FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Kemble at 'B+'; Outlook Negative

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Fitch Ratings - London - 07 Apr 2021: Fitch Ratings has affirmed Kemble Water Finance Limited's (holding company) senior secured debt rating and Long-Term Issuer Default Rating (IDR) at 'B+'. The Outlook on the IDR is Negative.

The rating reflects pressure on Kemble's financial profile from the challenging price control (AMP7) set for operating company Thames Water Utilities Limited (TWUL) by the UK water industry regulator (Ofwat). The Negative Outlook accounts for exhausted financial headroom at the current rating and uncertainty around the pace of improvement in TWUL's operational performance. The Negative Outlook also incorporates reduced headroom to dividend lock-up at TWUL. In addition, the rating reflects Kemble's flexible dividend policy, supporting the holding company's financial profile.

The rating could be downgraded if TWUL's operational performance improves at a slower pace than currently assumed, leading to outcome delivery incentives (ODI) penalties and total expenditure overspend in excess of Fitch's rating case. Conversely, the Outlook could be revised to Stable if TWUL shows continued accelerated improvement in operational performance, resulting in substantially lower overall ODI penalties and totex overspend in AMP7.

TWUL is the operating company structurally positioned below Kemble.

Feedback

KEY RATING DRIVERS

Reliance on TWUL's Dividends: Kemble's main source of cash flow is TWUL. Kemble relies on dividends from TWUL to service its debt. We therefore place emphasis on the analysis of the dividend stream, which could be negatively affected by operational underperformance, a low annual inflation index resulting in lower revenue and regulated capital value (RCV) growth, as well as in an extreme case the inability of TWUL to distribute dividends due to the dividend lock-up under its debt financing being triggered.

Weak Financial Profile: We estimate Kemble's adjusted gearing at about 92% at FYE25 (year-end 31 March), cash and nominal post-maintenance coverage ratios (PMICRs) averaging 1.0x and 1.2x, respectively, and dividend cover capacity at about 1.5x. Forecast gearing and nominal PMICR are at our negative rating sensitivities for the 'B+' IDR of 92% and 1.2x, respectively, while dividend cover is below our negative sensitivity of 2.0x. The updated forecast is weaker than last year's due to higher expected totex overspend and lower inflation expectations. At the same time, Kemble's forecast financial profile is supported by dividend flexibility: distributions to shareholders will remain subject to TWUL's performance and rating considerations for TWUL and Kemble.

Tight Covenant Headroom at TWUL: We expect TWUL to maintain modest headroom of 2.5%-3.5% RCV to its total senior gearing covenant of 85% during AMP7, aided by sizeable equity injections funded by new debt at Kemble. The low headroom at TWUL weighs on Kemble's credit quality as a covenant breach would lead to TWUL's inability to pay dividends. We do not rule out that a combination of an external shock and operational underperformance could absorb all of the forecast RCV headroom, depleting Kemble's financial resilience.

Totex Overspend Increasing: In its updated rating case Fitch assumes higher totex overspend against the allowance over AMP7 of around GBP600 million or 6.2% in nominal terms versus GBP240 million or 2.5% last year. The increase is associated with higher contingencies to de-risk Kemble's business plan, new projects related to water network transformation and higher-than-expected business rates. TWUL will only be able to recover 25% of its totex overspend through customer bills under the totex-sharing rate set by Ofwat, so any overspend would have a material financial impact.

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Mixed Operating Performance: TWUL demonstrated further improvement in its leakage performance in FY21. Forecast leakage in FY21 is 562 Ml/day (not considering the cold weather in March 2021), around 5.5% lower than in FY20 and slightly below the regulatory target of 569.5 Ml/day. It also made some progress in reducing supply interruptions to 18 minutes in FY20, but still has a large gap to close on its FYE21 target of 6.5 minutes (interruptions lasting over three hours). Its category 1-3 pollution incidents in FY20 increased to 321, hence requiring a major improvement to achieve the FYE21 regulatory target of 272.

Customer satisfaction scores remained poor with TWUL ranking last in the league table on the shadow C-Mex measure in FY20.

Sizeable ODI Penalties Assumed: Fitch rating case assumes about GBP170 million of net ODI penalties (nominal) related to TWUL's AMP7's operational performance, broadly in line with last year's assumptions. We estimate that the majority of penalties will come from customer satisfaction and supply interruptions. In cash terms, we expect AMP7's revenue to decrease by about GBP110 million in FY23-FY25, related to FY21-FY23 performance, due to a two-year lag between performance and revenue adjustment. Last year we expected around GBP95 million of revenue impact during AMP7.

Moderate Pandemic Impact: Coronavirus has adversely affected TWUL's revenue recovery, bad debts and per capita consumption (PCC) performance commitment in FY21. We expect the volume-related revenue under-recovery of around GBP70 million and lower contribution from developer services of around GBP30 million to be recovered in two years, while anticipated bad debt increase of around GBP24 million has uncertain recovery timeframe and prospects. PCC performance, according to Ofwat's latest guidance, will be reconciled at the end of AMP7 and will not impact TWUL's cash flows within AMP7. Additionally, lockdowns caused delays in the delivery of capital investments of around GBP90 million, which had a positive impact on cash flows.

TWUL Supported by Equity from Kemble: TWUL received its first equity injection of GBP250 million from Kemble in FY20 and the second one of GBP80 million in FY21. Fitch's rating case assumes that over FY22-FY25 Kemble would inject a further GBP300 million of equity into TWUL, funded by new debt issuance. As a result, we estimate that Kemble's standalone net debt-to-RCV could rise to about 9% by FY25 from about 7.2% at FYE20. The redistribution of debt between TWUL and Kemble helps create greater headroom to lock-up at TWUL and ensure dividends could still be paid to Kemble for servicing its debt.

Cash Flow Intermittent at Kemble: No dividend was paid by TWUL to Kemble during 1HFY21 due to uncertainty over the impact of pandemic and given Kemble's strong liquidity. We expect average cash dividend cover at Kemble of around 1.0x during AMP7 to be supported by an increase in TWUL dividends over FY22-FY25. Its liquidity is also supported by the recent large debt issuance and a fully undrawn revolving credit facility (RCF).

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DERIVATION SUMMARY

Kemble is the holding company of TWUL, one of the regulated, monopoly providers of water and wastewater services in England and Wales. Kemble's weaker rating than closest peer

Osprey Acquisitions Limited's (BB-/Negative) reflects weaker credit metrics and TWUL's weaker regulatory performance on ODI's and totex.

ESG CONSIDERATIONS

Kemble has an ESG Relevance Score of '4' each for Fair Messaging, Privacy & Data Security; Group Structure; Exposure to Environmental Impacts; and Water & Wastewater Management.

Kemble has an ESG Relevance Score of '4' for Water & Wastewater Management due to TWUL's significantly weaker-than-sector average leakage performance and the sizeable penalty of GBP120 million (in 2018/2019 prices) it received from Ofwat for failing its leakage performance targets in AMP6. This has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors. The score has been changed to '4' from '5', reflecting significant improvement in TWUL's leakage performance over FY20 and FY21.

Kemble has an ESG Relevance Score of '4' for Customer Welfare, Product Safety, Data Security due to large penalties expected for the customer service performance in AMP7 (around GBP73 million in nominal terms). These penalties will put further pressure on cash flows. This has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

Kemble has an ESG Relevance Score of '4' for Exposure to Environmental Impacts due to the potential impact severe weather events could have on its operational performance and financial profile. Colder winters, heavy rainfalls and extreme heat during summers causes higher leakage and mains bursts, as well as higher sewer flooding and pollution incidents. Although severe weather events have unpredictable nature and could be rare, they have the potential to significantly increase operating costs and lead to additional ODI penalties. This has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

Kemble has an ESG Relevance Score of '4' for Group Structure as its debt is structurally and contractually subordinated to TWUL's debt. This has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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KEY ASSUMPTIONS

- Ofwat's final determinations financial model used as main information source

- Allowed wholesale weighted average cost of capital (WACC) of 1.92% (RPI-based) and 2.92% (CPIH-based) in real terms, excluding retail margins

- 50% of RCV is RPI-linked and another 50% plus capital additions is CPIH-linked, starting from FY21

- Long-term RPI averaging 2.24% and long-term CPIH averaging 1.58% for 2021-2025

- Allowed wholesale totex of GBP9.6 billion in nominal terms (net of grants and contributions and excluding GBP300 million conditional allowance)

- Totex overspend of 6.2% or GBP600 million in nominal terms

- Weighted average PAYG rate of 45.6% over AMP7

- Weighted average run-off rate of 5%

- Net ODI penalties of around GBP170 million for AMP7's performance (nominal), of which GBP110 million reduce revenue in FY23- FY25

- Unregulated EBITDA of GBP67 million over AMP7 (nominal)

- Retail EBITDA of around GBP25 million over AMP7 (nominal), excluding additional bad debt related to Covid-19

- Dividends paid by TWUL in FY21-FY25 of GBP60 million per year; nil external dividends

- One-off working capital outflow in FY21 of GBP48 million related to bad debts as a result of Covid-19, with recovery of GBP24 million in FY22 and a further GBP20 million in even instalments over FY23-FY25

- GBP90 million of capex and GBP45 million of operating expenditure in FY21 delayed to FY23

- Equity injections from Kemble to TWUL of GBP390 million in during AMP7 (via new debt raised at Kemble)

- Operating company annual pension deficit recovery payments of GBP19.2 million on average in FY21-FY25

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- TWUL's average nominal cost of debt at around 4.59% in FY20, before decreasing to 3.86% by FY25

- Proportion of index-linked debt at TWUL increasing to 61.5% at FYE25 from 58.2% at FYE20

- Kemble's average nominal cost of debt at around 5.17% in FY20-FY25

Key Recovery Rating Assumptions

- Kemble Water's recovery analysis is based on a going-concern approach

- 100% of RCV would be recoverable at default, with 10% of liquidation value administrative claim, reflecting the negative mark-to-market value on index-linked swaps

- Default due to the dividend lock-up at TWUL (85% net debt-to-RCV), and the opco having drawn its liquidity facility

- Kemble's net debt-to-RCV at 9%, plus a full draw-down of the liquidity facility

- Our waterfall analysis output percentage on current metrics and assumptions was 40% corresponding to 'RR4' Recovery Rating for senior secured debt.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

A rating upgrade in the near-term is unlikely but we may revise the Outlook to Stable on:

-Adjusted net debt-to-RCV consistently below 92% and substantial improvement in regulatory performance at TWUL

-Dividend cover capacity sustained above 2.0x and cash PMICR above 1.1x and nominal PMICR above 1.2x during AMP7

In the longer term, an upgrade to 'BB-' could be considered if Kemble's financial profile is consistent with:

-Adjusted net debt-to-RCV below 87%

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-Dividend cover capacity sustained above 2.5x and cash PMICR above 1.15x and nominal PMICR above 1.3x during AMP7

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-Dividend cover capacity below 2.0x, increase of gearing to consistently above 92% and/or decrease of cash PMICR to below 1.1x or nominal PMICR below 1.2x during AMP7

-Significantly reduced headroom under TWUL's documentary or regulatory dividend lock-up covenants

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Strong Liquidity: As at FYE20, Kemble held GBP28.7million in unrestricted cash and cash equivalents and a GBP110 million of committed, undrawn RCF maturing in 2023. It issued GBP500 million of new debt in FYE21, GBP80 million of which was used for an equity injection into TWUL and a further GBP139million for early debt repurchase/repayment. The remaining cash balance provides more than sufficient financial resources for operating requirements, debt maturities and interest service until FY23.

Fitch expects negative free cash flow of around GBP46 million in FY21-FY22, with the nearest debt maturity being a GBP115 million remaining balance under a fixed-rate bond in FY22.

SUMMARY OF FINANCIAL ADJUSTMENTS

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- Capitalised interest added back to P&L and cash interest

- Statutory cash interest and total debt reconciled to match compliance certificate

- Developer grants and contributions excluded from post-maintenance cash flow (treated as a prepayment for capex)

- Cash interest was adjusted to include 50% of the five-year pay downs of inflation accretion from RPI swaps for the purpose of calculating PMICR

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Thames Water (Kemble) Finance Plc					
• senior secured	LT	B+	Affirmed	RR4	B+
• senior secured	LT	B+	Affirmed	RR4	B+
Kemble Water Finance Limited	LT IDR	B+ Rating Outlook Negative	Affirmed		B+ Rating Outlook Negative
• senior secured	LT	B+	Affirmed	RR4	B+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Parent and Subsidiary Linkage Rating Criteria (pub. 26 Aug 2020)

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

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APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Kemble Water Finance Limited	UK Issued, EU Endorsed
Thames Water (Kemble) Finance Plc	UK Issued, EU Endorsed

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