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A sea of trouble for Thames Water

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Water is typically regarded as a 'defensive' sector for investors – after all, none of us can survive without water for very long, but the recent travails of Kemble – the ultimate owner of by far the largest UK water utility Thames Water – have shown that the sector is not without its risks. In early April, Kemble defaulted on its £400m bonds and also said that would not be able to repay a £190m loan that was due to be repaid on 30 April.

For Thames Water investors this is a stressful time as the company's parent Kemble defaulted on its debt. Ratings agencies have also taken a dim view of the situation – for example, on 3 April 2024 Moody's downgraded Kemble's backed senior secured debt rating from B3 to Ca, reflecting the "heightened risk of a near-term payment default as well as potentially high loss for creditors as a consequence." In the media, there has been speculation of taxpayer funded bailouts for Thames Water and haircuts for its bondholders. In the meantime, Kemble and Kemble Water Finance ('KWF') have asked lenders to take no creditor action to allow discussions with stakeholders to continue and potentially enable a restructuring deal of some kind.

What is the outlook for bondholders?

For clarity, we don't own Thames or Kemble/KWF in any of our fixed income or credit portfolios. The outlook for their debtholders is bleak. Thames Water has very high operating leverage, which amounts to around 90% of the utility's regulatory capital value or RCV. Without a significant restructuring of the balance sheet, the scope to issue any additional debt is extremely limited. Moreover, the deeply subordinated nature of Kemble's creditors' claims against operating cash flow reduces the recovery prospects for lenders.

How to approach the water sector

The water sector in the UK has become a political football: consumers are extremely fed up with rising bills and the seemingly unending pollution of rivers and the sea by water companies through daily discharges of raw and untreated sewage, and there is a perception that the interests of the institutional owners of water companies (i.e. large and reliable dividend payments) are simply not aligned with those of the general public – who want clean, safe and reliable water supplies, and unpolluted rivers and seas while paying reasonable bills. Whatever your take on the current situation at Thames Water, it is clear that the current financing model is not sustainable – equity holders at least are likely to get wiped out in any restructuring at Thames Water and the prognosis for bondholders is poor too – Kemble has also cancelled its £150m revolving credit facility, which was sized to cover roughly 18 months of interest payments.

In the Sanlam International Inflation-Linked Bond Fund and the Sanlam Credit Fund, we have a position in Dwr Cmyru – Welsh Water. In our view, this is one of the lowest risk plays in the water sector in the UK:

- Firstly, gearing is low at just below 60%
- Secondly the ultimate parent is a not-for-dividend entity which not only insulates it from the kind of criticism that Thames Water has faced (i.e., shareholders' interests being prioritised over those of customers and the environment) but its structure also means it can focus on managing the utility's finances sensibly, and;
- Thirdly the Welsh government has taken a relatively cautious approach to water sector reform, unlike the more laissez-faire approach adopted in England. Crucially, Dwr Cymru also has plenty of cash at its disposal – as of 30 September 2023, it had total liquidity of £508m including cash balances of £308m and undrawn revolving credit facilities for £200m.

There are no easy solutions for Thames Water, and it is inevitable that water bills in general will have to rise if the current water system in the UK is to improve. However, Welsh Water shows that credit selection is key in choosing well-run utilities providing decent investment returns.

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