FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Kemble's IDR and Senior Secured Debt to 'B'; Outlook Negative

Mon 27 Mar, 2023 - 1:24 PM ET

Fitch Ratings - London - 27 Mar 2023: Fitch Ratings has downgraded holding company Kemble Water Finance Limited's (Kemble) Long-Term Issuer Default Rating (IDR) to 'B' from 'B+' and senior secured debt rating to 'B' from 'B+'. The Outlook on the IDR is Negative. The Recovery Rating remains 'RR4'.

The downgrade and Negative Outlook reflect increased pressure on Kemble's credit profile as key ratios are not commensurate with the previous rating, particularly its cash post-maintenance interest cover ratio (PMICR) and dividend cover capacity are weak also for a 'B' IDR.

In addition, the recent decision by the UK water regulation authority (Ofwat) to tighten the distribution lock-ups for UK water operating companies (opcos), in our opinion, increases the risk to Kemble's only source of cash flows for debt service as Thames Water Utilities Limited (TWUL, opco owned by Kemble) is implementing an eight-year transformation plan aimed at turning around its operational and environmental performance.

KEY RATING DRIVERS

Limited PMICR; Dividend Headroom: In our updated rating case for Kemble, we expect average cash and nominal PMICR at about 0.7x and 1.2x, respectively, over the five-year price control period ending in March 2025 (AMP7). The cash PMICR is below our revised negative sensitivity of 1.05x, while nominal PMICR is marginally above our negative sensitivity of 1.15x, reflecting the benefit of regulated capital value (RCV) inflation indexation compared with the overall cost of debt, including accretion. We forecast dividend cover capacity at 1.3x, which is also weak versus its negative rating sensitivity at 1.5x.

Fitch estimates dividend cover capacity using opco's additional distribution capacity (as a percentage of RCV), calculated as the difference between TWUL approaching dividend lock up covenant (1% below the 85% covenant level), and Fitch's forecast of adjusted net senior gearing (including accretion and swap re-couponing) at TWUL at end-AMP7. This updated approach takes into account recent developments such as swap re-couponing being added to Fitch adjusted net debt to RCV and represents our conservative view of the additional dividend capacity at TWUL. On a covenant basis, TWUL net debt to RCV excludes swap re-couponing adjustments.

Tighter Licence Conditions: Fitch believes Ofwat's decision to increase opco's minimum rating requirement for licence to 'BBB' (or equivalent) from 'BBB-' (from 1 April 2025) and to link dividends directly to operational performance on service delivery for customers and the environment (from 17 May 2023) increase the vulnerability of Kemble and its creditors, as it relies on dividends from TWUL to service its debt. In addition to the tighter licence conditions, TWUL's dividends to Kemble are subject to documentary covenants, which we view as more manageable for the company.

Option for CMA Referral: Fitch expects clarity over a potential referral to the Competition and Markets Authority (CMA) by water opcos against Ofwat's licence modifications by 18 April 2023. If a referral to the CMA occured, the timeline for licence modifications is likely to be protracted and subject to CMA's final decision, in Fitch's view.

TWUL Outlook Change a Risk: Ofwat monitors credit ratings across two credit rating agencies for TWUL, both of which are at 'BBB' (or equivalent) with a Stable Outlook, implying limited rating headroom before a cash lock-up is triggered under Ofwat's new licence condition from April 2025. Lock-up would follow an Outlook change to Negative by just one rating agency - with a three-month grace period before enforcement, subject to Ofwat's review of financial resilience. Application, exemption, or extension of grace period are three possible outcomes of Ofwat's review.

Weak Operations May Restrict Dividends: We view weak operational performance with outcome delivery incentives (ODI) penalties from customer measure of experience (C-Mex), and internal sewer flooding as a risk of Ofwat restricting dividend distribution from TWUL to Kemble. Fitch rating case assumes about GBP180 million (nominal) net

ODI penalties in FY23-FY25 (financial year end-March). TWUL lagged behind other regulated UK water companies in Ofwat's overall performance category.

Covenant Cash-Lock Up Mitigated: TWUL's documentary cash-lock up is mitigated by proactive steps taken by management to avoid a trigger event, including GBP1.5 billion of equity (GBP0.5 billion received at FYE23), with the remaining conditional equity expected before FYE25.

Kemble creditors benefit from cash-lock-up trigger at 92.5% net debt to RCV on a covenant basis, without any Fitch-adjustments. Fitch assumes no external dividends.

TWUL Covenant Protections: Kemble creditors are structurally subordinated to TWUL secured creditors who benefit from various credit-enhancing features, which include but are not limited to an effective cash-lock up set at 85% net debt to RCV, with a trigger event at 75% net debt to RCV for class A debt, and 90% senior net debt to RCV (class A and class B). TWUL interest cover ratios (ICRs) trigger event for class A debt is 1.3x and senior adjusted ICR for class A and B debt is 1.1x.

Sufficient Gearing Headroom: We expect sufficient gearing headroom with Kemble's adjusted net debt to shadow RCV at about 90% by FY25 against the revised negative sensitivity of 93.5%, benefiting from inflation and mostly equity-funded total expenditure (totex) increase. However, gearing headroom is not sufficient to offset weak cash-PMICR and dividend cover capacity.

Totex Underperformance Expected: Fitch expects TWUL to overspend totex by about GBP2 billion above Ofwat's allowance for AMP7. These investments are largely associated with customer and environmental outcomes, focused on reducing ODI penalties.

Standalone Assessment under PSL: Fitch rates Kemble on a standalone basis using the stronger subsidiary/weaker parent approach under our 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 ratings reflect its highly geared, secured covenanted capital structure, compared with its peer Osprey Acquisitions Limited (OAL; IDR BB+/Stable; senior secured BBB-). OAL's negative sensitivity for adjusted net debt to RCV is 79% compared with Kemble's 93.5%.

We forecast dividend cover capacity for Kemble at 1.3x, below our negative sensitivity, while OAL's dividend cover capacity is considerably stronger at 5.1x, comfortably above its positive sensitivity of 4.0x. OAL's Stable Outlook is supported by year-on-year improvement in PMICRs - especially at the end of AMP7.

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 (WACC) of 1.92% (RPI-based) and 2.92% (CPIH-based) in real terms, excluding retail margins

- Fifty per cent of RCV is RPI-linked and another 50% plus capital additions is CPIH-linked, since FY21

- RPI of 10.8% for FY23, 8% for FY24 and 3.9% for FY25

- CPIH of 8.5% in FY23, 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 ODI penalties of around GBP180 million for AMP7

- Equity injections from Kemble to TWUL of GBP1.5 billion in 2023-2025

- Fitch case assumes no external dividends

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

Key Recovery Rating Assumptions

- 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:

A rating upgrade in the near term is unlikely. We may revise the Outlook to Stable on:

- Improvement in operational and environmental performance reducing the risk of a cash-lock up

- Cash PMICR sustained above 1.05x

- Dividend cover capacity sustained above 1.5x

- Maintaining nominal PMICR and adjusted net debt to RCV above their negative sensitivities

In the longer term, an upgrade to 'B+' could be considered if Kemble's financial profile is consistent with:

- Adjusted net debt to RCV consistently below 92%

- Dividend cover capacity sustained above 2.0x, cash PMICR above 1.1x, and nominal PMICR above 1.2x

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

- Adjusted net debt to RCV above 93.5%

- Dividend cover capacity below 1.5x, cash PMICR below 1.05x, and nominal PMICR below 1.15x

- Exhausted headroom under TWUL's documentary covenants

- Cash-lock up of TWUL including due to breach of both documentary covenants and license conditions

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

Adequate Liquidity: As at FYE22, Kemble held about GBP250 million (excluding TWUL cash balance) of unrestricted cash and cash equivalents and undrawn committed revolving credit facility (RCF) of GBP110 million. The RCF has been upsized to GBP150 million in FY23, and now expires in November 2027 (currently fully undrawn) sized to cover 18 months of interest payments, while Kemble's documentation requires it to maintain on a reasonable endeavours basis liquidity sized for 12 months of interest payments.

Kemble is fully reliant on dividends from TWUL for its cash flows, including debt service and operational costs. In FY23, Kemble repaid its GBP115 million July 2022 bond maturity with available cash, with the next significant debt maturity due in FY25 for GBP190 million.

ISSUER PROFILE

Kemble is the holding company of TWUL, the largest of Ofwat-regulated, regional monopoly providers of water and wastewater services in England and Wales, based on its RCV of about GBP16.6 billion as of FYE22. 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 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 (over GBP70 million in nominal terms). 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 are colder winters, heavy rainfalls and extreme heat during summers which 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 ODI penalties, which has 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, visitwww.fitchratings.com/esg

RATING ACTIONS

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

Parent and Subsidiary Linkage Rating Criteria (pub. 01 Dec 2021)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 28 Oct 2022)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

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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