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Asset Management

Water, water everywhere

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Utilities with private equity owners show emerging vulnerabilities as high-interest rates bite, says Robert Lambert, BlueBay Portfolio Manager, Investment Grade.

Most European corporates have exhibited a deleveraging trend that can be traced back to the Global Financial Crisis and the European sovereign debt crisis. Stemming from the fallout of both situations, many banks in the euro area and the periphery tightened their lending standards. Meanwhile, regulatory reforms after 2009 raised banks' capital and liquidity requirements, affecting their willingness to lend. As a result, most corporates embarked on gradual deleveraging through reducing capital investments. Currently, aggregate corporate leverage in Europe has fallen from about 39% before 2007 to around 34% at the end of last year.

Utilities, most notably in the water space, are bucking this downward trend however with some subsectors recording an increase in leverage, primarily due to private equity (PE) involvement. PE has taken advantage of a decade-long zero-interest rate environment to maximise leverage as much as possible. However, the rise in interest rates has pushed fresh challenges to the fore.

Murky waters for private equity

Water companies (of which 70% ownership is PE, foreign companies and pension funds) and other PE-owned utilities are particularly vulnerable in the current economic cycle. PE operates on a model that pushes the boundary on debt levels in their holdings to maximise returns. That works when companies grow earnings, but after Covid, Ukraine and interest rate increases, they are struggling because some of the debt used to finance the buyouts was not hedged against interest rate rises.

PE firms are more reactive to interest rate changes because they employ two investment strategies: venture capital and leveraged buyouts. In the latter, PE funds the takeover of companies using very little capital, and they tend to rely on debt, which usually has a long-term horizon given the lenders are pension funds or investment banks. That enables them to magnify their returns but requires steady cash outflows regarding interest payments. There is a high sensitivity to interest rates, and the rate of return that PE firms achieve when they exit the company depends very much on the interest rates at which they take on the debt.

Generally, utilities have much higher leverage due to their regulated and often inflation-linked revenues, which provide strong visibility on cash flow to service their debt. Regarding leverage levels, investors can usually split utilities between generators and integrated utilities on one side and infrastructure operators such as water, grid, and network operators on the other. The latter tend to operate between 5.5 to 6 times leverage, and the generators and integrated utilities are closer to 3 times given their cyclicality.

> **“Ultimately, PE must adapt to a new environment, although falling inflation could alleviate that.”**

Inflation is the real kicker for the water industry when investors consider that nearly 50% of the debt is linked to the Retail Price Index (RPI). Moreover, revenue and customer bills are adjusted by the annual change in the Consumer Price Index, including housing (CPIH). There has been a material difference between the two, and debt servicing costs have increased quicker than they can increase revenues, exacerbated by lower return allowances by the regulator.

What is on the horizon?

Rates should be reaching the top of the cycle soon, but the outlook for rating cuts keeps pushing out, so funding will likely remain expensive for high-levered sectors well into 2024. That is likely to mean further discounted equity calls, as already seen in the UK water sector this year, along with the potential for further asset revaluations. Investors could see other utility sectors and real estate investment trusts look to employ some discounted equity to boost their balance sheets.

Investors could see some structural change stemming from this current environment. There is high political pressure in some sectors, and again, looking at UK water and UK power, leverage ratios or credit ratings could be further tightened. For PE, it means that they must operate with a lower leverage model. Ultimately, PE must adapt to a new environment, although falling inflation could alleviate that.

UK water has been going through a crisis this year. PE success will be less about piling on maximum leverage and playing multiple arbitrages and more about improving operating leverage and generating organic growth, which a well-operated business should be looking to achieve anyway.

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