

Research Update:

# Thames Water Class A And B Debt Ratings On Watch Negative On Management Transition, Unknown Timing Of Equity Injection

June 30, 2023

## Rating Action Overview

- The resignation of Thames Water's CEO and the ensuing management transition could hinder the company's efforts to address its operational performance via its eight-year transformation plan.
- Additional equity injections from shareholders totaling £1 billion--critical to fund the transformation plan and included in our base case--are conditional upon continuing operational improvements, and their exact timing remains unknown.
- We therefore placed our 'BBB' and 'BB+' issue ratings on Thames Water's class A and class B debt on CreditWatch with negative implications.
- The CreditWatch placement indicates that we could lower the ratings by one notch in the absence of sufficient clarity on the management transition and timing of additional equity support from shareholders.

## Rating Action Rationale

**We believe Thames Water's CEO's unexpected resignation with immediate effect increases risks to the implementation of the company's transformation plan, amid uncertainty regarding the timing of additional shareholder injections.** The CEO's resignation comes in the second year of the company's eight-year transformation plan. CFO, Alastair Cochran, as well as Strategy and Regulatory Affairs Director and previous Ofwat CEO, Cathryn Ross, will act as interim co-CEOs until the company formally appoints a replacement, providing a degree of continuity. Even then, we believe implementation risks to tackle long-standing operational issues have increased following the CEO's sudden departure, which comes before the company submits its business plan for the next regulatory period in October 2023. The company's shareholders have previously indicated support for equity injections totaling £1.5 billion by the end of the current regulatory period, ending March 2025, toward financing the turnaround. So far, £500 million of this has been

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received, with the remaining amount conditional on ongoing operational improvements and the company's submission of its business plan for the next regulatory period. The exact timing of additional injections is unknown. We understand that more information could be provided with the year-end results to be published in July. The absence of this support--which we include in our base case--would further pressure Thames Water's financial metrics. Financial headroom is limited, and we project key metrics will remain below thresholds commensurate with the ratings for another year. We estimate the class A's funds from operations (FFO) to debt ratio will average 4.3% for the years ended March 31, 2023, 2024, and 2025, compared with our 5% downside threshold, and debt to EBITDA will average 10.5x over that period compared with our 11x downside threshold for the current rating. We view liquidity as adequate, as defined by our criteria, with sources covering uses by 1.47x over the next 12 months (see liquidity section below for details).

**The company, along with the rest of the U.K. water sector, faces headwinds from a sharp rise in operating and financing costs.** We anticipate significantly higher investment needs for the sector in the next regulatory period, starting April 2025, to deliver improvements--notably in environmental quality--amid intense public, political, and regulatory scrutiny. These will coincide with a greater regulatory focus on financial resilience, potentially requiring lower overall leverage. We therefore envisage that additional shareholder support will remain critical for Thames Water beyond the current rating horizon. Thames Water is the most indebted water company we rate, with S&P Global Ratings-adjusted debt of £13.7 billion as of March 31, 2022, translating into 80.6% of its regulated capital value (RCV).

## **CreditWatch**

The negative CreditWatch placement indicates that we could lower the issue ratings by one notch within the next three to six months if we do not gain clarity on additional equity support from shareholders or on progress on the company's eight-year turnaround plan. Depending on the risks we see with the implementation of the transformation plan, we could revise our assessment of the company's business risk profile to strong from excellent.

We could lower our ratings on the debt issued by Thames Water if we do not believe equity support is forthcoming, if there are signs that the turnaround plan is not making sufficient progress, or if the company's results for fiscal year 2023 are much weaker than we currently expect (see "Issue Ratings On Thames Water Utilities Finance PLC's Class A And B Debt Lowered On Strained Metrics, Outlook Stable," published Sept. 16, 2022).

We could affirm the issue ratings and remove them from CreditWatch when we gain sufficient clarity on the turnaround plan and a firm timeline for the additional equity injections committed to the regulator.

## **Company Description**

Thames Water is the U.K.'s largest water and sewerage company, with an RCV of £16.6 billion on March 31, 2022. Thames Water serves 15 million customers and about 25% of the population of England and Wales, generating EBITDA of about £1.1 billion annually.

## Liquidity

We assess Thames Financing Group's liquidity position as adequate under our criteria, supported by our view that its liquidity resources will exceed its funding needs by 1.47x in the 12 months from March 31, 2023.

### Principal liquidity sources:

- Available cash and committed funding of £4.4 billion (excluding the dedicated debt-service reserve and operations and maintenance facility); and
- Cash FFO of about £750 million.

### Principal liquidity uses:

- Upcoming debt maturities of approximately £1.8 billion;
- Expected capital spending of approximately £1.60 billion; and
- Dividends of approximately £80 million-£100 million (to pay the holding company's debt interest).

## Covenants

We understand that the company operates with tight headroom under its covenants.

## Environmental, Social, And Governance

### ESG credit indicators: To E-3, S-3, G-3; From E-3, S-3, G-2

Environmental and governance factors are moderately negative considerations in our credit rating analysis of Thames Water, whose operating performance is below the sector average in certain areas, such as supply interruptions. The large turnover in senior management in recent years leaves uncertainty regarding a continuous and effective strategy for the company. The recently departed CEO had only been at the company since September 2020, while the new co-CEOs Al Cochrane and Cathryn Ross joined the company in September and June 2021, respectively. Improving operating performance is a key priority for the company, which is in the midst of an eight-year transformation plan. Although improvements have been visible in some areas, Thames Water is still failing to meet certain key targets.

Social factors are a moderately negative consideration. As one of the U.K.'s largest water and wastewater network operators, Thames Water provides a key service with a significant social impact. This exposes the company to additional scrutiny from regulators and the government to ensure not only high quality and reliability, but also affordable costs for customers. This scrutiny is evident from the latest price review in April 2020.

## Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

## Related Research

- Europe's Utilities Face A Power Price Cliff From 2026, June 22, 2023
- EMEA Utilities Outlook 2023: United Kingdom: Tailwinds For Energy, Cross-Currents For Water, Jan. 24, 2023
- High Level Of Index-Linked Debt Exacerbates Effect Of Inflation On U.K. Water Companies, Dec. 1, 2022
- Issue Ratings On Thames Water Utilities Finance PLC's Class A And B Debt Lowered On Strained Metrics, Outlook Stable, Sept. 16, 2022

## Ratings List

### CreditWatch/Outlook Action; Ratings Affirmed

	To	From
<b>Thames Water Utilities Finance PLC</b>		
Senior Secured	BBB/Watch Neg	BBB/Stable
Subordinated	BB+/Watch Neg	BB+/Stable

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such

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