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UK water utilities: What's exciting about water supply?

Research and Insights

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There is a lot to get excited about water supply, says Ausbil, but care and depth of understanding is crucial to getting it right. Recently we have witnessed a significant de-rating of listed UK water utilities, triggered in part by negative financial developments at Thames Water. We look at the key issues and opportunities in water infrastructure, and how Ausbil is positioned to take advantage of the potential in water infrastructure.

Key points

- Water utilities are not well understood, yet they can make a compelling addition to a diversified essential infrastructure portfolio.
- A quality water utility with sound management and appropriate gearing may offer stable asset values with a market yield and a steady but conservative growth profile that offers lower relative correlation to broad market equity returns.
- Regulated water and wastewater utilities generate returns for investors through the total ascribed asset value that represents the value of their activities and network in the gathering, treatment, provision and recycling of water and waste.
- Regulated water companies offer elements of yield and growth. Yield comes through the allowable return regulators support given prevailing returns on debt and equity for infrastructure assets. In the UK, the regulation is based on real returns and as such provide strong inflation protection characteristics for investors.
- Growth comes from the expansion of the total asset value of the utility, which can be driven by a range of factors, like population growth, new home and business development, increased demand and usage, replacement expenditure for ageing infrastructure and also improving environmental standards.
- Because of the major capital invested in water utilities and the nature of their business, success is heavily dependent on standards of operational excellence and appropriate levels of gearing. The three water and wastewater companies that are listed in this report are stronger operational performers and more conservatively geared than their unlisted peers.

Q: Quickly, what is the attraction in water infrastructure?

A: Water infrastructure is considered essential infrastructure and is typically monopolistic in nature given that most water infrastructure is unique and operate as the only provider of water and waste/sewage services in any given jurisdiction. Figure 1, from the listed water utility, Pennon Group PLC (Pennon) in the United Kingdom, illustrates the various components of water infrastructure, from the gathering, treatment and delivery of potable water; to the gathering, treatment, recycling and disposal of waste water and sewage.

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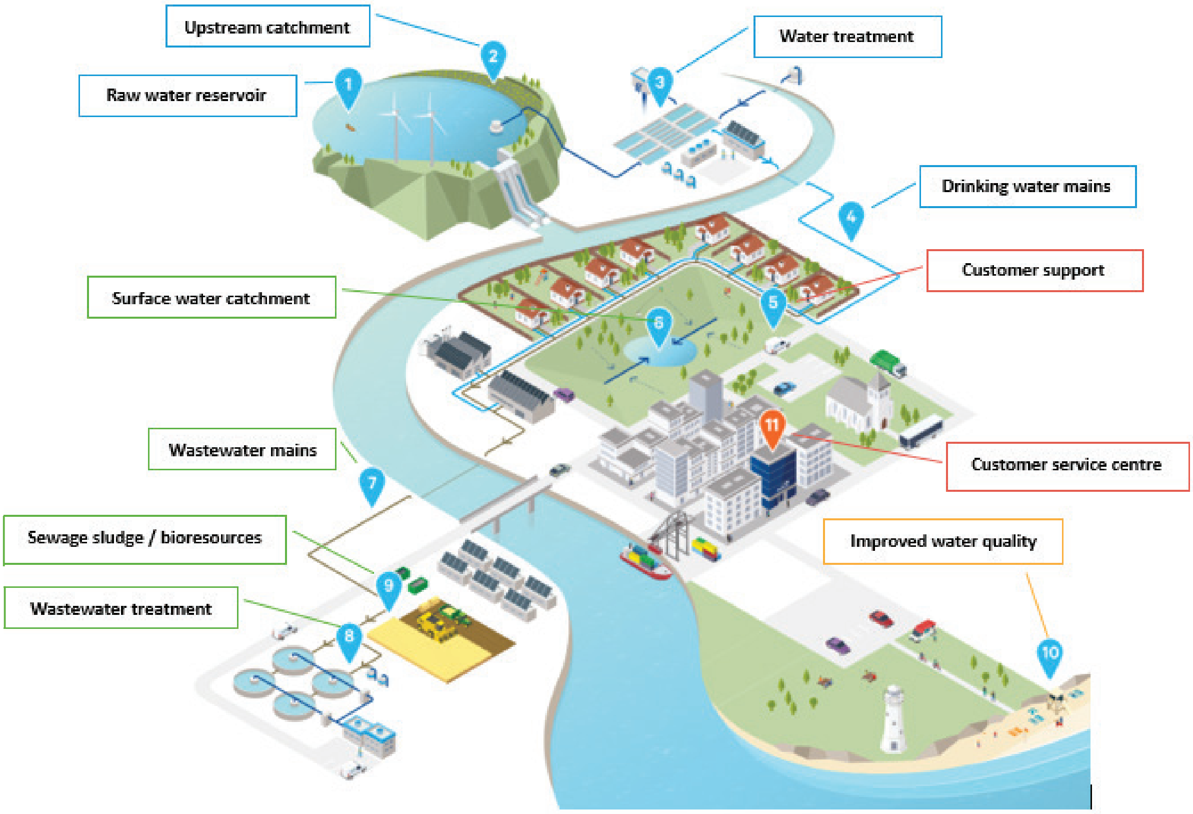
Figure 1: Pennon's[1] water assets: Understanding how water infrastructure works



Source: Pennon, Ausbil simplified.

Water companies offer elements of yield and growth. Yield comes through the allowable return regulators support given prevailing returns on debt and equity for infrastructure assets. As the utility's assets grow (as represented by the Regulated Capital Value or RCV), the yield for an allowable return naturally increases. Asset values grow through additional allowable capital investment a utility makes in improving and expanding their services and network to meet the water demands and environmental objectives of their region. In the UK, the regulation is in 'real' terms meaning equity investor returns enjoy inflation protection characteristics. The RCV is inflated by actual inflation annually.

For a given five-year regulatory reset period, revenue is capped at the allowable returns that are supported by OFWAT (Water Services Regulation Authority) at each review with the potential for the water companies to earn higher returns for superior operational and financial performance.

Growth comes from increased bills, the expansion of the billing base, and growth in the total asset value of the utility. This growth can be driven by a range of factors, like population growth, new home and business development, increased demand and usage, organic growth in the output and value of recycling and waste, and acquisition of complementary or differentiated utilities.

Because of the major capital invested in water utilities and the nature of their business, success is heavily dependent on standards of operational excellence and appropriate levels of gearing.

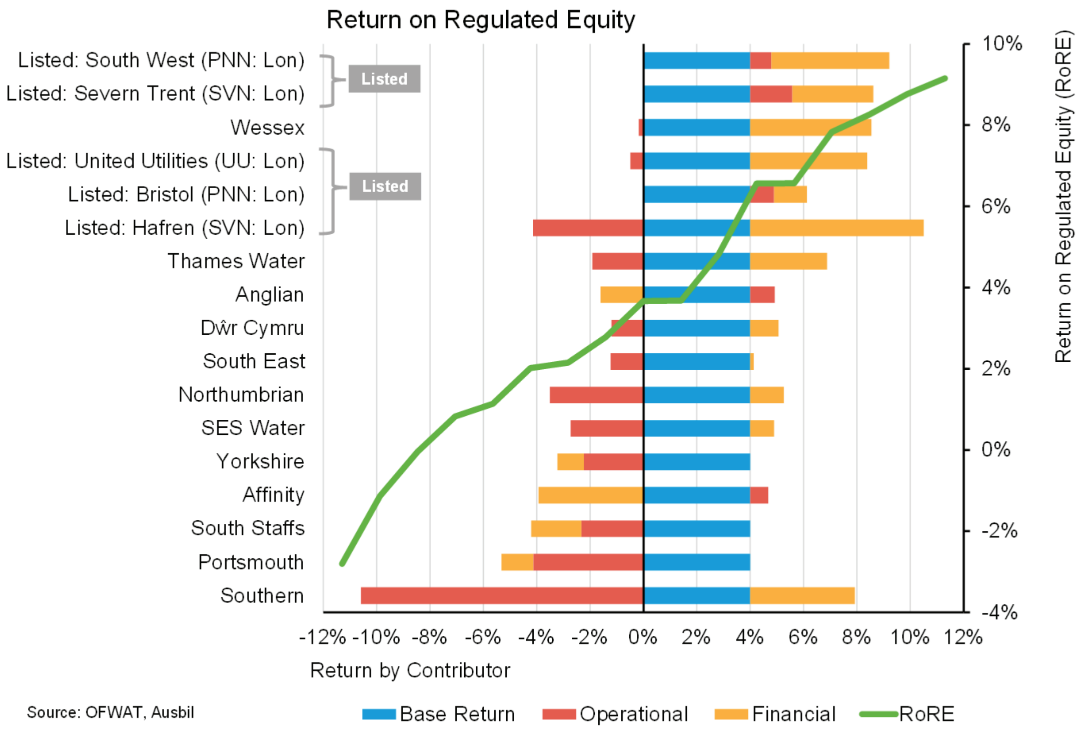
A quality water utility with sound management and appropriate gearing should offer stable asset values with a market yield, and a steady but conservative growth profile that offers lower relative correlation to broad market equity returns.

1. Source: Pennon. Note, Ausbil currently holds a position in the listed equity of Pennon, but we may not always hold a position. This diagram helps to illustrate the different ways water infrastructure generates returns.

Q: Do the listed utilities vary on financial metrics or are they very much the same?

A: It may seem that all water companies are the same, but in fact there are major differences across these utilities on many fronts, including their operational and financial performance. Chart 1 shows a list of water utilities in the United Kingdom ranked by total Return on Regulated Equity (RoRE). The return component is broken down into contribution from the base return on assets allowed by the regulator, plus the return from financial operations (such as funding, tax and margins), and from operational performance (including management, operations, customer service and capex).

Chart 1: Returns for UK water utilities in the 2022 year



Source: OFWAT as at March 2023.

The first observation is that some utilities operate with negative contributions from financial or operational inefficiencies, or both. For example, Thames Water added to their base returns with positive financial returns in 2022, but depleted this with a negative contribution from operational underperformance, dragging down their overall return (RoRE) for the year. Yorkshire, South Staffs and Portsmouth have depleted the base allowable returns by underperforming in both financial and operational activities.

The second observation is that of the top 6 performers, 5 are owned by listed water utilities and just one, Wessex, is unlisted. We believe the transparency of public markets has helped drive and improve efficiency and a focus on appropriate leverage, dividends and financial resilience compared to unlisted peers. As a note, of the three listed water utilities, Ausbil currently holds exposure to Pennon (PNN) and Severn Trent (SVN).

In this environment, there is clearly a reward for taking an active approach to selecting and rejecting assets in this space given the wide dispersion of performance, and the diverse potential range of attributable valuations.

Q: What risks do water utilities face?

A: While a privileged position as a sole provider of water infrastructure is attractive to investors, it also means such assets are heavily regulated. Moreover, the density and cost of capital required to make water assets work means that cashflow is particularly sensitive. In this context, as with most regulated assets, changes in policy and approach can be risky, however, given the critical nature of water supply, regulators are likely to work more constructively with companies to reduce overall operational risks.

Water assets come with key operational risks in terms of the environment, integrity in delivery and processing. Possibly the biggest risk in water infrastructure is management quality and the decisions made around gearing, term funding and credit rating and costs, the operational management of staff, expansion and capex. Here, management quality, track record and process can help demarcate good from bad assets. This is especially true for some of the issue we have seen coming from Thames Water, which is unlisted.

More recently, we have seen a heightened focus on pipeline leakage performance, and how they impact the environment, in particularly as it relates to pollution incidents and storm and sewerage overflows into UK rivers and beaches. This is in the context of a severe drought in parts of the UK, population growth, and rising community expectations regarding environmental performance. As a result, record capital investment is occurring and performance is improving for the sector, and it is expected to increase substantially over the coming years to address these challenges more effectively, and to implement specific initiatives laid out in Government policy documentation. This will be a key part of OFWAT's deliberations for the next regulatory reset (PR24) and will also raise important affordability issues that will need to be confronted by all infrastructure assets.

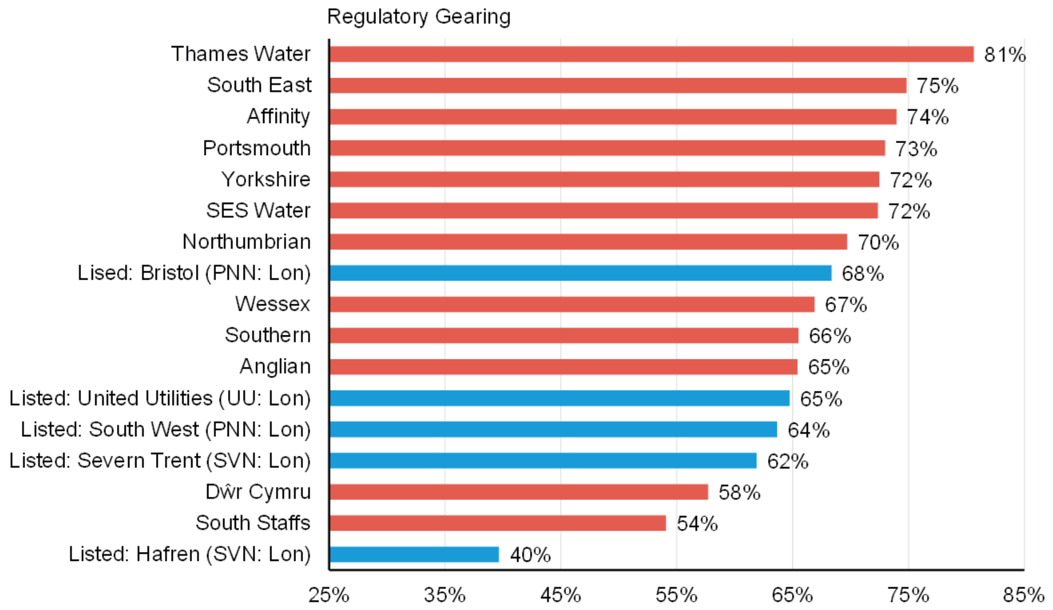
Q: What is currently happening in the UK water infrastructure sector with Thames Water?

A: Recent news that Thames Water, the largest water company in the UK, may need to seek help from the government took the market by surprise. On 27 June 2023, Thames Water announced the sudden departure of CEO Sarah Bentley amid growing speculation that Thames Water was in financial difficulty and could potentially require Government support or be placed into a special administration regime, essentially partly nationalised. This triggered a strong and indiscriminate sell-off in the listed UK water companies.

Subsequently in July 2023, Thames Water secured a £750m of equity funding from shareholders for the current regulatory period to 2025, subject to certain conditions including a more focused turnaround business plan. The £750m of equity funding commitment was in addition to a June 2022 commitment of £500m.Thames Water also announced that significant further funding would be required in the next regulatory period (2025-2030) to further improve operational performance and financial resilience.

We note that if Thames Water was a listed company, it would have been excluded from our investible universe. This is because it would fail at the outset on our stringent gearing and balance sheet analysis, noting that it is geared significantly above the level assumed by OFWAT of 60% net debt/RCV. Gearing at Thames Water sits at around 80% of net debt/RCV, well over the 60% level that the regulator OFWAT assumes. It would also fail on our fundamental analysis of its operational and financial performance. It is important to note that this gearing metric excludes any holding company debt that sits above the Thames Water asset company level, and where equity investors are reflected in the ownership structure, further increasing overall leverage.

Chart 2: Gearing varies significantly across the water sector

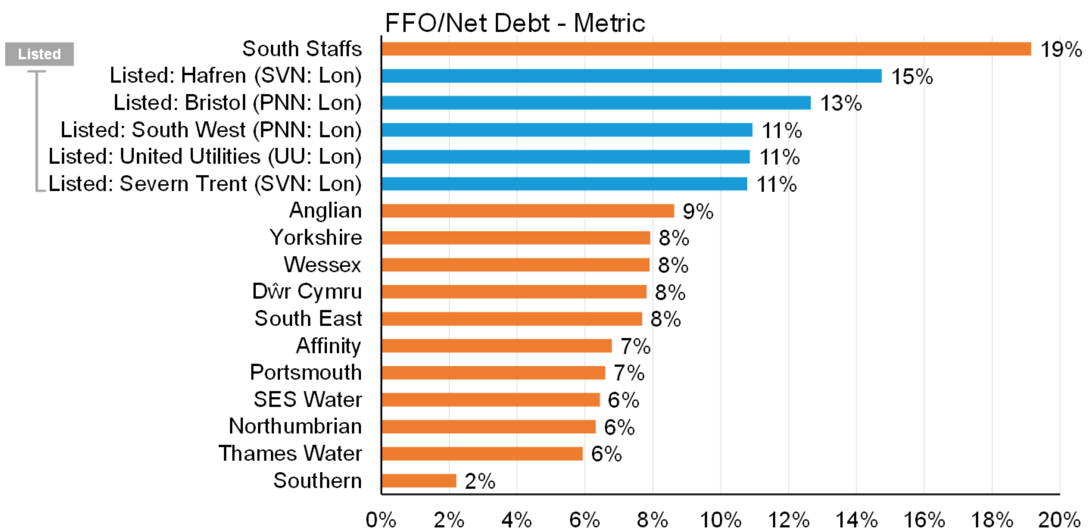


Source: OFWAT, Ausbil. Listed utilities shown in blue as at March 2023.

On debt overall, listed infrastructure companies generally have much lower gearing than private equity infrastructure assets, as illustrated in Chart 2. The gearing of companies in Ausbil's Global Essential Infrastructure portfolio is around 35% versus the over 80% for Thames Water, and an average of around 60-80% for privately held core infrastructure assets, in our experience.

Perhaps an even poorer statistic is that for debt serviceability or FFO / Net Debt. FFO stands for 'funds from operations' which is an income proxy for assets like infrastructure assets. Effectively, the higher FFO to net debt, the more an asset can fund its debt obligations. Chart 3 illustrates the difference in debt serviceability across the water infrastructure sector, and again, listed infrastructure accounts for five of the top 6 positions for FFO/Net Debt shown here for the 2022 year.

Chart 3: The UK water sector displays a vast disparity in debt capacity



Source: Ofwat, Ausbil, for 2022 year based on annual financial returns for each company at end March each year.

Interestingly, the challenges at Thames Water are not new, and have been well understood and publicly documented over the years. For example, in the most recent OFWAT Price Review PR19, the challenges facing Thames Water both operationally and financially were publicly disclosed. PR19 outlined detailed plans for Thames to achieve improved operational and financial performance over the period 2020-2025, including lowering gearing. However, what amplified Thames' challenges in more recent times is the very different macro environment than that of 2020, and their poor choice of funding structure. Very high inflation in the UK, and major rises in energy and chemical costs, has put pressure on the short-term profitability and cash flow generation for the UK water companies. High inflation coupled with the much higher leverage of Thames, and a much higher share of inflation-linked debt, poor operational performance and growing capital requirements, has created a 'perfect storm' for Thames compared to its listed peers, and the sector in general.

Despite the situation at Thames Water, UK Water Utilities generally have excellent inflation protection investment characteristics. The RCV is inflated by outturn inflation annually, and is the main determinant of tariffs and revenues, together with the assumed weighted average cost of capital. Water utilities are regulated on a 'real' basis, meaning the inflation impacts on operating and capital costs are reflected. As a result, inflation-linked debt has been, and will remain, an efficient approach to financing these assets. Indeed, OFWAT itself assumes a level of inflation-linked debt in its notional regulated company model. While all these properties exist for Thames Water, its circumstances are very different to the other listed water utilities.

Overall, the listed UK water utilities are in a much stronger financial position to navigate the challenges that are being most acutely felt by Thames Water. Generally speaking, the listed companies are leveraged at levels comparable to that assumed by OFWAT, and with solid investment grade credit ratings. Additionally, most have considerably less inflation-linked debt compared to Thames Water.

Q: Has the issues at Thames Water affected other water utilities?

A: UK equity markets have materially de-rated the three listed, regulated water utility companies in recent times – Pennon, Severn Trent and United Utilities. In the last 3-months, these companies share prices have fallen between 15-25%, even though the issues facing the sector are much more acute for Thames Water and other unlisted water utilities.

The dominant reason for the poor share price performance of the UK water utilities has been negative financial developments at Thames Water, and to a lesser degree, Southern Water, rather than any deterioration in their fundamentals. The listed companies remain in strong financial shape. But there have been other factors at play including regulatory uncertainty relating to OFWATs next reset, PR24 (2025-2029), concerns regarding the environmental performance of the sector, and sharply rising interest rates and inflation in the UK.

In the UK, only 5 of the 17 water utilities are currently owned within the 3 listed companies, with the remaining being owned by unlisted funds, pension funds, sovereign wealth and superannuation funds. Macquarie Bank, for example, was the owner of Thames Water from 2006 to 2017, and in August 2021, announced it had acquired a 2/3rd stake in Southern Water. Australian-based superannuation funds – REST, Spirit Super and Prime Super – count themselves as minority shareholders of Southern Water.

Q. Given the issues faced by Thames Water, what is your outlook for water utilities, and listed utilities specifically?

A: There is clear case for the superior performance of listed water utilities over unlisted peers, as evidenced in the performance and gearing data. The issues at Thames Water have been 'bubbling' away for 10-years or more, and this has been known for anyone who takes the time to follow the reporting issued by OFWAT.

Overall, if you look at the consistent quality performers, on operations, finance and in terms of prudent management, there are high-quality water assets in both the listed and unlisted markets. The listed markets clearly benefit from the additional transparency and scrutiny that comes with listing, and this likely helps keep these utilities focused on prudent management.

We believe that the sector has a bright future, and the two companies we currently hold, Severn Trent and Pennon, show strong defensive characteristics that benefit our portfolio. These characteristics include strong inflation protection, attractive dividend yields, lower correlations to listed markets bringing in diversification benefits, and strong financial performance when compared to any regulated utility, including water.

We see the dividends of the three listed UK water utilities as sustainable. This is due to a combination of factors including balance sheet health, payout ratios and superior relative cash flow generation. In terms of raising equity, we do not see much potential for this during the current regulatory period, however, for the next reset (P24 in 2024) there is some potential for new growth equity to be needed by the sector given the significant capital investments that may be incorporated in those plans. This will depend on a number of factors, including the base allowed returns from OFWAT and its composition, and some other parameters that affect cash flow generation such as the PAYG assumption and RCV run-off. However, new allowable capital investment is subsequently added to the RCV of each utility, and in turn, drives significant revenue growth under the regulatory system. This means that there is a significant potential opportunity in participating in an equity raise for utilities that pass our stringent criteria. Overall, we believe the future for water utilities is bright, especially in the listed space.

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