FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Rand Water at 'AA+(zaf)'; Outlook Stable

Mon 06 Nov, 2023 - 8:37 AM ET

Fitch Ratings - London - 06 Nov 2023: Fitch Ratings has affirmed South African state-owned Rand Water's National Long-Term Rating at 'AA+(zaf)' with a Stable Outlook.

The rating affirmation reflects continued strong links between Rand Water and the South African state (BB-/Stable), as per our Government-Related Entities (GRE) Rating Criteria. On a standalone basis, Fitch expects larger capex increases than historically, especially starting from FY25 (year-end at June). This would in turn gradually shift the company's financial position to net debt starting from FY26, from net cash.

Fitch could change the Outlook to Negative if significant water losses (within municipalities water distribution network) contributes to lower profitability and increasing municipality arrears. In addition, further delays of infrastructure investments would 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

Weakening Financial Profile: We forecast Rand Water's currently solid financial profile to gradually weaken, due particularly to significant capex, lower profitability and increasing municipality arrears. Fitch forecasts significant increase in average funds from operations (FFO) net leverage to around 2x in FY25-FY27 (FY22: net cash position of ZAR2.8 billion), mainly due to Rand Water's large capex expected in FY25-FY27.

Significant Capex Increase: We expect the company's annual capex to rise to an average of ZAR7.9 billion in FY25-FY27 from an average of ZAR1.9 billion in FY19-FY22. The upcoming capex is chiefly for the water infrastructure (pipelines, purification, and hydro power plant aimed at generating electricity for Rand Water). We expect this to entail some execution risk, via a likely step change in the pace of capex delivery. However, Rand Water has significant capex flexibility with low amounts of committed capex beyond one to two years.

Deteriorating Profitability: Fitch expects inflationary pressures, notably related to energy prices, chemicals and labour costs, to persist. This pressure, together with rolling electricity outages and significant water losses, could create a more challenging operating environment leading to weaker EBITDA margins.

Weakening EBITDA Margins; Positive FCF: Fitch expects weakening EBITDA margins, notwithstanding tariff and volume increases. We forecast average EBITDA margins of about 16% for FY23-FY26 (FY22; 18%), after factoring in the regulator DWS-approved tariff increases of 8.8% for FY23 and 9.2% for FY24. We expect about 1% volume increases during this period.

Rand Water's EBITDA (Fitch-defined) fell to ZAR3.3 billion in FY22 (from ZAR3.7 billion in FY21), mainly due to inflationary operating cost pressures. In the same year, it achieved positive free cash flow (FCF) of around ZAR1.1 billion, also due to fairly limited capex at ZAR1.6 billion (FY22: ZAR2.5 billion), at about 9% of revenues. Rand Water's cash and cash equivalents at FYE22 stood at ZAR7.2 billion.

Water Losses Hit Cash Collection: Rand Water's key customers, municipalities, face challenges in paying their full bill on time, and overdue trade receivables for FYE22 stood at about ZAR3.4 billion. Accordingly, we forecast average working-capital outflows of about ZAR200 million per year for FY24-FY26, due to delays in physical cash collections or agreed extension of credit terms. Rand Water secured a court judgement on one of its largest debtors to enforce payment and is working on effectively managing customer relationships to minimise the expected credit losses.

Strong Shareholder Links: Fitch applies a top-down approach from the sovereign's rating minus one notch, based on our view of the government's strong ability and willingness to provide support to Rand Water and our assessment of Rand Water's credit profile versus national peers. Under the GRE Criteria, we assess three factors as 'Strong' - namely status, ownership and control; support track record; and socio-political implications of the GRE's default - while we view the financial implications of the GRE's default as 'Moderate'.

Strength of Linkage: Our assessment of 'Strong' status ownership and control is due to Rand Water being wholly owned and controlled by the South African state, its status as a non-commercial entity, its zero-dividend policy, the absence of requirement for tax payments, a customer structure largely consisting of public entities and municipalities, and finally the procurement of raw water directly from the DWS. Its 'Strong' support track record reflects our expectation of tangible state support despite Rand Water receiving minimal direct financial support from the state so far, due to its solid financial position.

Incentive to Support: The government's support for Rand Water is further enhanced through the approval (and annual revision) of its borrowing limit by National Treasury. Fitch deems the socio-political implications of a default of Rand Water as 'Strong' given the essential character of water supply and the development needs for water infrastructure in the Gauteng province, an important contributor to the country's economy. The 'Moderate' financial implications of a default of the company for the sovereign mainly reflects the low amount of outstanding debt compared with other state-owned entities'.

Conditions on Borrowing Limit: Fitch does not expect a breach of either the borrowing limit or conditions set out by the National Treasury. The borrowing limit is set at ZAR9.5 billion for FY24 and includes existing and new debt issuance, reported gross debt at FYE22 was ZAR4.4 billion. Additional conditions are a gearing limit of 50%, minimum cash interest cover of 3x, and minimum debt service cover of 1x.

DERIVATION SUMMARY

In determining Rand Water's rating, we assess the links derived from the strategic importance of the company to South Africa's water sector and the company's sound credit profile, a key consideration. Fitch assesses the National Rating based on peer comparison using our National Scale Ratings criteria.

Rand Water's rating of 'AA+(zaf)' is at the same level as uMngeni-uThukela Water 'AA+(zaf)', and Namibian Water Corporation (NamWater) 'AA+(zaf)' - both on Stable Outlook. NamWater's ratings benefit from a sovereign guarantee, 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.

In comparison, uMngeni-uThukela Water, which is the closest peer, is smaller in water volume sold and revenue, but is supported by higher EBITDA margins (gravity-fed water supply lowers energy cost) and lower FFO net leverage.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer:

- Tariff increase of 8.8% for FY23 and 9.2% FY24, followed by an average increase of 6% per year from FY25 onwards

- Average water volume increase of about 1% per year for FY24-FY27

- Average capex of about ZAR1.7 billion per year for FY23 to FY24. This is followed by an increase to ZAR5 billion in FY25, and average of ZAR9.2 billion per year for FY26 and

FY27

- Average negative working-capital outflow of about ZAR200 million per year for FY23 to FY27, to reflect slower collections or agreed extension of credit terms

RATING SENSITIVITIES

Developments That May, 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

Developments That May, 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 cover at less than 3.0x on a sustained basis

LIQUIDITY AND DEBT STRUCTURE

Strong Liquidity: Rand Water has a strong liquidity position, with cash and cash equivalents of about ZAR7.2 billion at FYE22 and undrawn committed facilities of ZAR1 billion (renewed annually). Debt maturities are limited with ZAR1.2 billion due in December 2023, the only maturity in FY24, and no maturities in FY25. We expect positive FCF until FY24.

ISSUER PROFILE

Rand Water is a regional state-owned monopoly that provides bulk water supply services to more than 16 million people in Gauteng and parts of Mpumalanga, the Free State and north west provinces of South Africa.

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 ⬍	PRIOR ⬍

Rand Water	Natl LT Affirmed	AA+(zaf) Rating Outlook Stable		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

FITCH RATINGS ANALYSTS

Yeshvir Singh
Senior Director
Primary Rating Analyst
+44 20 3530 1810
yeshvir.singh@fitchratings.com
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf London E14 5GN

Sagar Nadkarni
Analyst
Secondary Rating Analyst
+44 20 3530 1289
sagar.nadkarni@fitchratings.com

Antonio Totaro
Senior Director
Committee Chairperson
+39 02 9475 8280
antonio.totaro@fitchratings.com

MEDIA CONTACTS

Isobel Burke
London
+44 20 3530 1499
isobel.burke@thefitchgroup.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

National Scale Rating Criteria (pub. 22 Dec 2020)

Corporate Rating Criteria - Effective from 28 October 2022 to 3 November 2023 (pub. 28 Oct 2022) (including rating assumption sensitivity)

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

Rand Water	-

DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read these limitations and disclaimers by following this link: https://www.fitchratings.com/understandingcreditratings. In addition, the following https://www.fitchratings.com/rating-definitions-document details Fitch's rating definitions for each rating scale and rating categories, including definitions relating to default. ESMA and the FCA are required to publish historical default rates in a central repository in accordance with Articles 11(2) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

Published ratings, criteria, and methodologies are available from this site at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance, and other relevant policies and procedures are also available from the Code of Conduct section of this site. Directors and shareholders' relevant interests are available at https://www.fitchratings.com/site/regulatory. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. Sector-specific best- and worst-case scenario credit ratings are listed in more detail at https://www.fitchratings.com/site/re/10238496

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch’s international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch’s approach to endorsement in the EU and the UK can be found on Fitch’s Regulatory Affairs page on Fitch’s website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.