S&P Global Ratings

RatingsDirect®

Research Update:

Ratings On Thames Water Utilities' Class A And B Debt Lowered To 'BBB+' And 'BBB-' On Weaker Ratios; Outlook Stable

Primary Credit Analyst:
Beatrice de Taisne, CFA, London (44) 20-7176-3938; beatrice.de.taisne@spglobal.com

Secondary Contacts:
Tania Tsoneva, CFA, London (44) 20-7176-3489; tania.tsoneva@spglobal.com
Matan Benjamin, London 972-3-7539731; matan.benjamin@spglobal.com

Table Of Contents

Research Update:

Ratings On Thames Water Utilities' Class A And B Debt Lowered To 'BBB+' And 'BBB-' On Weaker Ratios; Outlook Stable

Overview

- U.K. water and sewage utility Thames Water's operating performance in certain key regulatory areas continues to lag behind U.K. water regulated peers, which has led to regulatory penalties and fines.
- In response, management is spending more to improve operations and reducing dividend payments, but we anticipate weaker credit metrics until at least the end of the current regulatory period (2020).
- We are lowering our ratings on Thames Water's class A (senior) and class B (subordinated) debt to 'BBB+' and 'BBB-' from 'A-' and 'BBB', respectively.
- The stable outlook reflects the stability and predictability of U.K. water utilities' cash flows with each regulatory period, and the credit supportive measures implemented by the company.

Rating Action

On July 24, 2017, S&P Global Ratings lowered its ratings on the class A debt issued by Thames Water Utilities Cayman Finance Ltd. (TWUCF) and Thames Water Utilities Finance Ltd. (TWUF) to 'BBB+' from 'A-' and its ratings on the class B debt issued by TWUCF to 'BBB-' from 'BBB'. The issuers are both subsidiaries of Thames Water Utilities Ltd. (TWUL). The outlook on the debt is stable.

Rationale

The lowering of our ratings on the class A and class B debt reflects our view that the company continues to lag behind peers in operating performance in terms of customer services and below-ground water assets, resulting in regulatory penalties and fines at a time when the Thames Water financing group has no financial headroom with respect to its FFO to debt ratio. Thames Water's financing group includes TWUL, TWUCF, TWUF, and a holding company, Thames Water Utilities Holdings Ltd. (not rated). Management is taking proactive measures to improve its operations and meet regulatory standards over the remainder of the current regulatory period (ending March 31, 2020), which will require additional investments and operating expenses, which we understand will be about £100 million per year. Therefore, we expect that Thames Water's funds from operations (FFO)-to-debt ratios will deteriorate to about 5% based on consolidated class A (senior) and class B debt (subordinated), and 6% based on class A debt only. We distinguish between the financing group's senior debt and subordinated debt as we think that the subordinated debt has a higher probability of default than the senior debt, because of its lower ranking in the payment waterfall and deferral of interest and principal in case of insufficient funds.

We understand the group is cutting its dividend payments to finance the additional operating expense and capital expenditure, but we think it will be insufficient to offset the financial impact of the additional spending. However, we do see this action as positive in the medium-to-long term because it demonstrates a supportive financial policy and leads to broadly neutral discretionary cash flows (after capital expenditures and dividends). That said, we think that in light of regulator Ofwat's recently published methodology (see "Inefficient U.K. Water Utilities Most At Risk From Higher Penalties And Receding Returns," published on July 17, 2017, on RatingsDirect), an improvement in operating performance is essential if the England and Wales regulator goes ahead with its proposal for the next regulatory period (starting 2020). This is because companies will earn lower return on equity, either compensated or further reduced by higher, and potentially uncapped, incentive income or penalties based on operating measures.

Even though Thames Water's operating performance has improved in several areas, the company continues to be affected by the operating performance of its below-ground water assets, which led to the company failing its leakage target for 2017 and to a number of consumer interruptions. Customer service measures also remain below the sector average while recent operating issues led to an exceptional public comment by Ofwat.

TWUL benefits from a natural monopoly as the water and wastewater company for Greater London and the Thames Valley, which is the largest in terms of regulated capital value (RCV; £12.9 billion as of March 31, 2017), serving 25% of the population of England and Wales. We view as highly predictable and supportive the regulatory framework supervised by Ofwat. We continue to assess Thames Water's business risk profile as excellent.

In our base case, we assume:
- EBITDA margins of 50%-55%;
- Focus on the improvement of key performance areas such as leakage, metering, and strengthening of the network;
- Capital expenditure of about £600 million-£1 billion until 2020; and
- Reduced dividend payments of about £80 million-£90 million for the rest of the regulatory period.

Based on these assumptions, we arrive at the following credit measures:
- FFO to debt of 5% on average on a consolidated level and 6% for class A debt;
- EBITDA-to-interest ratio of 2.1x-2.3x, benefitting from the group having one of the lowest interest costs in the sector;
- Reduction in overall leverage so that unadjusted debt to RCV reduces

below 80% at the end of the regulatory period; and
- Neutral free operating cash flow generation from 2019.

We apply one notch of rating uplift to the senior debt, which benefits from structural features designed to increase cash flow certainty for debtholders. These include:
- Restrictions on mergers, acquisitions, and asset disposals, and a share pledge in the operating and holding company's assets (to the extent allowed by legislation) and shares;
- Dividend- and debt-restricted payment conditions and a covenanted liquidity structure that should, in our opinion, allow the Thames Water financing group to manage temporary cash flow shocks;
- An automatic 18-month standstill period after an event of default, during which time creditors can take control of TWUL and either aim for operational recovery or sell the shares in the operating and holding company; and
- Prudent management of foreign exchange, refinancing, and counterparty risks. Furthermore, the Thames Water financing group has no inflation-linked swaps with breaks, and currency swaps with breaks are less than 2% of its RCV.

Liquidity

We assess Thames Water financing group's liquidity position as adequate, supported by our view that its liquidity resources will exceed its funding needs by more than 1.2x in the next 12 months as of March 31, 2017.

We estimate Thames Water's liquidity sources over the subsequent 12 months to be:
- Unrestricted cash and short-term investments of £57.5 million;
- Access to £908 million undrawn credit facilities expiring in 2021. We exclude from our analysis £500 million debt service reserve (DSR) facilities expiring in August 2017 and currently being renewed;
- FFO of about £878 million; and
- Class B debt of £550 million pre-financed in May 2017.

We anticipate the following liquidity uses over the same period:
- Upcoming debt maturities of approximately £736 million, including £550 million class B debt already prefinanced;
- Expected capital spending of approximately £950 million; and
- Dividend payments of about £80 million-£90 million for the rest of the regulatory period.

Covenant analysis

The financing group operates under a number of financial and nonfinancial covenants that support the group's overall credit quality. For more details on the structure, please refer to "Presale: Thames Water," published on Aug. 8, 2007. The covenants include restrictions on mergers, acquisitions and asset disposals, and share pledges in the operating and holding company's assets (to the extent allowed by legislation) and shares; dividend- and debt-restricted payment conditions and dedicated liquidity facilities that should, in our opinion, allow the financing group to manage temporary cash flow shocks; and the automatic credit remedy period after breaching a debt restriction covenant (commonly called an event of default), during which creditors can take control of the group and either aim for operational recovery or sell the shares in the operating and holding company.

In particular, financial covenants include:

- A distribution lock-up would be triggered if the class A regulated asset to debt ratio is greater than 75% and 85% (consolidated) or if drawings under the DSR or operating and maintenance facilities occur.
- An event of default, if the operating company's senior debt to RCV ratio reaches 95% or if the adjusted interest coverage ratio based on consolidated debt is below 1.1x. Once an event of default has occurred, an automatic standstill of claims takes effect, and no enforcement action can be taken by creditors for a period of 18 months.

We expect that the financing group will remain compliant with its financial covenants. The class A debt-to-RCV ratio is expected to decline toward 70% at the end of the regulatory period, and consolidated debt to RCV toward below 80%. Interest cover ratios are also expected to remain well above covenant levels.

Outlook

Our stable outlook on the debt guaranteed by Thames Water reflects the high stability and predictability of regulated cash flows until the end of the current regulatory period on March 31, 2020. In our base case, we expect that Thames Water will post stable metrics of about 6% FFO to debt on average based on senior debt only and about 5% on average based on senior and subordinated debt. Furthermore, we see as strengths the solid interest cover ratios on the back of interest costs which are among the lowest in the sector, as well as the cash preserving dividend reductions which result in neutral discretionary cash flows to debt on average.

Upside scenario

We could raise our ratings on Thames Water's debt if its operating performance improves toward the average of the sector, therefore reducing the risk to profitability of any regulatory fines or penalties. This will also depend on management's dividends policy and its commitment to reducing leverage and improving its credit metrics to above 7% FFO to debt based on senior debt only and at least 6% FFO to debt based on senior and subordinated debt.

We think that the company's investment plan could enable Thames Water to improve its overall performance. Given the visibility within each regulatory period, we think that any ratio improvement could arise only if the company achieves a satisfactory determination for the next regulatory period starting in 2020.

Downside scenario

We currently see a negative rating action as unlikely given management's proactive investment plan and more prudent financial policy. We could lower our ratings on the subordinated class B debt to speculative grade (below 'BBB-') if we saw an increased risk of regulatory intervention, a potential breach of covenants (where headroom is significant at present), or any severe operating issues. A negative rating action could also arise if the EBITDA to interest cover deteriorated materially, indicating reduced investor appetite to provide attractive financing.

Ratings Score Snapshot

Class A

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

Financial risk: Highly leverage
- Cash flow/Leverage: Highly leverage

Anchor: bbb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (No impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: positive (+1 notch)

Stand-alone credit profile: bbb

Class B

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

Financial risk: Highly leverage
- Cash flow/Leverage: Highly leverage

Anchor: bbb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (No impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb-

Related Criteria

- 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 - Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Inefficient U.K. Water Utilities Most At Risk From Higher Penalties And Receding Returns, July 17, 2017
- Ratings On Debt Guaranteed By Thames Water Utilities Affirmed; Outlook Remains Negative, Sept. 29, 2016
- Debt Guaranteed By Thames Water Utilities On Negative Outlook On Challenging Draft Price Review; Ratings Affirmed, Sept. 11, 2014

Ratings List

Downgraded; Outlook Action

	To	From
Thames Water Utilities Cayman Finance Ltd.		
Senior Secured*	BBB+/Stable	A-/Negative
Subordinated*	BBB-/Stable	BBB/Negative
Thames Water Utilities Finance Ltd.		
Senior Secured*	BBB+/Stable	A-/Negative

*Guaranteed by Thames Water Utilities Ltd.

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com