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Research Update:

Thames Water's Class A and B Debt Downgraded On Deteriorating Liquidity; Outlook Negative

July 31, 2024

Rating Action Overview

- On July 9, 2024, Thames Water Utilities Finance PLC (Thames Water) announced that it could cover its liquidity needs until May 2025. The following day, we placed our issue ratings on Thames Water's debt on CreditWatch with negative implications.
- We do not believe that Thames Water will have a remedy plan to cover its liquidity needs by 1.1x for the next 12 months before the autumn of 2024.
- We have revised our assessment of Thames Water's business risk downward to strong from excellent. This reflects the difficulties the company is facing in financing its large and inflexible capital expenditure (capex), which is driven by regulatory requirements.
- In addition, the company is in breach of its current license conditions. As part of Ofwat's requirements, Thames Water needs to maintain two investment-grade ratings. We understand that Thames Water is in ongoing discussions with Ofwat about this.
- Thames Water has stated that it is committed to increasing its common equity from either new or existing shareholders. We see this as essential for Thames Water to improve its operating performance and reduce its leverage in the next regulatory period.
- However, we do not expect that this will improve Thames Water's liquidity position in the near term, as we assume that this process is unlikely to be completed before the regulator's final determination.
- We therefore lowered our issue ratings on the class A and class B debt to 'BB' and 'B', respectively, from 'BBB-' and 'BB' previously. We also assigned a recovery rating of '2' to the class A debt, reflecting our expectation of 70% recovery, and a recovery rating of '6' to the class B debt, reflecting our expectation of no recovery in a hypothetical default scenario as part of our recovery methodology.
- At the same time, we assigned a negative outlook to both ratings. The negative outlook on the class A and B debt ratings reflects our view of the risks stemming from a continued deterioration in Thames Water's liquidity position; a delay in equity contributions due to the uncertainty around the company's operating conditions for the upcoming regulatory period; and potential intervention by the regulator.

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Rating Action Rationale

In our view, Thames Water's liquidity has deteriorated to a less-than-adequate position as we forecast that the company will not be able to cover its financial needs by 1.1x over the 12 months from the end of June 2024. See the liquidity section below for more details on Thames Water's liquidity position. Separately, the company has announced that it is projecting a trigger event under its financial covenants for the fiscal year ending March 31, 2025. The trigger event is a feature of the company's structurally enhanced debt structure. It restricts the company's ability to incur additional debt without consent from the secured creditors, other than using the existing committed facilities, paying dividends, and making payments to associated companies. We don't expect this trigger event to undermine Thames Water's liquidity management.

We have revised our assessment of Thames Water's business risk profile to strong from excellent. This reflects the difficulties the company is facing in financing its large and inflexible capex, which is driven by regulatory requirements. In addition, the company is also in breach of its current license conditions. As part of Ofwat's requirements, Thames Water needs to maintain two investment-grade ratings. Ofwat has publicity stated that this would not lead to a revocation of Thames Water's license.

Shareholders' current view of Thames Water's business plan as "uninvestable" questions the availability of equity support and creates uncertainty around the company's operational performance in the next regulatory period. For more details, see "Thames Water Class A And B Debt Ratings Lowered On Delayed Shareholder Support; Outlook Negative," published April 4, 2024. Management had previously assumed £750 million in new equity, £500 million of which was due to be injected by end-March 2024. In April 2024, Thames Water estimated its equity needs at a total of £3.25 billion (£750 million in the current regulatory period and £2.5 billion in the next).

However, such injections depend on a favorable outcome from the current regulatory process, or a favorable outcome should the company request to refer its final determination to the Competition and Markets Authority, both of which we assume will involve complex discussions.

In the absence of sufficient and timely equity support for its turnaround and business plans, we believe that Thames Water's operational performance, which is already constrained and has consistently attracted regulatory penalties over the years, may weaken further.

We view Ofwat's draft determination as relatively negative for Thames Water. We acknowledge that it is still early days and that the regulatory process is ongoing. However, Ofwat's assessment of Thames Water's business plan as "inadequate" puts the company at risk of regulatory capital value deductions at the start of the next regulatory period starting in April 2025. The company could also bear a higher portion of its overspending. However, unlike in previous regulatory periods, Thames Water's resubmission of its business plan may lead it to exit the inadequate assessment as part of the final determination. In addition:

- Thames Water has received a £5.2 billion cut to its submitted total expenditure (totex), leaving it with £16.9 billion of totex for the upcoming regulatory period. This comprises £11.7 billion of base totex and £5.7 billion of enhancement totex.
- The specific turnaround oversight regime indicates a higher degree of intervention by the regulator, but questions remain about the implementation of this regime.
- Outcome delivery incentive targets remain very demanding for Thames Water, and we expect

that the company will continue to receive annual penalties under the regime.

We have increased the number of notches between the ratings on the class A and class B debt. This is because we believe that the gap between the likelihood of a default on the latter and that on the former has increased. With deteriorating credit quality and decreasing sources of liquidity, we believe that the Class B debt is increasingly at risk as the purpose of the class B is to protect and absorb losses for the class A debtholders.

Outlook

The negative outlook reflects continued deterioration in Thames Water's liquidity position and persistent uncertainties on support from existing or new shareholders for Thames Water's business plan.

Discussions between Ofwat and Thames Water are ongoing, and we expect to have greater visibility on the feasibility of the business plan and shareholder support by the end of 2024 or the first half of 2025, when the regulator publishes its final determination. Thames Water's liquidity position is a key risk during this period.

Delays in the equity injection would bring into question both shareholder support and the recovery in Thames Water's operational performance in the next regulatory period. In the absence of adequate equity support for Thames Water's turnaround and business plans, we think that its already constrained operational performance--which has consistently attracted regulatory penalties over the years--may weaken further.

Downside scenario

Further rating downside could occur due to Thames Water's liquidity position. This could also be the result of an unfavorable regulatory settlement for the next regulatory period as part of the ongoing price review, or if we believed that enforcement actions by Ofwat, such as an application to the High Court for a special administration order, are becoming increasingly likely. At this stage, special administration is not our base case; we understand that the credit impact on Thames Water in this scenario would remain at the discretion of the special administrator (see "Credit FAQ: Thames Water: Possible Rating Trajectories," published May 31, 2024, on RatingsDirect).

Upside scenario

We could revise the outlook to stable should Thames Water manage to improve its liquidity position to what we consider adequate, with sources covering uses by more than 1.1x over the coming 12 months.

Rating upside is contingent on Thames Water's ability to secure sufficiently favorable operating conditions for the next regulatory period. Thames Water would need to combine this with significant deleveraging as a result of raising new equity, a sustained improvement in operational performance, and an outcome from the Environmental Agency's current investigation that does not have a significant financial or reputational effect on the company.

Company Description

Thames Water is the U.K.'s largest water and sewerage company, with a regulatory capital value of £19.9 billion as of end-March 2024. Thames Water serves 16 million customers (about 25% of the population of England and Wales) and generated S&P Global Ratings-adjusted EBITDA of about £1.1 billion in fiscal 2024.

Liquidity

We assess Thames Water's liquidity position as less than adequate, reflecting our view that the company's liquidity resources will not cover its funding needs by at least 1.1x in the 12 months from June 30, 2024.

Principal liquidity sources over the 12 months from June 30, 2024, are:

- Available cash and committed funding of about £1.7 billion, consisting of £1.5 billion of cash and liquid investments, as well as about £200 million in committed facilities maturing in November 2025. Thames Water has drawn £2.23 billion from its revolving credit facilities. All drawn amounts become due six months after drawing, but can be rolled over for a further six months if no event of default or potential event of default is active.
- Adjusted cash funds from operations of about £1.1 billion.

Principal liquidity uses over the same period are:

- Debt maturities of approximately £660 million in the next 12 months.
- Swap accretion paydowns of about £250 million.
- Our forecast of capex of approximately £1.95 billion.
- No dividends.

In addition, Thames Water has access to £550 million of undrawn debt service and operation and maintenance reserve liquidity facilities. Drawing on these facilities would cause a standstill under Thames Water's covenants, but should cover its cash flow, albeit at a minimal level of capex, for a further 12 months.

Covenants

Covenant headroom

Thames Water has announced that it is anticipating a trigger event under its financial covenants for fiscal 2025 following the shareholders' decision not to provide £500 million of equity funding in March 2024 (see "Thames Water Class A And B Debt Ratings Lowered On Delayed Shareholder Support; Outlook Negative," published on April 4, 2024).

The trigger event is a feature of Thames Water's structurally enhanced debt structure. It restricts the company's ability to incur additional debt without consent from its secured creditors, other than using the existing committed facilities, paying dividends, and making payments to associated companies. It requires Thames Water to prepare a remedial plan for its lenders.

Issue Ratings--Recovery Analysis

Our recovery analysis estimates the percentage of principal and accrued interest due on a company's debt instruments at the point of hypothetical default and that can be recovered following its emergence from a hypothetical bankruptcy. As a result, the following recovery analysis does not represent our current base case.

Key analytical factors

- We assigned our '2' recovery rating to the class A debt, reflecting our expectation of substantial recovery prospects (70%-90%; rounded estimate: 70%) in the event of a default.
- The recovery rating reflects our hypothetical assumptions, particularly about Thames Water's future capex requirements. It does not attribute any value to any equity that the debtholders may receive. The recovery rating also reflects the company's going-concern valuation and the absence of material prior-ranking claims.
- We assigned our '6' recovery rating to the class B debt, reflecting our expectation of negligible recovery prospects in the event of a default. The rating reflects the class B debt's subordinated ranking in the capital structure.
- Our hypothetical default scenario would most likely stem from a liquidity crisis leading to Thames Water's placement in special administration. As stated above, this does not represent our current base case.
- We value Thames Water on a going-concern basis, since almost all of its revenues come from regulated activities in a strong regulatory environment.

Simulated default assumptions

- Year of default: 2025
- Jurisdiction: U.K.

Simplified waterfall

- Emergence EBITDA after recovery adjustments: About £2,209 million
- Implied enterprise value multiple: 6.0x
- Gross enterprise value at default: About £13.3 billion
- Administrative costs: 5%
- Net value available to debtors: £12.6 billion
- Priority claims: £1.5 billion
- Net value available to class A debtholders: £11.1 billion.
- Class A debt claims: About £15.3 billion [1]
- Recovery expectation: 70%-90% (rounded estimate: 70%) [2]
- Recovery rating: 2

- Net value available to class B debtholders: Nil
- Class B debt claims: About £1.4 billion [1]
- Recovery expectation: 0%-10% (rounded estimate: nil) [2]
- Recovery rating: 6

[1] All debt amounts include six months' prepetition interest.

[2] Rounded down to the nearest 5%.

Ratings Score Snapshot

Class A

Issuer Credit Rating	BB/Negative/
Business risk:	Strong
Country risk	Low
Industry risk	Very low
Competitive position	Satisfactory
Financial risk:	Highly leveraged
Cash flow/leverage	Highly leveraged
Anchor	bb
Modifiers:	
Diversification/Portfolio effect	Neutral (No impact)
Capital structure	Neutral (No impact)
Financial policy	Neutral (No impact)
Liquidity	Less than adequate (-1 notch)
Management and governance	Moderately negative (No impact)
Comparable rating analysis	Neutral (No impact)
Stand-alone credit profile:	bb-
Structurally enhanced debt	(+1 notch)

Class B

Issuer Credit Rating	B/Negative
Business risk:	Strong
Country risk	Low
Industry risk	Very low
Competitive position	Satisfactory
Financial risk:	Highly leveraged
Cash flow/leverage	Highly leveraged
Anchor	bb
Modifiers:	

Class B (cont.)

Issuer Credit Rating	B/Negative
Diversification/Portfolio effect	Neutral (No impact)
Capital structure	Neutral (No impact)
Financial policy	Neutral (No impact)
Liquidity	Less than adequate (-1 notch)
Management and governance	Moderately negative (No impact)
Comparable rating analysis	Neutral (No impact)
Stand-alone credit profile:	bb-
Structurally enhanced debt	(-2 notches)

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Thames Water Class A And B Debt Placed On CreditWatch Negative On Weakening Liquidity, July 10, 2024
- Credit FAQ: Thames Water: Possible Rating Trajectories, May 31, 2024
- Thames Water Class A And B Debt Ratings Lowered On Delayed Shareholder Support; Outlook Negative, April 4, 2024

- Economic Outlook Q2 2024: The U.K. Is Slowly Turning A Corner, March 26, 2024
- U.K. Utilities Outlook 2024: Cloudy With Sunny Spells, Jan. 30, 2024
- Industry Credit Outlook 2024: EMEA Utilities, Jan. 9, 2024
- Water Investments In England And Wales Poised To Nearly Double Over 2025-2030, Oct. 5, 2023
- Thames Water Utilities Finance PLC, Sept. 28, 2023

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Thames Water Utilities Finance PLC		
Senior Secured	BB/Negative	BBB-/Watch Neg
Recovery Rating	2(70%)	(--)
Subordinated	B/Negative	BB/Watch Neg
Recovery Rating	6(0%)	(--)

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