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Spotlight: Kemble Water

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> Thames Water continues to struggle operationally and will need sizeable equity injections to keep a balanced financial structure to avoid documentary and a regulatory lock-up. For Kemble, ultimately dependent on Thames Water's dividends, the risks are high.
>
> Fitch believes a gradual delivery of the turnaround plan, and making sufficiently attractive risk and return provisions for AMP8, will be key to keeping shareholders engaged and ensuring adequate equity across the structure.
>
> Yeshvir Singh, Fitch Ratings

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Analysts

Yeshvir Singh
+44 20 3530 1810
yeshvir.singh@fitchratings.com

Disha Kalsi
+44 20 3530 1319
disha.kalsi@fitchratings.com

Sagar Nadkarni
+44 20 3530 1289
sagar.nadkarni@fitchratings.com

Fitch Ratings expects Kemble Water Finance Limited (B/Negative) to be the most vulnerable rated holding company in the UK water sector. This is in comparison to Osprey Acquisitions Limited (OAL; BB+/Stable), Wessex Water Limited (WWL; BBB-/Stable), United Utilities PLC (UU; BBB+/Stable) and Severn Trent PLC (ST; BBB/Stable). While OAL and Kemble opcos have secured covenanted financing structures, all others have a simple structure.

Fitch believes a key rating driver is the shareholders' propensity to provide equity, with visibility over the current conditional equity package. While Fitch does not rate Thames Water Utilities Limited (TWUL, Kemble's operating company), we focus on TWUL's ability to pay dividends and support the debt servicing at Kemble.

We believe shareholder support depends mainly on a business plan that underpins a turnaround, together with appropriate risk-and-return for AMP8 (the five-year price control period ending March 2030). These will be key discussion points between the senior management, the board, recently appointed chair, shareholders, government representatives, and the regulator.

Fitch sees high execution risk around TWUL's more focused turnaround plan, which prioritises a lower number of initiatives now. The turnaround plan should mitigate the impact of higher costs, tightening regulation and refinancing risk.

The company is running its activities under a base case and does not expect liquidity tensions for TWUL and Kemble in financial year ending March 2024 (FY24). However, liquidity and refinancing risks for Kemble are key concerns for FY25 and beyond.

We have received many questions from investors about potential scenarios for Thames and Kemble, and they are mostly applicable also to the sector more generally.

Insights into Scenarios

In this report we focus on secured covenanted structures in the UK water sector, especially on TWUL and Kemble. We provide insights about the different hypothetical scenarios the company may face, including trigger events and standstill. We also consider the options of a special administration regime and re-nationalisation.

The problems are complex and the outcomes are uncertain. The situation has evolved with lower-than-expected conditional equity support of GBP750 million (previously GBP1 billion) in AMP7 (the five-year price control period ending March 2025).

While the management have guided for a further GBP2.5 billion of shareholder support during AMP8, it remains conditional. We expect it will mainly depend on the following: the risk-and-return for AMP8 as defined by the regulator; the AMP8 business plan (approved by the board); and maintaining progress on the turnaround plan, with improvement in operational and environmental performance, while taking mitigating measures to avoid trigger events.

Base Case and Hypothetical Scenarios

Base Case

- No trigger event
- No cash-lock up
- No Ofwat dividend restrictions
- Market access

Hypothetical scenarios

Trigger Event

- Covenant trigger
- Effective Cash Lock-up
- Remedial action
- Option for independent review

Standstill

- Event of default occurs
- Senior creditors secure position
- Remedial action
- Liquidity facilities
- 18 months (extension possible)
- Share pledge

Special Administration Regime

- Decision by Secretary of State
- Appointment of special administrator
- Special administrator aims to transfer the undertaking as a going concern and acts in interests of customers and creditors

Source: Fitch Ratings, Fitch Solutions, TWUL, Kemble

Base Case

This is the current condition of TWUL. There is no cash lock-up or trigger event being forecasted, and the dividend stream from TWUL to Kemble continues.

The base case does not imply high tension in the regulated licenced ring-fenced group, and assumes a successful refinancing of Kemble's next significant debt maturity due in April 2024 for GBP190 million.

The base case also implies continued market access for the group, with management well-positioned to handle liquidity and funding challenges, underpinned by the turnaround plan and the execution of mitigating measures by the shareholders.

These measures include an injection of GBP1.25 billion of equity (GBP500 million received in FY23, with the remaining GBP750 million of conditional equity expected before end of FY25), which Fitch currently includes in its rating case. We also expect joint CEO leadership to continue while a permanent replacement is found, and assume no further resignations from the senior leadership team.

TWUL's operational and environmental performance continues to remain weak and the sudden departure of the CEO in year two of the eight-year transformation plan amplifies execution risk. However, operating activities are proceeding as normal and we do not expect liquidity tensions for TWUL and Kemble in FY24.

TWUL's net outcome delivery incentives (ODI) penalties of GBP 92 million for the financial year ending March 2023 (FY23, worse than expected), only achieving 55% of its annual performance commitments, evidences weak operational and environmental performance.

We expect significant net ODI penalties in FY24 and FY25 (the two-year regulatory lag will affect allowances in AMP8), despite an increase in capex of 38% (GBP1.8 billion in FY23, compared to GBP1.3 billion in FY22).

We consider it challenging to significantly improve several key performance indicators, including sewage discharges, internal sewer flooding and sewer blockages, and the customer measure of experience.

Fitch forecasts net ODI penalties for FY21-FY25 (AMP7) of GBP424 million (nominal), with net cash ODI penalties of GBP220 million for FY24 and FY25. The lower-than-expected equity injection of GBP250 million for AMP7 will be offset against lower totex, also reflecting supply chain constraints.

This base case also assumes that the UK water regulatory authority's (Ofwat) decision to link dividends to operational and environmental performance for UK water operating companies does not affect TWUL. The following table summarises the reasons for which Ofwat may restrict dividends for UK water companies.

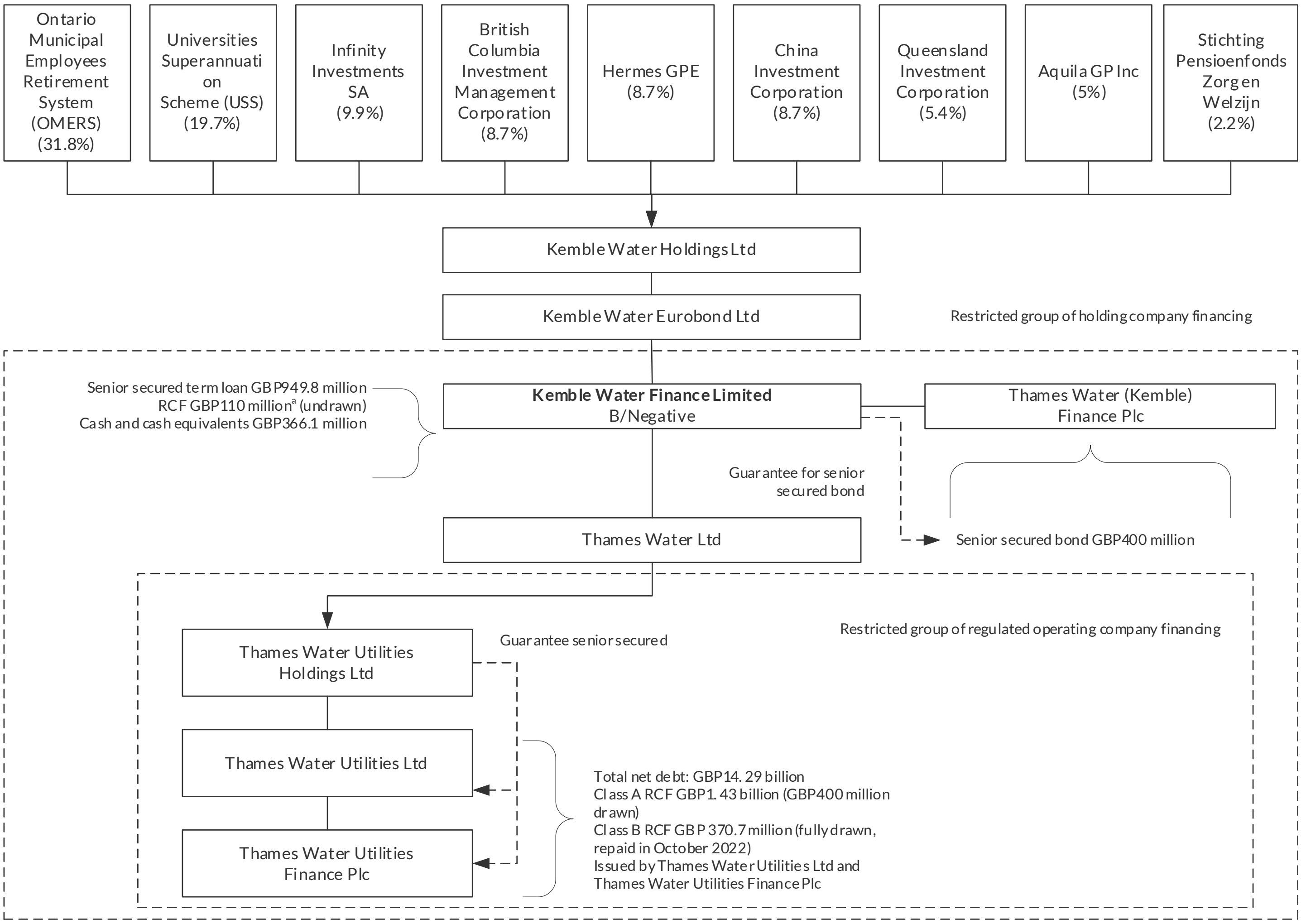
Summary of Dividend Policy Licence Conditions

Key Changes	Description
Financial resilience	Dividends declared or paid will not impair the ability of the appointee to finance the appointed business, taking account of current and future investment needs and financial resilience over the longer term
Customer service delivery and environment	Dividends declared or paid take account of service delivery for customers and the environment over time, including performance levels, and other obligations
Efficiency and effective risk management	Dividends to reward efficiency and the effective management of risks

Source: Fitch Ratings, Fitch Solutions, Ofwat

We believe that deviation from the base case will no longer be consistent with our senior secured debt rating at Kemble of 'B', and recovery rating of 'RR4'. Evidence of a successful operational turnaround, with mitigating measures including a conditional equity injection to maintain the credit profile in line with our rating sensitivities, as well as a favourable AMP8 regulatory outcome, would be essential to revising the Outlook to Stable.

Structure Diagram



[a] Revolving credit facility (RCF) upsized to GBP150 million in November 2022
Source: Fitch Ratings, TWUL and Kemble investor reports, 30 September 2022

Trigger Event

TWUL does not forecast a trigger event or a cash lock-up. This scenario assumes a hypothetical trigger event at TWUL, which would increase the risk to Kemble's only source of cash flows for debt service, and materially weaken debt market access for the holding company, in our view.

In the past Kemble relied on dividends from TWUL and its cash balance to service its debt requirements. With the cash balance at Kemble falling to GBP45 million at March 2023 from GBP250 million at March 2022, dividends from TWUL become even more critical.

It would be a challenging scenario for Kemble if the dividends received from TWUL were insufficient to service its debt, implying sizeable negative free cash flows and refinancing needs.

In Fitch's negative rating sensitivity for Kemble (published in March 2023) – a 'cash lock-up of TWUL including due to a breach of both documentary covenants and licence conditions' would likely lead to negative rating action.

TWUL has various specific events, the occurrence of which will lead to trigger events and a cash lock-up at TWUL. These include, but are not limited to, net debt-to-regulated capital value (RCV), interest cover ratios, accretion (from hedging agreements) exceeds 8% of class A net debt, and maintenance of 12-month liquidity (including operating cash-flows and committed facilities) for capex and working capital.

In addition, a failure to maintain 12-month interest cost through a debt service reserve (DSR) account or facility, a drawdown of operation and maintenance (O&M) reserve facility, or any circumstance that would reasonably be expected to lead to a special administration order (including notices and/or correspondence with Ofwat), would also lead to a trigger event.

On a trigger event, TWUL must present a remedial plan to the security trustee and agree remedial action for implementation. The security trustee can commission an independent review of the remedial plan by technical advisers if instructed by the majority creditors.

The outcome of the independent review will recommend appropriate corrective measures. Moreover, the security trustee would be entitled to discuss the remedial plan with Ofwat, subject to prior notice to TWUL.

The TWUL loan documentation and covenant package includes, but is not limited to, a dividend lock-up set at 85% net debt-to-RCV, with a trigger event at 75% class A net debt-to-RCV, and 90% senior net debt-to-RCV (class A and class B). The TWUL interest cover ratios (ICRs) trigger event for class A debt is 1.3x and senior adjusted ICR for classes A and B debt is 1.1x.

Moreover, Ofwat monitors credit ratings across two credit rating agencies for TWUL, with the Moody's corporate family rating at 'Baa2'/Stable and S&P class A at 'BBB'/Rating Watch Negative in July 2023. A negative rating action from either one would imply a cash lock-up in April 2025 under Ofwat's new licence condition that a minimum credit rating above 'BBB'/Negative must be maintained at the licenced operating company level.

On non-compliance with the credit rating condition related to cash lock-up (from 1 April 2025) under TWUL's licence, Ofwat's review will result in one of three possible outcomes: an application, an exemption, or an extension of the three months grace period.

A cash lock-up under TWUL's licence (before 1 April 2025) would occur if any of the monitored credit ratings were at or below 'BBB-' (or equivalent) with a Negative Outlook.

Key Implications for Kemble

Kemble is ultimately reliant on dividends from TWUL for its cash flows, including debt service and operational costs, in the absence of any mitigating measures by shareholders. In a scenario of insufficient dividend receipts and a liquidity shortfall, or a TWUL cash lock-up, the utilisation of the working capital facility could provide debt service to the secured creditors.

Nonetheless, we believe secured creditors will view the utilisation of the committed working capital facility as an early warning signal of weak liquidity.

A drawdown of Kemble's working capital facility will cause a cash lock-up for the holding company. Together with the TWUL cash lock-up, this would lead to a negative rating action at Kemble.

In this scenario, we expect Kemble's market access to debt finance and capital markets to materially weaken. However, the debt documentation allows for equity cure (available three times in any five-year period, but cannot be used consecutively).

Kemble debt documentation has various types of covenants including a cash lock-up set at 92.5% net debt to RCV. In addition, a trigger event at TWUL will also cause a cash lock-up at Kemble. If the cash lock-up is caused solely by a drawing of the working capital facility, a repayment of this facility will remedy the cash lock-up.

Financial Covenants Applicable to Kemble Water Finance

	Net debt/RCV (%)		ICR (x)
Tranche	Lock-up[a]	Event of default[a]	Event of default[b]
Senior holdco debt	>92.5	>95	<2.0

Note: A lock-up leads to restricted payments or dividend lock-up. Definitions of financial ratios used in the transaction documents differ from credit metrics applied by Fitch
[a] At calculation date, backward-looking
[b] Backward- and forward-looking
Source: Fitch Ratings, Fitch Solutions, Transaction documentation for Kemble Water Finance Limited and Thames Water (Kemble) Finance Plc

Kemble increased its working capital facility to GBP150 million in FY23 (from GBP110 million), expiring in November 2027. The facility is currently fully undrawn and sized to cover 18 months of interest payments, while Kemble's documentation requires it to maintain, on a reasonable endeavours' basis, liquidity for the following 12 months of interest payments.

Standstill

TWUL does not forecast an event of default (EoD) leading to a standstill, but this scenario assumes a hypothetical EoD leading to a standstill. The security trust deed and intercreditor agreements (STID) provides for a standstill of claims of the secured creditors against TWUL (the licenced operating company ring-fenced group).

The STID underpins the rights and obligations of creditors in a standstill period. A standstill would occur immediately on notification to the security trustee of an EoD occurring.

In the event of a standstill, the secured creditors have agreed to not enforce an EoD or accelerate their debt. Generally, the standstill lasts 18 months, but it could be extended.

Fitch believes the standstill is designed to reduce or postpone the prospect of a special administrator order against TWUL, and to co-ordinate the efforts of the security trustee to resolve concerns of financial and operational resilience (including remedial plans).

Financial Covenants Applicable to Thames Water Financing (Backward- and Forward-Looking)

	Net debt/RCV (%)			Conformed adjusted ICR (x)			
Tranche	Restricted payments[a]	Trigger event	Event of default	Trigger event	Event of default	Conformed average adjusted ICR (x) trigger event	Conformed ICR (x) event of default
Class A		>75		<1.3	<1.0	<1.4	<1.6
Senior - class A, class B	>85	>90	>95	<1.1		<1.2	

[a] Restricted payments lead to a dividend lock-up
Source: Transaction documentation for Thames Water Utilities Limited, Thames Water Utilities Finance Plc

The security trustee has the right to request additional information and appoint an independent technical adviser to recommend appropriate corrective measures, if instructed by majority creditors.

Remedial plans may be discussed with Ofwat, including the availability of committed liquidity facilities (including available cash and prefunding) for 12 month's capex, to enable TWUL to fulfil its licence requirement. This could reduce the risk of Ofwat revoking TWUL's licence, in our view.

Kemble creditors are structurally subordinated to TWUL secured creditors, with a cash lock-up set at 92.5% net debt to RCV designed to limit shareholder distributions, offering limited protection, in our view, as the EoD at both operating company and holding company level is 95%.

During the standstill period, interest is expected to be paid normally on classes A and B debt at TWUL, to the extent of available cashflow (applying priority of payments), or available liquidity including committed liquidity facilities. A standstill cash manager will replace TWUL in a standstill, and apply the priority of payments in line with the intercreditor agreements.

Share Pledge

Secured creditors benefit from a pledge over licensed ring-fenced operating group shares, perhaps the most significant collateral. The underlying assets of TWUL cannot be encumbered as it is a regulated licensed operating company. The secured creditors could enforce a sale of TWUL given the share pledge and gain ultimate control of the company, and become the new beneficial owners.

A TWUL share pledge ranks ahead of Kemble. Creditors of Kemble benefit from a security package at the holding company level, including the share pledge of Thames Water Limited, an intermediate holding company outside the licenced ring-fenced group. If the share pledge at Thames Water Utilities Holding Limited, TWUL's immediate holding company, is enforced, this may result in the sale of TWUL, and subsequently Kemble may no longer be an indirect shareholder of TWUL.

However, a default at Kemble should occur earlier than at operating company level assuming there is no equity cure. In a situation where Kemble defaults while TWUL does not, Kemble's creditors could take control of the intermediate holding Thames Water Limited and sell it.

Importantly, we believe that an uncured event of default at Kemble level could only result from disengagement of the shareholders, who might refuse to provide the funding support needed. We do, however, expect the shareholders to continue supporting the group, with the key risks being very disappointing operational results or an unfavourable AMP8 regulatory outcome, which could trigger a withdrawal of support.

Special Administration Regime

Fitch believes a special administration regime (SAR) is an extreme scenario and backstop to preceding protection mechanisms (trigger event, standstill, share pledge). Even in this scenario, there would be an incentive to minimise losses of secured creditors at both operating and holding companies, since large losses could weaken investor confidence in UK infrastructure generally and not only in water and energy.

If implemented, we expect a SAR at the UK's largest regulated water and wastewater company would carry contagion risk, leading to an increase in risk premium for investors. Therefore, this decision would not be taken lightly by the Secretary of State.

If a SAR commences under an extreme scenario, it would override security trustee (instructed by majority creditors) including its insolvency claim and aims to transfer the undertaking as a going concern. The special administrator must manage the undertaking in way that protects creditors interests.

A SAR is intended to be for a short period of time to find new owners, and to sell the business as a going concern, instead of requiring permanent government intervention to fund and operate the business.

Secured creditors have a right to petition if the sale is considered 'unfairly prejudicial'. However, even in a SAR, sale proceeds are expected to be distributed by the security trustee to the secured creditors in accordance with the agreed priority of payments. Equally, the debt may continue to exist as part of a transfer of the company to a new owner.

A SAR aims to protect essential services – water, wastewater, energy, transport, and investment services, from potential insolvency. The SAR process for special administration is set out in the Water Industry Act 1991 and Ofwat's process and procedures documentation for when a company is in financial distress. A SAR would apply if (among other conditions):

- A licensed company contravenes any principal duty which is serious enough to make it inappropriate for the company to continue to hold its appointment.
- A licensed company is unable to pay its debts.

SAR regime remain untested in the UK water sector and with very large companies, although it has been used in other sectors, as recently seen in the case of Bulb Energy. SAR is expected to ultimately protect customers from the risk of TWUL failing to provide water supply and wastewater services.

Re-Nationalisation

Fitch believes the prospect of water companies being re-nationalised is an extreme and unlikely scenario. In addition, re-nationalisation would be a political decision and neither the current government nor the opposition includes it as a policy. The consequences of nationalisation are difficult to envisage. If they were to compromise the predictability and long-term visibility of cash flows, one of the UK water sectors' key strengths, it would result in deterioration in the water companies' standalone credit quality.

Furthermore, the regulator's independence may be challenged if both Ofwat and the companies are ultimately controlled by the government, leading to the risk of the politicisation of water tariffs.

Re-nationalisation at the UK's largest regulated water and wastewater company would also carry contagion risk, leading to an increase in risk premium for investors, and more importantly, many fewer private investors willing to invest across UK infrastructure at a time of very high infrastructure needs.

The consequences for the holding companies would depend on whether the government repurchases water groups as whole entities, including holding companies, or operating companies only.

Holding-company creditors have the right to put the bond (or request an early repayment of debt) in the event of change of control. If only operating companies are nationalised, this clause may not be triggered. But there would likely be an event of default for the holding company in relation to the disposal of the interest in the operating company, as well as a nationalisation event of default in the debt documentation of TWUL.

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