Research Update:

Issue Ratings On Thames Water Utilities Finance PLC's Class A And B Debt Lowered On Strained Metrics, Outlook Stable

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Rating Action Overview

- Thames Water Utilities Finance PLC's financial resilience has been significantly affected by legacy operational performance issues, high leverage, a heavy investment plan, and the current high inflationary environment.
- Though the company's shareholders have announced an injection of £500 million plus an additional commitment of £1 billion, we do not expect this support to deliver a significant deleveraging within our forecast horizon; rather the additional equity will be channeled toward capital expenditure (capex) as part of the company's eight-year transformation plan.
- Moreover, high inflation has caused a significant increase in debt--given 56% of Thames Water's total debt stock is inflation-linked--as well as a decrease in our adjusted funds from operations (FFO), both via noncash accretion and through higher costs, notably for energy.
- We expect that Thames Water's S&P Global Ratings-adjusted debt to EBITDA will remain above the 10x and 11x thresholds for the 'BBB+' and 'BBB-' issue-level ratings on its class A and class B debt, respectively, and expect the FFO-to-debt ratio to be below the previous rating threshold for the next two to three years.
- We therefore lowered our class A debt rating to 'BBB' from 'BBB+' and our class B ratings to 'BB+' from 'BBB-'.
- The stable outlook reflects our expectation that metrics will gradually improve through the regulatory period ending March 2025, and Thames Water will achieve FFO to debt above 5% and adjusted debt to EBITDA below 11x for its class A debt, and FFO to debt above 4% and adjusted debt to EBITDA below 12x on a consolidated basis by the end of the regulatory period.
- A near-term improvement in Thames Water's credit metrics will ultimately depend on any potential further measures by its owners to shore up financial resilience. Although there is broad shareholder commitment in this regard, the timing and amount of any further support remains uncertain. In the longer term, we could see improved leverage metrics once current investments materialize, delivering a stronger asset base and better operating performance for the company.

Rating Action Rationale

Thames Water's large investment plan and high inflation will weigh on its financial metrics until the end of the regulatory period. The combination of capex and inflation led to an increase in net debt between March 2021 and March 2022 of £900 million-£13.7 billion--this contrasts with a regulatory capital value (RCV) of £16.6 billion in March 2022 and an adjusted EBITDA of about £1 billion. The company is in the midst of an eight-year transformation plan with planned investments of £11.5 billion during the current regulatory period, roughly £2 billion above the company's regulatory allowance. The scale of the plan highlights the extent of the operational issues facing the company, although we note that there have been improvements in some areas. We expect the company's financial metrics to remain depressed until the end of the current regulatory period, March 2025, due to negative free operating cash flows (FOCF, operating cash flow after capex). The negative FOCF during the rest of the regulatory period will not enable any natural deleveraging despite limited dividend payments. We forecast that Thames Water will operate relatively close to its financial covenants for the remainder of the regulatory period; that is, at 80.6% relative to its 85% trigger level, based on debt to RCV. The regulatory model allows for RCV growth in line with inflation, which should deliver some natural reduction in leverage, all else being equal.

Inflation has also led to a sharp increase in accretion, which weighs heavily on our adjusted FFO. Thames Water's exposure to index-linked debt is 56%, which is roughly in line with the industry average. Beyond this, the steep increases in energy costs, and to a lesser degree chemicals and employee costs, could also weigh on the company's metrics.

While the investment program and higher inflation will strain financial metrics for the next two to three years, we expect both to be beneficial to Thames Water over the medium term. We expect the additional investment to help accelerate Thames Water's operational turn-around plan, as well as to help build the company's regulated asset base. Inflation will also help boost the company's revenue with a delay, because the allowed income is based on inflation.

Despite supportive shareholders, metrics will remain constrained in the absence of further deleveraging initiatives. Thames Water is owned by a consortium of institutional shareholders, predominantly pension funds. The largest shareholders, comprising more than 50%, are OMERS (31.8%) and USS (19.7%). The consortium has not taken any dividends for the past five years, and we forecast only modest shareholder distribution during the remainder of the regulatory period while the company focuses on improving its operational performance.

In June 2022, the consortium approved a £500 million equity contribution to fund additional investments to speed up improvements in the water networks as well as committing an addition £1 billion in equity support, subject to certain conditions. This will be supportive in the long term, given the potential operational performance improvements and asset base growth it will provide. The chair of the water regulator, Ofwat, has commented publicly on the shareholder support, which is a positive signal to the company's relationship with its regulator.

Even then, we expect Thames Water's financial ratios to continue to be constrained for the remainder of the regulatory period, absent any further deleveraging initiatives from shareholders.

Thames Water has put additional investment in place to resolve legacy performance issues amid intense political and regulatory focus. Thames Water committed in June 2022 to spend £2 billion above its Ofwat-permitted total expenditure. Although we view this as a positive initiative, especially as it will be mostly financed by shareholders, it will delay deleveraging, given that the purpose of the injection is to help resolve significant legacy issues in performance via capex. Many of these issues have been troubling the company for a long time, so we view these investments positively and as essential to improve the company's operating performance and reputation. In this context, we note the intense political and regulatory pressure on the sector to transform its impact on the environment. The Environment Agency is currently investigating six water and wastewater companies, one of which is Thames Water, to clarify how these companies manage their wastewater treatment works.

Although Thames Water received significant penalties during the year ended March 31, 2022, the company did meet many of its targets and is showing clear signs of improvement. Thames Water's operating performance showed clear signs of improvement during the past year, with 60% of annual performance metrics being met. It achieved a 43% reduction in complaints and continued to meet its leakage target, as well as seeing a decline in pollution incidents. There are certain key targets where Thames Water is still failing to meet its commitments, in particular C-MeX (the customer experience score, where it sits in 17th place of 17), water quality compliance, and pollution incidents.

Outlook

The stable outlook is based on our expectation that metrics will gradually improve through the regulatory period ending March 2025, and Thames Water will achieve class A FFO-to-debt metrics on average above 5% and class B FFO-to-debt metrics on average at about 4% during our forecast period, as well as achieving debt to EBITDA below 11x on a class A basis and below 12x on a consolidated basis by the end of the regulatory period. The stable outlook also reflects our opinion that Thames Water's operational performance will continue to improve over the current regulatory period, through successful execution of the transformation plan.

Downside scenario

We could lower the ratings on the class A debt if there was insufficient FFO-to-debt headroom above 5% or if debt to EBITDA were sustainably above 11x. This could occur if Thames Water demonstrated deteriorating operating performance or a decline in profitability or if it could not maintain sufficient headroom under its financial covenants. We could lower the ratings on the class B debt if debt to EBITDA exceeded 12x on a consistent basis. If we were to view risks with the implementation of the transformation plan, we could potentially reassess the business risk profile.

Upside scenario

We could raise the rating on the class A debt if we saw a track record of Thames Water maintaining FFO to debt above 6% and debt to EBITDA below 10x with sufficient headroom, along with continued improved operational performance and upward trending financial performance. We could also upgrade the class B debt if the company maintained FFO to debt above the 5% target for a 'BBB' rating while also maintaining debt to EBITDA below 11x.

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.

Our Base-Case Scenario

Assumptions

- Revenue growth in line with the company's forecast and as set out in the regulatory allowance.
- Retail price index (RPI) and consumer prices index including owner occupiers' housing costs (CPIH) as per our in-house projections. We forecast an RPI in the U.K. of 9.9% on March 31, 2023, 5.3% on March 31, 2024, and 1.9% at March 31, 2025. We forecast a CPIH of 7.7% on March 31, 2023, 4.0% on March 31, 2024, and 1.7% on March 31, 2025.
- An EBITDA margin of roughly 50%-54% between 2023 and 2025.
- Fairly consistent leverage of about 80%-82% for the consolidated debt and 70%-74% for the class A debt.
- A continued focus on improving operating performance through the execution of the turn-around plan announced in March 2021.
- Outcome delivery incentive penalties of roughly £140 million-£160 million during AMP7.
- Capex of about £4.5 billion during the next three years.
- Limited dividend distributions of about £80 million-£100 million, for servicing of holdco debt.

Key metrics

Thames Water Utilities Finance PLC

	2021A	2022A	2023F	2024F	2025F
EBITDA	950	993	1,130-1,180	1,170-1,220	1,190-,1,240
Class A debt	11,270	12,104	12,600-12,700	13,100-13,200	13,000-13,100
Consolidated debt	12,812	13,704	14,200-14,300	14,700-14,800	14,600-14,700
Capital expenditure	1,035	1,229	1,450-1,490	1,550-1,590	1,360-1,400
FOCF	(296)	(427)	(840)- (820)	(730)- (710)	(340)- (310)
EBITDA margin	46.7	47.4	51.5-52.5	52-53	52.5-53.5
Class A metrics					
FFO/debt (%)	6.2	2.3	2.2-2.6	4.0-4.4	6.0-6.4
Debt/EBITDA (x)	11.9	12.2	10.5-11.5	10.5-11.5	10.0-11.0
Consolidated metrics					
FFO/debt (%)	5.1	1.3	1.3-1.8	3.0-3.4	4.8-5.2

Thames Water Utilities Finance PLC (cont.)

	2021A	2022A	2023F	2024F	2025F
Debt/EBITDA (x)	13.5	13.8	11.5-12.5	11.5-12.5	11.0-12.0

A--Actual. F--Forecast. FOCF--Free operating cash flow. FFO--Funds from operations.

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 more than 1.1x in the 12 months from June 30, 2022.

Principal liquidity sources:

- Unrestricted cash and short-term investments of about £60 million;
- Access to about £1,800 million undrawn credit facilities;
- FFO of about £680 million; and
- Equity injection of about £620 million.

Principal liquidity uses:

- Upcoming debt maturities of approximately £925 million;
- Expected capital spending of approximately about £1,500 million; and
- Dividends of approximately £80 million-£100 million (to pay holdco debt interest).

Environmental, Social, And Governance

ESG credit indicators: E-3, S-3, G-2

Environmental factors are a moderately negative consideration in our credit rating analysis of Thames Water, whose operating performance is below the sector average in certain areas, such as supply interruptions. The first year of the new regulatory period, fiscal 2021, led to an overall net penalty position of almost £50 million. That said, improving operating performance is a key priority for the company and it 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. The company has seen significant management changes in recent years, including a new CEO and chief financial officer. 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. Governance factors are a neutral consideration, even though we note some turnover at the senior level.

Issue Ratings - Subordination Risk Analysis

The financing group operates under a number of financial and nonfinancial covenants that support its overall credit quality. We rate the debt issued by Thames Water using our criteria, "Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses," published on Feb. 24, 2016. Thames Water issues two types of debt, senior (class A) and subordinated (class B). We analyze the company in two steps because we assess the subordinated debt as having a greater risk of default than the senior debt. This is because the subordinated debt would be repaid after the senior debt, has no claim on the security until the senior debt is repaid, and its default could not cause the senior debt to default.

- We rate the class A debt 'BBB' based on credit metrics that exclude the subordinated debt. We include one notch of uplift for various structural features, in particular the additional protection from the deferral of the interest and principal payments on the subordinated debt if the financing group has insufficient cash to make the payments due.
- We rate the class B debt 'BB+' based on credit metrics including both the senior and subordinated debt.

The various structural features of the transaction are designed to increase cash flow certainty for debtholders, including restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable Thames Water to manage temporary cash flow shocks.

Ratings Score Snapshot

Issue-Level Rating Class A: BBB/Stable/--

Business risk: Excellent

- Country risk: Low risk
- Industry risk: Very low risk
- Competitive position: Strong

Financial risk: Highly leveraged

- Cash flow/leverage Highly leveraged

Anchor: bbb-

Modifiers:

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Neutral
- Liquidity: Adequate
- Management and governance: Fair
- Comparable rating analysis: Neutral
- Stand-alone credit profile: bbb-
- Structural Enhancements: +1 Notch

Issue-Level Rating Class B: BB+/Stable/--

Business risk: Excellent

- Country risk: Low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Highly leveraged

- Cash flow/leverage: Highly leveraged

Anchor: bb+

Modifiers:

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Neutral
- Liquidity: Adequate
- Management and governance: Fair
- Comparable rating analysis: Neutral

Stand-alone credit profile: bb+

Structural enhancements: None

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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, 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

Ratings List

Downgraded; Outlook Action

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

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 criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914