

ISSUER COMMENT

2 March 2021



RATINGS

Dwr Cymru Cyfyngedig

Corporate Family Rating	A3
Outlook	Stable

Dwr Cymru (Financing) UK Plc

Senior Secured Debt	A3
Subordinated Debt	Baa2
Outlook	Stable

Source: Moody's Investors Service

KEY METRICS:

Dwr Cymru Cyfyngedig

	31-Mar-18	31-Mar-19	31-Mar-20
AICR	1.4x	1.5x	1.5x
Net Debt / RCV	56.7%	58.3%	59.1%
FFO / Net Debt	9.9%	9.4%	9.3%
RCF / Net Debt	9.9%	9.4%	9.3%

Source: Moody's Financial Metrics™

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Dwr Cymru Cyfyngedig

Proposed changes to credit documentation are credit neutral

On 1 March 2021, Dwr Cymru Cyfyngedig (Welsh Water, corporate family rating, or CFR, of A3 stable) launched a creditor consent process, commonly referred to as a STID proposal, with the aim of simplifying and modernising its transaction documents, which were originally put in place around 20 years ago.

We regard the proposed changes as credit neutral. If implemented, they will not adversely affect the rights of lenders, credit enhancing features incorporated within Welsh Water's financing structure, or the financial risk profile of the operating company. The value of the restrictions included within the company's financing structure are also limited while Welsh Water maintains its current very prudent financial policy with, for example, gearing that is amongst the lowest in the sector.

Exhibit 1 summarises core elements of the proposed amendments.

Exhibit 1

Proposals aim to simplify administrative tasks and are broadly credit neutral

Area of documentation	Key proposals
Outsourcing policy	Updates to allow more flexibility subject to a general requirement to follow good industry practice and for bidders to meet certain pre-qualification criteria and re-calibration of creditworthiness checks to align to the company's credit monitoring practices; secured lenders entitled to appoint independent reporter to assist with surveillance
Reporting	Semi-annual investor reports, rather than quarterly, to align with statutory reporting and reduce administrative burden
Hedging	Clarification of interest rate swaps definition to include inflation-linked derivatives; allow flexibility for hedging counterparties to provide rating support through associated group company or third party; allow intra-group swaps between operating company and issuer when an accompanying lending transaction is executed
Bank accounts and cash management	Allow bank accounts with banks for deposit purposes only, other than account bank; 2-business-day flexibility in transferring monthly portions of annual finance charge to debt service payment account; permit the issuer to hold authorised cash deposit investments with the operating company
Other amendments	Permit non-core documents to be updated for bilaterally agreed amendments without creditor consent; permit additional covenants for the benefit of creditors to be added to CTA provided that no existing covenants or representations are removed or amended

Source: Company's STID proposal documentation

Core features of the financing arrangements will remain in place, including a set of financial covenants (see Exhibit 2), particularly the limitations on additional indebtedness and permitted distributions (including customer dividends and distributions to the holding company). We note that Welsh Water's covenant structure is slightly different from other highly covenanted transactions in the UK water sector as the protection offered by certain financial covenants is perhaps less critical for a company without equity shareholders.

Exhibit 2

Summary of Welsh Water's key financial covenants and forecast metrics

Key Ratio	Trigger Event	Event of Default	March 2021*
Total Net Debt (Class A, B and C) to RCV	85%	95%	59.7%
Senior ICR (pre capital maintenance) **	2.0x	1.6x	3.4x
Senior ICR (post capital maintenance) **			1.8x
Total ICR (post capital maintenance) **	1.0x		1.8x

* Forecast ratios as per last published investor report for the period to 31 December 2020. ** Senior ICR excludes Class C interest, whereas Total ICR includes Class C interest. The ICR that is calculated post capital maintenance best compares with Moody's Adjusted Interest Coverage Ratio, although the latter is calculated pre-working capital and reflecting regulatory depreciation as a proxy for necessary capital maintenance rather than actual expenditure, which can be volatile.

Source: Financing documentation and investor reports

Welsh Water has very significant headroom against its financial covenants and has committed to a financial policy that maintains gearing at or below 60% of net debt to regulatory capital value (RCV). With this low level of gearing and at the current A3 rating level we see limited additional value in credit structural features, which also include (1) a standby liquidity facility of £135 million covering 12 months of debt service; (2) a first-ranking fixed charge over the shares in the company; and (3) agreement by financial creditors to give up their individual rights to petition for insolvency proceedings (which could modestly improve recovery in a default scenario).

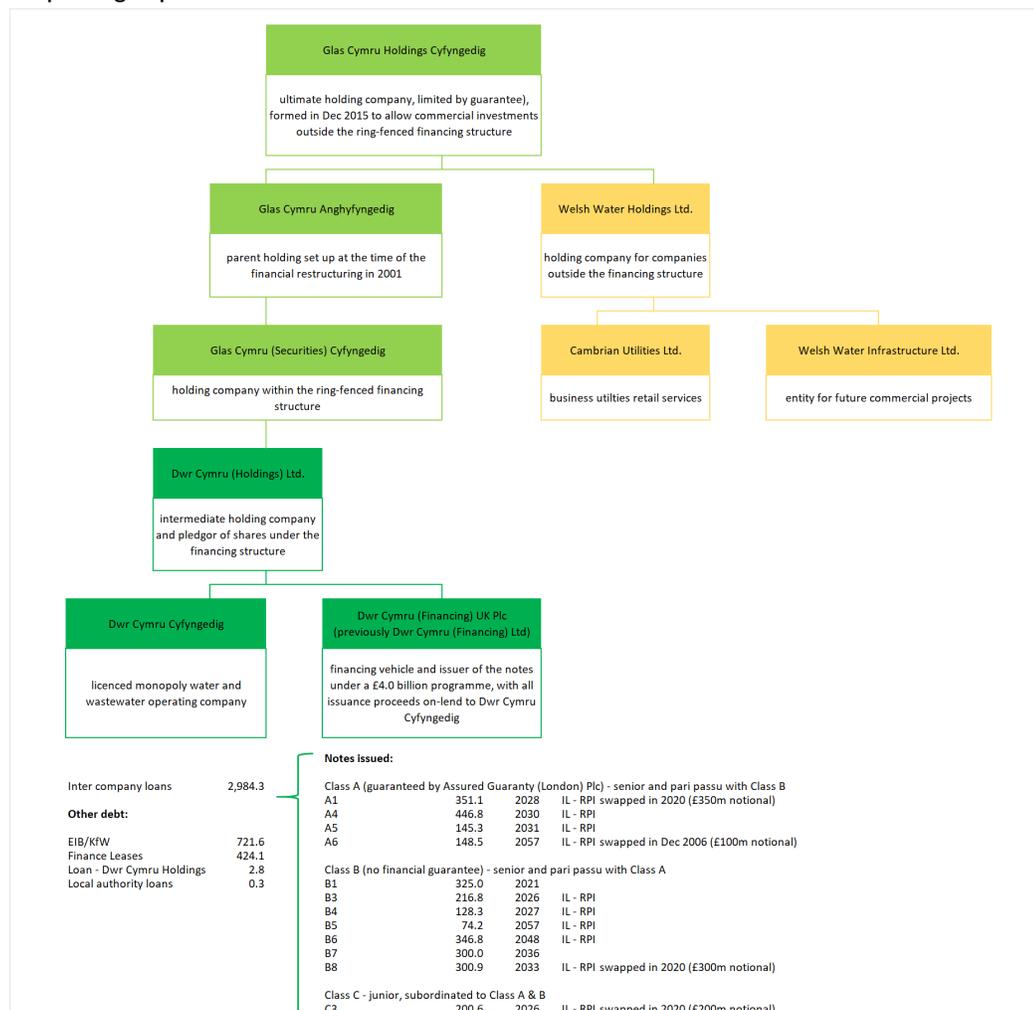
Furthermore, the benefit of the security provided to bondholders remains limited by the regulated and essential nature of the services provided by Welsh Water as governed by its licence and the Water Industry Act 1991.

Exhibit 3 summarises the corporate and debt structure, with currently all of the consolidated group's debt sitting within the financing structure around the core operating company.

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Exhibit 3

Simplified group and debt structure as at 31 March 2020



Source: Company's annual and investor reports

The Class C junior notes, re-introduced into the financing structure in February 2020, are rated Baa2, two notches below Welsh Water's A3 CFR, reflecting (1) their subordinated position relative to the senior debt, which ranks ahead in the cash flow waterfall; and (2) the limited decision-making ability of junior note holders so long as senior debt remains outstanding. The two-notch differential takes into account Moody's view that the senior and junior classes of debt have similar probabilities of default but the loss severity for the junior tranche will be significantly greater, post any default.

The re-introduction of junior debt into Welsh Water's capital structure did not result in any ratings uplift for the senior debt relative to the CFR. This is because the quantum of junior notes, at around 5% of aggregate senior and junior debt, is modest while the tenor of the notes, around six years, implies that they may not be a permanent part of the capital structure. The senior debt rating, therefore, remains aligned with Welsh Water's CFR at A3.

Moody's related publications

Credit Opinion

- » [Dwr Cymru Cyfyngedig: Regular update following publication of March 2020 results](#), 21 September 2020

Sector Outlook

- » [Regulated Water Utilities – UK: 2021 outlook returns to stable as companies settle into a tough regulatory period](#), 11 January 2021

Rating Methodologies

- » [Regulated Water Utilities](#), 8 June 2018

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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