S&P Global Ratings

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Summary:

Sutton and East Surrey Water PLC

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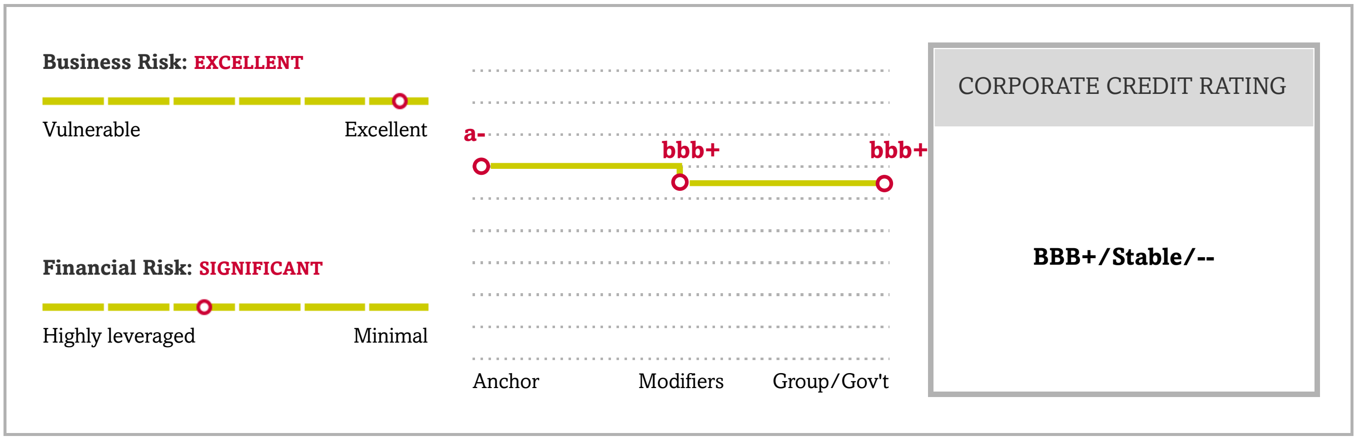

Rationale

Business Risk: Excellent	Financial Risk: Significant
• Mainly focused on low-risk, U.K.-water regulated monopoly activities. • Transparent, credit-supportive regulatory framework in the U.K., contributing to financial stability. • Strategic plan to increase the proportion of unregulated activities could have a negative impact on the business risk assessment. • Increased reset risk due to the pending start of the new five-year regulatory period in 2020. • Small size causes increased exposure to external shocks.	• Generally stable cash flows, but some emerging uncertainty stemming from growth in unregulated operations. • Limited headroom in the ratios over the next two years, with moderate recovery toward the end of the regulatory period. • High leverage, with almost no headroom under the 80% dividend lock-up covenant. • Index-linked bond constitutes most of the debt in the capital structure, leading to material inflation risk that could cause volatility in our cash flow debt coverage ratios.

Outlook: Stable

The stable outlook on U.K.-based regulated water utility Sutton and East Surrey Water PLC (SES Water) reflects S&P Global Ratings' view that SESW Group's capital structure will remain solid. We expect that over time, its funds from operations (FFO) to debt will remain at about 10%, despite a dip in the metrics in 2019, while FFO interest coverage will be above 2.5x.

In addition, we expect that the group's neutral to slightly positive discretionary cash flow will partly mitigate the high leverage, as measured by the debt to regulated capital value (RCV) ratio, and some uncertainty stemming from the planned expansion of unregulated activities.

Downside scenario

We could lower our rating on the SESW Group if its ratios fall below 10% in terms of FFO to debt and 2.5x FFO interest cover for an extended period. For example, this could occur if SES Water underperforms its regulatory allowances for operating costs, or its operating performance suffers, resulting in penalties. It could also occur if SESW Group's owners institute a more-aggressive dividend policy or introduce debt-like shareholder instruments within the SESW Group, leading to a materially negative discretionary cash flow.

We could also lower the rating if the planned expansion of the unregulated activities caused the SESW Group to incur additional costs that would have a negative impact on its credit metrics.

Upside scenario

We see rating upside as limited at the moment, as we do not foresee any likely upward movement in credit ratios. However, we could raise the rating if SESW maintains its FFO to debt above 12% on a sustainable basis.

Our Base-Case Scenario

Assumptions

- Regulated revenues rising by 2%-4% annually over 2018-2020. Unregulated revenue showing considerable volatility over the same period, stemming primarily from fast growth of SES Business Water.
- Regulated EBITDA margins exceeding 40%. Unregulated activities will have a slightly negative impact on EBITDA over the next two years.
- Retail price index (RPI) in the U.K. of 2.9% in 2018 and 2019, rising to 3.4% in 2020 and 3.6% thereafter.
- Capital expenditure (capex) of about £25 million in 2018 and £23 million in 2019 as per management's business plan, with some limited outperformance.
- Debt to RCV will remain high, close to the 80% dividend-lock-up covenant on SES Water's senior secured bond.
- We expect debt to remain broadly stable, although it is sensitive to RPI as most of it is index-linked and accrues each year, with payment at maturity.
- FFO to debt of about 10% for the remaining years of the regulatory period. FFO cash interest coverage of 5x-6x, with broadly positive discretionary cash flow to debt throughout asset management period 6 (AMP6; 2015-2020).

Key Metrics

	2017A	2018F	2019F	2020F
EBITDA margin (%)	39.2	44.5-47.5	43.5-46.5	46.0-49.0
FFO to debt (%)	12.3	9.5-10.5	9.0-10.0	9.5-10.5
FFO cash interest (x)	6x	4.5x-5.5x	4.5x-5.5x	4.5x-5.5x
DCF to debt (%)	(0.7)	(0.5)-0.5	0-1.0	1.0-2.0

DCF--Discretionary cash flow. FFO--Funds from operations. All figures are fully adjusted. FFO is adjusted for pensions. A--Actual. F--Forecast.

Company Description

SES Water is one of the smallest U.K. regulated water-only companies. Its monopoly water distribution area is east Surrey and parts of West Sussex, west Kent, and south London, including Gatwick Airport. Following the opening of the U.K. business retail water market to competition in April 2017, the Group began expanding into this segment via its subsidiary SES Business Water.

Business Risk: Excellent

SESW Group's excellent business risk profile reflects the stability and high quality of its revenues from regulated water activities in its service area, where it operates as a natural monopoly. The company operates in east Surrey, West Sussex, west Kent, and south London and serves over 282,000 homes and businesses and a population of approximately 675,000 people.

Until 2017, almost all of the Group's activities came from credit-supportive regulatory framework in the U.K., which we view as having a strong regulatory advantage (see "Why We See The Regulatory Frameworks For U.K. Utilities As Supportive", published on Sept. 26, 2017, on RatingsDirect). However, in April 2017, the U.K. business retail market was opened to competition and the SESW Group chose to take on this segment through a dedicated subsidiary, SES Business Water. Although these activities are not regulated, they are still in the utilities sector and as such closely related to the company's core business. That said, their future performance and contribution to EBITDA remains uncertain and will introduce a degree of instability to the future revenues. At this point, these activities don't have a credit impact due to their marginal contribution, but we view them as a potential risk.

The SESW Group's operating margins have historically been relatively weak, but have improved over the past few years. We expect the EBITDA margin to remain sustainably above 40% through the current regulatory period ending March 2020. Our EBITDA margin calculation currently excludes the nonregulated activities.

Additionally, SES Water's relatively small size compared with peers increases the company's exposure to operational risks and external shocks.

The company's net cumulative reward under the regulator's financial incentives remained unchanged in 2017 at £300,000, which we view favorably. That said, SES Water marginally missed some of the targets monitored by its regulator Ofwat. More specifically, there was underperformance in taste, odor, and discoloration contacts.

The company's Service Incentive Mechanism (SIM) score is below target, reflecting its challenges with customer satisfaction. In 2017 the time score was 79.6 points, compared with the target of 86.2 points. As per Ofwat's 2017 annual SIM score league table, SES Water ranked 14th out of 17 companies, same as last year.

Like all U.K. water companies, SES Water is exposed to regulatory reset risk every five years, as well as occasional policy updates proposed by the regulator or the government. Reset risk is gradually starting to increase as the end of AMP6 nears and Ofwat's review process for the next regulatory period reaches its final stages. Although we do not yet consider the reset risk high enough to influence the business risk profile, we will continue to monitor the magnitude of its potential impact over time. Furthermore, in its final methodology publication, Ofwat revealed that although it proposes to offer companies greater scope to increase earnings through incentives, it also intends to impose greater penalties on inefficient operators (see "Inefficient U.K. Water Utilities Most At Risk From Higher Penalties And Receding Returns," published on July 17, 2017, on RatingsDirect). The proposed shift could represent an opportunity for higher rewards, but also the risk of higher penalties for SES Water.

Peer comparison

Table 1

Sutton and East Surrey Water PLC -- Peer Comparison

	Sutton and East Surrey Water PLC	South Staffordshire Water PLC	South East Water (Finance) Ltd.	Northumbrian Water Ltd.
	--Fiscal year ended March 31, 2017--			
(Mil. £)				
Revenues	77.7	264.7	226.3	853.7
EBITDA	30.5	78.6	126.6	500.7
Funds from operations (FFO)	23.4	59.3	70.6	338.9
Net income from cont. oper.	14.2	29.0	27.1	89.5

Table 1

Sutton and East Surrey Water PLC -- Peer Comparison (cont.)				
Cash flow from operations	24.8	58.2	97.0	376.5
Capital expenditures	24.3	41.1	84.3	177.2
Free operating cash flow	0.5	17.1	12.7	199.3
Discretionary cash flow	(1.4)	(6.6)	(3.3)	(23.3)
Cash and short-term investments	17.1	12.6	11.4	108.6
Debt	191.1	365.6	964.9	3,170.7
Equity	199.2	88.2	452.7	(659.7)
Adjusted ratios				
EBITDA margin (%)	39.2	29.7	55.9	58.6
Return on capital (%)	4.8	10.7	5.5	13.0
EBITDA interest coverage (x)	4.9	4.4	2.4	3.4
FFO cash int. cov. (X)	6.0	6.0	3.3	1.9
Debt/EBITDA (x)	6.3	4.7	7.6	6.3
FFO/debt (%)	12.3	16.2	7.3	10.7
Cash flow from operations/debt (%)	13.0	15.9	10.1	11.9
Free operating cash flow/debt (%)	0.2	4.7	1.3	6.3
Discretionary cash flow/debt (%)	(0.7)	(1.8)	(0.3)	(0.7)

Financial Risk: Significant

In our base case, we expect the SESW Group to post a ratio of FFO to debt at about 10% for the regulatory period ending March 2020. We expect a small dip in FFO to debt in 2019, followed by a recovery to 10% in 2020. This is caused by slightly higher forecast operating costs and lower EBITDA from regulated activities and an increase in U.K. RPI.

In our view, the capital structure has aggressive leverage, as evidenced by the very limited headroom under the debt-to-RCV dividend lock-up covenant. This ratio was 76.8% in FY2017 and is projected to reach 79.7% by 2020. However, the company is currently in the process of reviewing the capital structure and one of its goals is to create more headroom under the covenant. We expect the company to maintain neutral to positive discretionary cash flows over the next few years.

We rate the SESW Group based on the consolidated accounts at its parent level (Sumisho Osaka Gas UK), which include a number of small unregulated entities.

SES Water is funded by a 30-year, 2.874% index-linked senior secured bond guaranteed by Assured Guaranty (Europe) Ltd. The bond has some protective structural features, which partially isolates SES Water from its parent company, East Surrey Holdings Ltd. These features include a distribution lock-up if net debt exceeds 80% of RCV, and some liquidity protection. In addition, financial covenants could restrict cash releases from the regulated company in certain circumstances.

We rate the index-linked bonds issued by Sutton and East Surrey and guaranteed by Assured Guaranty (Europe) Ltd. at 'AA', which is the higher of the rating on the issuer and that on the guarantor, in line with our methodology on rating debt guaranteed by insurance providers.

Financial summary

Table 2

Sutton and East Surrey Water PLC -- Financial Summary					
	--Fiscal year ended March 31--				
(Mil. £)	**2017**	**2016**	**2015**	**2014**	**2013**
Revenues	77.7	75.7	74.2	72.1	68.6
EBITDA	30.5	28.5	26.1	25.0	26.4
Funds from operations (FFO)	23.4	22.1	17.1	15.2	16.1
Net income from continuing operations	14.2	16.6	1.5	7.2	5.1
Cash flow from operations	24.8	22.4	18.2	18.7	17.9
Capital expenditures	24.3	18.4	14.7	14.5	15.7
Free operating cash flow	0.5	4.0	3.5	4.2	2.2
Dividends paid	1.8	5.1	3.6	6.7	6.6
Discretionary cash flow	(1.4)	(1.1)	(0.1)	(2.5)	(4.4)
Debt	191.1	189.6	187.4	154.3	145.8
Preferred stock	0.0	0.0	0.0	0.0	0.0
Equity	199.2	186.7	173.6	25.0	28.4
Debt and equity	390.3	376.2	361.0	179.4	174.2
Adjusted ratios					
EBITDA margin (%)	39.2	37.6	35.1	34.6	38.5
EBITDA interest coverage (x)	4.9	5.8	3.0	2.9	3.1
FFO cash int. cov. (x)	6.0	5.4	3.6	5.2	5.5
Debt/EBITDA (x)	6.3	6.7	7.2	6.2	5.5
FFO/debt (%)	12.3	11.6	9.1	9.8	11.1
Cash flow from operations/debt (%)	13.0	11.8	9.7	12.1	12.3
Free operating cash flow/debt (%)	0.2	2.1	1.9	2.7	1.5
Discretionary cash flow/debt (%)	(0.7)	(0.6)	(0.0)	(1.6)	(3.0)
Net cash flow/capex (%)	88.9	92.3	91.7	58.4	60.6
Return on capital (%)	4.8	5.0	4.0	8.5	9.7
Return on common equity (%)	7.4	9.6	1.6	31.5	14.5
Common dividend payout ratio (unadjusted) (%)	12.3	30.6	239.7	70.3	0.0

Liquidity: Adequate

We assess SESW Group's liquidity as adequate under our criteria, supported by our view that SESW Group's liquidity sources will exceed its funding needs by 1.1x over the next 12 months from Sept. 30, 2017. Our assessment is also supported by sufficient headroom under the default covenants and good relationship with banks.

Principal Liquidity Sources	Principal Liquidity Uses
• A cash balance of about £14 million; • £24.5 million available under the committed revolving credit facility; and • Our expectation that the SESW Group will generate cash FFO of about £25 million.	• Expected capital expenditure of about £25 million; and • Dividend payments of about £3.6 million annually.

Other Credit Considerations

SESW Group has relatively high exposure to operational risks, in our view, due to its small size and cash flow coverage ratios, which are at the lower end of the significant financial risk profile range.

Group Influence

We do not apply our group rating methodology as we consider that neither Osaka Gas Co. Ltd. nor Sumitomo Corporation Japan (the ultimate shareholders) have individual effective control over SESW.

Ratings Score Snapshot

Corporate Credit Rating

BBB+/Stable/--

Business risk: Excellent

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

Financial risk: Significant

- **Cash flow/Leverage:** Significant

Anchor: a-

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Negative (-1 notch)

Reconciliation

Table 3

Reconciliation Of Sutton and East Surrey Water PLC Reported Amounts With Our Adjusted Amounts (Mil. £)

	--Fiscal year ended March 31, 2017--						
Sutton and East Surrey Water PLC reported amounts							
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**
Reported	208.1	198.8	30.3	19.8	6.3	30.3	23.4
Our adjustments							
Interest expense (reported)	--	--	--	--	--	(6.3)	--
Interest income (reported)	--	--	--	--	--	0.1	--
Current tax expense (reported)	--	--	--	--	--	(1.5)	--
Operating leases	0.1	--	0.1	0.0	0.0	0.1	0.1
Postretirement benefit obligations/deferred compensation	--	--	0.2	0.2	--	0.8	1.2
Surplus cash	(17.1)	--	--	--	--	--	--
Nonoperating income (expense)	--	--	--	0.1	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	0.1
Non-controlling Interest/Minority interest	--	0.4	--	--	--	--	--
EBITDA - Gain/(Loss) on disposals of PP&E	--	--	(0.2)	(0.2)	--	(0.2)	--
Total adjustments	(17.0)	0.4	0.2	0.2	0.0	(6.9)	1.4
Our adjusted amounts							
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**
Adjusted	191.1	199.2	30.5	20.0	6.3	23.4	24.8

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 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.
- Why We See The Regulatory Frameworks For U.K. Utilities As Supportive, Sept. 26, 2017

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	**Significant**	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	**a-**	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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