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Research Update:

French Utility Company Veolia Affirmed At 'BBB/A-2' On Proposed Takeover Of Suez; Outlook Stable

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Rating Action Overview

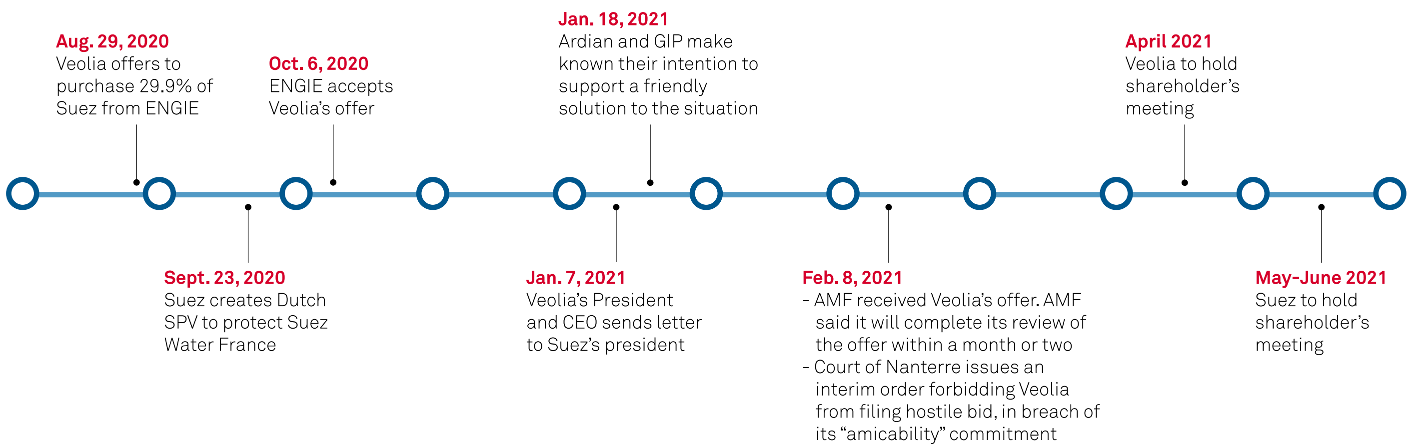
- On Feb. 7, 2021, Veolia Environnement S.A. submitted a proposal to France's stock market regulator AMF outlining its offer to acquire the remaining 70.1% stake in Suez for €20 billion, which corresponds to €12.1 billion for Suez's net debt and €7.9 billion for Suez's equity.
- We understand Suez's management remains opposed to Veolia's takeover of the company, and we anticipate operational and other hurdles for Veolia if the transaction proceeds; we therefore now regard Veolia's management and governance as fair rather than satisfactory.
- If the takeover succeeds, we believe Suez's assets would add significant scale and business diversification to Veolia's operations, almost doubling EBITDA compared with the €3.6 billion we expect will be reported for 2020. If the offer is not successful, we would reassess our base case scenario.
- If the offer succeeds, we understand Veolia plans to undertake several remedy measures, including disposals and bond issuance, should the takeover of Suez go ahead, and we expect it can restore its credit metrics before the end of 2023.
- We are affirming our 'BBB/A-2' long- and short-term ratings on Veolia.
- Our stable outlook takes into account Veolia's strong commitment to quickly improve its credit metrics after the proposed transaction that we expect could occur in 2022, as well as Veolia's strong stand-alone operating performance, with our adjusted FFO to debt metric anticipated to be well below the 20% threshold for the current rating, according to our criteria.

Rating Action Rationale

Veolia's proposal to take over Suez S.A. is subject to a number of operational and legal uncertainties that will likely lead to a lengthy and uncertain acquisition process. Veolia launched its offer to acquire the remaining 70.1% stake in Suez on Feb. 7. The bid price of €20 billion (€18 per share with dividends) includes €12.1 billion related to Suez's net debt and €7.9 billion for Suez's equity, according to our estimates. Veolia already owns a 29.9% stake in Suez, which it purchased in October 2020 from Engie SA (see "French Utility Veolia To Offset €3.4 Billion

Stake Purchase In Suez With Remedy Measures," published Oct. 6, 2020). Veolia's takeover offer is considered hostile and faces fierce opposition from Suez's board and management team. This has led to ongoing legal disputes and operational challenges, including the temporary suspension of Veolia's voting rights by a French court (later reversed by another court decision), and the transfer of Suez's French water activities to a Netherlands-based foundation. The latter could complicate the disposal of such assets in the future, a key part of Veolia's takeover plan to comply with anti-trust constraints. Although we do not believe these actions currently inhibit Veolia from moving ahead with the deal, we see increased risks of delays at least until Suez's next annual general meeting (expected for May or June 2021), which could provide more clarity on the stakeholders' intentions. That said, we do not expect the offer to become effective before the end of 2021, with payment expected in 2022, notably because the takeover is subject to European antitrust approval, which we understand could take nine to 15 months. Given these hurdles, we have revised our assessment of Veolia's management and governance to fair from satisfactory. This is despite Veolia's management's track record in improving profitability and restoring its balance sheet, particularly under challenging operating conditions, such as during its 2012-2019 transformation. We note that on Feb. 8, 2021, the Court of Nanterre issued an interim order forbidding Veolia from filing a hostile bid, in breach of its "amicability" commitment. Further court decisions are expected on this matter.

Veolia Environnement Transaction Timeline

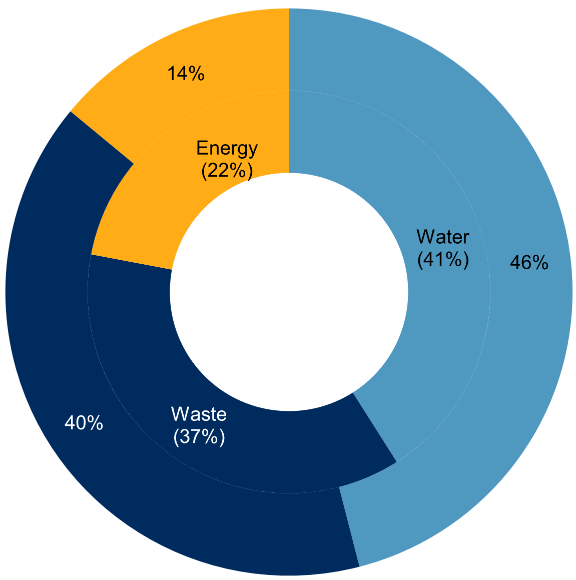


AMF--Autorité des marchés financiers. GIP--Global Infrastructure Partners. Source: S&P Global Ratings.

Suez's integration would strengthen Veolia's business profile, thanks to stronger market positions and increased diversification. If the takeover is completed, assuming Suez is integrated in 2023, we anticipate strengthening of the enlarged group's business risk profile within our strong category, in line with our criteria. This is because we see Suez's activities as slightly less volatile than Veolia's, owing to its geographic and business mix, including a higher proportion of regulated water activities. We also believe the combined group will benefit from a stronger market position and greater diversification. We recognize Veolia's management's capacity to integrate new businesses, and deliver on synergies and planned disposals, including the French water activities. However, we expect such a sale would not materially change the combined group's business profile. In particular, after the acquisition, the group would benefit from long-term contracted water distribution operations in highly rated countries such as France, Spain, and the U.S. Water services would represent about 46% of Veolia's revenue compared with 41% previously, and the share of waste will increase to 40% from 37%. The contribution from energy solutions would decrease to 14% from 22%. In terms of geography, the enlarged Veolia group would have an increased presence in low-risk regions, including North America, Europe, and Asia and less exposure to country risk in regions like Central and Eastern Europe that weighs slightly on the group's business profile. Should the takeover of Suez proceed as planned by Veolia, we might revise downward our credit metric thresholds for the current rating to reflect greater scale and business diversification. However, this is unlikely to happen before 2023 and depends on Veolia restoring its balance sheet after the transaction, full clarity on the final selling price of Suez and assets Veolia will dispose of as part of its remedy measures. If the offer is not successful, we would reassess our base-case scenario.

Chart 2

Veolia Environnement S.A.--Revenue Split
2019 stand-alone (inner circle) and Veolia plus Suez after disposals (outer circle)



Source: S&P Global Ratings.

We understand Veolia will undertake significant measures in 2022-2023 to restore its balance sheet. In our view, Veolia's management team has demonstrated in recent years its ability to streamline and optimize the group, including through cost cutting and realizing synergies to improve profitability. We expect that it can replicate similar actions for the combined group, notably on IT, purchasing, and additional operating efficiency measures to achieve synergies of about €500 million annually in four years. The current hostility between Veolia's management and that of Suez can complicate Veolia's proposed action plan. We expect Veolia to enact remedies--which could include hybrid bond issuance, asset disposals, and capital increase--within 24 months after the takeover offer becomes effective, which we don't anticipate before the end of 2021 (we expect all the remedies will be completed before end of 2023). Should Veolia increase its offer for Suez beyond the current €18 per share including dividends, we would reassess our base-case scenario.

Veolia's stand-alone operational performance will be a key rating driver, since we anticipate a strong improvement for 2021. Last year, Veolia suffered challenging operating conditions, notably in the waste and energy businesses, which we expect will translate into reported EBITDA decreasing to about €3.6 billion for 2020, from about €4.0 billion reported in 2019. We estimate that the S&P Global Ratings-adjusted funds from operations (FFO) to debt metric declined below 17% in 2020 from 22.6% in 2019. We expect Veolia's operating performance to improve in 2021, with a strong rebound notably in waste and energy activities that should translate into adjusted FFO to debt increasing beyond the 20% lower threshold for the current rating.

Outlook

The stable outlook factors in our expectation that Veolia can offset the proposed cash outlay of about €20.0 billion to purchase the remaining 70.1% stake in Suez. Should Veolia increase its offer to Suez's shareholders from the current proposal of €18 per share (including dividend), we would reassess our base-case scenario.

Moreover, we expect that Veolia will take timely action to restore its balance sheet within 24 months of the takeover offer becoming effective, which we expect could occur at year-end 2021 if Veolia's offer is approved by the AMF (Autorité des marchés financiers). This should result in our adjusted FFO to debt metric for Veolia recovering to more than 20% in 2023 following just under 20% in 2022, when the cash outflow will likely happen. We also note that the competition authorities' review could take up to 15 months, potentially delaying the outcome of the offer even further, in which case we would reassess our base-case scenario. We also consider Veolia's track record of improving profitability and restoring its balance sheet after a transformation, as in 2012-2019. In our base case, we assume Veolia's stand-alone operating performance will remain supportive.

Downside scenario

We could downgrade Veolia if one or a combination of the following conditions were to happen, namely if Veolia is unable to:

- Restore its stand-alone operating performance in 2021, notably with adjusted FFO to debt above 20% after the dip expected in 2020.
- Offset (within 24 months at the latest) the about €20.0 billion cash payment for the 70.1% stake in Suez to restore its credit metrics to a level commensurate with the current rating.
- Fully control Suez, with an adverse impact on the consolidated entity's operating performance in 2022-2023, including markedly lower cost synergies than expected.

Upside scenario

An upgrade is conditional on Veolia overcoming the operational challenges it faces over the next two years. In particular:

- In 2021 Veolia will need to restore its operating performance to a level commensurate with the current rating, since we estimate that adjusted FFO to debt will be well below the 20% threshold for the current rating in 2020, in line with our criteria.
- Over 2021-2023, should Veolia launch its full takeover of Suez, the cash outlay will use up the headroom under its credit metrics for a potential upgrade.

Although remote, we could consider raising the rating if Veolia were able to increase the S&P Global Ratings-adjusted FFO to debt to more than 25% over the next two years.

Company Description

Veolia operates worldwide within three main business segments: water services, waste services, and energy. Water services have been the core business since the company's inception in 1853, but the group has also increased its waste projects (especially hazardous waste in Asia) since 2003. In 2019, water services represented 44% of EBITDA, waste 36%, and energy 20%. Geographically, 38% of EBITDA came from Europe (excluding France), 29% from the rest of the world (excluding Europe), and 23% from France.

- The water business integrates drinking water and wastewater activities, such as distribution and treatment, industrial process water, and manufacturing of water treatment equipment and technologies.
- The waste solutions business collects, processes, and disposes of household, commercial, and industrial waste. It also includes waste sorting, recycling, and recovery.
- The energy business produces renewable energy, comprising heat and electricity generated primarily from waste. Additionally, it develops a range of energy-management activities, including heating and cooling networks, thermal, and multi-technical services.

At year-end 2019, Veolia reported revenue of €27.2 billion, EBITDA of €4.0 billion, and net debt under International Financial Reporting Standard 16 of €10.7 billion.

Our Base-Case Scenario

Assumptions

- Revenue growth in line with EBITDA growth of around 2.2% in 2021, supported by investments in international activities (mainly China's hazardous waste), new contracts with industrial customers, and to a lesser extent more favorable energy prices.
- Reported EBITDA in 2021 of €4.0 billion, the same level as in 2019, after about €3.6 billion in 2020.
- Reported EBITDA almost doubling to about €6.5 billion in 2022 and €6.8 billion in 2023.
- The EBITDA margin after IFRIC 12 and principal payments on operating financial assets stable at about 13%, increasing to about 15% with the consolidation of Suez in 2022.
- Annual cost cuts of €250 million with a 40% retention rate. Suez's acquisition leading to €500 million of annual cost synergies from 2023.
- Acceleration of capital expenditure (capex) in 2020-2021 to yield a strong EBITDA contribution

by the end of the plan, leading to capex of about €5 billion over 2020-2021 and €3 billion per year over 2022-2023.

- Ordinary dividends increasing in line with net income.
- Cash outflow of €3.4 billion for the 29.9% stake in Suez in 2020.
- Annual dividends from Suez averaging €100 million-€150 million in 2021.
- Full contribution from Suez as of midyear 2022 (expected closing time of the transaction) with a total cash outflow of €7.9 billion, and an additional €12.1 billion impact on reported net debt stemming from Suez's net debt consolidation.
- Veolia executing all the necessary measures to restore its balance sheet before year-end 2023.

Key metrics

Veolia Environnement S.A.--Key Metrics

(Bil. €)	2019a	2020e	2021e	2022e	2023e
EBITDA reported	4.0	3.5-3.7	3.9-4.1	6.2-6.7	6.5-7.0
EBITDA*	3.7	3.3-3.6	3.8-4.1	6.2-6.7	6.2-6.7
Debt*	13	15.0-16.0	15.0-16.0	25.0-30.2	20.0-30.0
Capex*	1.9	2.2-2.5	2.2-2.7	3.0-3.5	2.8-3.3
Dividends*	0.7	0.4-0.5	0.7-0.8	1.0-1.3	1.0-1.3
FFO/debt* (%)	22.6	16.5-19.0	20.0-21.0	18.0-20.0	20.0-22.0
Debt/EBITDA* (x)	3.5	4.4-4.9	3.5-4.0	3.7-4.2	3.5-4.0

Capex--Capital expenditure. FFO--Funds from operations a--Actual. e—Estimate. *S&P Global Ratings' adjusted figures.

Liquidity

We assess Veolia's liquidity as adequate. According to our projections, Veolia's sources of liquidity will exceed uses by about 1.2x over the next 12 months. In addition, we believe that the group's good access to capital markets, proactive liability management, and solid relationships with banks support its liquidity position. The group's debt is not subject to financial covenants. We note that, on Feb. 14, 2021, Veolia signed an agreement for an €8.0 billion bridge loan to finance its proposed takeover of the remaining 70.1% of Suez.

Principal liquidity sources:

- About €8.6 billion in available cash or highly liquid money market funds as of Sept. 30, 2020.
- Nearly €4 billion of available committed credit lines maturing beyond 12 months, including a €3 billion multicurrency syndicated loan maturing in November 2022.
- Our forecast of annual cash flow from operations of about €2.9 billion.

Principal liquidity uses:

- Debt repayment of about €8.5 billion including commercial paper of about €5.8 billion.
- Our estimate of €2.5 billion-€3 billion in annual capex, including for expansion.
- Dividends of about €650 million to be distributed over the next 12 months and about €1.0 billion-€1.2 billion annually afterward.

Issue Ratings--Subordination Risk Analysis

Capital structure

The group's debt comprises solely senior unsecured debt (mostly bonds issued at Veolia's level). Should we include Suez's debt in our structural subordination analysis based on year-end 2019 information (excluding Suez's €1.6 billion hybrid bonds), the priority debt ratio would be at about 45%.

Analytical conclusions

Since there is no marginal debt at the subsidiaries, we rate Veolia's senior unsecured debt in line with the issuer credit rating, even in the event of a full takeover of Suez. Veolia's €2.0 billion hybrid bonds are rated 'BB+', two notches below the senior unsecured debt; the difference reflects the hybrid bonds' subordination and potential interest deferral.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/A-2

Business risk: Strong

- Country risk: Intermediate
- Industry risk: Low
- Competitive position: Strong

Financial risk: Significant

- Cash flow/Leverage: Significant (standard volatility table)

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)

- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Ratings On Six European Integrated Utilities Affirmed Amid Accelerated Energy Transition; One Outlook Now Negative, Feb. 17, 2021
- The Energy Transition And The Diverging Credit Path For European Utilities, Feb. 16, 2021
- The Energy Transition And What It Means For European Power Prices And Producers: January 2021 Update, Jan. 27, 2021
- France-Based Utility Veolia Environnement's Proposed Junior Subordinated Hybrid Notes Rated 'BB+', Oct. 14, 2020
- French Utility Veolia To Offset €3.4 Billion Stake Purchase In Suez With Remedy Measures, Oct. 6, 2020
- French Utility Veolia Environnement 'BBB' Rating Affirmed After €2.9 Billion Bid For 29.9% Stake In Suez; Otlk Stable, Sept. 1, 2020
- Veolia Environnement S.A., June 10, 2020
- French Utility Veolia Environnement S.A. Affirmed At 'BBB' Despite COVID-19 Operating

Uncertainty; Outlook Stable, March 27, 2020

Ratings List

Ratings Affirmed	
Veolia Environnement S.A.	
Issuer Credit Rating	BBB/Stable/A-2
Senior Unsecured	BBB
Junior Subordinated	BB+
Commercial Paper	A-2