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Research Update:

French Utility Veolia Environnement 'BBB' Rating Affirmed After €2.9 Billion Bid For 29.9% Stake In Suez; Otlk Stable

September 1, 2020

Rating Action Overview

- On Aug. 30, 2020, the French waste, water, and energy utility Veolia Environnement S.A. proposed to buy a 29.9% stake in Suez from Engie SA for €2.9 billion. If accepted and given regulatory approvals, Veolia would launch a full takeover bid for Suez in the following 12-18 months.
- We expect that Veolia will enact remedy measures to maintain rating headroom, and that operating performance, which will likely see a dip in 2020 from COVID-19, will rebound over the course of 2021 and thereafter.
- We are affirming our 'BBB/A-2' long- and short-term ratings on Veolia.
- The outlook is stable, reflecting the company's financial policy and commitment to rapidly reduce leverage, as well as our preliminary views that the proposed acquisition, while complex, would likely be positive for its business risk profile.

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Rating Action Rationale

Veolia's €2.9 billion bid for a 29.9% stake in Suez could be the first step to create a global water, waste, and energy leader. On Aug. 30, 2020, Veolia announced a €2.91 billion offer for 29.9% of Suez' capital held by Engie SA as a prelude to launch a full bid for Suez over the following 12-18 months. Engie currently owns a 32% stake in Suez, and the proposed offer would remain below the regulatory threshold that would force Veolia to immediately launch a full takeover bid. Engie is Suez' largest shareholder by far and said earlier this summer that its holding in Suez was under strategic review. Veolia's binding offer to Engie expires on Sept. 30, 2020.

If Engie accepts the offer and upon regulatory clearances, Veolia envisages a full takeover bid on Suez within 12-18 months, which could cost about €10 billion (including the full stake from Engie) and would add another €10 billion to Veolia's debt taking into account Suez' debt, according to our estimates. If successful, the transaction would create a global leader in the highly fragmented water and waste markets, with complementary businesses and geographies, potential for synergies, a combined EBITDA of about €7 billion, and over 200,000 employees. While we believe the transaction will be broadly positive for Veolia's business risk profile, it is too early to assess its full impact, given significant uncertainties around the transaction at this stage, including its financing, the long time frame until completion, Veolia's final ownership in Suez, integration risks, the operating performance of each group amid COVID-19, and the likely evolving business perimeter. In particular, the acquisition would require the sale for competition reasons of a number of activities, including Suez' French water operations (already pre-agreed with French infrastructure fund Meridiam).

Strong remedy measures will allow Veolia's credit metrics to recover after the dip in 2020. Taking into account the €2.9 billion cash outflow for the 29.9% stake in Suez and the more challenging operating conditions in 2020, we expect 2020 S&P Global Ratings-adjusted funds from operations (FFO) to debt will decline to well below 20% from 22.6% in 2019. In addition, we anticipate reported EBITDA of close to €3.6 billion, adjusted debt increasing to €15 billion-€16 billion, and adjusted debt to EBITDA increasing above 4.0x from 3.5x.

In line with its financial policy and leverage targets, we expect Veolia will implement remedy measures in 2020 and 2021 and benefit from a rebound in operating performance in 2021. We now forecast reported EBITDA will increase to more than €4.0 billion. This would support improvement in credit metrics. In particular, in 2021, we anticipate adjusted FFO to debt improving to at least 20% (threshold for the rating) and adjusted debt to EBITDA declining to close to 4.0x.

Although the fallout from COVID-19 is weighing on operating performance, Veolia has taken remedy measures to maintain credit headroom. We anticipate Veolia's 2020 operating performance will be weaker than in 2019, as reflected in its half-year 2020 results. While EBITDA declined by 17.3% at end-June 2020 compared with the same period last year, we anticipate some rebound during the second half of the year and in 2021.

Veolia is notably exposed to the COVID-19 pandemic and associated economic downturn in its waste division (36% of 2019 EBITDA), and to a lesser extent via its energy business (20%). Following the spread of COVID-19 in Europe, Veolia suspended its EBITDA guidance for 2020, and then announced the following remedy measures, among others, which we expect will lead to adjusted FFO to debt well below 20% in 2020, with a rebound expected at or above 20% in 2021:

- A 50% reduction of the ordinary dividend for 2020.
- Additional cost cutting of €200 million for 2020 on top of the €250 million already planned (€120 million already achieved in the second quarter).
- A €500 million reduction in capital expenditure (capex). Veolia expects overall capex, including acquisitions, to decline to €2.0 billion from its previous expectation of €2.5 billion.

Outlook

The stable outlook on French waste, water, and energy utility Veolia factors in our expectation that the company will be able to offset the €2.9 billion outflow for a 29.9% stake in Suez with significant remedy measures.

The stable outlook also takes into account our expectation of a rebound in operating performance after the dip in 2020 due to COVID-19-related lockdown measures and the consequent economic slowdown.

We currently project that Veolia will post credit metrics commensurate with a 'BBB' rating on a sustainable basis, including adjusted FFO to debt above 20% on average over 2021-2023 (22.6% at year-end 2019 and well below 20% in 2020 should the €2.9 billion offer be accepted by Engie).

Downside scenario

A negative rating action on Veolia could stem from:

- The company not enacting significant remedy measures in a timely manner to achieve adjusted FFO to debt above 20% in 2021 and after.
- Veolia experiencing operational issues leading to materially weaker-than-expected operational performance in 2021, with reported EBITDA declining being below €4.0 billion.

Upside scenario

We could upgrade Veolia if the group were to generate strong free operating cash flow before dividends, with adjusted FFO to debt sustainably above 25% and debt to EBITDA below 3.0x. We could also raise the rating if we consider its business risk profile to have strengthened on the back of improved profitability, business flexibility, and market conditions.

Ultimately, any upgrade potential would also hinge on management's financial policy, especially since we believe that the group may use its financial headroom to further accelerate growth rather than materially strengthen its balance sheet.

Company Description

Veolia operates worldwide within three main businesses: water services, waste services, and energy. Water services has been the core business since inception in 1853, but the group has also increased its projects in waste (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 water distribution, water and wastewater 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 including International Financial Reporting Standard 16 of €10.7 billion.

Our Base-Case Scenario

Assumptions

- Challenging macroeconomic conditions in the geographies where Veolia operates, with French GDP declining by 9.5% in 2020, with an increase of 6.8% in 2021 and 4.8% in 2022.
- Revenue growth of about 2.2% over 2021-2023, supported by investments made in international activities and new contracts with industrial customers.
- A slowdown in business activity following COVID-19 lockdown measures in 2020, and back to 2019 levels, with 2021 reported EBITDA increasing to at least €4.0 billion, after dipping to close to €3.6 billion in 2020, with growth and recovery stemming notably from waste and energy.
- An EBITDA margin post International Financial Reporting Interpretations Committee 12 and principal payments on operating financial assets stable at about 13%, before increasing at the end of the plan.
- Cost-cutting efforts of €450 million for 2020.
- Lower capex then previously assumed to compensate for lower EBITDA contributions from waste and energy.
- Ordinary dividends increasing in line with net income.
- Cash outflows of €2.91 billion for Engie's 29.9% stake in Suez.
- Annual dividends received from Suez averaging €150 million-€200 million over 2021-2023.

Key metrics

(Bil. €)	2019a	2020e	2021e	2022e	2023e
EBITDA reported	4	3.5-3.7	3.9-4.1	4.0-4.2	4.2-4.4
EBITDA*	3.7	3.3-3.6	3.8-4.1	4.0-4.3	4.2-4.4
Debt*	13	15.0-16.0	15.0-16.0	15.0-16.0	15.0-16.0
Capex*	1.9	1.9-2.3	2.2-2.7	1.5-2.0	1.5-2.0
Dividends*	0.7	0.4-0.5	0.7-0.8	0.8-0.9	0.8-0.9
FFO to debt* (%)	22.6	17.0-19.0	20.0-21.0	20.0-22.0	20.0-22.0
Debt to EBITDA* (x)	3.5	4.0-4.5	3.5-4.0	3.5-4.0	3.5-4.0

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

Liquidity

We now assess Veolia's liquidity as adequate. According to our projections, 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.

Principal liquidity sources for the next 12 months include:

- About €5 billion in available cash or highly liquid money market funds as of March 31, 2020.
- Nearly €4.1 billion of available committed credit lines maturing beyond 12 months, including a €3.0 billion multicurrency syndicated loan maturing in November 2022.
- Our forecast of annual cash flow from operations of about €2.3 billion.
- Issuance of a €700 million eight-year bond in April 2020 and a €500 million 12-year bond in June 2020.

Principal liquidity uses over the same period include:

- Debt repayment of about €2.8 billion and commercial paper standing at about €3.2 billion.
- Our estimate of €2.0 billion in annual capex, including expansion capex.
- About €2.9 billion of committed acquisitions in 2020 for the 29.9% stake in Suez.
- Dividends of about €500 million to be distributed in 2020.

Issue Ratings - Subordination Risk Analysis

Capital structure

Veolia's debt comprises solely senior unsecured debt (mostly bonds issued at Veolia's level).

Analytical conclusions

Since there is no marginal debt at subsidiary level, we rate the senior unsecured debt in line with the issuer credit rating.

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: Satisfactory (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 | 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

- 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
Veolia Environnement S.A.	
Senior Unsecured	BBB
Commercial Paper	A-2