FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Kemble to 'CCC'

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Fitch Ratings - London - 21 Dec 2023: Fitch Ratings has downgraded holding company Kemble Water Finance Limited's Long-Term Issuer Default Rating (IDR) and senior secured debt rating to 'CCC' from 'B'. The Recovery Rating remains 'RR4'.

The downgrade mainly reflects that Kemble will have to engage with syndicated banks to amend and extend (A&E) the GBP190 million loan due April 2024 under terms that could be viewed as a distressed debt exchange (DDE), under our criteria.

The downgrade also reflects rising liquidity pressure due to increased regulatory and political scrutiny of the dividend distribution from Thames Water Utilities Limited (TWUL) to Kemble. There is limited visibility of the liquidity position beyond end-March 2024 (FY24).

Fitch also sees material challenges beyond the next few months, since the equity contributions from shareholders in the five-year price control period ending March 2025 (AMP7) at the TWUL level remain conditional and there is currently limited visibility on regulatory development and further shareholder support in the next five-year price control period ending March 2030 (AMP8). A strong operational turnaround at TWUL would be needed to improve profitability and the prospects for future dividend distribution to Kemble.

KEY RATING DRIVERS

Refinancing Risk: Kemble has to refinance a GBP190 million loan due in April 2024. In the parliamentary committee in December 2024, management confirmed its plans to proceed with an A&E of the loan. The A&E could be viewed as a DDE under our criteria, a key consideration for the negative rating action.

Liquidity Under Pressure: Increasing regulatory scrutiny from the UK water regulatory authority (Ofwat) on the dividend distribution to Kemble from TWUL increases the risk to Kemble's primary source of cash flows for debt service. This materially weakens debt market access for the holding company, in our view.

With Kemble's cash balance estimated at about GBP20 million as of the end of November 2023, dividends from TWUL become even more critical. We note that TWUL's latest decision to distribute dividends (paid usually every six-months) of GBP37.5 million in October 2023 has been subject to an information request from Ofwat. Kemble's annual interest burden stands at around GBP80 million-GBP85 million in FY24. We do not forecast covenant cash-lock up at TWUL in the remainder of AMP7; however, risk of regulatory cash-lock up is increasing, in our view.

Limited Relief from Committed Line: In a scenario of insufficient dividend receipts to cover interest expenses at Kemble, the GBP150 million working capital facility could be used for Kemble debt service to secured creditors. Nonetheless, we believe the use of the committed working capital facility would be seen by existing and potential lenders as a last resort to avoid a payment default of servicing Kemble interest.

Conditional Equity Support Fundamental: We believe shareholder support at TWUL mainly depends on progress on the refocused turnaround plan (approved by TWUL's board in November 2023), together with appropriate risk-and-return balance for AMP8 (Draft Determination due in May/June 2024, final regulatory outcome in December 2024). We see the execution and timing of the uncommitted equity of GBP750 million in AMP7 as uncertain. In addition, management has guided for a further GBP2.5 billion of conditional shareholder equity support during AMP8.

Covenant Forecasts Include Equity: Fitch expects both TWUL and Kemble to comply with their financial covenants in the remainder of AMP7. For the purposes of covenant calculation, management deems it reasonable to include GBP500 million and GBP250 million of additional equity receipts at TWUL in FY24, and FY25, respectively. The closing net debt/Regulatory Capital Value (RCV) at Kemble (on a covenant basis) was 86.4% at end September 2023 compared with an event of default of 95%.

TWUL Lock-up a Key Risk: TWUL's risk of regulatory cash lock-up will increase from April 2025, since the revised licence condition will include a monitored credit rating falling to 'BBB'/Negative or below (vs. current condition being at 'BBB-'/Negative or below).

A lock-up event would be followed by a three-month grace period before enforcement, subject to Ofwat's review of financial resilience. Application, exemption, or extension of the grace period are three possible outcomes of Ofwat's review.

Refocused Turnaround Plan: Fitch sees execution risk around TWUL's refocused turnaround plan, which now prioritises a lower number of initiatives. The plan, under the leadership of the new CEO starting in January 2024, aims to strengthen the company's performance in key areas like pollution, leakage, supply interruptions and water quality. Successful delivery of the plan is fundamental to mitigating the impact of higher operating and financing costs and tightening regulation, improving TWUL's creditworthiness and ultimately the dividends stream to Kemble in the medium to long term.

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

Kemble's 'CCC' IDR is weaker than its peer Osprey Acquisitions Limited (OAL; IDR BB+/Stable; senior secured BBB-), the intermediate holding company for Anglian Water Services Limited (AWS). Anglian Water Services Financing Plc's (AWSF) senior secured debt rating is 'A-'/Stable. AWSF is AWS's debt financing vehicle.

OAL's higher rating reflects its stronger liquidity, lower gearing, higher dividend cover capacity and stronger regulatory performance of the underlying operating companies.

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

- Fitch case assumes totex underperformance of about GBP2 billion across AMP7 with 70% from capex and remaining 30% from operating expenditure

- Net nominal cash outcome delivery incentive penalties of around GBP180 million for AMP7

- Equity injections from Kemble to TWUL of GBP750 million in 2024-2025

- Fitch case assumes no external dividends

- No-cash lock up, and a continuation of dividend stream from TWUL to service debt at Kemble

RECOVERY ANALYSIS

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

- RCV would be fully recoverable at default, with a 10% liquidation-value administrative claim, reflecting the negative mark-to-market value on index-linked swaps

- Default at Kemble due to the dividend lock-up at TWUL (85% net debt to RCV)

- Kemble's net debt to RCV assumed at about 10%, including a full draw-down of its liquidity facility

- Our waterfall analysis output percentage on current metrics and assumptions is 50%, corresponding to 'RR4' for senior secured debt

RATING SENSITIVITIES

Factors that could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Addressing the short-term refinancing risk

- Evidence of timely equity support

- Increasing dividends distributions from TWUL, comfortably covering Kemble's debt service on a sustained basis, allowing for gradual cash increase at Kemble's level

- Evidence of material operating performance improvement at the TWUL level

Factors that could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

- Ongoing pressure on liquidity and slow progress with debt refinancing

- Failure to provide timely equity support

- Indication of debt restructuring on terms that would constitute a DDE based on Fitch's definition

- A cash-lock at TWUL, or TWUL's inability to distribute dividends at least sufficient to cover Kemble's debt service

LIQUIDITY AND DEBT STRUCTURE

Insufficient Liquidity: Liquidity is insufficient to cover short-term debt maturities, which are related to a GBP190 million syndicated loan maturity due 30 April 2024. FY25 does not have any further debt maturities, and the next are due in FY26 for about GBP510 million between July-December 2025. We have low visibility of dividends from TWUL being sufficient to cover interest payments at Kemble level.

As at end-FY23, Kemble held about GBP45 million (excluding TWUL's cash balance) of unrestricted cash and cash equivalents and undrawn committed working capital facility of GBP150 million expiring November 2027, sized to cover 18 months of interest payments. Kemble's documentation requires it to maintain on a reasonable endeavour basis liquidity sized for 12 months of interest payments.

ISSUER PROFILE

Kemble is the holding company of TWUL, the largest of 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 (PMICRs) 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 (ODI) penalties, which haves 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.

RATING ACTIONS

ENTITY / DEBT ⬍	RATING ⬍	RECOVERY ⬍	PRIOR ⬍

Thames Water (Kemble) Finance Plc					
senior secured	LT	CCC	Downgrade	RR4	B
Kemble Water Finance Limited	LT IDR	CCC	Downgrade		B Rating Outlook Negative
senior secured	LT	CCC	Downgrade	RR4	B

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Parent and Subsidiary Linkage Rating Criteria (pub. 16 Jun 2023)

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

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

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

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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

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