FitchRatings

RATING ACTION COMMENTARY

# Fitch Affirms Dwr Cymru's Senior Secured Debt at 'A'; Stable Outlook

Tue 26 Jan, 2021 - 1:35 PM ET

Fitch Ratings - London - 26 Jan 2021: Fitch Ratings has affirmed Dwr Cymru (Financing) UK Plc's senior secured class A debt and class B debt (both wrapped and unwrapped) at 'A' and subordinated class C debt at 'BBB+'. The Outlooks are Stable.

The affirmation reflects our expectation that cash flows and credit ratios for the new price control (AMP7) will remain commensurate with the debt ratings. Although these leave a post-maintenance interest cover ratio (PMICR) below our negative rating sensitivity, this is offset by ample and increasing gearing headroom through AMP7. The affirmation also reflects our expectation of a moderate impact from the coronavirus pandemic.

## KEY RATING DRIVERS

Challenging Regulatory Period: In its final determinations for the sector, Ofwat reduced significantly the allowed weighted average cost of capital (WACC) to 1.96% from 3.7%, which will put pressure on earnings and cash flows of companies. Compared with the draft determination, the final outcome, however, was better than expected for Dwr Cymru with a significant increase in allowed revenue due to higher PAYG and regulatory capital value (RCV) run-off rates. In contrast, we expect penalties for Dwr Cymru on outcome delivery incentives (ODI), which could to some extent be offset by rewards.

Refinancing Reduces Cost of Debt: In February 2020 Dwr Cymru issued GBP300 million of class B bonds and GBP200 million of class C bonds, both swapped to RPI-linked with negative cash rates. As it repays its GBP325million 6.91% coupon bond due in March 2021, we expect lower cost of debt for the remainder of the forecast period until FY25 (year-end March). Nevertheless, we forecast senior PMICR to remain weak (cash around 1.3x and nominal around 1.6x when excluding our forecast for FY21) against our sensitivities (1.5x and 1.7x) during AMP7. This is offset by increasing gearing headroom. Furthermore, while we have assumed new debt at a 3.5% coupon, the company is likely to issue at lower rates.

Increasing Gearing Headroom: Expected reduction in EBITDA for AMP7, further exacerbated by the pandemic, is expected to slightly increase senior (total) net debt/RCV yoy to around 57% (61%) for FY21. This compares with our negative rating sensitivity of 65% (74%). However, with stronger free cash flow (FCF) generation, based on lower interest costs from refinancing, we forecast senior (total) net debt/RCV to improve to around 55% (58%) by FY25, increasing gearing headroom. 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.

Performance Challenge: We have assumed zero totex overspend in AMP7, but the base totex allowance for the period is around GBP2.4 billion (in 2017/2018 prices) versus GBP2.7billion in AMP6, which could prove challenging. Part of this reduction could be achieved through zero customer distributions, but would also rely on other cost efficiencies. Furthermore, we have estimated GBP44 million of ODI penalties for AMP7, reflecting challenging performance targets. Partly offsetting this is the company's top ranking in the new customer measure of experience (C-Mex), which could result in rewards.

Moderate Covid-19 Impact: We expect Dwr Cymru to see GBP35 million of exceptional costs, including increased bad debts, for FY21 due to the pandemic, before gradually reducing in the next two years. Given the challenging totex targets, we have not included any recovery of the exceptional costs in later years. We also expect temporary impact from the pandemic on volumes and revenues for FY21, although this should be fully recoverable in FY22. We have also revised down our inflation assumptions to reflect the current economic environment. We estimate an increase in average gearing of 1.3% and a reduction in average cash PMICR of 0.1x as a result.

## DERIVATION SUMMARY

The rating reflects an expected average senior (class A and B) gearing over AMP7 with net debt/RCV around 56% compared with Anglian Water Services Financing Plc's (AWF, class A rated A-/Stable) estimated 80%. While average senior cash interest PMICR is expected to be 1.2x for AMP7, which is the same level as AWF's, for Dwr Cymru this is offset by significant gearing headroom. As a non-profit organisation, Dwr Cymru does not have access to equity financing nor pay dividends to external shareholders, with the latter being offset by spending on social tariffs.

## KEY ASSUMPTIONS

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

- RPI of 2.17% and CPIH of 1.51% on average through AMP7

- Average PAYG rate of 55.8%, average run-off rate of 4.77% for AMP7

- AMP7 totex of around GBP3.3 billion (nominal)

- Zero totex outperformance and GBP44 million of ODI-related penalties for AMP7 performance

- Retail EBITDA of around GBP20 million per year during AMP7

- Around GBP20 million revenue reduction in FY21 due to the pandemic, but to be recovered fully in FY23

- GBP35 million of exceptional costs in FY21 due to the pandemic

- Average cash interest cost falls to 2.9% towards the end of AMP7 as a result of refinancing from around 4% currently

## 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 gearing to 65% and decline in cash PMICR to below 1.5x (nominal 1.7x)

- For the class C notes, a sustained increase in 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

Solid Liquidity: As at 30 September 2020, the company's undrawn credit facilities and cash totalled GBP762 million. This included GBP180 million of revolving credit facilities (RCF), debt service reserves of GBP48 million and cash of GBP534 million. Total RCF amount was increased to GBP200 million in November 2020 with all facilities available until 2022 (with a one-year extension option).

The higher than usual cash position reflects the new class B and C debt issued in February 2020, which will be used to repay around GBP400 million of debt maturities in March 2021, including a GBP325 million 6.9% class B bond.

## 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.

## ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

## 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

## FITCH RATINGS ANALYSTS

**Harry Monthen**
Associate Director
Primary Rating Analyst
+44 20 3530 1247
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf London E14 5GN

**Niccolo Ronga**
Analyst

Secondary Rating Analyst
+44 20 3530 2479

**Josef Pospisil, CFA**
Managing Director
Committee Chairperson
+44 20 3530 1287

## MEDIA CONTACTS

**Adrian Simpson**
London
+44 20 3530 1010
adrian.simpson@thefitchgroup.com

Additional information is available on www.fitchratings.com

## APPLICABLE CRITERIA

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

## 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 |

## DISCLAIMER

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY

FOLLOWING THIS LINK: HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, THE FOLLOWING HTTPS://WWW.FITCHRATINGS.COM/RATING-DEFINITIONS-DOCUMENT DETAILS FITCH'S RATING DEFINITIONS FOR EACH RATING SCALE AND RATING CATEGORIES, INCLUDING DEFINITIONS RELATING TO DEFAULT. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY.FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR WHICH THE LEAD ANALYST IS BASED IN AN ESMA- OR FCA-REGISTERED FITCH RATINGS COMPANY (OR BRANCH OF SUCH A COMPANY) CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH RATINGS WEBSITE.

**READ LESS**

## COPYRIGHT

 In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

**READ LESS**

## SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

## ENDORSEMENT POLICY

Fitch’s international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch’s approach to endorsement in the EU and the UK can be found on Fitch’s Regulatory Affairs page on Fitch’s website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Corporate Finance Utilities and Power Europe United Kingdom