FITCH AFFIRMS THAMES WATER (KEMBLE) FINANCE PLC'S BONDS AT 'BB'

Fitch Ratings-London-31 January 2018: Fitch Ratings has affirmed Kemble Water Finance Limited's (Kemble Water) Long-Term Issuer Default Rating (IDR) at 'BB-' with a Stable Outlook and its senior secured rating at 'BB'. The agency also affirmed Thames Water (Kemble) Finance PLC's (TWKF) GBP400 million and GBP175 million senior secured bond issues at 'BB', which are guaranteed by Kemble Water.

The affirmation and Stable Outlook reflect the adequate dividend capacity of Thames Water Utilities Limited (Thames Water or OpCo) in comparison with the debt service requirements of Kemble, and its adequate credit metrics for the remainder of the price control from April 2015 to March 2020 (asset management plan 6; AMP6).

The ratings also take into account Thames Water's position in the lower half of Fitch's rated peer group in terms of regulatory and operational performance, as the main operating subsidiary of the group, as well as the structurally and contractually subordinated nature of the holding-company financing at the Kemble level.

Kemble Water is a holding company of Thames Water Utilities Limited, the regulated monopoly provider for water and wastewater services in London and the surrounding areas.

KEY RATING DRIVERS

Adequate Dividend Cover: For the remainder of AMP6, Fitch forecasts dividend cover mainly above 2.5x, although for the year ended 31 March 2018 (FY18) dividend cover is projected to be weak as we expect the operating company to only distribute sufficient funds to service holding-company debt and not to pay distributions to shareholders. This is due mainly to materially higher capital expenditure in the early years of the price control and expected underperformance of total expenditure (totex) compared to previous expectations of totex outperformance. If there are any developments that would restrict dividend cover for longer, especially an operational underperfomance, a downgrade would be considered.

Adequate Credit Metrics: We forecast Kemble Water will maintain economic gearing below 90% pension-adjusted net debt/regulatory asset value (RAV) over AMP6 and average post-maintenance and post-tax interest cover (PMICR) at around 1.2x. Our forecast gearing differs from the company's forecast as we calculate economic gearing taking into account adjustments for totex out/underperformance.

For FY17 Fitch calculates Kemble's dividend cover at 2.4x, pension adjusted net debt/RAV at 89.5%, and PMICR at 1.26x. These financial ratios differ from Kemble Water's investor report. Fitch adjusts cash interest to reflect non-cash debt movements resulting from certain index-linked swaps by removing those with pay-down provisions.

Incremental Debt at HoldCo: The GBP850 million of debt at the holding level represents around 6% of RAV and incurs an annual finance charge of around GBP58 million on average for FY18 to FY20. We expect the dividend stream from the OpCo for the remainder of the price control to allow servicing of the debt. We see modest refinancing risk from the maturity of the GBP400 million bond in April 2019 due to management's prudent approach in managing liquidity. We expect refinancing plans to be in place well in advance of the bond's maturity.

Underperformance Anticipated: Fitch expects Thames Water to underperform totex targets over AMP6. Lower than previously expected outperformance in the fast money allowance of totex (opex) and higher than expected underperformance in the slow money allowance of totex (capex) results in net totex underperformance. The higher spending is driven by the need to improve regulatory performance, especially in leakage and customer services, additional investment in water mains replacement and increasing IT capabilities. Fitch's forecast includes underperformance of GBP100 million and GBP70 million for totex and retail business respectively in nominal terms.

Performance Needs Improving: For FY17, Thames Water has reported stable asset health for water non-infrastructure assets and sewerage infrastructure and non-infrastructure assets, but water infrastructure assets continue as marginal. The company did not meet its targets for leakage, security of supply and internal sewage flooding, but met targets for drinking water quality, supply interruptions and pollution incidents. Although the company improved its score on the service incentive mechanism which measures customers' satisfaction, to 77.3 from 76.74 in FY16, the company is still lagging behind peers in customer service.

Ratings Pressure From 2019: The new price control methodology which will apply from April 2020 (PR19) is credit-negative for the sector as it will increase both financial and business risks. The regulator's low view on the cost of capital of 2.4% will reduce the water companies' cash-flow generation ability despite the recent rise in UK inflation.

Companies that are lagging regulatory and operational performance targets, likely including Thames Water, may struggle to achieve significant additional cash flow from outperformance of totex and Outcome Delivery Incentives to offset pressure on credit metrics. We will reflect that in our ratings once we have better visibility on business plans post 2020.

Renewed Management and Shareholders: We view as positive the management changes implemented since 2016 as we expect the new management will take a more proactive, transparent and focused approach and will implement new initiatives and processes in order to improve the company's operational and regulatory performance. There has also been a number of changes to the composition of the group's shareholders, leading to more than two-thirds of the shareholder base being made up of pension funds.

Index-Linked Swaps: Thames Water has a portfolio of index-linked swaps with a notional amount of GBP1.5 billion embedded in its capital structure, which do not contain breaks. Around GBP700 million of those swaps contain five-year pay-down provisions of accretion of swap notional and the timing of such payments is spread across each year. In our view these swaps do not have the same cash-enhancing effect as long-dated index-linked bonds. Therefore, Fitch has conservatively removed the benefit of these swaps from the calculation of PMICR.

DERIVATION SUMMARY

Kemble Water Finance Limited is a holding company of Thames Water Utilities Limited (NR), one of the regulated, monopoly providers for water and wastewater services in England and Wales. The weaker rating compared to peers such as Osprey Acquisitions Limited (BB/Stable) and Kelda Finance (No.2) Limited (BB/Stable) reflects Kemble's weaker operating and regulatory performance as well as weaker credit metrics.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for Thames Water include:
Regulated revenues in line with the final determination of tariffs for AMP6, ie assuming no material over- or under-recoveries
Combined totex underperformance of around GBP100 million in nominal terms for FY18 to FY20

Underperformance in retail costs of around GBP70 million above allowances for FY18 to FY20
Unregulated EBITDA of around GBP10 million per annum
Retail price inflation of 3% from 2018 onwards
Limited impact on cash-flow generation from outcome delivery incentives (ODIs), given that financial rewards and penalties will be taken into account as part of the next price review
We have included GBP40 million of penalties related to ODIs in FY18 given that the company has agreed to return this to customers earlier.
Fitch's key assumptions for Kemble Water include:
Incremental debt at the holding-company level based on pension adjusted net/debt to RAV of 90% or below for the whole group
Average annual finance charge at holding company level of around GBP58 million from FY18 to FY20

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Rating upside is limited. A higher rating for the holding company would be contingent on Thames Water materially reducing its regulatory gearing and substantially improving its performance.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action
- A sustained drop of expected dividend cover below 2.5x, increase of gearing above 90% and/or decrease of post-maintenance and post-tax interest cover below 1.05x
- Possibility of a dividend lock-up at Thames Water
- A marked deterioration in operational and regulatory performance at Thames Water or a material change in business risk of the UK water sector

LIQUIDITY

Adequate Liquidity: Kemble mainly relies on upstreamed dividends in order to service its debt payments. As of 31 September 2017, Kemble Water held GBP28.4 million in unrestricted cash and cash equivalents and access to GBP65 million of a committed, undrawn revolving credit facility maturing in 2022, compared with an annual finance charge of around GBP58m. The next debt maturity is a GBP400 million bond maturing in April 2019.

Contact:

Principal Analyst
Vincent Race
Analyst
+44 20 3530 1862

Supervisory Analyst
Victoria Munarriz
Associate Director
+44 20 3530 1419
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Committee Chairperson
Josef Pospisil
Managing Director

+44 20 3530 1287

Summary of Financial Statement Adjustments

- Cash interest is adjusted to reflect pay-down provisions on some index-linked swaps
- Debt and interest cost as published in the statutory accounts are adjusted to reconcile with the amounts published in the company's investor report
- Net debt is adjusted by the proportion of pension deficit not funded by regulatory allowances

Media Relations: Adrian Simpson, London, Tel: +44 203 530 1010, Email: adrian.simpson@fitchratings.com.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017)
https://www.fitchratings.com/site/re/901296
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)
https://www.fitchratings.com/site/re/886557