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Research Update:

Environmental Services Group Veolia Outlook To Stable On Stronger Credit Metrics And Profit; 'BBB/A-2' Ratings Affirmed

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Overview

- We forecast that Veolia Environnement's earnings will continue to strengthen, supported by cost-cutting and organic growth.
- In our view, the turnaround in profitability and credit metrics is sustainable, and risks to our base case have subsided.
- We are therefore revising our outlook on Veolia to stable from negative and affirming our 'BBB/A-2' ratings.
- The stable outlook reflects our anticipation that the group will consolidate its profitability and credit metrics in the coming years while self-financing its capital expenditures and dividends.

Rating Action

On May 6, 2015, Standard & Poor's Ratings Services revised its outlook to stable from negative on French environmental services group Veolia Environnement S.A. At the same time, we affirmed the 'BBB' long-term and 'A-2' short-term corporate credit ratings.

Rationale

The outlook revision reflects our view that the turnaround in Veolia's profitability and credit metrics is sustainable. In 2014, Veolia posted stronger earnings and credit metrics than we anticipated in our previous base-case scenario. In a still very challenging and uncertain business environment, Veolia's Standard & Poor's-adjusted funds from operations (FFO) increased by more than 10% (pro forma for the consolidation of Dalkia International and deconsolidation of Dalkia France). Despite significant adverse currency effects, adjusted debt remained flat and credit metrics improved. In particular, the adjusted FFO-to-debt ratio strengthened to about 18.4% from 16.5% in 2013, a level consistent with our 'BBB' rating.

We believe this improvement is chiefly due to the successful execution of the company's major 2012-2015 transformation plan (and marginally from milder macroeconomic conditions). We see very remote risks to our updated base-case scenario, which largely reflects management's indications for the medium term; Veolia will formally announce its guidance at a forthcoming investor day.

In our view, the improvement over the past year is structural and sustainable,

due to:

- Veolia's recent and numerous commercial successes, notably in strategic growth markets (oil and gas, circular economy, hazardous pollution, dismantling, and innovative solutions for cities) that accounted for about €700 million of new revenues in 2014. This gives credit to the company's growth strategy and pipelines and supports its forecast of 3% organic annual revenue growth;
- Veolia's execution of its ambitious cost-cutting plan, ahead of schedule and on target. The cost savings totalled €582 million at year-end 2014, of which €232 million was realized in 2014, making management highly confident to reach its €750 million target in 2015. Veolia has so far focused mainly on cutting overheads. We believe management has significant room for further efficiencies and savings now that the group is leaner and more centralized, and Dalkia International has been fully integrated. This gives credence to the company's target of 5% in organic EBITDA growth per year, which we understand includes retained savings of about €75 million annually;
- More vigorous growth in Europe, where Veolia generates about half its revenues, compared with our previous base case. This could also boost the recovery at Veolia's more cyclical operations, including industrial waste or recycled material, given our growth forecasts (see "Cheap Oil And An Expansive QE Program Underpin The Eurozone Recovery," published April 2, 2015, on RatingsDirect). We understand that Veolia's management does not assume a turnaround in economic activity in Europe; and
- Our visibility on Veolia's financial trajectory, despite uncertainty regarding the timing and outcome of Veolia's plan to dispose of its stake in Transdev, which owns 66% of ferry company SNCM. In our updated base-case scenario, we have not assumed any proceeds from the sale of the stake in Transdev, which had a book value of €382 million at year-end 2014, or from the repayment of €465 million in shareholder loans. Should the exit from Transdev succeed, we believe management would likely use the proceeds to repay the €1.47 billion hybrid issue callable in 2018. We continue to regard the hybrid notes as having intermediate equity content because we consider that their call is contingent on the disposal of the Transdev stake, and the overall impact on Veolia's adjusted debt and credit metrics would therefore be almost neutral.

Veolia's "strong" business risk profile, in our opinion, continues to be underpinned by the group's leading worldwide positions in water and waste, recurring revenues from long-term municipal contracts that pose minimal volume and performance risk, and wide diversification in terms of customers, contracts, and geography. The strong structural growth drivers for environmental services globally provide additional support. Offsetting factors are local authorities' strong bargaining powers, which have structurally impaired Veolia's historically high margins in core markets, such as water in France; the waste business' exposure to economic cycles, fuel, and raw material price volatility; and the energy business' exposure to weather conditions and energy prices. Together, these constraints create some

volatility in the group's earnings. In addition, we believe Veolia's strategic shift toward emerging markets and industrial clients somewhat dilutes its business risk profile.

We continue to assess Veolia's financial risk profile as "significant," based on the group's structurally negative cash flows before disposals, which have led to subpar credit metrics in recent years. Furthermore, disposals have hardly curbed debt accumulation stemming from sizable capital expenditures and dividends. Management's financial discipline and the group's prudent and proactive liability management temper the weaknesses of Veolia's financial risk profile, in our view. We benchmark Veolia's financial risk profile against the medial volatility table in our criteria, because we believe Veolia's core activities have medial volatility characteristics: More than 50% of the group's activities are regulated utility or environmental services.

The long-term rating continues to reflect our view of Veolia's stand-alone credit profile following the neutral impact of modifiers: Our positive diversification assessment is offset by our negative view of Veolia under our comparable rating analysis, due to its structurally lower profitability than peers'.

In our base case for Veolia, we assume:

- Low single-digit adjusted EBITDA growth in 2015, strengthening to about 5% annually from 2016, consistent with the company's target, supported by continuous cost-cutting efforts and organic growth.
- A dividend of €0.70 per share, paid in cash.
- Capital expenditures and acquisitions, net of disposals of about €1.6 billion annually.
- Maintenance of €1.47 billion in hybrid bonds with intermediate equity content and no exit from Transdev.
- The pro forma consolidation of Dalkia International, pro forma deconsolidation of Dalkia France for 2014, and reconsolidation of a 30% stake in a Chinese water concession over 2014-2016.

Based on these assumptions, we forecast that Veolia will generate neutral or positive discretionary cash flow, and its adjusted debt levels will remain fairly stable, excluding foreign currency effects. In addition, we forecast that its adjusted FFO-to-debt ratio will exceed 18% over 2015-2017 and potentially 20% by the end of this period.

Liquidity

We assess Veolia's liquidity as "strong" under our criteria. According to our projections, Veolia's sources of funds will exceed uses by more than 1.5x over the next 12 months and by more than 1.0x in the subsequent 12 months. In addition, we believe that the group's good access to capital markets, proactive liability management, positive discretionary cash flows, and solid relationships with banks support its liquidity position.

We calculate the following principal liquidity sources:

- About €2.7 billion in available cash or highly liquid money market funds at the end of March 2015.
- Nearly €3.3 billion of available committed credit lines maturing beyond 12 months, including a €2.3 billion multi-currency syndicated loan maturing in 2018.
- Our forecast of cash flow from operations, including repayment of operating financial assets, of about €1.9 billion.
- Proceeds from asset sales of about €300 million, excluding the recently divested Israeli operations.

We calculate the following principal liquidity uses:

- Short-term debt of about €3 billion, including €1.3 of outstanding commercial paper.
- Our estimate of €1.6 billion in nondiscretionary capital expenditures.
- About €250 million on acquisitions.
- Dividends of about €520 million.

Outlook

The stable outlook reflects our anticipation that the group will consolidate its profitability levels and credit metrics in the coming years, while self-financing its capital expenditures and dividends. Moreover, we anticipate that Veolia will post credit metrics commensurate with our 'BBB' rating on a sustainable basis, such as an adjusted FFO-to-debt ratio comfortably above 18% over 2015-2017.

Downside scenario

The rating could come under pressure if Veolia's profitability deteriorated, credit metrics fell short of our current projections, or financial discipline loosened, including regarding debt stabilization.

A negative rating action could result from unexpected and far-reaching adverse changes in Veolia's market and regulatory environment, expansion into more volatile markets beyond currently announced plans, midsize acquisitions, or higher shareholder returns.

Upside scenario

We may consider raising the ratings should Veolia's medium-term strategic update, expected by the end of 2015, reaffirm its financial discipline, and Veolia's financial risk profile improves materially beyond our assumptions. We view positive discretionary cash flows and an adjusted FFO-to-debt ratio comfortably and sustainably above 20% and close to 23% as consistent with our "intermediate" financial risk profile.

However, we see rating upside as remote because stronger credit metrics may only compensate for the gradual rebalancing of Veolia's activities toward

emerging countries and industrial clients that dilute its business risk profile.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/A-2

Business risk: Strong

- Country risk: Very low
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Moderate (+1 notch)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Related Criteria And Research

Related Criteria

- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Key Credit Factors For The Environmental Services Industry, Feb. 12, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Related research

- Cheap Oil And An Expansive QE Program Underpin The Eurozone Recovery, April 2, 2015

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Veolia Environnement S.A.		
Corporate Credit Rating	BBB/Stable/A-2	BBB/Negative/A-2
Senior Unsecured	BBB	BBB
Senior Unsecured	cnA-	cnA-
Junior Subordinated	BB+	BB+
Commercial Paper	A-2	A-2

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