FitchRatings

Corporates
Water/Wastewater Utility
South Africa

uMngeni-uThukela Water

Ratings

uMngeni-uThukela Water

National Long-Term Rating	AA+
National Short-Term Rating	F1+

Outlook

National Long-Term Rating	Stable

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Fitch Ratings' affirmation of uMngeni-uThukela Water's (UW; renamed following the merger of Mhlathuze Water and Umgeni Water) National Long-Term Rating reflects Fitch's expectations of weaker credit metrics over the medium term with a deteriorating financial profile and weaker EBITDA margins, albeit still commensurate with the 'AA+(zaf)' rating. The affirmation also reflects continued strong links between UW and the South African state (BB-/Stable) as per our Government-Related Entities (GRE) Rating Criteria.

Fitch could revise the Outlook to Negative if significant water losses and further delays of 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 non-revenue water) of about 52% to remain a key risk through to the financial year ending March 2027 (FY27). These losses, which largely occur in municipalities' water distribution network, are due to poor maintenance and illegal connections.

UW's EBITDA margins are hit by increased bad debt provisions, as municipalities face challenges in paying their full bill on time. The most significant challenge for municipalities is the mismatch between water volume supplied and billed. Water losses represents lost revenue for municipalities through lower end-user bills, negatively affecting UW's operating cash flows as well.

Supply Constraint: Fitch expects both continuing significant water losses and delays in infrastructure investments to negatively affect UW's water supply capacity. While Fitch forecasts water volume demand to increase by about 1% per year from FY24, worsening water losses could further strain supply.

Delays in infrastructure investment are mainly attributed to UW's contracting strategy that is aligned with Public Finance Management Act and National Treasury's onerous guidance and approval process.

Weakening Financial Profile: We forecast UW's currently solid financial profile to gradually weaken, due particularly to significant capex, lower profitability and increasing municipality arrears. Fitch forecasts significant increase in funds from operations (FFO) net leverage to about 1.6x in FY27 (FY22: net cash position of ZAR4.7 billion), albeit still commensurate with its rating.

Fitch expects UW's large capex to weigh on its free cash flow (FCF) in FY24-FY27. Fitch projects average cash flow from operations (CFO) of about ZAR1.3 billion per year to FY27, resulting in average negative FCF of about ZAR2.2 billion per year, after total investments of ZAR14 billion but before grant funding of about ZAR1.2 billion.

Lower Forecast Profitability: Fitch estimates UW's EBITDA margins to average about 23% in FY24-FY27, down from about 33% in FY22, due to expected smaller tariff adjustments and slower volume increases during this period. Profitability is also reduced sharply by our expectations of above-inflation increases in electricity, raw water, chemicals and employee costs.

Applicable Criteria

National Scale Rating Criteria (December 2020)

Government-Related Entities Rating Criteria (September 2020)

Corporate Rating Criteria (October 2022)

Related Research

Global Corporates Macro and Sector Forecasts

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Conservative Financial Policy: UW has a conservative capital structure and low leverage. Fitch does not expect a breach of either the borrowing limit in FY23 and FY24 nor conditions set out by the National Treasury. The borrowing limit is set at ZAR2 billion for FY23 and ZAR3.3 billion for FY24.

Additional conditions set by the 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 UW to breach its loan covenants on its European Investment Bank (EIB) loans of about ZAR174 million at FYE22. 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%.

Expansion of Service Area: Fitch views the merger as benefitting UW's operational profile via increased scale and diversification in the service area of KwaZulu-Natal region. However, the risk of the expansion could further weigh on the financial profile if infrastructure needs and bad debt provisions are higher than expected.

Fitch does not expect the South African government and DWS to issue directives to UW to take on projects that are not financially viable. This is supported by the Water Services and Public Finance Management Act for water utilities to maintain financial sustainability on a standalone basis.

Strong Shareholder Links: Fitch views the government's ability and willingness to provide support to UW as high. The support consideration under our GRE criteria and our assessment of UW's credit profile versus national peers' result in a top-down minus-one approach on our National Rating scale. Under the GRE criteria, we assess status, ownership and control; support track record and expectation; and socio-political implications of a default by UW as 'Strong', while we view the financial implications of a default as 'Moderate'.

Ownership and Control: Our assessment of ownership and control factors in UW being wholly owned and controlled by the South African state, its status as a non-commercial entity, its zero-dividend policy, no requirement of tax payments, a customer structure largely consisting of public entities and municipalities, and finally the procurement of raw water directly from DWS. Our support track record and expectations reflect our expectations of the state to provide tangible support, including government grant funding for projects that are not economically viable.

Essential Water Infrastructure: The government's support of UW is further entrenched in the approval (and annual revision) by DWS of the company's capex programme and the setting of its borrowing limit by the National Treasury. The 'Strong' socio-political implications of a default of UW reflects the essential character of water supply and the development needs for water infrastructure in the Kwa-Zulu Natal province, an important contributor to the country's economy. The 'Moderate' financial implications of a default reflect the company's low amount of outstanding debt compared with other state-owned entities'.

Financial Summary

(ZARm)	Jun 20	Jun 21	Jun 22	Jun 23F	Jun 24F	Jun 25F
Gross revenue	4,154	4,528	4,909	6,066	6,455	6,785
EBITDA leverage (x)	1.1	0.7	0.7	0.6	0.8	0.7
FFO	2,089	2,012	2,462	1,981	1,461	1,574
FFO interest coverage (x)	10.9	10.6	19.0	15.6	12.3	13.9
FFO net leverage (x)	-1.2	-1.8	-2.0	-2.7	-2.4	-0.7

F — Forecast
Source: Fitch Ratings, Fitch Solutions

Rating Derivation Relative to Peers

In determining UW'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.

UW'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 pre-merger UW, 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.

Rating Sensitivities

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

- Tighter links with the state or strengthening state support

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

- Weakening linkages with the sovereign, in conjunction with deterioration in the operating profile, leading to sustained negative FCF, FFO net leverage above 3.0x and FFO interest coverage of less than 3.0x on a sustained basis

Liquidity and Debt Structure

Strong Liquidity: Liquidity was supported by cash and liquid investments of about ZAR5.8 billion as of end-June 2022. This compares with expectations of negative FCF of about ZAR265 million in FY23. The next significant maturity is due in March 2026 (UG 26) for ZAR935 million.

The 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 for ZAR20 million for the next 12 months.

Liquidity and Debt Maturities

Liquidity Analysis

(ZARm)	2023F	2024F
Available liquidity		
Beginning cash balance	5,843	5,553
Rating-case FCF after acquisitions and divestitures	-265	-1,860
Total available liquidity (A)	**5,578**	**3,693**
Liquidity uses		
Debt maturities	-25	-25
Total liquidity uses (B)	**-25**	**-25**
Liquidity calculation		
Ending cash balance (A+B)	5,553	3,668
Revolver availability	20	20
Ending liquidity	**5,573**	**3,688**
Liquidity score (x)	223.9	148.5

F – Forecast.
Source: Fitch Ratings, Fitch Solutions, uMngeni-uThukela Water

Scheduled debt maturities

(ZARm)	30 Jun 22
2023	25
2024	25
2025	993
2026	25
2027	25
Thereafter	49
Total	**1,142**

Source: Fitch Ratings, Fitch Solutions, uMngeni-uThukela Water

Key Assumptions

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

- Bulk water tariff increase of 3% for FY23, followed by an average increase of 6% per year for FY24- FY27
- Average increase in water volumes of about 1% for per year for FY24-FY27
- Receipt of government grants of about ZAR400 million per year in FY23-FY25
- About ZAR15.8 billion of capex for FY23-FY27 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 ZAR300 million per year for FY23-FY27

Financial Data

(ZARm)	Jun 20	Jun 21	Jun 22	Jun 23F	Jun 24F	Jun 25F
Summary income statement						
Gross revenue	4,154	4,528	4,909	6,066	6,455	6,785
Revenue growth (%)	17.4	9.0	8.4	23.6	6.4	5.1
EBITDA before income from associates	1,674	1,666	1,637	1,787	1,360	1,577
EBITDA margin (%)	40.3	36.8	33.3	29.5	21.1	23.2
EBITDA after associates and minorities	1,680	1,672	1,642	1,792	1,365	1,582
EBITDAR	1,674	1,666	1,637	1,787	1,360	1,577
EBITDAR margin (%)	40.3	36.8	33.3	29.5	21.1	23.2
EBIT	1,267	1,242	1,142	1,143	775	1,004
EBIT margin (%)	30.5	27.4	23.3	18.8	12.0	14.8
Gross interest expense	-191	-165	-127	-121	-119	-117
Pretax income including associate income/loss	1,265	1,447	1,464	1,350	889	1,063
Summary balance sheet						
Readily available cash and equivalents	4,246	4,719	5,843	6,189	4,559	2,255
Debt	1,817	1,167	1,142	1,111	1,086	1,061
Lease-adjusted debt	1,817	1,167	1,142	1,111	1,086	1,061
Net debt	-2,429	-3,553	-4,701	-5,079	-3,474	-1,194
Summary cash flow statement						
EBITDA	1,674	1,666	1,637	1,787	1,360	1,577
Cash interest paid	-191	-186	-126	-121	-119	-117
Cash tax	-0	—	—	—	—	—
Dividends received less dividends paid to minorities (inflow/outflow)	6	5	5	5	5	5
Other items before FFO	404	310	759	100	100	50
FFO	2,089	2,012	2,462	1,981	1,461	1,574
FFO margin (%)	50.3	44.4	50.1	32.7	22.6	23.2
Change in working capital	-205	-572	-524	-419	-286	-320
CFO (Fitch-defined)	1,885	1,440	1,938	1,562	1,175	1,254
Total non-operating/nonrecurring cash flow	—	—	—	—	—	—
Capex	-857	-802	-1,050	—	—	—
Capital intensity (capex/revenue) (%)	20.6	17.7	21.4	—	—	—
Common dividends	—	—	—	—	—	—
FCF	1,028	638	887	—	—	—
FCF margin (%)	24.7	14.1	18.1	—	—	—
Net acquisitions and divestitures	0	2	5	—	—	—
Other investing and financing cash flow items	-1,064	11	-841	642	255	318
Net debt proceeds	-31	-630	-25	-31	-25	-25
Net equity proceeds	—	—	—	—	—	—
Total change in cash	-66	21	26	346	-1,630	-2,304
Leverage ratios (x)						
EBITDA leverage	1.1	0.7	0.7	0.6	0.8	0.7
EBITDA net leverage	-1.4	-2.1	-2.9	-2.8	-2.5	-0.8
EBITDAR leverage	1.1	0.7	0.7	0.6	0.8	0.7
EBITDAR net leverage	-1.4	-2.1	-2.9	-2.8	-2.5	-0.8
EBITDAR net fixed-charge coverage	-329.4	-55.4	-26.8	-20.1	429.6	27.3
FFO adjusted leverage	0.9	0.6	0.5	0.6	0.7	0.7
FFO adjusted net leverage	-1.2	-1.8	-2.0	-2.7	-2.4	-0.7
FFO leverage	0.9	0.6	0.5	0.6	0.7	0.7
FFO net leverage	-1.2	-1.8	-2.0	-2.7	-2.4	-0.7
Calculations for forecast publication						
Capex, dividends, acquisitions and other items before FCF	-857	-800	-1,045	-1,827	-3,036	-3,851
FCF after acquisitions and divestitures	1,028	640	892	-265	-1,860	-2,597
FCF margin after net acquisitions (%)	24.7	14.1	18.2	-4.4	-28.8	-38.3

(ZARm)	Jun 20	Jun 21	Jun 22	Jun 23F	Jun 24F	Jun 25F
Coverage ratios (x)						
FFO interest coverage	10.9	10.6	19.0	15.6	12.3	13.9
FFO fixed-charge coverage	10.9	10.6	19.0	15.6	12.3	13.9
EBITDAR fixed-charge coverage	8.8	9.0	13.0	14.8	11.4	13.5
EBITDA interest coverage	8.8	9.0	13.0	14.8	11.4	13.5
Additional metrics (%)						
CFO-capex/debt	56.6	54.7	77.7	-23.9	-171.3	-244.8
CFO-capex/net debt	-42.3	-18.0	-18.9	5.2	53.6	217.5
CFO/capex	220.0	179.6	184.5	85.5	38.7	32.6

CFO – Cash flow from operations
Source: Fitch Ratings, Fitch Solutions, uMngeni-uThukela Water

How to Interpret the Forecast Presented

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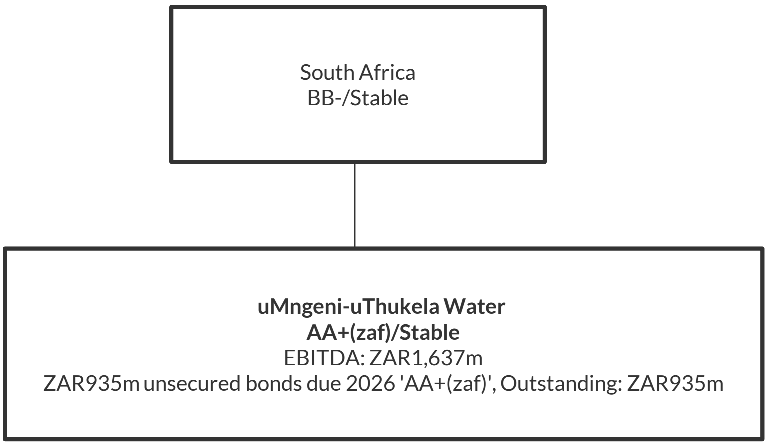
Simplified Group Structure Diagram



Source: Fitch Ratings, Fitch Solutions, uMngeni-uThukela Water, as of September 2023

Peer Financial Summary

Company	National Credit Rating	Financial statement date	Gross revenue (ZARm)	EBITDA margin (%)	FFO (ZARm)	FFO interest coverage (x)	FFO net leverage (x)
uMngeni-uThukela Water	AA+(zaf)						
	AA+(zaf)	2022	4,909	33.3	2,462	19.0	-2.0
	AA+(zaf)	2021	4,528	36.8	2,012	10.6	-1.8
	AA+(zaf)	2020	4,154	40.3	2,089	10.9	-1.2
Rand Water	AA+(zaf)						
	AA+(zaf)	2022	17,661	18.4	3,028	6.8	-1.0
	AA+(zaf)	2021	16,556	22.3	4,360	9.7	-0.6
	AA+(zaf)	2020	16,424	26.5	4,421	10.3	-0.3
Namibia Water Corporation	AA+(zaf)						
	AA+(zaf)	2022	2,042	23.9	440	34.4	-4.1
	AAA(zaf)	2021	1,952	23.6	522	28.2	-2.8
	AAA(zaf)	2020	1,665	23.7	354	8.8	-3.3

Source: Fitch Ratings, Fitch Solutions

Fitch Adjusted Financials

(ZARm) 30 Jun 22	Notes and formulas	Reported values	Sum of adjustments	CORP- lease treatment	Other adjustments	Adjusted values
Income statement summary						
Revenue		4,909				4,909
EBITDAR		1,416	221	-1	222	1,637
EBITDAR after associates and minorities	(a)	1,421	221	-1	222	1,642
Lease expense	(b)	0				0
EBITDA	(c)	1,416	221	-1	222	1,637
EBITDA after associates and minorities	(d) = (a-b)	1,421	221	-1	222	1,642
EBIT	(e)	921	222	0	222	1,142
Debt and cash summary						
Other off balance sheet debt	(f)	0				0
Debt	(g)	1,147	-5	-5	0	1,142
Lease-equivalent debt	(h)	0				0
Lease-adjusted debt	(i) = (g+h)	1,147	-5	-5	0	1,142
Readily available cash and equivalents	(j)	5,843				5,843
Not readily available cash and equivalents		0				0
Cash flow summary						
EBITDA after associates and minorities	(d) = (a-b)	1,421	221	-1	222	1,642
Preferred dividends paid	(k)	0				0
Interest received	(l)	187				187
Interest paid	(m)	-127	0	0	0	-126
Cash tax paid		0				0
Other items before FFO		981	-222		-222	759
FFO	(n)	2,463	-1	-1	0	2,462
Change in working capital (Fitch-defined)		-524				-524
CFO	(o)	1,938	-1	-1	0	1,938
Non-operating/nonrecurring cash flow		0				0
Capex	(p)	-1,050				-1,050
Common dividends paid		0				0
FCF		888	-1	-1	0	887
Gross leverage (x)						
EBITDAR leverage[a]	(i/a)	0.8				0.7
FFO adjusted leverage	(i/(n-m-l-k+b))	0.5				0.5
FFO leverage	(i-h)/(n-m-l-k)	0.5				0.5
EBITDA leverage[a]	(i-h)/d	0.8				0.7
(CFO-capex)/debt (%)	(o+p)/(i-h)	77.4				77.7
Net leverage (x)						
EBITDAR net leverage[a]	(i-j)/a	-3.3				-2.9
FFO adjusted net leverage	(i-j)/(n-m-l-k+b)	-2.0				-2.0
FFO net leverage	(i-h-j)/(n-m-l-k)	-2.0				-2.0
EBITDA net leverage[a]	(i-h-j)/d	-3.3				-2.9
(CFO-capex)/net debt (%)	(o+p)/(i-h-j)	-18.9				-18.9
Coverage (x)						
EBITDAR fixed-charge coverage[a]	a/(-m+b)	11.2				13.0
EBITDA interest coverage[a]	d/(-m)	11.2				13.0
FFO fixed-charge coverage	(n-l-m-k+b)/(-m-k+b)	19.0				19.0
FFO interest coverage	(n-l-m-k)/(-m-k)	19.0				19.0

[a]EBITDA/R after dividends to associates and minorities.
CFO – Cash flow from operations.
Note: Debt includes other off balance sheet debt.
Source: Fitch Ratings, Fitch Solutions, uMngeni-uThukela Water

SOLICITATION & PARTICIPATION STATUS

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