FITCH AFFIRMS DWR CYMRU'S SENIOR SECURED DEBT AT 'A'; STABLE OUTLOOK

Fitch Ratings-London-03 October 2017: Fitch Ratings has affirmed Dwr Financing'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 Financing'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 Outlooks are Stable.

The affirmation reflects the company's target gearing on net debt/ regulatory capital value (RCV) of 60%, reflecting lower cash flows for the regulatory period from April 2015 to March 2020 (AMP6). Although estimated post maintenance post tax interest cover (PMICR) is low at an average 1.4x, the company has refinancing options and gearing on net debt/ RCV gives more than adequate headroom for the ratings. 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.

KEY RATING DRIVERS

Regulatory Performance & Delivery on AMP6: Dwr Cymru continued to deliver totex outperformance in the financial year to March 2017 (FY17), although at a lower rate and unlike FY16, this was based on opex, notably in wholesale. This amounted to GBP14 million in FY17, compared with nearly GBP100 million in FY16, of which GBP62 million was capex re-profiling, mainly due to timing issues. The company expects to catch up the capex underspend by FY19. Fitch continues to assume totex in line with Ofwat's regulatory allowances over the remainder of AMP6. The company has achieved improvements in leakage and supply interruptions performance.

Increase in Customer Distributions: In contrast to the rest of the Ofwat-regulated UK water sector, the company is a non-profit organisation with no equity or dividends paid to outside shareholders. Dwr Cymru expects to invest customer distributions of GBP230 million over the course of AMP6 to reinforce asset resilience and operational sustainability. This spending is outside the scope of Ofwat's final determination and raises regulatory gearing by 2020. The company is additionally investing up to GBP100 million outside the regulatory ring fence in energy from waste and commercial business opportunities complementary to the core business. Dwr Cymru has paid GBP30 million dividends to the holding company as part funding of the GBP100 million investment.

Funding Plans: Although liquidity is strong, with around GBP504 million available at end-June 2017, the funding of customer distributions and unregulated activities has created a further funding requirement for AMP6 and AMP7 of GBP300 million-GBP350 million. We expect an improvement in PMICR from 2021 when a 6.91% GBP325 million bond, representing over 10% of debt, matures.

Longer Term Regulatory Challenge: Ofwat is due to publish a final methodology for AMP7 (April 2020-March 2025) in December 2017. The central scenario of lower base returns than for AMP6, reduced scope for financial outperformance and an increase in revenue at risk implies potential pressure on credit metrics from FY21. Dwr Cymru is assessing its approach to capex under AMP7 to deliver progress on its long-term plan to 2050. A potentially lower pay-as-you-go (PAYG) ratio would likely relieve pressure on leverage on net debt/ RCV.

Gearing Headroom: With no access to equity funding, Dwr Cymru has reduced gearing over time to ensure continued access to debt finance. This is underpinned by strict board governance on customer distributions, which may only be made after returns have been earned. Regulatory gearing at FYE17 was 57.5%. Fitch forecasts pension-adjusted net debt/RCV at or below 60% for the company's combined class A and B debt for AMP6, materially lower than our ratio guideline of 67.5%. This gearing headroom compensates for our expectations of post maintenance post tax interest cover (PMICR) at around 1.4x over the remainder of AMP6, close to our ratio guideline of a minimum 1.4x.

DERIVATION SUMMARY

The rating reflects a lower target leverage on net debt/ RCV at 60% compared with peers Yorkshire Water, Anglian Water & Southern Water, all targeting around 70% (Class A debt rated 'A' for Yorkshire and Anglian and 'A-' for Southern Water). Leverage on net debt/RCV is potentially overstated at Dwr Cymru, reflecting the impact of customer distributions on net debt over the course of AMP6, but not RCV. A non-profit organisation, Dwr Cymru is in the unique position of not paying dividends to external shareholders. With customer distributions effectively substituting external dividends, Dwr Cymru is arguably in a stronger position ahead of the regulatory challenges of AMP7 than its peers. The company's PMICR levels at around 1.4x are weaker than Yorkshire, Anglian & Southern at 1.5x, 1.5x and 1.8x respectively. However, Dwr Cymru has refinancing options and this is balanced by more than ample gearing headroom.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
-Totex in line with Ofwat's regulatory allowance over the remainder of AMP6;
-RPI for FY18 onwards of 3%, consistent with peers;
-Cash flow impact of GBP188 million of planned customer distributions from FY18 through FY20;
-No RCV recognition of additional expenditure funded through customer distributions (these do not form part of the company's capex programme) or for the Loughor project reducing local sewage flooding, potentially for GBP73 million;
-Working capital projections in line with management guidance;
-50% share of pension deficit liability assumed at GBP46.2 million as part of pension-adjusted net debt
-Planned customer distributions of GBP19 million paid out as dividends to the holding company over the rest of AMP6.

RATING SENSITIVITIES

Positive: Future developments that could lead to positive rating action include:
- A sustainable reduction in target gearing to below 60% and improvement of PMICR above 1.6x along with maintenance of second quartile regulatory performance.

Negative: Future developments that could lead to negative rating action include:
- A marked deterioration in operating and regulatory performance or adverse changes to the regulatory framework, and
- A sustained increase in gearing to 67.5% and decline in PMICR to below 1.4x.

LIQUIDITY

As of 30 June 2017 Dwr Cymru had unrestricted cash and cash equivalents of GBP130 million and GBP400 million undrawn revolving credit facilities and committed loans. Fitch expects around negative GBP270 million cumulative free cash flow up to and including FY19. We believe liquidity is adequate for the next 24 months considering the GBP300 million-GBP350 million funding requirement above. The group also has GBP135 million committed reserve liquidity facilities available in the event of financial distress.

Contact:

Principal Analyst
Ross Macaulay
Associate Director
+44 20 3530 1395

Supervisory Analyst
Chris Moore
Director
+44 20 3530 1683
Fitch Ratings
30 North Colonnade
London E14 5GN

Committee Chairperson
Josef Pospisil
Managing Director
+44 20 3530 1287

Media Relations: Adrian Simpson, London, Tel: +44 203 530 1010, Email: adrian.simpson@fitchratings.com.

Summary of Financial Statement Adjustments
-GBP48.3 million of accrued interest is removed from total debt
-GBP69.7 million of infrastructure renewals expenditure is moved from operating costs to capex

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017)
https://www.fitchratings.com/site/re/901296