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Research Update:

Ratings Affirmed On Class A And Class B Debt Issued By Thames Water Utilities Finance; Outlook Remains Negative

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PRIMARY CREDIT ANALYST

Matan Benjamin
London
+ 44 20 7176 0106
matan.benjamin
@spglobal.com

SECONDARY CONTACT

Beatrice de Taisne, CFA
London
+ 44 20 7176 3938
beatrice.de.taisne
@spglobal.com

Rating Action Overview

- Thames Water is relatively resilient to the effects of COVID-19 given the essential service it provides and the regulated nature of its activities. However, we still expect the company will struggle to achieve credit metrics commensurate with the current ratings in the current regulatory period.
- Thames Water's operational performance remains below par, but we note the recent improvement in number of areas and we expect this to continue over the next few years on the back of additional investment and the new CEO's clear focus.
- We are affirming our ratings on Thames Water's class A and class B debt.
- The outlook remains negative because the company risks not being able to improve its operational performance in light of its very limited ratings headroom.

Rating Action Rationale

We have affirmed our ratings on Thames Water's class A and class B debt, but the outlook remains negative to reflect Thames Water's relative weakness in operational performance and our expectations that the company will struggle to achieve credit metrics commensurate with the current ratings. Specifically:

- For the class A debt only: funds from operations (FFO) to debt could trend above 6% and debt to EBITDA to below 10x
- For the class A and B debt on a consolidated basis: FFO to debt could trend above 5% and debt to EBITDA below 11x.

Thames Water is relatively resilient to the effects of COVID-19 given the essential service it provides and the regulated nature of its activities. In line with government guidance, Thames has a contingency plan to manage any disruption, deliver on its core responsibilities, and carry out essential operations while protecting employees and supporting customers. Nonetheless, the initial estimate is that the pandemic will still have a net £50 million-£60 million negative effect on revenues in the financial year ending March 2021 (FY2021). This reflects reduced billable volumes by non-household retailers more than offsetting cost reductions and the increase in household consumption since the beginning of the pandemic. The effect on revenues could be worse if the third lockdown has a material economic impact. The regulatory mechanism provides protection for under-recovery of revenues, albeit with two-year lag between any under collection and the subsequent true-up.

Operational performance remains below average but we expect a gradual improvement over the next few years. Thames Water's operating performance lags that of other U.K. regulated water companies in AMP6 and we expect it to remain below average in the first year of the current regulatory period. In FY2020, Thames Water incurred a performance-related penalty of £7 million (compared to £86 million, £63 million, and £41 million in FY2019, FY2018, and FY2017) mostly because of weak leakage performance and customer service. Nonetheless, in FY2020, the company significantly improved its leakage performance and performed well on water quality contacts, water use, internal sewer flooding, and pollution incidents.

Thames is facing challenging performance commitments for the current regulatory period (2020-2025) including at least 20% leakage reduction, 53% reduction in water supply interruptions to five minutes, and 6.3% reduction in per capita consumption. We therefore consider it highly likely that it could face penalties in the current AMP.

Thames will operate with limited headroom at the current rating level. We expect FFO to consolidated debt and debt to EBITDA (debt classes A and B) to remain at about 5% and 11x, respectively, during AMP7, which we consider very tight for the current rating. The ratio of discretionary cash flow (cash flow from operation minus capital expenditure [capex] minus dividends) to debt will remain negative (-3% to -5%) given that capex will likely remain significant at £1.1 billion-£1.3 billion per year and assuming annual dividends of £70 million-£90 million per year during AMP7 (2020-2025). Only £20 million annually is used to distribute to external shareholders (with the remainder used to cover interest on the HoldCo debt). The group's consolidated gearing is expected to reach 80% by 2025 from about 82% currently.

Outlook

The negative outlook reflects our view that Thames Water will struggle to improve its operational performance and achieve FFO to debt above 6% and debt to EBITDA below 10x (class A debt only) and FFO to debt above 5% and debt to EBITDA below 11x on a consolidated basis (class A and class B).

Downside scenario

We could lower the ratings on the class A debt if there is insufficient FFO-to-debt headroom above 6% and if debt to EBITDA stays above 10x. This could occur during the next regulatory period if Thames Water continues to demonstrate below-average operating performance and cannot maintain sufficient headroom under its financial covenants.

We could lower the ratings on the class B debt if there is insufficient FFO-to-debt headroom above 5% and debt to EBITDA stays above 11x, or if we lower the class A debt ratings.

Upside scenario

We would revise the outlook to stable if:

- Thames Water's financial risk profile builds more headroom;
- Its operational performance improves;
- We anticipate it can sustain weighted average FFO to debt above 6% on the class A debt and above 5% on its consolidated debt; and
- Debt to EBITDA stays consistently below 10x for the class A debt only and below 11x at the consolidated level.

We believe that the group could achieve this through effective implementation of the final determination and support from its shareholders.

Company Description

Thames Water is the U.K.'s largest water and sewerage company, with regulatory capital value of £14.7 billion on March 31, 2020. Thames Water serves 15 million customers and about 25% of the population of England and Wales, generating EBITDA of around £1 billion annually.

Our Base-Case Scenario

Assumptions

- We forecast retail price index (RPI) inflation in the U.K. of 1.5% in 2021, 2.6% in 2022, and 3.3% in 2023.
- Additional investment beyond total expenditure allowances of about £600 million through the regulatory period.
- Capex to remain significant at £1.1 billion-£1.3 billion annually.
- Shareholder dividends of £70 million-£90 million annually in 2021-2025.
- The group's consolidated gearing is expected to reach 80% by 2025, from about 82% currently.

Key metrics

Based on these assumptions, we arrive at the following credit measures for 2021-2023:

- Average FFO to debt of about 5% on a consolidated basis, and about 6% for class A debt; and
- Discretionary cash flow to debt will remain negative (-3% to -5%).

Liquidity

We assess Thames Water's liquidity position as adequate, supported by our view that its liquidity resources will exceed its funding needs by more than 1.3x in the 12 months from Dec. 31, 2020.

Principal liquidity sources are:

- Unrestricted cash and short-term investments of £303 million;
- Access to £1721 million undrawn credit facilities expiring in 2024 and 2025; and
- Cash FFO of about £594 million.

Principal liquidity uses are:

- Upcoming debt maturities of approximately £630 million
- Expected capex of about £1.2 billion; and
- Dividend payments of £70 million.

Ratings Score Snapshot

CLASS A ISSUE RATING BBB+/Negative

Business risk: Excellent

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

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

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 ISSUE RATING BBB-/Negative

Business risk: Excellent

- Country risk: Low
- Industry risk: Very Low
- Competitive position: Strong
- Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

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

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- 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: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed

Thames Water Utilities Finance Plc	
Senior Secured – Class A	BBB+/Negative
Subordinated – Class B	BBB-/Negative