FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Dwr Cymru's Senior Secured and Subordinated Debt at 'A' and 'BBB+'; Outlooks Stable

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Fitch Ratings - London - 11 Nov 2021: Fitch Ratings has affirmed Dwr Cymru (Financing) UK Plc's (DWR) senior secured class A debt and class B debt (both wrapped and unwrapped) at 'A' and its subordinated class C debt at 'BBB+'. The Outlooks are Stable.

The affirmation of DWR's debt ratings reflect the company's forecast financial profile, updated for the impact of the pandemic and the company's recent operational performance, which we expect to remain commensurate with the ratings. The Stable Outlook is supported by the large senior gearing headroom against the negative rating sensitivity of 65%, which is only partially offset by weak cash post maintenance interest cover ratios (PMICRs).

KEY RATING DRIVERS

Challenging Price Control: A significantly lowered allowed weighted average cost of capital (WACC) of 1.96% (real, long-term RPI of 3.00%) in the price review, Asset Management Plan 7 (AMP7), continues to pressure DWR's cash flow and interest coverage metrics. DWR's mixed operational performance in FY21 (financial year ending 31 March 2021) and challenging performance commitments are likely to lead to meaningful outcome delivery incentive (ODI) penalties in AMP7 and put pressure on the company's return on regulated equity (RoRe), which was 0.86% in FY21.

Solid Gearing Profile: We expect DWR's senior net debt to shadow regulated capital value to be around 59.4% by end-FY25. Our forecast is higher than our January 2021 forecast of around 58.2%. Higher gearing is driven by change in our assumption for totex underperformance to 7.5% from zero. Better totex performance than our expectations and stronger FCF may be used as additional social tariffs (above the GBP55 million that the company has committed to over AMP7) or to reinforce asset resilience and operational sustainability towards the end of AMP7.

Cash PMICRs Under Pressure: We estimate average senior cash and nominal PMICRs around 1.2x and 1.6x for AMP7, against the negative rating sensitivities of 1.5x and 1.7x, respectively. We also estimate average total cash and nominal PMICRs at just below the rating sensitivities of 1.2x and 1.5x, respectively, for AMP7. Weak coverage ratios are mainly due to the challenging AMP7, and we believe that they are sufficiently offset by the large gearing headroom.

Totex Underperformance Assumed: In FY21, DWR underperformed totex by around 0.48% in RoRe terms, mostly due to additional expenditure due to Covid-19 and delayed efficiency initiatives related to lockdowns - this was partially offset by capex re-phasing. Across AMP7, we expect DWR to underperform its totex allowance by 7.5%. Our forecast is primarily driven by historical performance in AMP6, continued cost pressures and funding gap for AMP7. Some of the cost pressures in energy prices, however, are mitigated through hedges on energy purchases for the entire AMP and increasingly significant self-generation capacity - which we expect to reach 35% by FY25.

Net ODI Penalties Assumed: Our rating case assumes around GBP44 million of net Outcome Delivery Incentives (ODI) penalties (nominal) related to operational performance in AMP7, including C-Mex and D-Mex. Fitch continues to include penalties related to per capita consumption, although payments will be deferred to the end of AMP7. In cash terms, we anticipate revenue to decrease by about GBP22 million over FY23-FY25 due to a two-year lag between performance and revenue adjustment.

DERIVATION SUMMARY

DWR is one of the of the regulated monopoly providers of water and wastewater services in England and Wales. Dwr Cymru does not have access to equity financing or pay dividends to external shareholders, with the latter offset by spending on social tariffs.

DWR's senior secured (Classes A + B) and subordinated (Class C) ratings of 'A'/Stable and 'BBB+'/Stable, respectively, reflect the company's more conservative gearing profile and its secured covenanted structure versus the plain vanilla structures of peers such as United Utilities Water Limited (BBB+/Stable; senior unsecured debt: A-) and Wessex Water Services Limited (BBB/Stable; senior unsecured: BBB+).

KEY ASSUMPTIONS

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

- RPI of 2.98% and CPIH of 2.07% on average through AMP7

- Average PAYG rate of 57.85%, average run-off rate of 4.77% for AMP7

- AMP7 totex of around GBP3.1 billion for water and wastewater networks (nominal)

- Totex underperformance of 7.5%

- GBP22 million of cash ODI-related penalties over FY23-FY25

- Retail and non-appointed EBITDA of around GBP15 million a year during AMP7

- Working capital outflow of around GBP8 million on average a year

- Around GBP33 million revenue reduction in FY21 due to the pandemic, but to be recovered fully in

FY23

- No further bond issuances across AMP7 and cash cost of debt of 2.6% on average

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- A sustained reduction in target gearing to below 57% and improvement of cash PMICR above 1.7x (nominal 1.9x) would be positive for the class A and B notes. Improvement of the respective metrics to below 59% and above 1.4x (nominal 1.6x) would be positive for the class C notes

Factors that could, individually or collectively, lead to negative rating action/downgrade:

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

- For the class A and B notes, a sustained increase in debt gearing to 65% and decline in cash PMICR to below 1.5x (nominal 1.7x)

- For the class C, a sustained increase in debt gearing to 74% and decline in cash PMICR to below 1.2x (nominal 1.5x)

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Strong Liquidity: As at 30 September 2021, the company's cash totalled GBP511.1 million following the issuance of a Class C bond for GBP300 million with the formal issuance occurring on 9 April 2021. The company further has access to GBP200 million of revolving credit facilities that are undrawn and were renewed in FY21 for two years with a one-year extension option. Fitch expects negative free cash flow of around GBP16 million for FY22 with no further bond maturities within AMP7.

ISSUER PROFILE

Glas Cymru provides regulated water and sewerage services through its licensed water and sewerage undertaker, Dwr Cymru, to household and business customers across most of Wales, parts of Herefordshire, and Cheshire. Dwr Cymru also provides services to its business customers.

Criteria Variation

Finance leases of about GBP411 million were included in the debt figure to reconcile debt with the investor report. This is a criteria variation from the corporate rating criteria's treatment of leases where we exclude it for most sectors, including utilities.

SUMMARY OF FINANCIAL ADJUSTMENTS

- Statutory cash interest reconciled with investor reports

- Statutory total debt reconciled with investor reports

- Infrastructure renewal expenditure reclassified as opex from capex

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Dwr Cymru (Financing) UK Plc				
• subordinated	LT	BBB+ Rating Outlook Stable	Affirmed	BBB+ Rating Outlook Stable
• senior secured	LT	A Rating Outlook Stable	Affirmed	A Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 15 Oct 2021) (including rating assumption sensitivity)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub. 15 Oct 2021)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Dwr Cymru (Financing) UK Plc	UK Issued, EU Endorsed

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