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# FEATURE ARTICLE:

## *THE CURRENT STATE OF THE UK WATER SECTOR*

# The Current State of the UK Water Sector

It is fair to say that the UK has traditionally been seen as a 'gold standard' for global investors seeking to allocate to the infrastructure asset class.

However, one of the country's flagship sectors within this asset class, the water sector, has certainly received its fair share of attention of late as the industry finds itself at the centre of significant changes within both regulatory and political spheres.

With an opposition party leader wanting to renationalise the sector and a regulator demanding "*profound change*", investors in this space are currently cautious, and it comes as no surprise that the bull run in the sector's valuations has been tested over the last 12 months.

In this feature article we discuss the political landscape and decisions of the UK water regulator, Ofwat, in its recent price determination, as well as the impact this has had on company valuations in the sector over the last 12 months.

Finally, we look at whether Ofwat's enhanced stick and carrot approach may lead to a more disperse valuation range across the sector as strong performers look to earn increased incentive payments whilst their poorer performing cousins may suffer tougher penalties than in the past.

## REGULATORY RISK – PRICE REVIEW

Since its establishment in 1989, Ofwat has set the base regulatory rate of return that UK water companies can earn in five-year intervals, undertaking six price reviews since privatisation of the industry. Ofwat is currently overseeing the regulatory period AMP6 (Asset Management Plan 6) following the PR14 process (abbreviated for price review set in 2014 for the period of 2015-2020).

The regulator officially initiated its consultation process PR19 for the 2020 to 2025 regulatory period (AMP7) in July 2017, publishing its much-anticipated final methodology for the 2020-2025 period in December 2017.

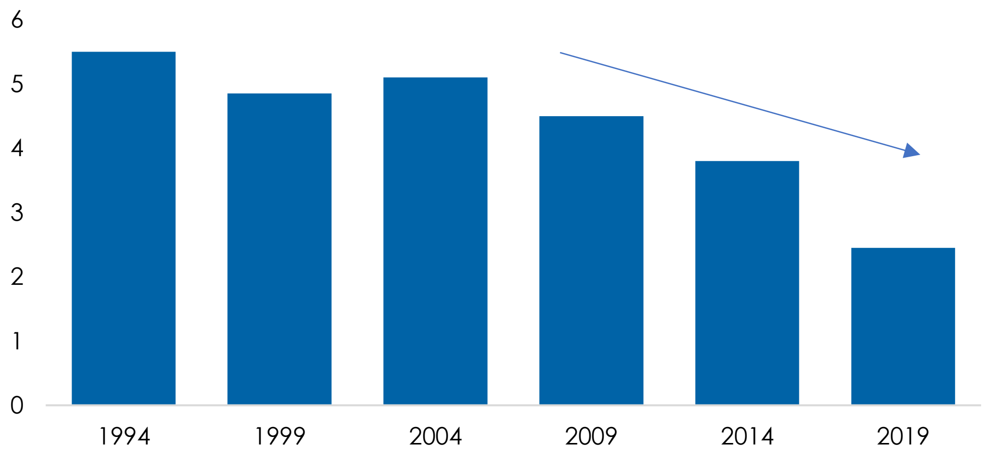
Whilst not changing the existing regulatory mechanisms, Ofwat bowed to recent public and political pressure by slashing the proposed regulatory returns available to water companies.

As highlighted in Figure 1 below, Ofwat backed up its cuts in 2009 and 2014 with its biggest cut to date, being a proposed reduction in the allowable rate of return from 3.7% to 2.4% for PR19. According to Ofwat, this translates into an average saving of between £15 and £20 per customer each year from 2020 to 2025.

Furthermore, Ofwat's increased scrutiny on operational performance now mandates greater community consultation from the sector, and for the first time Ofwat has set an explicit incentive to improve customer service.

Ofwat has proposed a tighter framework for rewarding and incentivising well performing companies, and increased penalties for underperforming companies.

Figure 1: Regulatory Average Cost of Capital Targets – UK Water Industry (%)




*Source: Financial Times*

UK water companies will be allowed to earn more than the base regulatory returns when they exceed their cost saving targets and/or operational targets. Conversely, if they fail to meet these targets, they will be penalised. As such, top performing water companies will be able to earn greater incentives, while underperforming companies will be faced with greater penalties.

This tighter framework will have a direct impact on a company's returns and therefore its valuation. Based on the regulator's analysis, this impact can range between ±1% to ±3% of the Return on Regulated Equity (RoRE). Whilst the outperformance reward is currently limited to 2% of RoRE in the current AMP6, under the proposed PR19 guidelines, Ofwat has proposed to remove this cap for AMP7, allowing efficient companies to generate higher returns.

By doing this, Ofwat has introduced a more stick and carrot approach to its regulation. This includes tougher new operational targets for water utilities, the promotion of efficiency by removing the cap on cost savings claimable over approved costs in company business plans, and greater financial incentives for meeting company operational targets.

In addition to the above, Ofwat considers that aggressive levered financial structures impose additional risks to the customers. As a result, in PR19 it proposes that highly geared companies (those with gearing above 70%) will be required to share the financial benefits resulting from the levered position with customers. Further details on the leverage structures currently implemented throughout the sector are discussed in the section below.

Chief Executive of Ofwat, Cathryn Ross was recently quoted saying:

*"The next decade will see profound changes in customers' expectations and we are pushing the water sector to be at the very forefront of that. We've said many times already that this will be a tough price review for companies. We will cut the financing costs they can recover from customers and, with this lower guaranteed return, they will need to be more efficient and innovative than ever before."*[1]

Ofwat cited that the largest driver for this drop in the rate of return to 2.4% was the continued decline in UK government bond yields, which have fallen from 3% in 2014 to 1% in 2018, and the flow on decrease in the utility companies' cost of debt.

However, whilst this is true, the current political landscape in the UK certainly played its part. This view is shared by credit agency Moody's, who now holds negative outlooks on 60% of the rated water companies and the UK water sector as a whole.

Moody's stated:

*"We see heightened risk of future political interference in the design of the regulatory framework and are changing our assessment of the stability and predictability of the UK water regulatory regime under our methodology to Aa from Aaa".*[2]

This statement is significant in itself. No longer is the strength and stability of the UK water regulatory system rated by Moody's as AAA. Will investors demand higher returns as compensation for the additional risk now evident in this system?

1 Ofwat Press Office: PN 32/17: Delivering a decade of lower bills and better service for water customers
2 (22 May 2018) Moody's changes outlook to negative on ratings on 4 UK utilities

# The Impact on Recent Valuations

UK LISTED WATER STOCKS – RECENT PERFORMANCE

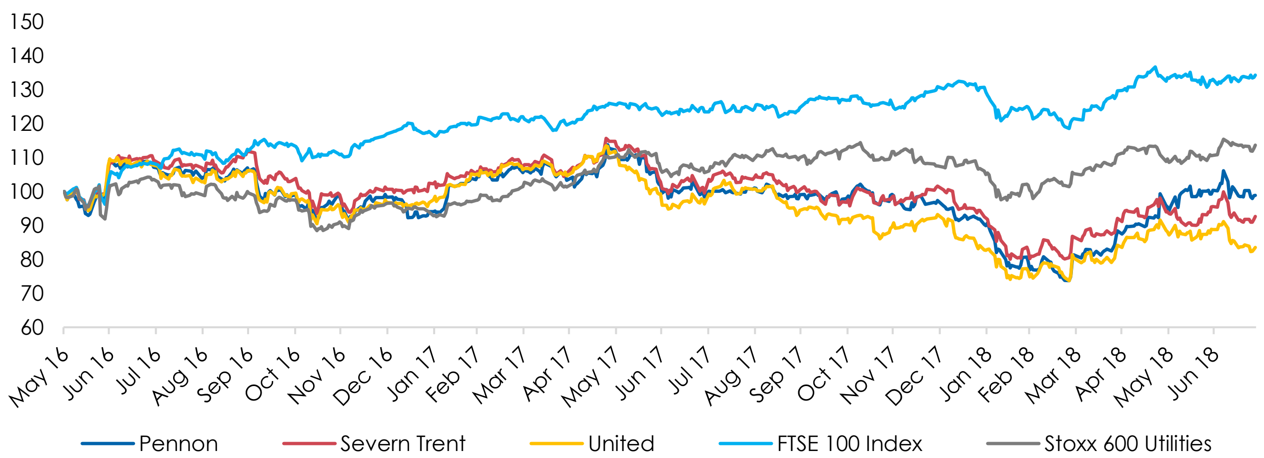
Coinciding with the unexpected success of the Labour party in the general election, in May 2017 Ofwat released its updated metrics intended for use in its regulatory period due to start in 2020.

The combination of these, and fuelled by rising interest rates in the UK, led the share price of the three listed water companies in the UK (Pennon, Severn Trent and United Utilities) to suffer a material fall, hitting a short-term nadir in February 2018.

Specifically these three companies experienced an average maximum drawdown of 34% between May 2017 and February 2018.

Although rallying since this low point, these three UK listed water stocks have recorded a total return of *minus* 20% on average in the past 13 months whereas the benchmark UK stock index the FTSE, and European Stoxx 600 utilities index have provided a total return of +7% and +3%, respectively over the corresponding period.

Chart 1: UK Water Utilities, Total Returns Indexed from May 2016




*Source: Bloomberg*

## MORE HEADACHES FOR THE SECTOR: UPWARD PRESSURE ON INTEREST RATES

As mentioned above, in addition to both the threat of renationalisation, and Ofwat's crackdown on allowable returns, the value of the UK water sector is materially impacted by global interest rates. Like many utilities and monopolistic infrastructure assets, UK water assets are often considered as bond proxies, responding positively to declining yields (rising bond prices) and negatively to rising yields (falling bond prices).

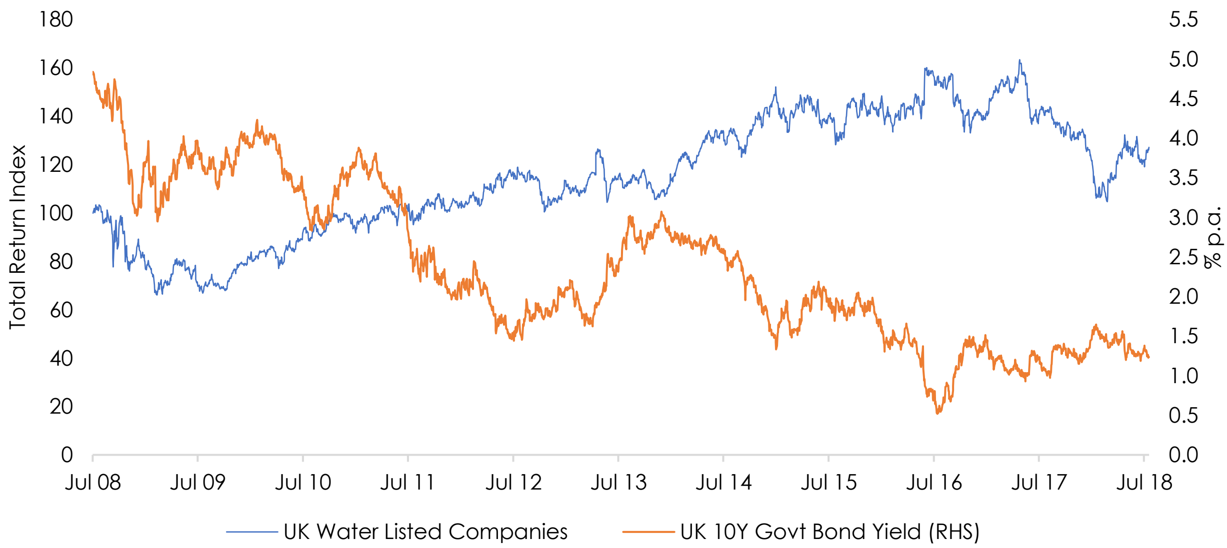
The yield on the benchmark 10-year UK government bonds rose from 0.93% in June 2017 to a peak of 1.65% in February 2018. More than half the pickup in the UK bond yields during this period was due to the global bond market's reaction to the rising inflationary and wage pressures in the US in January and February.

As a result, government bond yields in France, Germany, the US, and UK all rose through these months coinciding with the sharp declines experienced in the UK listed water stocks.

As shown in Chart 2, the correlation between UK water stocks and the UK 10-year government bond yield is very strong with a negative correlation of 0.8 in the last 10 years.

This strong correlation is likely attributed to the 'discount rate effect'. That is, the government bond yield is a direct input into the rate in which the typically stable cash flows of these stocks are valued. So all other things being equal, as yields compress, the discount rate applied to these stocks falls – increasing their value and vice-versa for rising rates.

**Chart 2: UK Water Stocks vs Bond Yields**




*Source: Bloomberg*

Given the stability in their cash flows, regulated utilities have the ability to adopt a significant amount of leverage, and UK water utilities are no exception. In fact as shown Chart 3, UK water utilities generally have a much higher level of debt as compared to other regulated utilities, both in the UK and Europe. The average gearing ratio of the 15 water utilities published was slightly above 70%, with very high levels of debt (gearing ratios of 79%-85%) being employed by seven of these companies.

Furthermore, as seen in Chart 3, on average these companies currently see the value of their long-term debt at three times the value of their equity, with total debt currently standing at a noticeable 8 times their EBITDA (Chart 4).

These high debt levels do not go unnoticed by Ofwat, who looks to provide guidance on what it considers an appropriate financing structure for the sector.

**Chart 3: Gearing Ratio & LT Debt/Equity**

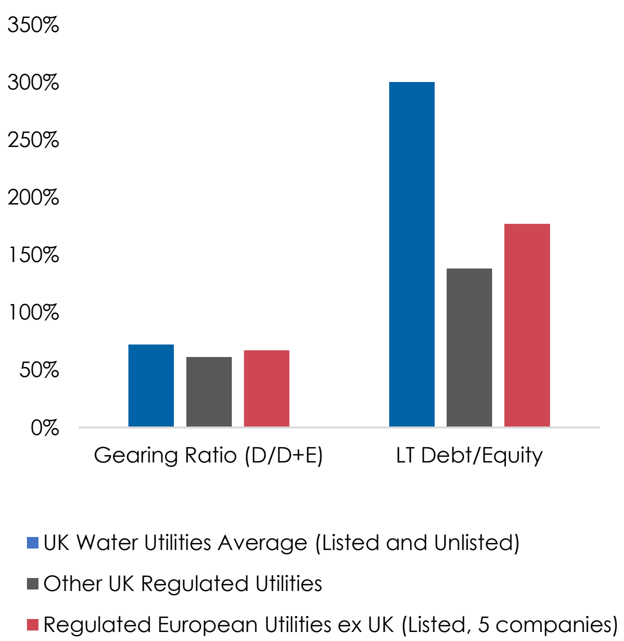
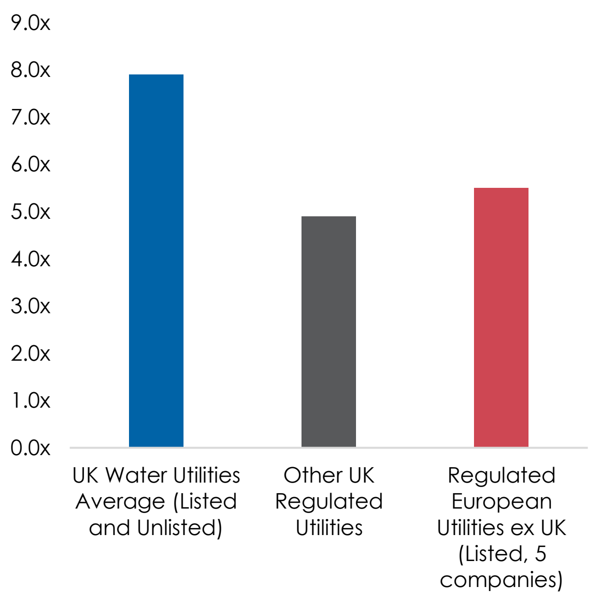



**Chart 4: Debt/EBITDA**




*Source: Bloomberg*

To provide consistency and to benchmark the sector, Ofwat introduced the concept of Net Debt to Regulated Capital Value (ND/RCV). Under pressure to reduce the leverage in the sector, Ofwat lowered its benchmark ratio from 62% to 60% in PR19 – making it a further challenge for the industry who currently has an average ND/RCV ratio of 73%. In addition, as mentioned earlier, companies with a gearing level above 70% will be penalised.

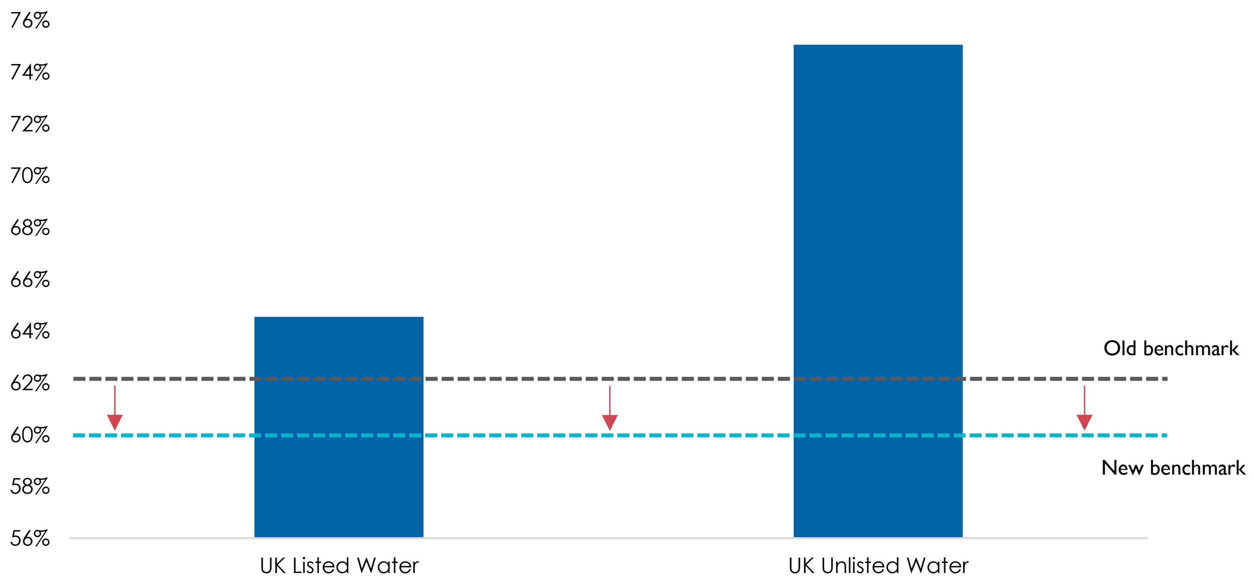
As highlighted in Chart 5 below, this impact will be felt more acutely by unlisted water utilities given that these companies on average have a significantly higher debt level as compared to their listed counterparts.

Additionally, UK water companies appear to be more susceptible to rising bank financing rates (term loans) than their European peers given the European Investment Bank (EIB) has announced it will cease funding for projects in the UK post Brexit – cutting term loan financing supply to the market.

Pennon currently sources 9.5% of its existing debt from the EIB, whilst the EIB currently provides nearly a quarter (24%) of United Utilities' term loans.

Whilst this will affect all borrowers, the UK water sector will feel this the hardest given it currently sources 32% of its financing needs from term loans compared to 16% by other regulated utilities in the UK and 17% by regulated utilities in Europe.

**Chart 5: UK Listed/Unlisted Water Debt to RCV and Old Benchmark and New Benchmark**




*Source: Bloomberg*

## VALUATION ANALYSIS: ARE THESE ASSETS NOW CHEAP?

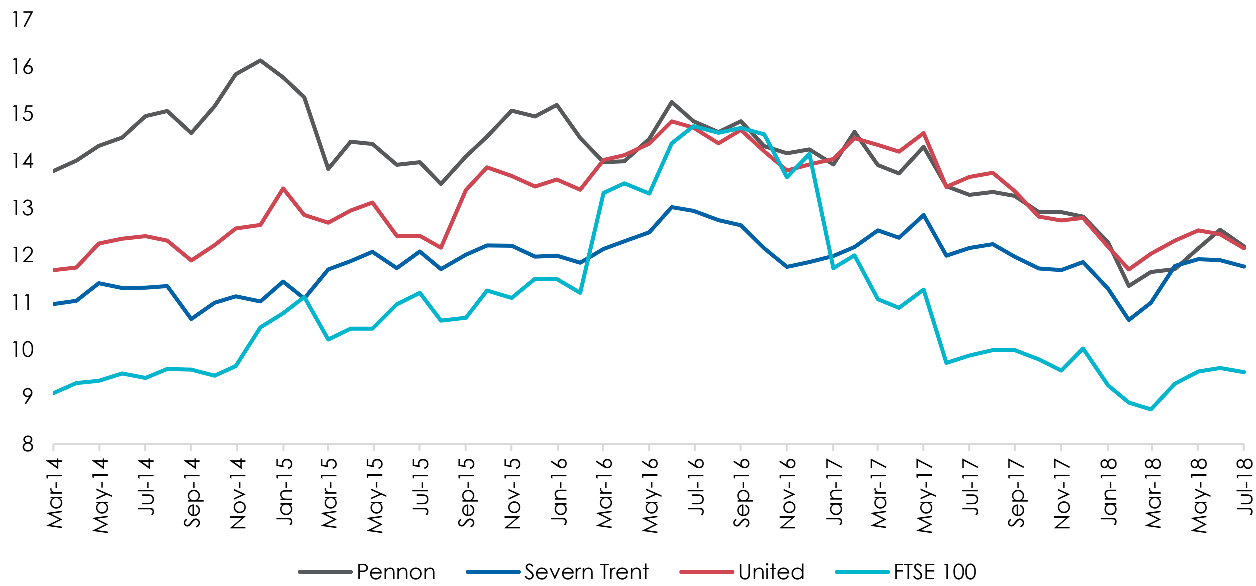
With listed water stocks declining sharply in the past year, it is not surprising that we are witnessing these stocks trade at valuation multiples significantly lower than seen over the past four years.

That is, they are trading at an average EV/EBITDA of 12x, which is more than two turns of EBITDA less than their high point of 14.4x in June 2016.

In February 2018, Pennon, Severn Trent, and United Utilities traded at their lowest EV/EBITDA level over the last four years.

However, even though these stocks seem cheap compared to their own historical valuations, they have still been trading at higher multiples relative to the FTSE 100 index. Part of this can be attributed to yield hungry investors favouring regulated utilities in the last eight years when interest rates in the UK were at historical lows.

Chart 6: EV/EBITDA – Listed UK Water Stocks



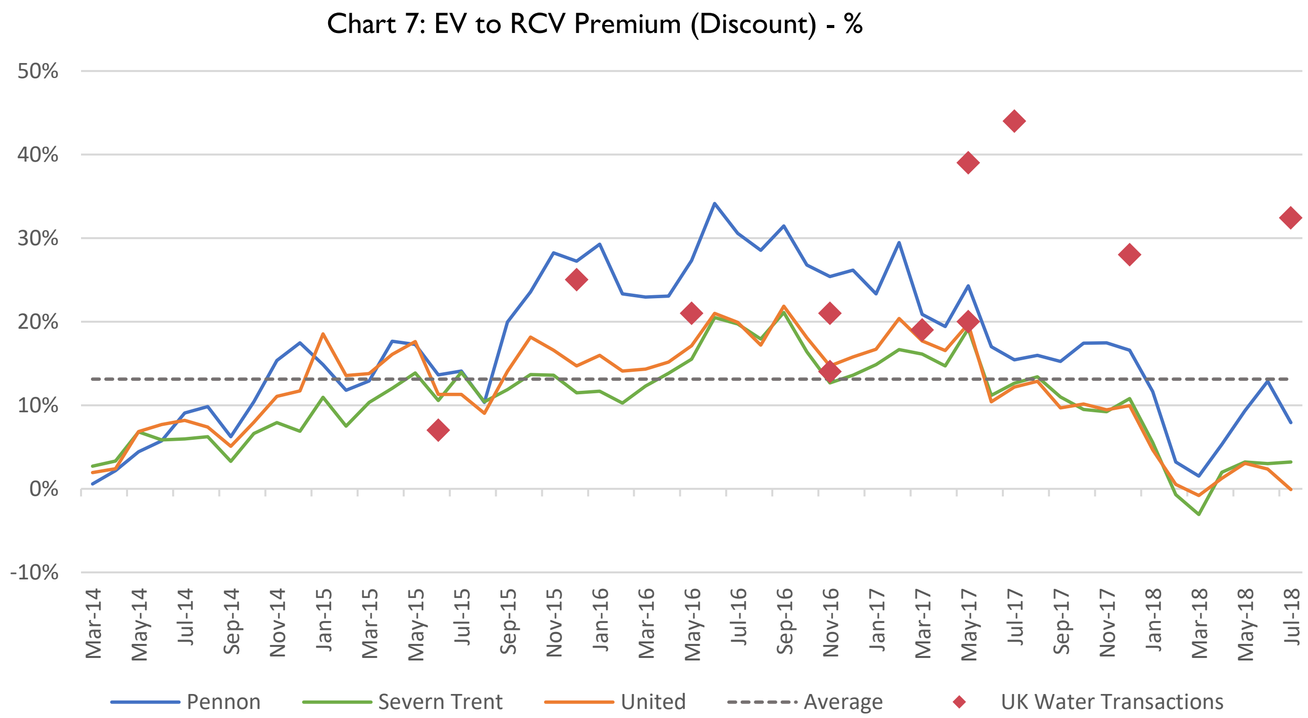

*Source: Bloomberg*

## UK WATER: LISTED VS UNLISTED

While EV/EBITDA ratios are a good valuation metric which reflects the level where these stocks are priced compared to both the broad market and other peers, EV/RCV is a far more appropriate measure to compare regulated utilities against each other. That is, EV/RCV measures the current enterprise value of a company as a ratio to its regulated capital value or regulated asset base.

Given their falls over the last 13 months, listed water stocks in the UK are currently trading at an average of 4% premium to their regulated capital value (RCV) compared to an average EV/RCV premium of 25% in June 2016.

Caveated by the limited data set, the fall in value in the listed sector appears not to have spilled into the unlisted water space. Chart 7 below shows that the four most recent transactions in the UK unlisted water sector were not only completed at far higher premiums compared to the levels where the listed stocks were trading, but they also transacted at prices higher than unlisted transactions of a few years prior.




*Source: Ofwat, Bloomberg, S&P Capital IQ*

In the most recent transaction, ADIA acquired a 6.8% stake in Anglian Water for £276 million, paying a 32% premium to the company's March 2018 RCV.

Another recent transaction was when Dalmore Capital and GLIL Infrastructure also acquired a minority stake in Anglian Water from 3i Infrastructure Fund at an enterprise value of 15.2x its EBITDA. This translated into a 28% premium paid to the company's March 2018 RCV value, whereas the listed stocks were going at that time for an average EV/RCV of 1.12x.

Prior to these transactions, HICL Infrastructure company sold its 3.4% stake in Affinity Water in July 2017 at an EV/RCV multiple of 1.44 times compared to an average EV/RCV of 1.13x for its listed counterparts. This was not an isolated price point given that a consortium of Allianz Capital, HICL Infrastructure, and Dutch Infrastructure Fund acquired 100% stake in Affinity Water at an EV/RCV multiple of 1.39x two months prior.

Importantly, whilst the Affinity Water transactions closed when Labour's renationalisation plan and Ofwat's draft methodology were front and centre, UK bond yields were still close to their lowest levels in recent times providing support to justify these high prices.

However, both the ADIA and the Dalmore/GLIL acquisitions in Anglian Water were later, when yields were on the rise. Whilst we witnessed in these transactions a decline in the premium to RCV relative to Affinity, there were still meaningfully higher than where listed water stocks were trading at.

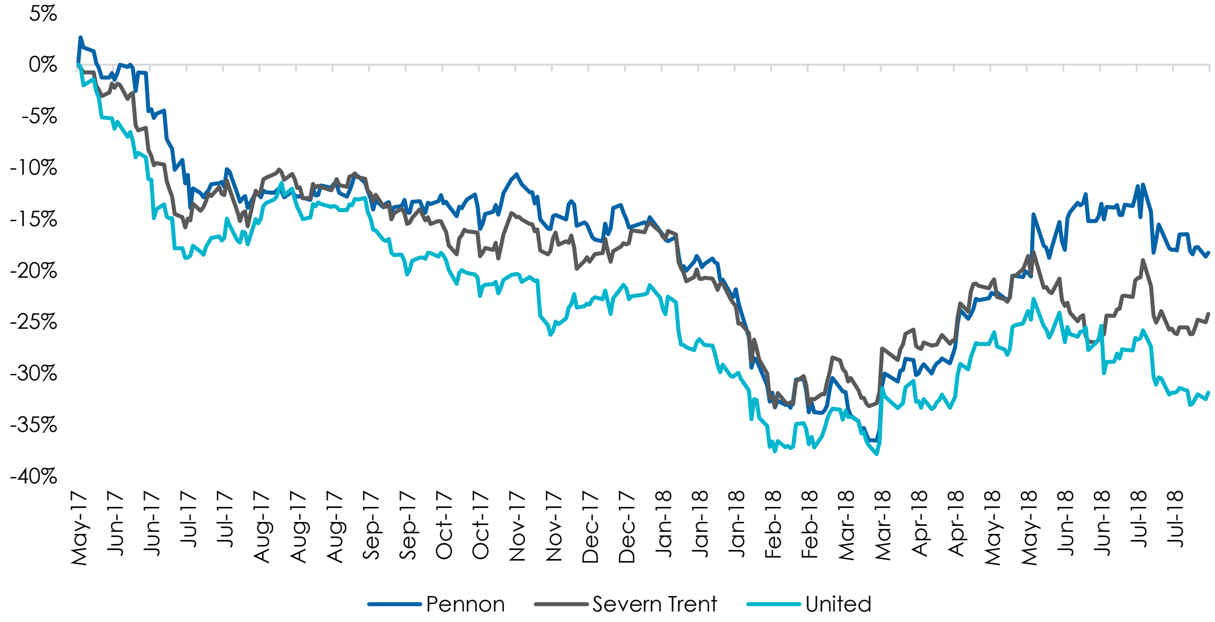
When Dalmore CEO Michel Ryan was asked about his acquisition he said, "*at a time when regulators are challenging investors on returns, we are delighted to be investing in one of the best performing and best run UK water companies*".[3]

Given the new financial incentives water utilities can earn if they outperform their targets, this sentiment of paying for quality is also playing out in the listed space.

As seen in Chart 8 below, when Ofwat released its draft report in May 2017, the three listed water utilities were trading within a narrow band of each other. But as Ofwat has looked to finalise the methodology of its 2019 price review, we have witnessed a growing wedge in the value of these stocks over the last six months.

[3] IPE: 'Dalmore and GLIL to buy a 15% stake in Anglian Water Group from 3i' – 18 December 2017

Chart 8: Recent Performance




*Source: Bloomberg*

Specifically, Chart 8 shows that although Pennon's share price has dropped 18% from May 2017 to the end of July 2018, it has enjoyed a better ride than Severn Trent (minus 24%) and United Utilities (minus 32%).

More importantly, the cumulative returns for these stocks have continued to drift apart from each other during this period as Pennon and Severn have delivered returns on regulated equity of 11.8% and 11.5% respectively against United's 7.7%.

These results reflect the fact that Pennon and Severn Trent continue to deliver well on their financial and operational targets set by the regulator in the current regulatory cycle relative to the targets delivered by United Utilities.

United Utilities underperformed because it failed to meet both its carrot and the stick regulatory targets. In particular, the company incurred a penalty of £8 million in the last financial year for not meeting its operational targets and has only accumulated £2 million in incentives over the first three years of the current regulatory period.

Conversely, Severn Trent and Pennon have accumulated incentives of £80 million and £8 million, respectively, over the same period.

## OUTLOOK

The take out in both these listed and unlisted examples suggest that, now more than ever, investors in this sector are willing to pay higher premiums for those companies with superior business plans that have a greater focus on operational and financial objectives.

It is likely that this means the end of high valuations for inefficient and poor-quality water companies in the UK that, over the last decade, have seen their value rise with the tide of broader valuation uplifts within the sector.

Furthermore, when looking to deploy capital into the sector, the effectiveness of comparable and trading transaction data will depend on how well investors look under the hood to see how the operations of these prospective investments stack up against peers.

In our view, the proposed regulatory framework will likely increase the valuation gap among UK water utilities given it is designed to reward companies with an effective business plan concentrating on top operational performance as well as greater financial discipline, while penalising the less efficient companies who are not achieving their targets.

Going forward, companies will be evaluated on the direction they intend to take leading up to April 2020 when the new regulatory changes are implemented.

Now more than ever, investors in this space will need to put less emphasis on broader market comparables in the sector and expend greater effort reviewing the sustainability of financing structures, as well as the ability of each company to earn incentives and avoid penalties. As such, we expect the performance differential between companies will result in a wider range of valuations within the sector going forward.

Furthermore, as UK water utilities look to expand their non-regulated business lines, investors may need to rethink their required rates of returns for the sector as the mix of regulated core revenue and non-regulated business lines evolve over time.

*This feature article is a condensed version of a more in-depth article. If you are interested in accessing the longer-form version, contact Nicole McMillan at*

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