Moody's downgrades Kemble's notes to B3 from B2, maintains negative outlook

London, December 13, 2023 -- Moody's Investors Service (Moody's) has today downgraded to B3 from B2 the backed senior secured rating of the GBP400 million medium term notes due 2026, issued by Thames Water (Kemble) Finance PLC (Kemble). The outlook remains negative.

The rating action on Kemble follows additional scrutiny from the Water Services Regulation Authority (Ofwat) on recent dividend payments by Kemble's core operating subsidiary Thames Water Utilities Ltd. (Thames Water, Corporate Family Rating: Baa2 stable), on which Kemble relies for its debt service.

RATINGS RATIONALE

Today's rating action on Kemble reflects Moody's view that the risk of a disruption to dividend payments by Kemble's core operating subsidiary Thames Water has increased, despite Thames Water not currently being in breach of any explicit lock-up conditions under its financing structure nor licence.

This reflects continuing high scrutiny of Thames Water's financial resilience, which will weigh on lender appetite in the context of Kemble's forthcoming refinancing needs, likely to the detriment of the availability and/or cost of capital for the holding company. While shareholders have reiterated their support for Thames Water, further equity injections remain subject to conditions and may fall short of what is needed to underpin the credit quality of the holding company in the context of a challenging turnaround and heightened political and regulatory scrutiny.

Regulatory scrutiny and social expectations that may have an adverse impact on a company's access to capital markets is a key social risk consideration under Moody's approach for assessing environmental, social and governance (ESG) risks. Accordingly, the rating agency has changed its social risk issuer profile score for Kemble to S-5 from S-4.

Under current licence conditions, regulated water and wastewater companies may not, without Ofwat's consent, pay dividends (or make similar distributions, including through upstream loans) while their credit rating is Baa3 (or equivalent), with a negative outlook, or lower by any one credit rating agency. As announced in March 2023, the regulator decided to raise this threshold to Baa2 (or equivalent), with a negative outlook, from April 2025.[1] The higher rating requirement will serve to trap cash at an earlier point as the credit quality of an operating water company deteriorates. The lock-up will be subject to a three months grace period, during which companies may seek to persuade Ofwat that their financial resilience is not at risk.

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asked Thames Water to provide details of its decision to pay a dividend of GBP37.5 million in October this year, which would have been earmarked to support Kemble's ongoing debt service payments. The regulator asked for the information to be provided during December and will use it to assess compliance with the new dividend policy licence condition. Ofwat can impose penalties of up to 10% of relevant turnover, if a company is in breach of its licence conditions, but will have to consider, among other things, that any penalty is proportionate to the circumstances of the case.

Ofwat's guidance on the more stringent licence conditions around distributions includes that dividend payments may be acceptable, where companies can evidence significant improvement under an ongoing recovery plan or where they can demonstrate that it may be in the best interest of customers, including, for example, where the prospect of a distribution being permitted may assist with attracting new equity during a turnaround period. However, the increasing scrutiny of Thames Water's distributions reduces the likelihood of a reliable cash flow stream to Kemble, on which the company relies for its debt service.

The likelihood of a formal dividend block, which will increase with the new licence rating trigger becoming effective on 1 April 2025, will also be influenced by factors including progress in Thames Water's ongoing turn-around programme and Ofwat's 2024 price review. The turnaround is being supported by the company's shareholders who provided a GBP500 million equity injection in March 2023 and have agreed to provide a further GBP750 million over the remainder of the current AMP7 regulatory price control period which runs to March 2025. The additional equity is, however, subject to "preparation and production of a business plan that underpins a more focused turnaround that delivers targeted performance improvements for customers, the environment and other stakeholders over the next three years and is supported by appropriate regulatory arrangements".[2] Shareholders have also indicated further support of around GBP2.5 billion over the next regulatory period (1 April 2025-31 March 2030), with final amounts dependent upon Ofwat's final determination expected in December 2024.

Liquidity and financial strategy at Kemble will determine, how long the holding company may be able to withstand a (temporary) distribution block if it were to occur. Kemble is obliged to make reasonable endeavours to maintain sufficient cash to cover for 12 months of interest payments, and the group has a track record of a prudent cash management policy through maintaining cash reserves and/or liquidity facilities. Liquidity is currently supported by a GBP150 million revolving credit facility at Kemble. The facility, which matures in November 2027, is sized to cover 18 months of interest payments. In addition, Moody's estimates that the company held around GBP20 million of cash at September 2023. The GBP37.5 million dividend payment from Thames Water, received in October, will be applied to service ongoing interest payments, but would cover only approximately half of the total annual interest requirement on external Kemble debt.

Considering Kemble's ongoing interest payments, existing cash and available undrawn amounts under facilities are unlikely to fully support repayment of a GBP190 million bank loan maturing in April 2024, unless Thames Water can continue to make distributions. Because of the further tightened regulatory scrutiny of Thames Water's distributions, Moody's believes that the uncertainty around the operating company's ability to make necessary distributions has increased materially.

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payments, reflecting existing cash reserves at Kemble. While Kemble's debt service has remained assured by this element of cash reserves, these are being exhausted and – absent additional liquidity – future dividend payments from Thames Water would need to be sized to cover Kemble's interest cost in full.

Kemble's B3 rating assumes continued shareholder support for the operating company, Thames Water, and additional equity injections to improve its operational and financial performance. Equity support for Thames Water benefits lenders to the holding company directly by supporting the turnaround and reducing the risk of a distribution block but also indirectly because of the – in Moody's view – implied willingness to provide support to the holding company, should it be necessary. Kemble's own senior secured financing structure includes a fixed charge over all of the investments by Kemble Water Finance Limited, including in its shares in its finance subsidiary Thames Water (Kemble) Finance PLC as well as its shares in Thames Water Limited, the intermediate holding company owning Thames Water Utilities Holdings Limited and the Thames Water group. Therefore, any event of default under Kemble debt, would allow Kemble creditors to enforce their share security and take over ownership of the operating company group. This would cause shareholders to lose the investment made to date in the operating company. At the same time, Moody's notes that support to the holding company may not prevent creditors from potentially incurring a loss.

More broadly, Kemble's rating continues to reflect (1) the low business risk of its key operating subsidiary, Thames Water; and (2) very high leverage at the Kemble group level, up to 90% of Thames Water's regulatory capital value (RCV). It also takes into account the higher probability of default that creditors at the holding company level are facing and the higher severity of loss in an actual default scenario because of holding company creditors' structural and contractual subordination to operating company creditors.

RATING OUTLOOK

The outlook is negative, reflecting the increased risk of dividend payments from Thames Water to Kemble being constrained as well as heightened uncertainty around the successful execution of the turn-around programme and Kemble's ability to meet its forthcoming refinancing needs without a significant increase in its funding costs over time.

Moody's could change the outlook to stable upon a strengthening of the business or financial risk profile of the operating company and/or sizeable liquidity support at the holding company, including from additional shareholder commitment, that would allow it to sustain a multi-year dividend block.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATING

Given the current negative outlook as well as the deeply subordinated nature, structurally as well as contractually, of the Kemble notes in the context of the operating group's financing structure and regulatory protections, Moody's does not expect any upward rating pressure for the Kemble notes.

Kemble's rating could be downgraded further if the holding company failed to refinance its near-term maturities; the ratings of Thames Water were downgraded; or the risk of a dividend lock-up at the operating company increased further.

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which owns Thames Water through intermediate holding companies including Thames Water Limited. Thames Water is the largest of the ten water and sewerage companies in England and Wales by both RCV (GBP19 billion at March 2023) and the number of customers served. It provides drinking water to around nine million customers and sewerage services to around 15 million customers in London and the Thames Valley. Kemble is ultimately owned by a consortium of national and international infrastructure and pension funds, the largest being OMERS (31.8%) and the Universities Superannuation Scheme (19.7%).

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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At least one ESG consideration was material to the credit rating action(s) announced and described above. Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit

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REFERENCES/CITATIONS

[1] https://www.ofwat.gov.uk/wp-content/uploads/2022/07/Decision_document_financial_resilience_proposals.pdf

[2] https://www.londonstockexchange.com/news-article/BA18/shareholder-funding-update/16033297

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