

04 APR 2024

## Fitch Downgrades Kemble to 'CC'

Fitch Ratings - London - 04 Apr 2024: Fitch Ratings has downgraded Kemble Water Finance Limited's (holding company of Thames Water Utilities Limited, TWUL) Long-Term Issuer Default Rating (IDR) and senior secured debt rating to 'CC' from 'CCC'. The Recovery Rating is 'RR4'.

The downgrade follows Kemble's announcement on 28 March 2024 that it will not be able to fulfill its upcoming interest payments or refinance or repay the GBP190 million loan maturing on 30 April 2024, unless a maturity extension is granted by lenders.

We believe that some form of default is probable and even if lenders agree to amend and extend (A&E) the upcoming loan, it is highly likely that the agreement would constitute a distressed debt exchange (DDE) under our criteria, which would trigger a downgrade of Kemble to 'Restricted Default' (RD) on completion.

### Key Rating Drivers

**Likely DDE Upcoming:** With Kemble's shareholders not injecting the GBP500 million of equity into TWUL expected for end-March 2024, and Kemble considering it not possible currently to fulfill upcoming interest payments, we believe that a downgrade to RD has become highly likely. Even assuming that lenders will agree to A&E the GBP190 million loan due on 30 April 2024, this agreement would probably constitute a DDE under our criteria.

The completion of the DDE would indicate a material deviation from the original contractual terms, typically to the detriment of creditors, under financial distress conditions. The company has appointed an advisor to assist with lender and noteholder engagement.

**No Relief from Liquidity Line:** Fitch believes Kemble can no longer draw on its GBP150 million working capital facility for debt service of secured creditors. Fitch also believes that there is a high possibility that lenders of the working capital facility may exercise their right to halt further draws following the public announcement of liquidity constraints.

**Limited Liquidity:** TWUL's decision to distribute dividends (paid usually every six months) of GBP37.5 million in October 2023 has been subject to an information request from the UK water regulatory authority (Ofwat). To date, Ofwat has not taken action so far following its information request. Any adverse updates or negative regulatory developments could put additional strain on the already intricate A&E process at Kemble. Kemble's cash balance is estimated at about GBP20 million as of end-November 2023 while gross debt stands at GBP1.35 billion.

**TWUL Lock-up a Key Risk:** We expect increasing risk of a covenant cash-lock up at TWUL for the

remainder of AMP7 (the five-year price control period ending March 2025). The risk of documentary cash lock-up is increasing, in our view, as the covenant calculation included GBP500 million and GBP250 million of additional equity receipts at TWUL in the financial year ending March 2024 (FY24), and FY25, respectively. The first tranche of GBP500 million was not received before FY24 ended following the standoff between shareholders and Ofwat.

**Regulatory Proposition Delays Equity Support:** Ofwat's feedback to TWUL on risk-and-return for AMP8 (the five-year price control period ending March 2030) has triggered a noticeable shift in shareholder engagement. This development has had a specific impact on the timeliness of equity support assumed by management by FYE24. Both the operating company and the shareholders have expressed concerns, indicating that initial feedback (which is not a formal draft determination) on AMP8 does not represent an investible proposition, which in turn has influenced shareholders' decision to not provide timely equity support in FY24.

TWUL is engaged in ongoing discussions with Ofwat and other stakeholders, intending to explore all options to secure the necessary equity investment from either new or existing shareholders

**Opco's Strategy for Cash Preservation:** Management continues to invest in capex for FY25 but notes that mitigating actions (deferring or delaying investments) could be taken in order to preserve cash. Nonetheless, we believe such actions, while financially prudent, could worsen TWUL's operational and environment performance.

**Standalone Assessment under PSL:** Fitch rates Kemble on a standalone basis using the stronger subsidiary/weaker parent approach under its Parent and Subsidiary Linkage (PSL) Rating Criteria. This assessment reflects 'insulated' legal ring-fencing as underlined by a well-defined contractual framework, and tight financial controls imposed by Ofwat and designed to support TWUL's financial profile. We view access and control as overall 'porous' as TWUL operates with separate cash management and a mixture of external and intercompany funding.

## Derivation Summary

In Fitch's view, Kemble's liquidity constraints and the high likelihood of getting to some form of Restricted Default are consistent with the 'CC' rating, which indicates that a default of some kind appears probable.

## Key Assumptions

### Fitch's Key Assumptions Within Our Rating Case for the Issuer:

- Ofwat's final determinations financial model used as main information source
- Allowed wholesale weighted average cost of capital of 1.92% (RPI-based) and 2.92% (CPIH-based) in real terms, excluding retail margins
- RPI of 8% for FY24 and 3.9% for FY25

- CPIH of 6% in FY24 and 2.8% in FY25
- Net nominal cash outcome delivery incentive penalties of around GBP180 million for AMP7
- Dividend stream from TWUL not sufficient to service debt at Kemble, indicating a poor cash position and high likelihood of a DDE

## Recovery Analysis

Kemble's recovery analysis is based on a going-concern approach

- We apply a 6% discount to the reported regulatory capital value (RCV) at 30 September 2023 (GBP19.6 billion), also reflecting the large equity injections that are needed to preserve TWUL's business stability
- We then apply an administrative claim of 0.8% of the discounted RCV or around 10% of Kemble's outstanding debt, to reflect that the default would only occur at Kemble level (not involving TWUL)
- We assume TWUL's net debt to amount to 85% of the reported RCV (correspondent to the dividend lock-up at TWUL) and we add TWUL's derivatives mark-to-market at September 2023 (GBP1.04 billion) as priority debt
- For Kemble, we consider the reported net debt at September 2023 (GBP1.35 billion) plus the mark-to-market of its own derivatives at the same date (around GBP160 million). We do not include the draw-down of its liquidity facility, assuming this is no longer possible
- Our waterfall analysis output percentage on current metrics and assumptions is 38%, corresponding to 'RR4' for senior secured debt

## RATING SENSITIVITIES

### Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- We do not expect to take positive rating action at least until after the IDR is downgraded to 'RD' with the DDE executed and the amended structure re-rated.

### Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Fitch expects to downgrade the IDR to 'C' when Kemble enters into a cure period following non-payment of a material financial obligation or when it formally announces a DDE.
- The rating could be downgraded to 'RD' when the DDE is executed or to 'D' in the absence of an agreement with lenders and bondholders, leading to bankruptcy filings or other procedures

## Liquidity and Debt Structure

**Strained Liquidity:** With only GBP20 million of cash balance estimated at end-November 2023, liquidity is insufficient to cover interest payments (around GBP80 million-GBP85 million in FY24) and

short-term debt maturities, which are related to a GBP190 million syndicated loan due 30 April 2024. There are no further debt maturities in FY25, and the next maturities are due in FY26 for about GBP510 million between July-December 2025.

Draw stop by lenders prevent draw down on the GBP150 million working capital facility expiring November 2027, sized to cover 18 months of interest payments. Fitch does not rate TWUL, but we focus on TWUL's ability to pay dividends and support the debt servicing at Kemble. We expected dividends from TWUL (if any) will be insufficient to cover Kemble's annual interest burden going forward.

## **Issuer Profile**

Kemble is the holding company of TWUL, the largest Ofwat-regulated, regional monopoly provider of water and wastewater services in England and Wales, based on its RCV of about GBP18.9 billion as of end-FY23. TWUL provides water and wastewater services to over 15 million customers across London and the Thames Valley.

## **Summary of Financial Adjustments**

- Statutory cash interest reconciled with investor reports
- Statutory total debt reconciled with investor reports
- Capex and EBITDA net of grants and contributions
- Cash post maintenance interest cover ratios adjusted to include 50% of the accretion charge on index-linked swaps with five-year pay-down, and 100% of the accretion charge on indexed-linked swaps with less than five-year pay-down

## **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**

Kemble has an ESG Relevance Score of '4' for customer welfare - fair messaging, privacy & data security due to large penalties expected for the customer service performance measure in AMP7. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Kemble has an ESG Relevance Score of '4' for group structure due to its debt being contractually and structurally subordinated to TWUL, which has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Kemble has an ESG Relevance Score of '4' for exposure to environmental impacts due to the impact severe weather events could have on its operational performance and financial profile. These include colder winters, heavy rainfalls and extreme heat during summers that cause higher leakage and mains bursts, as well as higher internal sewer flooding and pollution incidents. Although severe weather

events are unpredictable in nature, they have the potential to significantly increase operating costs and lead to additional outcome delivery incentives penalties and regulatory fines from combined sewer overflows, which have a negative impact on the credit profile, and are relevant to the ratings in conjunction with other factors.

Kemble has an ESG Relevance Score of '4' for water & wastewater management due to TWUL's significantly weaker-than-sector average operational performance and sizeable penalties under AMP7. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit <https://www.fitchratings.com/topics/esg/products#esg-relevance-scores>.

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## Rating Actions

ENTITY/DEBT	RATING		RECOVERY	PRIOR
Thames Water (Kemble) Finance Plc				
• senior secured	LT	CC	Downgrade	RR4
				CCC
Kemble Water Finance Limited	LT IDR	CC	Downgrade	
				CCC
• senior secured	LT	CC	Downgrade	RR4
				CCC

### RATINGS KEY OUTLOOK WATCH

POSITIVE	⊕	◇
NEGATIVE	⊖	◇
EVOLVING	◊	◆
STABLE	○	

### Applicable Criteria

[Corporate Rating Criteria \(pub.03 Nov 2023\) \(including rating assumption sensitivity\)](#)

[Corporates Recovery Ratings and Instrument Ratings Criteria \(pub.13 Oct 2023\) \(including rating assumption sensitivity\)](#)

[Parent and Subsidiary Linkage Rating Criteria \(pub.16 Jun 2023\)](#)

[Sector Navigators – Addendum to the Corporate Rating Criteria \(pub.03 Nov 2023\)](#)

## Applicable Models

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

## Additional Disclosures

### Solicitation Status

## Endorsement Status

Kemble Water Finance Limited      UK Issued, EU Endorsed

Thames Water (Kemble) Finance Plc      UK Issued, EU Endorsed

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