

RatingsDirect®

Research Update:

Outlook On U.K.-Based Dwr Cymru's Class A Debt Revised To Negative On Weaker Credit Ratios; Ratings Affirmed

Primary Credit Analyst:

Matan Benjamin, London (44) 20-7176-0106; matan.benjamin@spglobal.com

Secondary Contact:

Beatrice de Taisne, CFA, London (44) 20-7176-3938; beatrice.de.taisne@spglobal.com

Table Of Contents

Overview

Rating Action

Rationale

Outlook

Related Criteria

Related Research

Ratings List

Research Update:

Outlook On U.K.-Based Dwr Cymru's Class A Debt Revised To Negative On Weaker Credit Ratios; Ratings Affirmed

Overview

- Dwr Cymru (Financing) Ltd. (Welsh Water) is currently operating below the threshold for the rating because of sizable capital expenditure (capex) and higher inflation, which has caused an increase in indexation on debt leading to increased interest costs.
- This is in the context of the company's below par profitability mainly due to discretionary actions to improve customers' bills.
- That said, balance-sheet leverage remains the lowest compared to peers. We believe that management could implement mitigating actions to restore credit metrics.
- Therefore, we are revising our outlook to negative from stable on the class A debt issued by Welsh Water. At the same time, we are affirming our 'A' issue credit rating on the senior secured class A debt and our 'BBB+' issue credit rating on the subordinated class C debt. We note Welsh Water currently does not have subordinated debt outstanding.
- The negative outlook reflects the risk that Welsh Water will not restore credit metrics to a level commensurate with the current ratings.

Rating Action

On June 26, 2018, S&P Global Ratings revised its outlook to negative from stable on the senior secured class A debt issued by U.K.-based Dwr Cymru (Financing) Ltd. At the same time, we affirmed the 'A' issue rating on the class A debt and the 'BBB+' issue rating on the subordinated debt program (Class C).

Four of the senior secured class A bonds issued by Welsh Water retain an unconditional and irrevocable guarantee provided by Assured Guaranty (London) Ltd. We rate monoline-insured debt issues at the higher of the rating on the monoline and the S&P underlying rating (SPUR). The long-term debt ratings on the four class A insured bonds reflect the SPUR, which is 'A'. The ratings on these four class A bonds remain on CreditWatch positive (where they were placed on Oct. 2, 2017), reflecting Assured Guaranty Ltd.'s (AGL) acquisition of Assured Guaranty (London) PLC (AG London). We expect AG London to be folded into AGL's affiliated European insurance companies and its insured obligations to become obligations of AGL's operating subsidiaries. This would lead us to rate the four class A bonds at the same level as AGL's affiliated European

insurance companies (currently 'AA').

Rationale

The outlook revision reflects the risk that Welsh Water will not restore credit metrics at a level commensurate with the current ratings, for example in the absence of mitigating actions by management.

For the financial year (FY) ending March 2018, Welsh Water's S&P Global Ratings-adjusted funds from operations (FFO) to debt fell to 5.4%, which is below what we view as commensurate with the ratings; that is, 7% for the senior debt rating. Under our base case for the next two years, we forecast that the ratio of FFO to debt could remain below this threshold due to higher inflation, leading to an increase in interest costs, while the group's planned large capex constrains cash flow generation. This is in addition to lower profitability compared to peers as explained below. We recognize that there is a timing difference between the inflation index used to calculate indexation on debt and the bill profile, which could lead to an improvement in the metrics in 2020.

Welsh Waters' operational performance remains below par, based on the level of profitability. The company is committed to reducing customer bills (it held average customer bills at, or below, the rate of RPI inflation for nine consecutive years). This is partly attributable to the company's discretionary policy of maintaining a much longer RCV run-off rate in comparison to peers. This policy keeps bills to customers down and insures long-term build-up of the RCV, but at the same time leads to lower revenue in the short term. Furthermore, Welsh Water has over 105,000 vulnerable customers on reduced tariffs, far more than any of its peers. This also has a negative impact on revenue and profitability.

We expect potential further pressure when the company enters the next regulatory period in April 2020. The regulator Ofwat has adjusted its guidance for water companies' allowed cost of capital to 2.8% from the current 3.6%. The new figure represents the average of 2.3% retail price index weighted-average cost of capital (WACC), and 3.3% CPIH (consumer price index including owner occupiers' housing costs) WACC. We estimate that the reduction in the allowed cost of capital could lead to a 5%-6% fall in Welsh Water's revenues over the period 2020-2025. In addition, Ofwat is introducing more rigorous benchmarks on cost efficiencies and service performance.

That said, Dwr Cymru's balance-sheet leverage at its lowest level compares to peers, with a debt to RCV ratio of 57% as of March 31, 2018. We believe that management could take mitigating actions to restore its credit metrics.

The 'A' ratings on the senior secured debt reflect our assessment of the Dwr Cymru financing group's 'a-' SACP plus one notch of uplift for structural enhancements. The 'BBB+' rating on the subordinated debt program (Class C) reflects the group's 'bbb+' subordinated SACP. Welsh Water's SACP reflects our

view of its excellent business risk profile and aggressive financial risk profile. We also give further credit for Welsh Water's unique ownership structure and the company's track record of decreasing leverage. Our assessment is underpinned by its financial policy to maintain leverage well below (60%) the maximum allowed in its legal documentation (85%). The higher SACP for senior debt also incorporates our view of the better positioning of senior creditors in terms of security enforcement and decision-making power.

In our base case, we assume:

- Revenue growth to be around 2%-4% from 2019 onward. This is due to a combination of real price declines and our retail price index (RPI) assumption.
- No outperformance on total expenditures against an already tight regulatory allowance, as per the company's track record.
- Adjusted EBITDA margin at 49%-52% over 2019-2021.
- Higher capex of about £415 million a year on average over the remainder of AMP6.
- An increase in leverage from current levels of around 57% debt to RCV toward 60% for AMP6, as per the company's internal policy.

Based on these assumptions, we arrive at the following credit measures for the senior and subordinated debt:

- Adjusted FFO to debt of 5.0%-6.0% in FY2019 and 6.0%-7.0% in FY2020.
- FFO cash interest coverage ratio of 3.0x-3.5x in FY2019 and 2020.
- Leverage increases up to the company's target debt to RCV ratio of 60%.

Liquidity

We assess Dwr Cymru's liquidity position as strong, supported by our view that the company's liquidity resources will exceed its funding needs by more than 1.93x in the next 12 months and by more than 1.2x in the subsequent 12-24 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

We estimate that Welsh Water will have the following principal liquidity sources over the next 12 months, from March 31, 2018:

- A cash balance of about £280 million;
- FFO of about £255 million; and
- Access to £420 million of undrawn credit facilities comprising a loan from the European Investment Bank and operating and maintenance reserve.

Principal Liquidity Uses

We estimate that Welsh Water will have the following principal liquidity uses over the next 12 months, from March 31, 2018:

- Upcoming short-term debt maturities of approximately £35 million;
- Expected capex of approximately £420 million; and
- Working capital outflows of approximately £30 million.

In addition, the company must maintain a liquidity facility that will be available if it goes into default and is unable to pay interest charges. This facility amounted to £135 million as of March 31, 2018, equivalent to the next 12 months of cash interest payable. Drawing on this liquidity facility results in a distribution lock-up. If we lower the short-term ratings on the liquidity facility providers to below 'A-1', the providers must be replaced within 30 calendar days or the funds available under the facility must be fully drawn.

Outlook

The negative outlook reflects the risk of a downgrade over the next 12-18 months if Welsh Water does not restore FFO to debt to above 7%, which is the threshold for the current rating. The negative outlook also reflects our expectations of further pressure as the company enters the next regulatory period in April 2020, in light of lack of financial headroom today.

Downside scenario

We will lower our rating if the company's ratio of FFO to debt remains below 7% and in the absence of mitigating actions by management to improve profitability and restore the credit metrics.

Upside scenario

We could revise the outlook to stable if Welsh Water could maintain average FFO to debt metrics above 7%. Such an outlook revision would also depend on an improvement in the company's profitability.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria - Corporates - Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses , Feb. 24, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013

- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Why We See The Regulatory Frameworks For U.K. Utilities As Supportive, Sept. 26, 2017
- New Ofwat Regulations Will Keep U.K. Water Utilities On Their Toes, Jan. 30, 2018.
- Seven Issue Ratings Placed On CreditWatch Positive In Line With Assured Guaranty (London), Oct. 2, 2017

Ratings List

Ratings Affirmed; Outlook Action

Dwr Cymru (Financing) Ltd.

Senior Secured	A/Negative	A/Stable
Senior Secured	A/Watch Pos	A/Watch Pos
Senior Secured	A	A
Subordinated	BBB+	BBB+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44)

Research Update: Outlook On U.K.-Based Dwr Cymru's Class A Debt Revised To Negative On Weaker Credit Ratios; Ratings Affirmed

20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.