Research Update:

Ratings on U.K.-Based Dwr Cymru's Class A Debt Affirmed At 'A'; Outlook Negative

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Rating Action Overview

- As the next regulatory reset for the U.K. water sector approaches (April 2020) we see operating conditions becoming increasingly challenging.
- Welsh Water currently operates below the rating threshold and may not be able to restore its credit metrics over the next regulatory period because of below-par profitability and large capital expenditure (capex) outlays, limiting deleveraging prospects.
- However, its leverage remains markedly lower than the industry average. We also note uncertainties around its business plan for next regulatory period.
- We are affirming our 'A' issue rating on the senior secured class A debt (and the outlook stays negative) and our 'BBB+' issue rating on the subordinated class C debt. We are also affirming the 'AA' issue rating with a stable outlook on the senior secured class A bonds issued by DWR Cymru (Financing) Ltd. and guaranteed by Assured Guaranty Europe PLC.
- The negative outlook reflects the risk that Welsh Water may not restore credit metrics to a level commensurate with the current ratings.

Rating Action Rationale

The rating affirmation and negative outlook reflect the risk that, due to challenging operating conditions, Welsh Water may not restore credit metrics to a level commensurate with the current ratings.

Although we now assessed Welsh Water's liquidity profile as adequate, from strong previously, this is neutral to the rating.

Based on currently preliminary results for the financial year ending in March 2019, Welsh Water has continued to post S&P Global Ratings-adjusted funds from operations (FFO) to debt below the 7% threshold we deem commensurate with a 'A' rating on its senior debt. We estimate this ratio improved moderately over the year and will hover around 5.5% for financial year (FY) 2019, after being 5.2% in FY2018. This indicates that Welsh Water has not yet managed to offset the relatively marked deterioration in its credit metrics over the past three years (FY2016 in 9.3% and 7.2% in

FY2017). While we expect the ratio to recover, we see a growing risk that it will remain below the 7% target for the next two to three years.

Welsh Water has undergone a significant rise in capex, which has hindered its cash generation and has ultimately limited its ability to deleverage. It has gradually accelerated its capital program over AMP6 from £220 million (excluding infrastructure renewal) in 2016 to about £400 million in March 2019, to enhance the network over and above the allowances set by the financial determination in 2014. We expect capex to remain high over the next regulatory period, rising by around 25% to £2.1 billion for AMP7. Another reason for the gradual deterioration of the ratio over the past two years was higher inflation, which increased interest costs given the indexation of inflation-linked debt instruments.

Welsh Water's operating performance is below the industry average, in our view. We also foresee a neutral rewards position on its regulatory key performance indicators (Outcome Delivery Incentives) for the current regulatory period (net penalty of £0.4 million for March 2019) along with sub-par profitability. We attribute this to the discretionary policy of maintaining a much longer regulatory capital value (RCV) run-off rate in comparison to peers. This policy keeps customers' bills down and insures a 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 125,000 vulnerable customers on reduced tariffs, far more than any of its peers. This also has a negative impact on revenue and profitability.

We foresee rating pressure continuing to build over AMP7 as Welsh Water pledges to reduce its bills by 5% (£22) in real (CPI) terms in its latest business plan. We expect additional pressure to build due to the regulator Ofwat's decision to adjust its guidance for water companies' allowed cost of capital to 2.8% from 3.6% currently. The new figure represents the average of 2.3% retail price index (RPI) weighted-average cost of capital (WACC), and 3.3% CPIH (consumer price index including owner occupiers' housing costs) WACC. The regulator is expected to update its view on WACC along with the publication of the draft determination in mid-July 2019.

We recognize, nonetheless, that there is still much uncertainty as to whether Welsh Water will execute its business plan in its updated form. We also do not rule out that Welsh Water may be able to generate efficiencies and operate under more favorable financial conditions by the time the next regulatory period kicks off in April 2020, although the regulator queried £450 million of planned capital enhancement expenditures, potentially limiting room for capex outperformance at Welsh Water over AMP7. Like nine other U.K. water companies that the regulator has placed in the "slow-track" category, the publications of the draft and final determination for Welsh Water are scheduled for July 2019 and December 2019, respectively. We have not discerned any major differences between the company's initially submitted business plan and the resubmission in April 2019.

We also recognize that there is a timing difference between the inflation index used to calculate indexation on debt and the bill profile, which could see ratios improving. Finally, we note that the company's leverage is lower than peers, with debt to RCV of 58% as of March 31, 2019. It is committed to keep this below 60%. In light of its unique ownership structure and track record of decreasing leverage, we believe that management could take mitigating actions to restore its credit metrics.

Consistent with many of its water sector peers and in response to sector ongoing political pressure and negative press coverage, Dwr Cymru is also in the process of closing its offshore finance subsidiary and replacing it with a U.K.-based entity. While we view this transaction as neutral to Dwr Cymru's overall credit quality, we expect it to reduce the complexity of its capital structure and enhance transparency.

The 'A' ratings on the senior secured debt reflect our assessment of the Dwr Cymru (financing) group's 'a-' stand-alone credit profile (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.

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 expectation of further pressure on the rating as the company enters the next regulatory period in April 2020, in light of the 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 management takes no actions to improve profitability and restore credit metrics.

Upside scenario

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

Company Description

Welsh Water is the sixth-largest of the 10 regulated water and sewerage companies in England and Wales, according to its RCV, which was £5.7 billion as of March 31, 2019. It supplies water and wastewater services to 1.4 million properties and 3 million people across most of Wales and some adjoining areas of England.

Dwr Cymru (Financing Limited) is a financing vehicle that is ultimately owned by Glas Cymru, a Welsh non-profit company. Glas Cymru is controlled by members with no financial interest in the company. The financial beneficiaries of outperformance are primarily the customers and, to a lesser extent, debtholders, although the latter also bear some underperformance risk. This unique ownership structure distinguishes Glas Cymru from other U.K. water utilities because it eliminates pressure to pay dividends and other shareholder returns.

Our Base-Case Scenario

In our base case, we assume:

- Revenue growth to be around 1%-2% for FY2020 and stable for FY2021. This is due to a combination of real price declines, our RPI assumption, and the company's draft business plan.
- No outperformance on total expenditures against an already tight regulatory allowance, as per the company's track record.
- Adjusted EBITDA margin at 50%-55% over 2020-2021.
- Stable capex of about £400 million for the last year of AMP6, with an uptick to £450 million for 2021.

- An increase in leverage from current levels of around 58% debt to RCV toward 60% for AMP6, under 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 6.0%-7.0% in FY2020 and FY2021.
- FFO cash interest coverage ratio of 3.0x-3.5x in FY2020 and 2021.
- Leverage increases up to the company's target debt to RCV ratio of 60%.

Liquidity

We now assess Dwr Cymru's liquidity position as adequate (previously strong), supported by our view that the company's liquidity resources will exceed its funding needs by more than 1.8x in the next 12 months. Our liquidity assessment is further underpinned by Dwr Cymru's high standing in the capital markets and its good relationship with banks. We note that it is working on refinancing both its March 2021 £325 million Class B notes and its £170 million RCF.

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 £362 million (this includes a £250 million drawdown from an EIB loan in December 2018);
- FFO of about £240 million; and
- Access to £170 million of undrawn credit facilities.

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 £43 million; and
- Expected capex of approximately £400 million.

Covenants

Dwr Cymru continues to comply with the debt-maturity limitations stipulated in the documentation. The next significant maturity is that of £325 million of class B notes in 2021. There are no mandatory break clauses in the index-linked swaps and Dwr Cymru does not have any outstanding class C bonds.

Dwr Cymru has continued to perform well under its current covenants and improve the headroom since the debt transaction closed on May 10, 2001. On March 31, 2019, the senior and class C regulated asset ratio was 58%, well within the trigger level of 85% and the interest cover ratio was 3.4x, well above the trigger of 2x. The covenants are calculated on a consolidated basis at the level of Glas Cymru, the ultimate parent company.

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

- Credit FAQ: U.K. Utilities Are Feeling The Heat, June 14, 2019

Ratings List

Ratings Affirmed	
Dwr Cymru (Financing) Ltd.	
Senior Secured (SPUR)	A/Negative
Senior Secured	AA/Stable
Senior Secured	A
Senior Secured	A/Negative
Subordinated	BBB+

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