



## RATING ACTION COMMENTARY

# Fitch Affirms Kemble at 'B+'; Outlook Negative

Wed 30 Mar, 2022 - 12:24 ET

Fitch Ratings - London - 30 Mar 2022: Fitch Ratings has affirmed holding company Kemble Water Finance Limited's (Kemble) Long-Term Issuer Default Rating (IDR) and senior secured debt rating at 'B+'. The Outlook on the IDR is Negative.

The ratings reflect pressure on Kemble's financial profile from the challenging price control (AMP7) set by the UK water industry regulator (Ofwat) for operating company Thames Water Utilities Limited (TWUL). The Negative Outlook reflects exhausted financial headroom at the current rating and uncertainty around the pace of improvement in TWUL's operational performance. The ratings also factor in Kemble's flexible dividend policy, which continues to support the holding company's financial profile.

The ratings could be downgraded if TWUL's operational performance improves at a slower pace than currently assumed, leading to higher outcome delivery incentives (ODI) penalties; if total expenditure (totex) overspend is in excess of Fitch's rating case; or due to a low inflationary environment. Conversely, the Outlook could be revised to Stable if TWUL shows accelerated improvement in operational performance, resulting in substantially lower ODI penalties, and if totex overspend is supported by ongoing shareholder support.

## KEY RATING DRIVERS

**Reliance on TWUL's Dividends:** TWUL is the main source of cash flow for Kemble, which relies on dividends from the subsidiary to service its debt. Our analysis therefore places emphasis on the dividend stream, which could be negatively affected by

operational underperformance, regulatory fines, as well as, in an extreme case, the inability of TWUL to distribute dividends due to the dividend lock-up under its debt financing being triggered. Given its strong record of support, we expect shareholders to moderate dividends to maintain financial metrics while remaining able to service debt at Kemble.

**High Gearing Profile:** We expect Kemble's adjusted net debt to shadow regulated capital value (RCV) to be around 92% by FYE25 (year-end March), which is marginally better than our April 2021 forecast and in line with our negative rating sensitivity. The improvement is driven by shareholders' commitment and flexibility regarding dividends, our updated inflation assumptions and Fitch-calculated reduced pension deficit adjustment due to a proactive prepayment by management during FY21. These positive developments have been partially offset by greater totex underperformance while our rating case continues to exclude unforeseen event risks such as regulatory fines.

**Totex Underperformance Assumed:** In FY21, Kemble outperformed totex by around 3.55% in return on regulated equity (RoRe), as capex delays were partially offset by additional spending due to the pandemic. Across AMP7, we expect TWUL to underperform its totex allowance by 6.5% which is slightly worse than our assumption of 6.2% in April 2021. Totex underperformance is largely associated with higher contingencies to de-risk Kemble's business plan, new projects related to water network transformation and higher-than-expected business rates. Some cost pressures in energy prices, however, are mitigated by hedges on energy purchases across AMP7 and significant self-generation capacity, which provides around 23% of its power needs.

**Mixed Operating Performance:** TWUL performed the worst in the sector in customer satisfaction scores measured through surveys in FY21. We forecast financial penalties, which are largely dependent on the company's score relative to the sector median, could reach close to GBP90 million. Customer satisfaction performance is offset by significantly improved leakage-and-supply interruption performance across FY21. Leakage improved over 5% to 635.6 MI/day, which was slightly below the regulatory target of 644.3 MI/day while supply interruptions fell to over 13 minutes from 18 minutes. The latter, however, remained below the tight target of 6:30 minutes (interruptions lasting over three hours).

**Net ODI Penalties Assumed:** Fitch's rating case assumes about GBP170 million of net ODI penalties (nominal) related to TWUL's AMP7's operational performance, broadly in line with last year's assumptions. We estimate that the majority of penalties will come from customer satisfaction measured through C-Mex and D-Mex, leakage and supply interruptions. In cash terms, we expect AMP7's revenue to decrease by about GBP110

million in FY23-FY25, related to FY21-FY23 performance, due to a two-year lag between performance and revenue adjustment.

## **DERIVATION SUMMARY**

Kemble is the holding company of TWUL, one of the regulated, monopoly providers of water and wastewater services in England and Wales. Kemble's weaker rating than its closest peer Osprey Acquisitions Limited (OAL; BB+ /Stable) reflects its weaker credit metrics and operational performance. OAL carried out a capital structure review in 2021, which led to significant deleveraging and strengthened its overall covenanted regime.

## **KEY ASSUMPTIONS**

- Ofwat's final determinations financial model used as main information source
- Allowed wholesale weighted average cost of capital (WACC) of 1.92% (RPI-based) and 2.92% (CPIH-based) in real terms, excluding retail margins
- 50% of RCV is RPI-linked and another 50% plus capital additions is CPIH-linked, starting from FY21
- Long-term RPI averaging 3.7% and long-term CPIH averaging 2.9% for 2022-2025
- Totex underperformance of 6.5% across AMP7
- Net ODI penalties of around GBP170 million for AMP7's performance (nominal), of which GBP110 million will be reflected in reduced revenue in FY23- FY25
- Equity injections from Kemble to TWUL of GBP380 million in 2022-2025 (via new debt raised at Kemble)
- Flexible shareholder dividend policy at Kemble

## **Key Recovery Rating Assumptions**

- Kemble's recovery analysis is based on a going-concern approach
- 100% of RCV would be recoverable at default, with 10% of liquidation-value administrative claim, reflecting the negative mark-to-market value on index-linked swaps
- Default at holdco level due to the dividend lock-up at TWUL (85% net debt-to-RCV)

- Kemble's net debt-to-RCV at over 9%, including a full draw-down of its liquidity facility
- Our waterfall analysis output percentage on current metrics and assumptions is 40%, corresponding to 'RR4' Recovery Rating for senior secured debt

## **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

A rating upgrade in the near-term is unlikely. We may revise the Outlook to Stable if there is sufficient evidence of:

- Adjusted net debt-to-RCV consistently below 92% and substantial improvement in regulatory performance at TWUL
- Dividend cover capacity sustained above 2.0x and cash post maintenance interest coverage ratio (PMICR) above 1.1x and nominal PMICR above 1.2x during AMP7

In the longer term, an upgrade to 'BB-' may result from

- Adjusted net debt-to-RCV below 87%
- Dividend cover capacity sustained above 2.5x and cash PMICR above 1.15x and nominal PMICR above 1.3x during AMP7

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Dividend cover capacity below 2.0x, increase of gearing above 92% and/or decrease of cash PMICR below 1.1x or nominal PMICR below 1.2x during AMP7
- Significantly reduced headroom under TWUL's documentary or regulatory lock-up covenants, due to weaker-than-expected operational performance or an event risk such as significant regulatory fines

## **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**

**Strong Liquidity:** As at end-February 2021, Kemble held around GBP282 million in cash and cash equivalents and access to an undrawn GBP110 million working-capital facility. The cash balance and available liquidity provide more than sufficient financial resources for operating requirements, debt maturities and interest service in the next 12 months with the next holding company debt maturity in FY23.

## **SUMMARY OF FINANCIAL ADJUSTMENTS**

- Capitalised interest added back to profit&loss and cash interest
- Statutory cash interest and total debt reconciled to match compliance certificate
- Cash interest adjusted to include 50% of the five-year paydowns of inflation accretion from RPI swaps for the purpose of calculating PMICR

## **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 (over GBP70 million in nominal terms). These penalties will put further pressure on cash flows, 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 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. Colder winters, heavy rainfalls and extreme heat during summers cause higher leakage and mains bursts, as well as higher sewer flooding and pollution incidents. Although severe weather events are unpredictable in nature and are rare,

they have the potential to significantly increase operating costs and lead to additional ODI penalties, 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 leakage performance and the sizeable penalty of GBP120 million (in 2018/2019 prices) it received from Ofwat for failing its leakage performance targets in AMP6 and forecast fines under AMP7. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

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](http://www.fitchratings.com/esg)

## RATING ACTIONS

ENTITY / DEBT <span>◆</span>	RATING <span>◆</span>	RECOVERY <span>◆</span>	PRIOR <span>◆</span>
Thames Water (Kemble) Finance Plc			
senior secured	LT B+ Affirmed	RR4	B+
Kemble Water Finance Limited	LT IDR B+ Rating Outlook Negative Affirmed		B+ Rating Outlook Negative
senior secured	LT B+ Affirmed	RR4	B+

[VIEW ADDITIONAL RATING DETAILS](#)

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**APPLICABLE CRITERIA**

[Corporates Recovery Ratings and Instrument Ratings Criteria \(pub. 09 Apr 2021\)](#)  
(including rating assumption sensitivity)

[Corporate Rating Criteria \(pub. 15 Oct 2021\)](#) (including rating assumption sensitivity)

[Parent and Subsidiary Linkage Rating Criteria \(pub. 01 Dec 2021\)](#)

## 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

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UK Issued, EU Endorsed

Thames Water (Kemble) Finance Plc

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