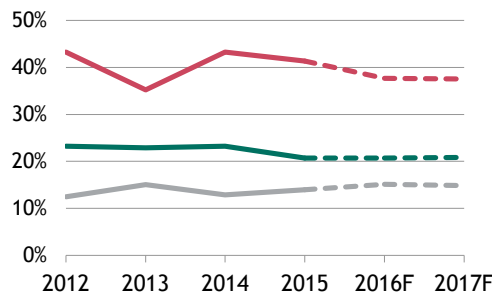
### Free Cash Flow/Revenues



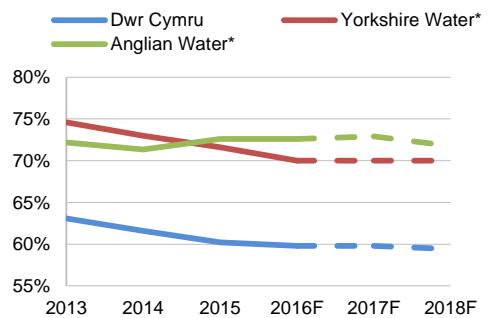
Source: Fitch, Companies

### FFO Profitability

including Fitch expectations

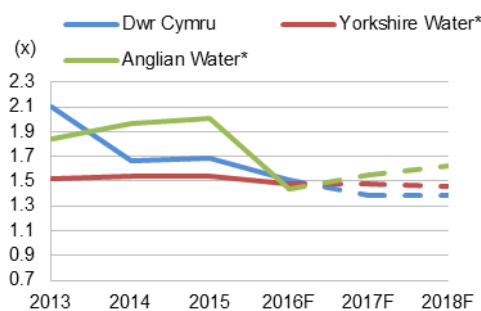


### Pension Adjusted Net Debt/RAV



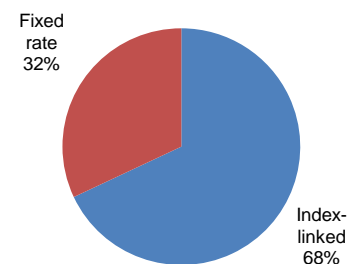
\*Class A debt only  
Source: Companies, Fitch

### PMICR



\*Class A debt only  
Source: Companies, Fitch

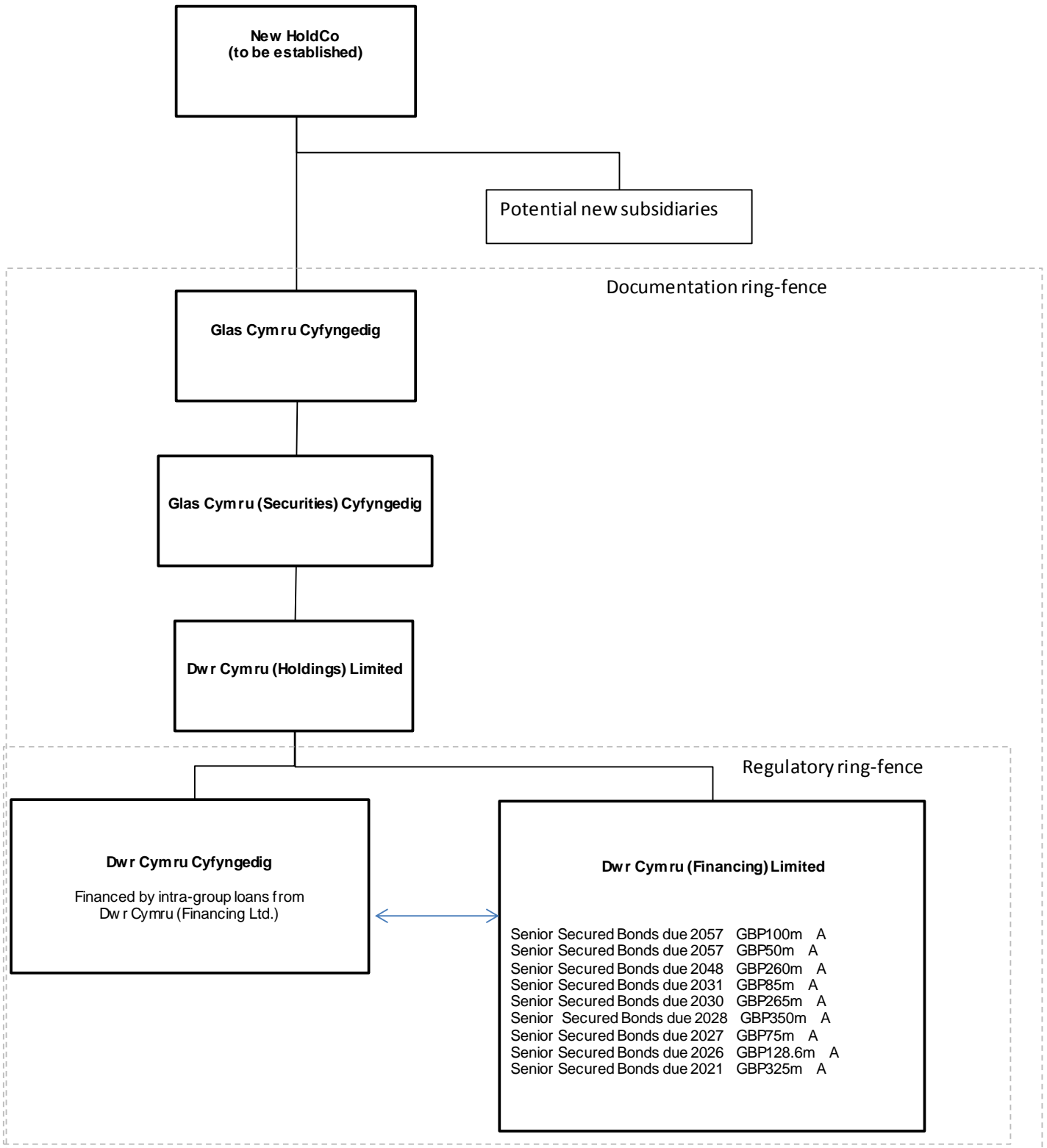
### Debt Structure FY14



Source: Company

Figure 1

**Simplified Group & Debt Structure Diagram**



→ Intra-group loans

Source: Fitch, Company, As at December 2015

## Dwr Cymru Cyfyngedig

### FINANCIAL SUMMARY

	31 Mar 2015	31 Mar 2014	31 Mar 2013	31 Mar 2012
	GBPm	GBPm	GBPm	GBPm
	Year End	Year End	Year End	Year End
<b>Profitability</b>				
Revenue	751	737	716	695
Revenue Growth (%)	1.96	2.81	3.08	2.70
Operating EBIT	242	237	221	233
Operating EBITDA	462	445	421	423
Operating EBITDA Margin (%)	61.55	60.43	58.82	60.79
FFO Return on Adjusted Capital (%)	11.04	11.17	11.50	12.12
Free Cash Flow Margin (%)	(4.62)	(11.66)	(3.66)	2.95
<b>Coverages (x)</b>				
FFO Gross Interest Coverage	3.70	2.45	3.43	2.86
Operating EBITDA/Gross Interest Expense	3.84	2.55	3.39	2.92
FFO Fixed Charge Coverage (inc. Rents)	3.70	2.45	3.43	2.86
FCF Debt-Service Coverage	0.44	0.43	0.48	0.74
Cash Flow from Operations/Capital Expenditures	0.91	0.75	0.92	1.27
<b>Debt Leverage of Cash Flow (x)</b>				
Total Debt with Equity Credit/Operating EBITDA	6.42	6.43	6.78	6.98
Total Debt Less Unrestricted Cash/Operating EBITDA	6.11	6.22	6.41	6.27
<b>Debt Leverage Including Rentals (x)</b>				
Annual hire lease rent costs for long-term assets (reported and/or estimate)	0	0	0	0
Gross Lease Adjusted Debt/Operating EBITDAR	6.42	6.43	6.78	6.98
Gross Lease Adjusted Debt /FFO+Int+Rentals	6.67	6.69	6.69	7.14
FFO Adjusted Net Leverage	6.34	6.47	6.32	6.42
FCF/Lease Adjusted Debt (%)	(1.17)	(3.00)	(0.92)	0.70
<b>Debt Leverage Including Leases and Pension Adjustment (x)</b>				
Pension and Lease Adjusted Debt /EBITDAR + Pension Cost	6.42	6.21	6.66	6.72
<b>Balance Sheet Summary</b>				
Readily Available Cash	146	93	156	299
Restricted/Not Readily Available Cash	0	0	0	0
Short-Term Debt	76	30	80	77
Long-Term Senior Debt	2,893	2,831	2,777	2,872
Subordinated debt	0	0	0	0
Equity Credit	0	0	0	0
Total Debt with Equity Credit	2,969	2,860	2,856	2,949
Off-Balance-Sheet Debt	0	0	0	0
Lease-Adjusted Debt	2,969	2,860	2,856	2,949
Fitch- identified Pension Deficit	0	2	25	24
Pension Adjusted Debt	2,969	2,863	2,881	2,974
<b>Cash Flow Summary</b>				
Operating EBITDA	462	445	421	423
Gross Cash Interest Expense	(120)	(175)	(125)	(145)
Cash Tax	0	0	4	3
Associate Dividends	0	0	0	0
Other Items before FFO (incl. interest receivable)	(17)	(11)	9	40
<b>Funds from Operations</b>	<b>325</b>	<b>259</b>	<b>310</b>	<b>320</b>
Change in Working Capital	6	(5)	(18)	8
<b>Cash Flow from Operations</b>	<b>331</b>	<b>255</b>	<b>292</b>	<b>328</b>
Total Non-Operating/Non-Recurring Cash Flow	0	0	0	0
Capital Expenditures	(365)	(341)	(318)	(257)
Dividends Paid	0	0	0	(50)
<b>Free Cash Flow</b>	<b>(35)</b>	<b>(86)</b>	<b>(26)</b>	<b>21</b>
Net (Acquisitions)/Divestitures	0	1	0	0
Net Equity Proceeds/(Buyback)	0	0	0	0
Other Cash Flow Items	(21)	18	(25)	(52)
Total Change in Net Debt	(55)	(67)	(51)	(31)
<b>Working Capital</b>				
Accounts Receivable Days	29	24	23	21
Inventory Days	0	0	0	0
Accounts Payable Days	59	59	59	53

Figure 2  
Dwr Cymru Cyfyngedig — Forecast Financial Information

	Historical			Fitch Forecast		
	31/03/2013	31/03/2014	31/03/2015	31/03/2016	31/03/2017	31/03/2018
<b>GBPm</b>						
<b>Summary Income Statement</b>						
Gross Revenue	716	737	751	746	749	758
Revenue Growth (%)	3.1%	2.8%	2.0%	-0.6%	0.3%	1.2%
Operating EBITDA	421	445	462	438	449	466
Operating EBITDA Margin (%)	58.8%	60.4%	61.6%	58.7%	59.9%	61.5%
Operating EBITDAR	421	445	462	438	449	466
Operating EBITDAR Margin (%)	58.8%	60.4%	61.6%	58.7%	59.9%	61.5%
Operating EBIT	221	237	242	191	196	209
Operating EBIT Margin (%)	30.9%	32.2%	32.2%	25.6%	26.2%	27.5%
Gross Interest Expense	-148	-169	-154	-123	-162	-176
Pretax Income	81	76	91	68	35	33
<b>Summary Balance Sheet</b>						
Readily Available Cash	156	93	146	39	38	41
Total Debt with Equity Credit	2,856	2,860	2,969	2,978	3,084	3,182
Total Adjusted Debt with Equity Credit	2,856	2,860	2,969	2,978	3,084	3,182
Net Debt	2,701	2,768	2,823	2,939	3,046	3,141
<b>Summary Cash Flow Statement</b>						
Operating EBITDA	421	445	462	438	449	466
Cash Interest	-125	-175	-120	-118	-130	-135
Implied Interest Cost %	4.4%	6.1%	4.1%	4.0%	4.3%	4.3%
Cash Tax	4	0		-5	-4	-5
Associate Dividends less Distributions to NCI				0	0	0
Other Items Before FFO	9	-11	-17	-2	-2	-2
Funds Flow from Operations	310	259	325	313	313	324
FFO Margin (%)	43.3%	35.2%	43.2%	41.4%	37.6%	37.5%
Change in Working Capital	-18	-5	6	3	-1	-2
Cash Flow from Operations (Fitch Defined)	292	255	331	310	308	301
Total Non-Operating/Non-Recurring Cash Flow						
Capital Expenditure	-318	-341	-365			
Capital Intensity (Capex/Revenue) (%)	44.4%	46.2%	48.6%			
Common Dividends	0	0	0			
Net Acquisitions & Divestitures	0	1	0			
Capex, Dividends, Acquisitions & oth. Items before FCF	-318	-340	-365	-387	-415	-396
Free Cash Flow after Acquisitions & Divestitures	-26	-85	-35	-77	-107	-95
Free Cash Flow Margin (after net acquisitions) margin (%)	-3.6%	-11.6%	-4.6%	-10.3%	-14.3%	-12.5%
Other Investing and Financing Cash Flow Items	-25	18	-21	0	0	0
Net Debt Proceeds	-93	4	109	54	106	98
Net Equity Proceeds				0	0	0
Total Change in Cash	-143	-63	53	-23	-1	3
<b>Coverage Ratios (x)</b>						
FFO Interest Coverage	3.4	2.4	3.7	3.7	3.4	3.4
FFO Fixed Charge Coverage	3.4	2.4	3.7	3.7	3.4	3.4
Operating EBITDAR/Gross Interest Expense + Rents	3.4	2.5	3.8	3.7	3.7	3.7
Operating EBITDA/Gross Interest Expense	3.4	2.5	3.8	3.7	3.7	3.7
<b>Leverage Ratios (x)</b>						
Total Adjusted Debt/Operating EBITDAR	6.8	6.4	6.4	6.8	6.9	6.8
Total Adjusted Net Debt/Operating EBITDAR	6.4	6.2	6.1	6.7	6.8	6.7
Total Debt with Equity Credit/Operating EBITDA	6.8	6.4	6.4	6.8	6.9	6.8
FFO Adjusted Leverage	6.7	6.7	6.7	6.9	7.0	6.9
FFO Adjusted Net Leverage	6.3	6.5	6.3	6.8	6.9	6.8

**HOW TO INTERPRET THE FORECAST PRESENTED**

The forecast presented is based on the agency's internally produced, conservative rating case forecast. It does not represent the forecast of the rated issuer. The forecast set out above is only one component used by Fitch to assign a rating or determine a rating outlook, and the information in the forecast reflects material but not exhaustive elements of Fitch's rating assumptions for the issuer's financial performance. As such, it cannot be used to establish a rating, and it should not be relied on for that purpose. Fitch's forecasts are constructed using a proprietary internal forecasting tool, which employs Fitch's own assumptions on operating and financial performance that may not reflect the assumptions that you would make. Fitch's own definitions of financial terms such as EBITDA, debt or free cash flow may differ from your own such definitions. Fitch may be granted access, from time to time, to confidential information on certain elements of the issuer's forward planning. Certain elements of such information may be omitted from this forecast, even where they are included in Fitch's own internal deliberations, where Fitch, at its sole discretion, considers the data may be potentially sensitive in a commercial, legal or regulatory context. The forecast (as with the entirety of this report) is produced strictly subject to the disclaimers set out at the end of this report. Fitch may update the forecast in future reports but

Figure 3

**Reconciliation of Key Financial Metrics for Dwr Cymru Cyfyngedig**

<b>(GBPm)</b>	<b>31 Mar 15</b>	<b>31 Mar 14</b>
<b>Interest bearing loans and borrowings</b>	<b>2,969</b>	<b>2,860</b>
+ Subordinated debt	0	0
- Equity credit	0	0
<b>= Total debt with equity credit</b>	<b>2,969</b>	<b>2,860</b>
+ Gross pension deficit	0	0
<b>= Total pension-adjusted debt</b>	<b>2,969</b>	<b>2,860</b>
- Cash and equivalents (unrestricted)	146	93
<b>= Pension-adjusted net debt (a)</b>	<b>2,823</b>	<b>2,767</b>
<b>Real regulatory asset value (b)</b>	<b>4,793</b>	<b>4,580</b>
<b>Net debt/Regulatory Asset Value (RAV) (%)</b>		
Pension adjusted net debt/RAV (a/b)x100	<b>59</b>	<b>60</b>
<b>EBITDA</b>	<b>462</b>	<b>445</b>
- Current Cost Depreciation (CCD) & Infrastructure Renewal Charge (IRC)	233	227
- Taxation paid	-2	0
- Pension deficit repair	5	17
<b>= EBITDA-CCD &amp; IRC-tax-pensions (c)</b>	<b>226</b>	<b>201</b>
<b>Proxy for cash interest (d)</b>	<b>133</b>	<b>120</b>
<b>Post maintenance interest cover ratio (x)</b>		
EBITDA-CCD & IRC-tax-pensions/proxy for cash interest c/d	<b>1.7</b>	<b>1.7</b>

Source: Fitch based on company reports

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