

Dwr Cymru (Financing) UK Plc

Ratings of Dwr Cymru (Financing) UK Plc

Fitch Rating's affirmation of Dwr Cymru (Financing) UK Plc's debt ratings reflects the company's forecast financial profile, updated for the impact of the pandemic and the company's recent operational performance, which Fitch expects 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 coverage ratios (PMICRs).

Key Rating Drivers

Challenging Price Control: A significantly lowered allowed weighted average cost of capital (WACC) of 1.96% (real, long-term retail price index 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 the financial year to end-March 2021 (FY21) 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 1.18% in FY21.

Solid Gearing Profile: We expect DWR's senior net debt to shadow regulated capital value, and 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 total expenditure (totex) underperformance to 7.5% from 0%. Better totex performance than our expectations and stronger free cash flow (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, but we believe that they are sufficiently offset by the large gearing headroom.

Totex Underperformance Assumed: In FY21, DWR underperformed totex by around 0.17% 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 a 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.

Rating Type	Rating	Outlook	Last Rating Action
Senior	A	Stable	Affirmed 11 Nov 21
Secured			
Subordinated	BBB+	Stable	Affirmed 11 Nov 21

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Applicable Criteria

[Corporate Rating Criteria \(October 2021\)](#)
[Sector Navigators - Addendum to the Corporate Rating Criteria \(October 2021\)](#)

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Financial Summary

(GBPm)	Mar 20	Mar 21	Mar 22F	Mar 23F
Gross revenue	779	778	808	844
Total cash PMICR (x)	1.0	1.7	1.0	1.3
Senior cash PMICR (x)	1.0	1.7	1.0	1.2
Total nominal PMICR (x)	1.6	1.8	1.5	1.6
Senior nominal PMICR (x)	1.6	1.8	1.6	1.6
Total pension adjusted net debt/shadow RCV (%)	59.4	60.1	60.4	60.3
Senior pension adjusted net debt/shadow RCV (%)	56.0	57.6	52.0	51.9

Source: Fitch Ratings, Fitch Solutions

Rating Derivation Relative to Peers

DWR is one of the of the regulated monopoly providers of water and wastewater services in England and Wales. DWR 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 and 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 rated 'A-') and Wessex Water Services Limited (BBB/Stable; senior unsecured debt rated 'BBB+' under Wessex Water Services Finance Plc).

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 notes, a sustained increase in debt gearing to 74% and decline in cash PMICR to below 1.2x (nominal 1.5x)

Liquidity and Debt Structure

Strong liquidity: As of 30 September 2021, the company's cash totalled GBP511 million following the issuance of a Class C bond for GBP300 million with the formal issuance occurring on the 9 April 2021. The company also has access to a GBP200 million revolving credit facility (RCF) that is undrawn and was renewed in FY21 for two years with a one-year extension option. Fitch expects negative FCF of around GBP16 million for FY22 with no further bond maturities within AMP7.

Liquidity and Debt Maturities

Dwr Cymru Cyfyngedig – Liquidity Analysis

(GBPm)	2022F	2023F	2024F
Available liquidity			
Beginning cash balance	221	425	361
Rating-case FCF after acquisitions and divestitures	-16	-12	33
Class C4 bond issuance	300		
Total available liquidity (A)	505	413	394
Liquidity uses			
Debt maturities	-80	-52	-284
Total liquidity uses (B)	-80	-52	-284
Liquidity calculation			
Ending cash balance (A+B)	425	361	110
Revolver availability	200	200	200
Ending liquidity	625	561	310
Liquidity score (x)	8.8	11.8	2.1

F – Forecast

Source: Fitch Ratings, Fitch Solutions, Dwr Cymru (Financing) UK Plc

Scheduled debt maturities (GBPm)	Original 31 March 2021
2022	80
2023	52
2024	284
2025	159
Thereafter	3,216
Total	3,791

Source: Fitch Ratings, Fitch Solutions, Dwr Cymru (Financing) UK Plc

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
- Nominal AMP7 totex of around GBP3.1 billion for water and wastewater networks
- Totex underperformance of 7.5%
- GBP22 million of cash ODI-related penalties from FY23-25
- Retail and non-appointed EBITDA of around GBP15 million a year during AMP7
- Working capital outflow of around GBP8 million on average each 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

Financial Data

(GBPm)	Historical		Forecast		
	Mar 20	Mar 21	Mar 22	Mar 23	Mar 24
Summary income statement					
Gross revenue	779	778	808	844	817
Revenue growth (%)	-0.3	-0.1	3.8	4.5	-3.3
Operating EBITDA before income from associates	390	375	361	394	379
Operating EBITDA margin (%)	50.0	48.2	44.7	46.6	46.4
Gross interest expense	-147	-126	-215	-190	-182
Summary balance sheet					
Net debt	5,906	6,010	6,274	6,470	6,617
Shadow RCV	2,979	3,570	3,715	3,831	3,912
Summary cash flow statement					
Operating EBITDA	390	375	361	394	379
Cash interest paid	-119	-108	-94	-92	-94
Cash tax	2	3	0	0	0
Other items before FFO	0	0	0	0	0
Funds flow from operations	275	271	267	302	285
FFO margin (%)	35.2	34.9	33.1	35.8	34.9
Change in working capital	-1	7	-18	3	-6
Cash flow from operations (Fitch-defined)	273	279	249	305	279
Capex, dividends, acquisitions and other items before free cash flow	-455	-304	-265	-317	-246
Free cash flow after acquisitions and divestitures	-181	-59	-16	-12	33
Free cash flow margin after net acquisitions (%)	-23.3	-7.5	-2.0	-1.4	4.0
Coverage ratios					
Senior cash PMICR (x)	1.0	1.7	1.0	1.2	1.0
Senior nominal PMICR (x)	1.6	1.8	1.6	1.6	1.5
Total cash PMICR (x)	1.0	1.7	1.0	1.3	1.1
Total nominal PMICR (x)	1.6	1.8	1.5	1.6	1.4
FFO interest coverage (x)	3.3	3.7	3.9	4.3	4.0
Leverage ratios					
Total pension adjusted net debt/shadow RCV (%)	59.4	60.1	60.4	60.3	60.1
Senior pension adjusted net debt/shadow RCV (%)	56.0	57.6	52.0	51.9	51.7
FFO leverage (x)	9.4	9.5	10.9	10.3	10.9
FFO net leverage (x)	7.7	8.9	10.3	9.7	10.3

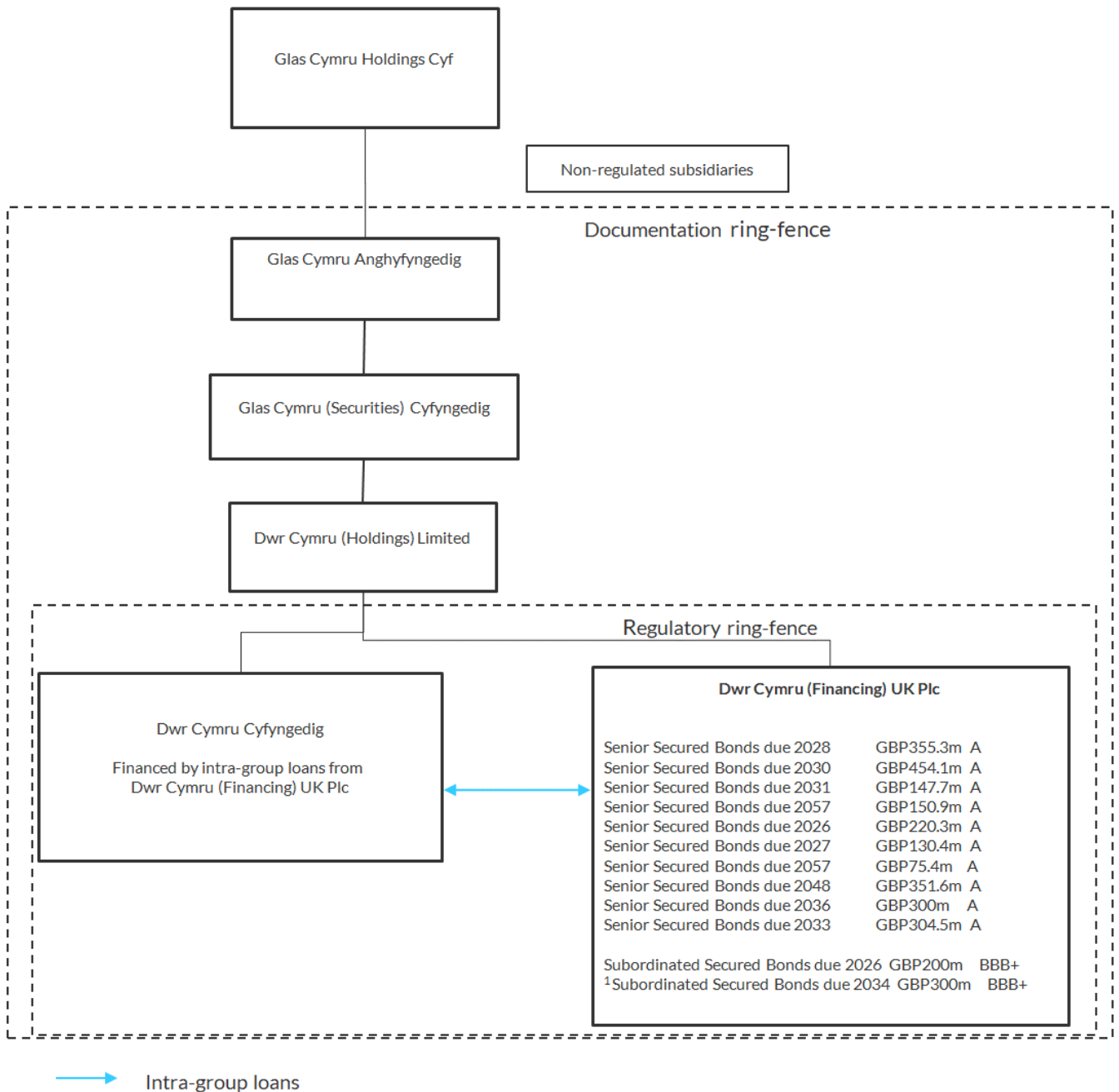
Note: Senior debt excludes subordinated Class C debt

Source: Fitch Ratings, Fitch Solutions

How to Interpret the Forecast Presented

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Simplified Group Structure Diagram

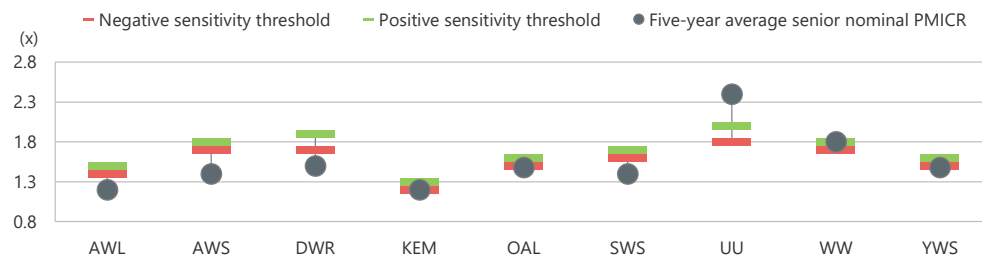


Source: Fitch Ratings, Fitch Solutions, Dwr Cymru (Financing) UK Plc, as of March 2021

¹Subsequent to year end - New Class C debt issuance on 9 April 2021

Peer Financial Summary

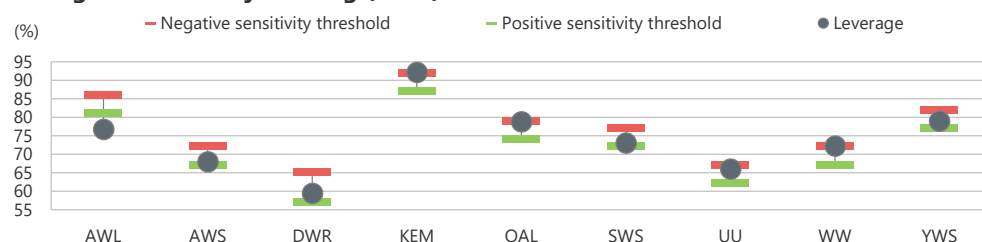
Rating Headroom by Nominal PMICR (Five-Year Average)



Notes: Ratios for AWS, DWR, YWS and AWL reflect total senior interest; YWS is not updated for the provisional findings (PFs) of the Competition Market Authority (CMA)

Source: Fitch Ratings, Fitch Solutions, companies' data

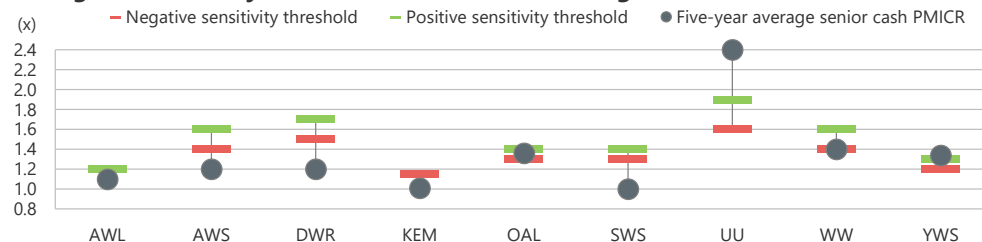
Rating Headroom by Gearing (FY25)



Notes: Ratios for AWS, DWR, YWS and AWL reflect total net senior debt; YWS is not updated for the PFs of the CMA

Source: Fitch Ratings, Fitch Solutions, companies' data

Rating Headroom by Cash PMICR (Five-Year Average)



Notes: Ratios for AWS, DWR, YWS and AWL reflect total senior cash interest; YWS is not updated for the PF of the CMA

Source: Fitch Ratings, Fitch Solutions, companies' data

Key

AWL	Affinity Water Limited
AWS	Anglian Water Services
DWR	Dwr Cymru (Financing) UK Ltd
KEM	Kemble Water Finance Limited
OAL	Osprey Acquisitions Limited
SWS	Southern Water Services
UU	United Utilities Water Limited
WW	Wessex Water Services Limited
YWS	Yorkshire Water Services
TWU	Thames Water Utilities Limited

Source: Fitch Ratings

Performance in AMP6 and Latest Assumptions for AMP7

(%)	AWL	AWS	DWR	SWS	TWU	UU	WW	YWS
Fitch assumption for AMP7								
Totex out/underperformance ^a	0.8	0.0	-7.5	-6.6	-6.2	-3.8	3.0	0.0
Ofwat final determination (FD): outcomes								
FD funding gap	-0.7	-12.4	-5.3	-6.6	-2.3	-2.6	-6.4	-7.9
Base funding gap	-0.8	-12.0	0.4	-3.5	3.1	-0.6	-0.4	-4.2
Enhancement funding gap	-0.2	-13.4	-22.7	-14.4	-27.1	-12.0	-20.8	-19.1
Companies AMP6 performance								
AMP6 Totex performance ^b	-2.2	8.2	-6.1	0.5	10.9 ^c	-6.7	8.3	-3.1

^a Negative value is underperformance, Positive value is outperformance

^b Performance based on actual adjusted totex at base year (2012-2013) prices

^c Excludes Thames Tideaway

Source: Fitch Ratings, companies' 2020 performance reports, Ofwat's FDs

Fitch Adjusted Financials

Fitch Adjustments and Reconciliation Table for Dwr Cymru Cyfyngedig

(GBPm)	Notes and Formulas	Reported Values	Sum of Adjustments	CORP- Lease Treatment	Other Adjustments	Adjusted Values
31 March 2021						
Income Statement Summary						
Revenue		778				778
Operating EBITDAR		341	34		34	375
Operating EBITDAR After Associates and Minorities	(a)	341	34		34	375
Operating Lease Expense	(b)	0				0
Operating EBITDA	(c)	341	34		34	375
Operating EBITDA After Associates and Minorities	(d) = (a-b)	341	34		34	375
Operating EBIT	(e)	7	34		34	41
Debt and Cash Summary						
Total Debt with Equity Credit	(f)	3,755	36	84	-48	3,791
Lease-Equivalent Debt	(g)	0				0
Other Off-Balance-Sheet Debt	(h)	0				0
Total Adjusted Debt with Equity Credit	(i) = (f+g+h)	3,755	36	84	-48	3,791
Readily Available Cash and Equivalents	(j)	221				221
Not Readily Available Cash and Equivalents		0				0
Cash Flow Summary						
Operating EBITDA After Associates and Minorities	(d) = (a-b)	341	34		34	375
Preferred Dividends (Paid)	(k)	0				0
Interest Received	(l)	5				5
Interest (Paid)	(m)	-111	3		3	-108
Cash Tax (Paid)		3				3
Other Items Before FFO		0	-3		-3	-3
Funds from Operations (FFO)	(n)	238	34		34	271
Change in Working Capital (Fitch-Defined)		7				7
Cash Flow from Operations (CFO)	(o)	245	34		34	279
Non-Operating/Nonrecurring Cash Flow		0	-34		-34	-34
Capital (Expenditures)	(p)	-304				-304
Common Dividends (Paid)		0				0
Free Cash Flow (FCF)		-59				-59
Gross Leverage (x)						
Total Adjusted Debt/Operating EBITDAR ²	(i/a)	11.0				10.1
FFO Adjusted Leverage	(i)/(n-m-l-k+b)	10.9				10.1
FFO Leverage	(i-g)/(n-m-l-k)	10.9				10.1
Total Debt with Equity Credit/Operating EBITDA ²	(i-g)/d	11.0				10.1
(CFO-Capex)/Total Debt with Equity Credit (%)	(o+p)/(i-g)	-1.6%				-0.7%
Net Leverage (x)						
Total Adjusted Net Debt/Operating EBITDAR ²	(i-j)/a	10.4				9.5
FFO Adjusted Net Leverage	(i-j)/(n-m-l-k+b)	10.3				9.5
FFO Net Leverage	(i-g-j)/(n-m-l-k)	10.3				9.5
Total Net Debt with Equity Credit/Operating EBITDA ²	(i-g-j)/d	10.4				9.5
(CFO-Capex)/Total Net Debt with Equity Credit (%)	(o+p)/(i-g-j)	-1.7%				-0.7%
Coverage (x)						
Operating EBITDA/(Interest Paid + Lease Expense) ²	a/(-m+b)	3.1				3.5
Operating EBITDA/Interest Paid ²	d/(-m)	3.1				3.5
FFO Fixed-Charge Coverage	(n-l-m-k+b)/(-m-k+b)	3.1				3.5
FFO Interest Coverage	(n-l-m-k)/(-m-k)	3.1				3.5

² EBITDA/R after dividends to associates and minorities.

Source: Fitch Ratings, Fitch Solutions, Dwr Cymru Cyfyngedig

Reconciliation of Key Financial Metrics for DWR Senior Instruments and Class C debt

(GBPm)	31 Mar 19	31 Mar 20	31 Mar 21
Interest bearing loans and borrowings	3,621	4,130	3,791
+ Gross pension deficit	96.2	87.4	89.9
- Pension deficit expected to be funded by customers (nominal)	-48.1	-43.7	-45.0
- Deferred tax impact of pension deficit repair			
= Total pension-adjusted debt	3,669	4,174	3,836
- Cash and equivalents (unrestricted)	362 ^a	667	221
= Pension-adjusted net debt (a)	3,307	3,507	3,615
Shadow real regulatory asset value (b)	5,671	5,906	6,010
Net debt / regulatory asset value (RAV) (%)			
Pension adjusted net debt / RAV (a / b) x 100	58.3%	59.4%	60.2%
EBITDA	447.0	443.2	449.3
- Current cost depreciation (CCD) & adjustment for infrastructure renewals expenditure capitalised	272	290	252
- Taxation paid	0	0	0
- Pension deficit repair	7	12	0
- PAYG adjustment	0	0	-13
= EBITDA - CCD & IRC - tax - pensions (c)	169	141	185
Net cash interest (d)^b	143	137	108
Post maintenance interest cover ratio (x)			
EBITDA - CCD & IRC - tax - pensions / Proxy for cash interest (c / d)	1.2x	1.0x	1.7x
Nominal post maintenance interest cover ratio (x)			
RCV indexation	164	147	71
Nominal PMCF	333	288	255
Net debt indexation	46	42	37
Total Interest	189	179	145
Nominal PMCF / total interest	1.8x	1.6x	1.8x

^a Net of GBP 139.3 million of overdrawn funds; ^b Including capitalised interest

Source: Fitch Ratings, based on company reports

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