FitchRatings

Fitch Revises Dwr Cymru's Outlook to Stable, Affirms Ratings

Fitch Ratings - London - 30 January 2020:

Fitch Ratings has revised the Outlook on Dwr Cymru (Financing) Ltd to Stable from Negative and affirmed Dwr Cymru's senior secured class A Debt, class B debt ratings at 'A' (both wrapped and unwrapped) and class C debt programme rating at 'BBB+'. As there is no class C debt currently in issue the rating indicates the level at which Fitch would rate prospective class C issuance, depending on the size.

The Outlook revision reflects our forecast of stronger than previously expected cash flows and credit ratios for the next price control (AMP7) based on the final regulatory determination and expected refinancing. Although these leave a post-maintenance interest cover ratio (PMICR) still below our negative rating sensitivity, this is offset by an increase in gearing headroom. However, an inability to refinance upcoming bond maturity at a cost below the regulatory allowance would likely lead to a revision of the Outlook back to Negative.

Key Rating Drivers

Regulatory Challenge Set: Ofwat published final determinations (FD) for Price Review (PR) 19 in December 2019. Despite a 16bp lower WACC (at 2.92% CPIH/1.92% RPI) compared with draft determination (DD), Dwr Cymru's total allowed revenues for 2020-25 are GBP320 million (2017-18 prices) higher than the DD, largely reflecting changes to pay as you go (PAYG) and regulatory capital value (RCV) run-off rates, which however do not markedly improve Fitch's key ratios. Although wholesale totex allowance is GBP150 million higher, we believe especially base totex and the reduced retail cost allowance represent a challenge for the company. Positively, outcome delivery incentive (ODI) penalties are lower compared with the DD.

Refinancing to Benefit PMICR: Within GBP957 million of debt maturing in AMP7, Dwr Cymru plans to refinance the GBP325 million 6.91% bond due 2021 and considers other transactions to improve financing cash flows and interest coverage, which we assume are achievable in the short term. Nevertheless, we estimate PMICRs (cash around 1.4x and nominal around 1.6x) to remain weak compared with our rating sensitivities (1.5x and 1.7x) during AMP7. This is offset by the increased gearing headroom.

Increase in Gearing Headroom: An expected reduction in EBITDA in the fiscal year to end-March 2021 (FY21) with AMP7 start coincides with a peak in estimated gearing on net debt/ RCV between 58%-59% compared with our negative rating sensitivity of 65%. However, with stronger free cash flow (FCF) generation, based on the assumption of lower interest costs from refinancing, expected average net debt/RCV improves for AMP7 to around 57%, increasing gearing headroom. In reality, we believe stronger FCF may be used in additional social tariffs (above the GBP55m assumed within the FD) or to reinforce asset resilience and operational sustainability towards the end of AMP7.

Totex Performance Challenge: We assume Dwr Cymru does not outperform wholesale totex for AMP6, partially due to additional discretionary capital spending. We also assume zero totex outperformance in AMP7 with levels approved still likely to stretch the company. For retail, the company has decided to spend more than the FD to continue to improve customer service. However, with Ofwat's latest Service Delivery Report putting Dwr Cymru between the middle and bottom quartile, there is scope for further improvement.

Derivation Summary

The rating reflects lower expected average gearing over AMP7 on net debt/RCV at around 57% compared with Anglian Water Services Financing Plc (AWF, Class A rated 'A'/Rating Watch Negative) estimated around 80%. Average cash interest PMICR is expected to be 1.4x, also stronger than AWF's at around 1.1x. As a non-profit organisation, Dwr Cymru does not have access to equity financing or pay dividends to external shareholders with the later offset by spending on social tariffs.

Key Assumptions

- Allowed WACC in AMP7 of 1.92% (RPI-based) and 2.92% (CPIH-based)

- Average PAYG rate of 55.8%, average run-off rate of 4.12%

- AMP 7 FY21-25 totex of GBP3,356 million (nominal)

- Zero totex outperformance, GBP38 million of ODI-related penalties of which GBP28 million during AMP7

- Retail EBITDA of around GBP13 million a year during AMP7

- Average cash interest expense falls on expected refinancing from around 4% to 2.8% towards the end of AMP7

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- A sustained reduction in target gearing to below 57% and improvement of cash PMICR above 1.7x (nominal 1.9x)

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- A marked deterioration in operating and regulatory performance or adverse change to the regulatory framework.

- A sustained increase in gearing to 65% and decline in cash PMICR to below 1.5x (nominal 1.7x)

Liquidity and Debt Structure

As at 31 December 2019, the company's undrawn credit facilities and cash totaled GBP444million. This includes revolving credit facilities (RCF) available until 2020 of GBP170 million, debt service reserves of GBP83 million and cash of GBP191 million. The company expects to renew the RCF from April 2020. In line with prudent policies approved by the board, cash is invested in 'AAA' rated liquidity funds and bonds, the group's account bank Royal Bank of Scotland and additional banks, subject to minimum short-term rating criteria of 'F1'. Excluding debt service reserves, the company's liquidity position is sound and this covers at least 18 months of operating needs before refinancing.

Summary of Financial Adjustments

-GBP51 million of accrued interest is deducted from total debt.

-GBP84 million of infrastructure renewal expenditure has been reclassified fom operating costs to capex.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. Credit relevance score of 3 means that ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Dwr Cymru (Financing) Limited			
subordinated	LT BBB+ Affirmed		BBB+
senior secured	LT A Affirmed		A

Additional information is available on www.fitchratings.com

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Applicable Criteria

Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019)

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