

CREDIT OPINION

6 April 2020

Update

 Rate this Research

RATINGS

Ekurhuleni Water Care Company

Domicile	South Africa
Long Term Rating	Ba2
Type	LT Issuer Rating - Dom Curr
Outlook	Negative

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Ekurhuleni Water Care Company (South Africa)

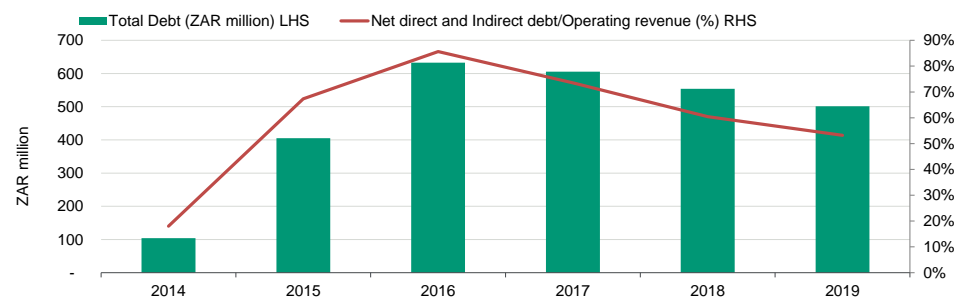
Update following rating downgrade to Ba2

Summary

The credit profile of [Ekurhuleni Water Care Company](#) (ERWAT) (Ba2 negative) reflects the company's close financial and operational links with its support provider, the [City of Ekurhuleni](#) (Ba1 negative), which guaranteed 89% of ERWAT's debt as of 30 June 2019, as well as its legal status as a public-sector entity. The credit profile also reflects the company's deteriorating liquidity and high but declining debt levels. The coronavirus outbreak and the associated deterioration in the global and national economic outlook will also likely constrain ERWAT's financial performance through possible lower transfers from its support provider.

Exhibit 1

High but declining debt levels



Fiscal year ending 30 June.

Sources: Moody's Investors Service and ERWAT's financials

Credit strengths

- » Strong support from and close supervision by the City of Ekurhuleni
- » Public legal status and close integration with the City of Ekurhuleni
- » Strong financial performance, and conservative governance and management

Credit challenges

- » Very high debt, although it is likely to decline over the next three years
- » Weakening liquidity
- » Limited prospects for business diversification and expansion

Rating outlook

The negative outlook on ERWAT's global scale rating reflects the weakening of the credit profile of its support provider, the City of Ekurhuleni, taking into account the strong operational and financial links between the two.

Factors that could lead to an upgrade

A rating upgrade is unlikely considering ERWAT's negative outlook. We would consider changing the outlook of ERWAT to stable if its support provider's outlook is changed to stable from negative.

Factors that could lead to a downgrade

A downgrade of ERWAT's rating would require a corresponding change in the City of Ekurhuleni's rating. In addition, any reduction or changes in government support for ERWAT would likely lead to a downgrade.

Key indicators

Exhibit 2

Ekurhuleni Water Care Company, (ERWAT)					
	2015	2016	2017	2018	2019
Total Assets (ZAR million)	1,737.5	2,143.1	2,223.7	2,342.3	2,318.3
Operating margin (%)	32%	32%	31%	33%	28%
Surplus (Deficit) for the Year / Total income (%)	13%	17%	16%	16%	5%
Total Debt / Total Assets (%)	23%	30%	27%	24%	22%
Debt / Cash flow from operations (x)	35.9	8.1	100.2	68.9	20.2
Cash interest cover ratio (x) [1]	0.7	1.7	0.3	0.2	0.5
Current Assets / Current Liabilities (x)	2.3	2.4	1.5	1.1	0.6

Fiscal year ending 30 June.

Sources: Moody's Investors Service and ERWAT's financials

Detailed credit considerations

On 1 April 2020, we downgraded ERWAT's global scale rating to Ba2 from Ba1 and maintained the negative outlook. The decision to downgrade ERWAT's ratings reflects the challenges emanating from the weakening of its support provider, the City of Ekurhuleni. At the same time, we affirmed the company's long-term national scale issuer rating of Aa3.za.

The credit profile of ERWAT reflects its status as the public wastewater treatment entity that is largely owned by the City of Ekurhuleni. ERWAT's rating is derived solely from the support from the City of Ekurhuleni.

High degree of support from and supervision by the City of Ekurhuleni

We consider ERWAT a government-related issuer. From a credit risk perspective, it is not possible to distinguish between ERWAT and the City of Ekurhuleni because of the inextricable operational and financial links between the two. As a result, ERWAT's rating is derived solely from the support it receives from the City of Ekurhuleni, as described in our Government-Related Issuers rating methodology, published on 6 June 2018. We have positioned ERWAT's rating one notch below that of its support provider to reflect the fact that its debt is not fully guaranteed and the City of Ekurhuleni controls other state-owned entities.

ERWAT derives 78% of its total revenue from service charges collected by the City of Ekurhuleni and transferred to the company in equal monthly instalments, ensuring regular cash flow. It derives a further 7% of its revenue from capital grants. Other income, such as laboratory services, makes up the remaining 15% of the total revenue. The City of Ekurhuleni approves ERWAT's capital expansion and borrowing plans, as well as its budget plans. As of 30 June 2019, 89% of ERWAT's total debt exposure benefited from explicit guarantees from the City of Ekurhuleni.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Public legal status and close integration with the City of Ekurhuleni

ERWAT is a public company, majority owned by the Ekurhuleni Metropolitan Municipality. Its credit profile is underpinned by its public legal status as a municipal entity under the Municipal Finance Management Act.

The rating also incorporates ERWAT's status as the only wastewater treatment company for the Ekurhuleni Metropolitan Municipality, as well as its strategic role and close financial links with the municipality. ERWAT provides bulk wastewater conveyance and wastewater treatment services to around 2,000 industries and more than 3.2 million people, predominantly in the Ekurhuleni metropolitan area. It operates 19 wastewater treatment plants within its major shareholder's area of jurisdiction. ERWAT's management structure and governance reflect close control by the City of Ekurhuleni, which owns 97% of its shares.

Strong financial performance, and conservative governance and management

ERWAT's total revenue increased by 5% to ZAR1 billion (\$81 million) in the fiscal year ended 30 June 2019 (fiscal 2019), largely because of a 36% increase in government grants and a 10% increase in service charges. ERWAT derives most of its revenue from service charges for wastewater sewage in the Ekurhuleni metropolitan area, and determines these charges through negotiations with the municipal administration. The support provider is responsible for collecting revenue from users, which it redistributes to ERWAT. The company accrues other income from service agreements with private clients outside its jurisdiction. This business line, which contributes 15% of the company's total income, includes laboratory services and R&D for other public-sector entities. ERWAT operates under a very rigid cost structure, with major expenditure items, such as staff costs and bulk purchases, decided at the support level. These costs, which offer limited spending flexibility, accounted for 58% of its operating spending in fiscal 2019.

ERWAT's revenue and spending structure is well established, and in our opinion, there are limited prospects for any shift in its business model that could affect its revenue structure. ERWAT's monopolistic status as the sole provider of municipal statutory services is also unlikely to change in the medium term.

ERWAT's administration reflects its relatively conservative financial management. The parent municipality oversees both the company's strategic direction and compliance with respect to financial governance and reporting. Ekurhuleni does this by (1) approving ERWAT's board members, and (2) conducting the company's internal audit.

High debt, although it is likely to decline over the next three years

ERWAT's reported debt stock of ZAR501 million represented a very high 53% of its operating revenue as of 30 June 2019, down from 60% in fiscal 2018. We expect ERWAT's debt to continue to gradually decline over the next three years because the company intends to finance its entire capital spending plans for fiscal 2020-22 using capital transfers. In addition, one of its loans will mature in fiscal 2020, contributing to the overall decline in debt. Although we regard ERWAT's debt as very high compared with its annual budget volume, the company is supported by its municipal shareholder in the form of a guarantee to cover debt incurred by its owned entities. The guaranteed debt of ZAR550 million reflects the municipality's absolute backing for investments it considers strategic. We have factored both the gradual decline in debt and the guarantee into ERWAT's rating.

Weakening liquidity

ERWAT's cash position declined to ZAR54 million in fiscal 2019 from ZAR87 million a year earlier. The decrease reflected the company's decision not to borrow and to fund a large part of its capital spending with its own funds. The move led ERWAT's liquidity ratio to decline to 0.6x in fiscal 2019 from 1.1x in fiscal 2018. We expect ERWAT's liquidity to remain strained over the next three years. Over the medium term (2020-22), ERWAT plans to fund 100% of its capital spending using capital grants from its support provider.

Limited prospects for business diversification and expansion

ERWAT is 97% owned by the Ekurhuleni Metropolitan Municipality, with the remaining 3% divided equally between the [City of Johannesburg](#) (Ba1 negative) and the Lesedi Local Municipality. Thus, its operating area is within its major shareholder's boundaries and there is very little to no prospect of it expanding its core business operations outside Ekurhuleni's borders, except for a small portion of research and laboratory services performed on behalf of other industries and government entities. The company, which does not pursue profit as a business objective and is tax exempt, operates under a mandate from its major shareholder and is governed by the Municipal Finance Management Act.

The Ekurhuleni Metropolitan Municipality is responsible for setting ERWAT's wastewater services tariffs, and exercises strong control and oversight over the company's strategy, annual budgets and cash flow. ERWAT is the largest governmental entity that Ekurhuleni owns and the municipality takes into consideration the fact that ERWAT plays a crucial role in fulfilling one of its statutory responsibilities. The facilities under ERWAT's operations form an integral part of the metropolitan municipality's infrastructure network. We understand that there is no political will to privatise the company.

ESG considerations

How environmental, social and governance risks inform our credit analysis of ERWAT

We take into account the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of ERWAT, the importance of ESG factors to its credit profile is as follows:

Environmental considerations are important for ERWAT. The company is 97% owned by the City of Ekurhuleni and is exposed to similar water shortages that affect its support provider. Moreover, 78% of ERWAT's operating revenue, which is derived from the City of Ekurhuleni, could be affected in case of severe water shortages resulting from drought.

ERWAT is exposed to some social risks, particularly in its water services business. Nevertheless, this risk has limited credit impact, given the company's strategic role and the support provided by the City of Ekurhuleni.

Governance risks are important for ERWAT's rating. Its governance framework is intrinsically intertwined with that of its supporting regional and local government, the City of Ekurhuleni, which exerts strong oversight and ultimately takes key decisions.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG factors is explained in our cross-sector methodology, [General Principles for Assessing Environmental, Social and Governance Risks](#), published in January 2019.

Rating methodology and scorecard factors

The methodology used in rating ERWAT was our [Government-Related Issuers](#) rating methodology, published on 21 February 2020.

Ratings

Exhibit 3

Category	Moody's Rating
EKURHULENI WATER CARE COMPANY	
Outlook	Negative
Issuer Rating -Dom Curr	Ba2
NSR Issuer Rating	Aa3.za

Source: Moody's Investors Service

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