FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms uMngeni-uThukela Water at 'AA+(zaf)'; Outlook Stable

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Fitch Ratings - London - 05 Sep 2024: Fitch Ratings has affirmed South African state-owned uMngeni-uThukela Water's (UUW) National Long-Term Rating at 'AA+(zaf)' with a Stable Outlook.

Fitch expects weaker credit metrics over the medium term with a deteriorating financial profile and weaker EBITDA margins, albeit still commensurate with the 'AA+(zaf)' rating. This, coupled with poorer operating performance linked to water losses and infrastructure investment delays, has led to a tightening of our rating sensitivities. The affirmation reflects continued strong links between UUW and the South African state (BB-/Stable) under our Government-Related Entities (GRE) Rating Criteria.

Fitch could change the Outlook to Negative if significant water losses and delays in infrastructure investments constrain water supply and remain a key risk without proactive mitigating measures by management and the Department of Water and Sanitation (DWS).

KEY RATING DRIVERS

Significant Water Losses: Fitch expects significant water losses (or unbilled water revenue) to remain a key risk through to the financial year ending June 2028. These losses, primarily occurring in municipalities' water distribution networks, are due to poor maintenance and illegal connections.

UUW's operating cash flows are adversely affected by delayed payments from municipalities, which are struggling to settle their full bills on time. This results in a sustained outflow of working capital over FY24-FY28. The major challenge for municipalities is the discrepancy between the water volume supplied and billed. Water losses represent lost revenue for municipalities through lower end-user bills.

Supply Constraint: Fitch expects that persistent large water losses, coupled with delays in infrastructure investments, will constrain UUW's water supply capacity. Additionally, we expect average water volume sales to decline 1% over FY24-FY28, as UUW reduces water abstraction to within its licensing provision from DWS. Worsening water losses could further strain supply. However, UUW's capex for FY23 was sharply higher at ZAR1.8 billion versus previous years, increasing further in FY24 to about ZAR2.7 billion. We expect total capex of about ZAR13 billion across FY25-FY28 to help address some of the supply constraints.

Weakening Financial Profile: We forecast UUW's currently solid financial profile will gradually weaken, due primarily to large capex, lower profitability as cost increases are not fully passed onto tariffs, and increasing municipality arrears. Fitch forecasts a sharp increase in funds from operations (FFO) net leverage to about 1.0x in FY28, versus a net cash position of ZAR5.5 billion in FY23. Despite this weakening, the financial profile remains in line with its rating.

Negative Free Cash Flow Ahead: Fitch expects UUW's large capex to weigh on its free cash flow (FCF) in FY24-FY28. Fitch projects average cash flow from operations (CFO) of about ZAR1.3 billion per year to FY28, resulting in average negative FCF of about ZAR1.9 billion per year, after total capex of ZAR15.7 billion but before grant funding of about ZAR1.4 billion.

Lower Forecast Profitability: Fitch estimates UUW's EBITDA margins to average about 20% for FY24-FY28, down from about 23% in FY23, due to expected smaller tariff adjustments and decline in volumes during this period. Profitability is also reduced by our expectations of above-inflation increases in electricity, raw water, chemicals and employee costs.

Internal Controls Risks: Internal controls at UUW have identified significant irregular expenditure amounting to about ZAR2.5 billion at FYE23. This, combined with overall wasteful expenditure, irregular expenditure, and allegations of potential fraud, corruption, and financial misconduct, increases corporate governance risks. The absence of corrective measures may further undermine financial oversight and weaken our view on corporate governance.

Conservative Financial Policy: UUW has a conservative capital structure and low leverage. Fitch does not expect a breach of either its borrowing limit in FY24 and FY25 or conditions set out by the National Treasury. The borrowing limit is set at ZAR3.3 billion for FY24 and ZAR4.5 billion for FY25.

Additional conditions set by National Treasury include a gearing limit of 50% (interest-bearing debt/total equity), minimum cash interest coverage of 3x and minimum debt service coverage of 1x. Further, Fitch does not expect UUW to breach its loan covenants on its European Investment Bank (EIB) loans of about ZAR149 million. The National Treasury covenants are tighter than the EIB loan covenants, with a minimum interest coverage of 2.5x and a gearing limit of 70%.

Limited Operational Benefits from Merger: We believe UUW's merger with Mhlathuze Water (MW) is unlikely to enhance its operational profile through increased scale or diversification. MW's integration into UUW became effective in July 2023, encompassing the transfer of all staff, assets, and liabilities to UUW. The transfer included about ZAR600 million in cash and cash equivalents and about ZAR1billion of net assets, with loans of about ZAR35 million from MW to UUW in FY24.

Strong Links with Government: Fitch assesses decision-making and oversight as 'Very Strong', precedent of support and preservation of government policy role as 'Strong' and contagion risk as 'Not Strong Enough' for incentives to support under our GRE Criteria.

Expectations of Support: Our support assessment reflects UUW's full ownership and control by the South African state, its status as a non-commercial entity, its zero-dividend policy, no tax payment requirements, a customer structure largely consisting of public entities and municipalities, and finally the procurement of raw water directly from DWS. It also reflects our expectations of the state to provide tangible support, including government grant funding for projects that are not economically viable.

DERIVATION SUMMARY

In determining UUW's ratings, we assess the links derived from the strategic importance of the company to the South Africa's water sector and its sound credit profile. This is despite expectations of a weakening financial profile, which is a key consideration. Fitch assesses the National Rating based on peer comparison using our National Scale Ratings Criteria.

UUW's rating is at the same level as that of Rand Water, (AA+(zaf)/Stable) and Namibia Water Corporation (NamWater; AA+(zaf)/Stable). Rand Water, which is the closest peer, is larger in water volumes sold and revenue, but has historically had lower EBITDA margins and higher FFO net leverage than UUW, although we expect these to converge over the next four years. NamWater's ratings benefit from better geographical diversification as the national water utility in Namibia, a strong financial profile, the zero cost of raw water, but these strengths are offset by its smaller scale.

KEY ASSUMPTIONS

Fitch's Key Assumptions within its Rating Case for the Issuer:

- Bulk water tariff increase of 6.7% for FY24 and 9.9% for FY25, followed by an average increase of about 6% per year for FY26- FY28

- Average decrease in water volumes of about 1% for per year for FY24-FY27

- Receipt of government grants of about ZAR280 million per year in FY24-FY28

- About ZAR15.8 billion of capex for FY24-FY28 leading to negative FCF, as capex will primarily be funded from internally generated funds and available cash as well as borrowing and government grant funding

- Average working-capital outflow of about ZAR360 million per year for FY24-FY28, including increasing municipalities arrears

RATING SENSITIVITIES

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Tighter links with the state or strengthening state support may lead to a positive rating action

Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Weakening linkages with the sovereign, in conjunction with sustained negative FCF, FFO net leverage above 2.0x (tightened from 3.0x before) and FFO interest cover at less than 3.0x on a sustained basis

- A sustained deterioration in the operating profile due to the absence of or, failure to implement, measures to reduce water losses, inadequate tariff increases, rising arrears from municipalities, or supply constraints stemming from delays in infrastructure investments

LIQUIDITY AND DEBT STRUCTURE

Strong Liquidity: Liquidity was supported by cash and short-term investments of about ZAR6.5 billion as at FYE23. This compares with negative FCF of about ZAR1.4 billion in FY24. The next significant maturity is in March 2026 (UG 26) for ZAR935 million.

Management's financial policy is to maintain a minimum cash buffer of ZAR200 million at all times. In addition, the utility maintains a committed facility of ZAR20 million for the next 12 months.

ISSUER PROFILE

UUW is a state-owned regional utility that supplies bulk water and provides wastewater services to the Kwa-Zulu Natal region of South Africa. It owns and operates about 930 kilometers of pipelines, 53 kilometers of tunnels, 14 reservoirs, 48 water treatment plants and 11 wastewater treatment plants.

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.

MACROECONOMIC ASSUMPTIONS AND SECTOR FORECASTS

Click here to access Fitch's latest quarterly Global Corporates Macro and Sector Forecasts data file which aggregates key data points used in our credit analysis. Fitch's macroeconomic forecasts, commodity price assumptions, default rate forecasts, sector key performance indicators and sector-level forecasts are among the data items included.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
uMngeni-uThukela Water	Natl LT	AA+(zaf) Rating Outlook Stable	Affirmed	AA+(zaf) Rating Outlook Stable
	Natl ST	F1+(zaf)	Affirmed	F1+(zaf)
senior unsecured	Natl LT	AA+(zaf)	Affirmed	AA+(zaf)

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

National Scale Rating Criteria (pub. 22 Dec 2020)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Government-Related Entities Rating Criteria (pub. 09 Jul 2024)

APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

uMngeni-uThukela Water	-

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