MOODY'S INVESTORS SERVICE

Credit Opinion: Veolia Environnement S.A.

Global Credit Research - 29 Dec 2011

Paris, France

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Issuer Rating	*A3
Sr Unsec Bank Credit Facility -Dom Curr	*A3
Senior Unsecured	*A3
Commercial Paper -Dom Curr	P-2
Veolia Water Central Limited	
Outlook	Rating(s) Under Review
Issuer Rating	*A3
Veolia Water Central Finance Plc	
Outlook	Rating(s) Under Review
Bkd Senior Unsecured -Dom Curr	*A3
Tyseley Finance PLC	
Outlook	No Outlook
Bkd Senior Secured -Dom Curr	Aa3

* Placed under review for possible downgrade on December 13, 2011

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Key Indicators

Veolia Environnement S.A.[1]

	12/31/2010	12/31/2009	12/31/2008	12/31/2007	12/31/2006
EBIT Margin	7.2%	6.8%	7.2%	8.6%	8.3%
EBIT/Interest Expense	2.0x	1.9x	2.0x	2.5x	2.5x
FFO Interest Coverage	4.1x	4.1x	4.0x	4.4x	4.8x
FFO/Net Debt	18.6%	18.5%	17.4%	19.5%	19.4%

RCF/Net Debt	**15.1%**	**16.4%**	**13.9%**	**16.6%**	**16.9%**
RCF/Capex+ Acquisitions (net of divestitures)	**92%**	**97%**	**80%**	**97%**	**115%**

[1] All ratios are calculated using Moody's Standard Adjustments.

Note: For definitions of Moody's most common ratio terms please see the accompanying *User's Guide*.

Opinion

Corporate Profile

Headquartered in Paris, France, Veolia Environment SA ("Veolia/the Group", rated A3 under review for downgrade, and Prime-2) is a leading provider of outsourced services for the urban environment, with a presence in more than 70 countries worldwide. Following finalisation in March 2011 of the combination of Veolia Transport with CDC-owned Transdev the Group's transportation assets are represented by its 50% stake in the combined entity (VTD), although Veolia recently announced its intent to sell this stake as part of a broader group re-organisation. Veolia's three other main businesses are grouped around intermediary holding companies, namely: Veolia Water (formerly Compagnie Générale des Eaux), the company's water and waste water division; Veolia Environmental Services, the waste division; and Veolia Energy, which provides energy services. The Group's underlying vision is to provide services for the urban environment to a common customer base, mainly public authorities (which account for roughly two thirds of turnover) and industrial and commercial customers (one third) which provides scope for revenue and cost synergies. The Water division is largest, and accounted for 39% of EUR 24 billion revenues generated during the nine-month period to September-2011.

Rating Rationale

Veolia's ratings reflect that its financial risk profile is underpinned by the cash flow generated by its diversified operating businesses, much of which is based on revenues derived from multi-year contracts to deliver essential services, mainly to relatively low risk counterparties in the public sector. Although its core activities continue to be in water and waste in France, the company's portfolio of thousands of contracts across four divisions is relatively diversified by sector, service and contract type, and geography. This has helped mitigate the Group's overall revenue and cash flow volatility during the recent periods of economic weakness, notwithstanding the waste business's relatively high exposure to the economic cycle.

However during 2011 the Group's performance has suffered from intensifying pricing pressure in the French Water business, as well as the challenges of controlling so diverse and widespread a group. A 6.3% decline in adjusted operating cash flow (at constant exchange rates, and excluding VTD) during the nine-month period to September-2011 also reflected the effects of slowing but still positive growth in waste, adverse weather conditions and costs associated with its planned reorganisation, and prompted the Group to issue a second profit warning for the year.

RECENT CREDIT DEVELOPMENTS

On 13 December Veolia's long term ratings were placed on review for possible downgrade following the presentation on 6 December of its strategic plan and updated outlook. The plan is designed to address the pressures being exerted on revenue growth and profitability in the mature economies in which it operates and provides for (i) the restructuring of the Group's divisions and portfolio of activities through a substantial EUR 5 billion divestment programme over 2012-13; (ii) a reduction in net financial debt from an estimated EUR 15 billion at end 2011, to under EUR 12 billion by end-2013; and (iii) a reduction in its cost base by streamlining and introducing greater standardization of management structures across the Group.

As Veolia puts its plan into effect, the Group should benefit progressively from a more focused asset portfolio, a reduced cost base and lower leverage. However, the review for downgrade was prompted by the wide-ranging scope of the transformation, which includes the planned disposal of its transportation division and regulated UK water assets and US Solid Waste. When combined with its targeted gradual increase in exposure to faster growing markets and the industrial sector, this will lead to a change in the Group's business risk profile in Moody's view. Moreover, although Veolia has a reasonable track record in recent years of realising targeted disposal proceeds, completing the planned divestments and cost cutting "Convergence" programme on a timely basis could be challenging in the current market.

In the meantime, negative pressure is likely to be exerted on Veolia's cash flows by the costs of restructuring, the weak market outlook and the commitment to a dividend pay-out of EUR 0.70 per share in 2012 and 2013, with the risk that its financial flexibility will fall short of Moody's current ratio guidance for the A3 rating. This assumes that metrics will strengthen steadily and sustainably within the 15% - 20% range for retained cash flow (RCF)/net debt and towards 20% for funds from operations (FFO)/net debt.

Rating Drivers

ASSESSMENT OF BUSINESS RISK FACTORS

Both water and waste industries benefit from positive long-term underlying structural trends. Population growth, the ongoing trend to urbanisation and industrialisation, and an expectation of rising living standards combine to exert demand pressure on water distribution and waste management infrastructure in most countries. Together with public and regulatory concern at the impact of climate change on scarce resources this is combining (i) to increase demand for existing technologies for the provision of water, waste water and waste management services; and (ii) to extend demand into new service areas and technologies. However, these positive underlying dynamics for which Veolia has leading-edge expertise are offset by changing consumption patterns. In the water segment, greater awareness of water as a scarce resource and water saving programmes have for some time been impacting volumes of water consumption. In France, for example, a steady although modest decline in unit consumption has been the norm in recent years. In Moody's view the steady, structural contraction in like-for-like water volumes, especially in France which accounted for 39% of the water division's nine-month period to September 30 2011 revenues will continue to exert negative pressure on turnover growth with potential impact on margins. This can be to an extent offset by indexation increases, new service and efficiencies - but customers are increasingly looking to maximize their share of savings.

The A3 rating factors in the relatively low exposure to the economic cycle of the Group's water, energy services and transportation businesses. Although demand for water continues to experience a slow ongoing structural decline in advanced economies, variations in water consumption tend mainly to be driven by the weather. And while certain of its transport activities are exposed to a slowdown in economic conditions, the bulk of its contracts includes protection in the event of lower passenger volumes. By contrast, the greater susceptibility of the Waste business (31% of the Group's EUR 24 billion turnover during the first nine months of 2011) to changes in economic activity reflects both the higher proportion of industrials within its customer base compared to the Group's other divisions, contract terms more often linked to volumes collected or processed, and the exposure of the sorting and recycling business (roughly 14% of divisional revenues in 2010, 17% as at June 30, 2011) to paper and scrap metals price movements. Having declined by 8% in 2009, an unusually severe year, Waste revenues rebounded by just under 7% (at constant scope and FX) in 2010 thanks in large part (+5%) to higher volumes and prices of recycled materials, and also to the turn-around of previously underperforming business (especially Germany) through renegotiation of tariffs. 9M2011 like-for-like waste revenues rose by 6.1% (on a current exchange rates basis), driven by a combination of higher solid and hazardous waste volumes and price increases, and rise in the prices and volumes of recycled materials. With some exceptions contracts by and large include broad based cost indexation, which helps offset capital oriented contracts with shorter term operating contracts, and broadly maintain the average contract term.

Nevertheless, as contracts mature the Group's revenue base is a risk - whether with respect to pressure on tariffs or non-renewal - both from industrial competitors and the local authorities themselves, even if Veolia is able to an extent to offset contract losses with wins elsewhere. Moreover, in Moody's view, such competition is likely to be more intense during periods of weaker economic growth, such as the present, although the savings opportunities and the incremental tax capacity (where billing is direct to the consumer) can underpin the appeal of outsourcing. For example the city of Paris did not renew the delegated management contracts expiring at end-2009, which in 2009 generated turnover of EUR 143 million (roughly 1% of Veolia Eau's annual revenue). More positively Moody's notes the Group was able in 2010 to renew the SEDIF (Syndicat des eaux d'ile de France) public water supply service contract, which covers 144 municipalities in the Ile de France and 4 million consumers. This should generate EUR 3 billion in revenues over its 12 year term, although at a significantly reduced margin reflecting the competitive process and strategic nature of the concession.

Veolia highlighted the intensification of pricing pressures experienced during the first three quarters of 2011 in the French Water segment, implying that margins achieved at renewal have been both lower than expected and lower than its portfolio average: the company expects contractual erosion and water volumes to have a cumulated negative impact of EUR 70 million on adjusted operating income in 2011. In Moody's view there is a risk that such pressures begin also to be felt across the Group's other activities even if its next significant water contract renewal in France is the Marseille contract in 2013 which generated EUR 112 million of revenue in 2010.

More generally management has highlighted that the Group's transformation as the Strategic Plan is carried out will also be characterised by certain broad trends which in Moody's view will imply a gradual deterioration in its business risk profile over time including: a greater emphasis on faster growing and away from more mature economies; a shift towards higher-added value activities where it already has a competitive advantage, such as hazardous waste; an increasing proportion of industrials within its customer base as it follows its major customers across the world; and a gradual move from relatively stable cost-plus-margin contracts to ones more closely linked to volumes and performance against targets.

At the same time Moody's notes that the transformation will take place over time. These risks should therefore be mitigated by (i) the fact that the Group's business will remain predominantly based in mature countries for the foreseeable future; (ii) that it will continue to generate a significant portion of its revenues from municipal and creditworthy industrial counterparties through multi-year contracts; and (iii) the extent to which it is able to limit its exposure to volume or price risk through revenues based on capacity and services with indexation mechanisms.

The use and development of partnerships as a way to achieve scale and share development risk forms an integral part of the Group's strategy. In that regard, in March 2011, Veolia and CDC finalised an agreement to merge their respective transport businesses, Veolia Transport and Transdev, although the Group now plans to divest this as part of the EUR 5 billion disposal programme. More recently Veolia announced plans to reinforce its partnership with EDF in the Energy Division, such that EDF's share could rise to 50% from one third. Currently conceived as an asset swap, such a transaction would allow Veolia to widen the scale of its Energy Services operations, share financing needs with a strong partner, and simplify the ownership structure while maintaining operational control of the business.

ASSESSMENT OF FINANCIAL RISK FACTORS

The A3 rating reflects that Veolia's financial risk profile is underpinned by the cash flow generated by its operating businesses, much of which is based on revenues derived from multi-year contracts to deliver essential services, mainly to relatively low risk counterparties in the public sector. Although France accounts for 39% of turnover, the company's portfolio of thousands of contracts across its four businesses is diversified by sector, service and contract type, and geography. This helps mitigate the Group's overall cash flow volatility even if over the last two years the waste business's relatively high exposure to the economic cycle has been apparent, both during the downturn and subsequent recovery.

The resilience of Veolia's diversified revenue base was reflected in 2010 turnover growth of 2.5% to EUR 34.8 billion in 2010 (on a current exchange rates basis, +1.3% like-for-like), notwithstanding the negative effects of substantial contract completions in Veolia Water technologies & Networks and contract losses in Transportation. Revenue declines in Water and Transportation were more than offset by recovery in Waste, on the back mainly of a stronger recycling business, and Energy Services, which benefited from the cold winter. Positive revenue development continued in first nine months 2011, which included like-for-like aggregate turnover growth of 3.7% to EUR 24 billion, reflecting growth across Water, Waste and Energy Services.

Adjusted operating cash flow declined by 6.3% (excluding Transdev) to EUR 2.3 billion in the same period. Much of the decline was attributable to the negative impact of operational problems in southern Europe, North Africa and the US (total expected impact of EUR 240 million for 2011 on adjusted operating income) - which management has said are localized and therefore not symptomatic of potential problems elsewhere in the portfolio. However, further pressure on water margins, adverse weather effects and additional restructuring costs are reflected in management's full year guidance of a ca 12% decline in adjusted operating income in 2011 vs 2010, in line with the decline reported during the first three quarters of the year.

At end-September 2011, net financial debt of EUR 15 billion, down from EUR 15.2 billion at end-2010, reflected free cash flow generation of EUR 58 million (versus a negative EUR 220 million for the period ending September 30, 2010) and positive FX effects of EUR 97 million. Positive free cash flow generation benefited from the deconsolidation of EUR 540 million of debt because of the proportional consolidation of the merged Veolia Transportation/Transdev, and lower dividend outflows - which helped offset lower cash from operations and higher than usual working capital outflows.

Liquidity

With some EUR 5.5 billion in cash and cash equivalents at end-September 2011 and limited medium-term debt maturities (including bond repayments of less than EUR 700 million in 2012) Veolia's liquidity profile is sound. The syndicated facility was reduced to EUR 3 billion in Q1 2011, spread across two facilities maturing between 2014 and 2016, of which EUR 311 million was drawn in September. The Group also has access to undrawn bilateral facilities of EUR 1 billion, of which EUR 300 million matures in March 2012. These facilities contain no triggers, covenants, MAC or general restrictions. Veolia also has a EUR 4 billion treasury note program, of which EUR 198million was outstanding as at September 2011. The group accesses the CP market on a daily basis and aims to cover a high proportion of its short term debt, including CP outstanding at any given time, by its undrawn committed bank lines and cash.

Rating Outlook

The A3 rating is on review for possible downgrade. The rating review will consider the impact of the recently announced strategic plan on the business risk profile of the group. The review will evaluate the extent to which any increase in business risk should be compensated by strengthened financial flexibility, and any appropriate re-calibration of metric guidance to reflect that. It will also include an evaluation of the quantum and timing of asset disposals and cost reductions planned and the expected path to deleveraging outlined by the Group.

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