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Ratings

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**Summary:**

# Veolia Environnement S.A.

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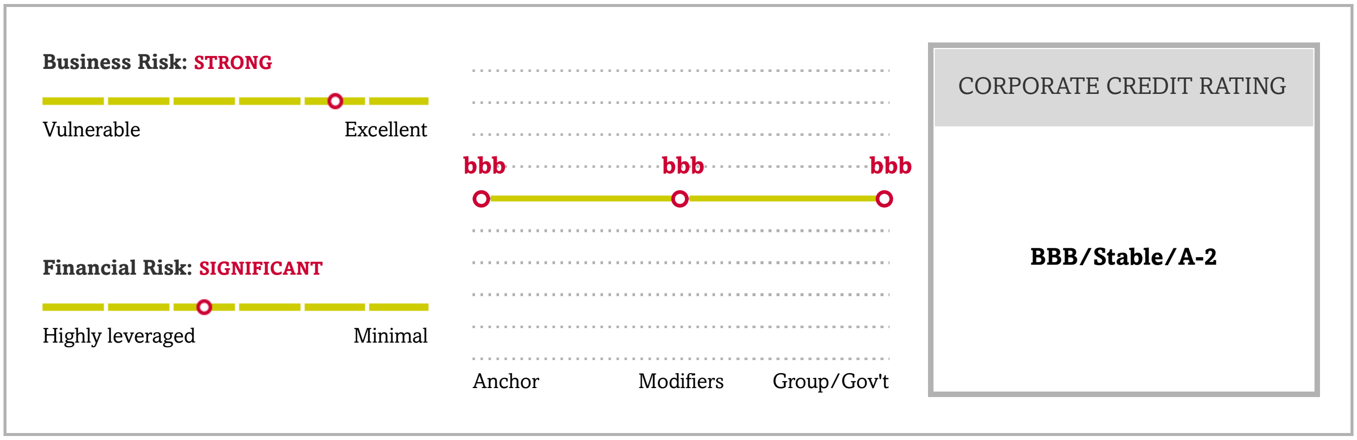
## Summary:

# Veolia Environnement S.A.




## Rationale

| Business Risk: Strong | Financial Risk: Significant |
|---|---|
| • Leading positions worldwide in water and waste management.<br>• Wide diversity in business, customers, contracts, and geography.<br>• Increasing contribution from growing and higher margin environmental services to industrial customers.<br>• Significant improvement in profitability, thanks to ongoing restructuring efforts.<br>• Exposure to the declining and less profitable core domestic water market and to waste business' sensitivity to economic cycles. | • Improving free operating cash flow generation, with development of more asset-light models.<br>• Track record of significant debt reduction over the past years.<br>• Financial policy of debt stabilization and neutral discretionary cash flows.<br>• Active debt management and sound liquidity. |



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**Outlook: Stable**

S&P Global Ratings' stable outlook on France-based Veolia Environnement S.A. reflects its anticipation that the group will continue improving its profitability and credit metrics in the coming years, while self-financing its capital expenditures (capex) and dividends. It incorporates our projection that Veolia will post credit metrics commensurate with its 'BBB' rating on a sustainable basis, including an adjusted FFO-to-debt ratio comfortably above 20% in 2016-2018.

### Downside scenario

The rating on Veolia could come under pressure if its profitability deteriorated, if credit metrics fell short of our current expectations, or if management departed from its financial discipline, including its debt stabilization objective.

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 than in our base case.

### Upside scenario

We may consider raising the ratings if Veolia generates substantial positive discretionary cash flows, if the adjusted FFO-to-debt ratio sustainably rises above 25%, and if its business mix does not materially differ from its announced strategic targets.

## Our Base-Case Scenario

**Assumptions**

- Revenue growth of 2%-3% in 2016-2018, driven by international activities and increasing industrial customers.
- EBITDA margin improving by 100-150 basis points over the same period, owing to cost-cutting efforts of about €200 million per year over 2016-2018.
- Investments of more than €1.6 billion per year.
- The acquisition of Kurion and Chemours' sulfur products division in 2016, for a total of about €600 million.
- Proceeds received for the partial disposal of Transdev in 2016, for a total of €565 million, including a €345 million loan repayment from Transdev.
- Minimal equity content from 2016 for the hybrid bonds, compared with intermediate previously.

**Key Metrics**

| | 2015a | 2016e | 2017e |
|---|---|---|---|
| EBITDA (bil. €) | 3.3 | 3.2-3.6 | 3.4-3.7 |
| FFO/debt* (%) | 21.2 | 20-23 | 20-23 |

*S&P Global Ratings-adjusted figures. a--Actual. e--Estimate. FFO--Funds from operations.

## Business Risk: Strong

### Leading worldwide positions in water and waste management

Our assessment of Veolia's strong business risk profile is supported by its leading worldwide positions in water and waste management, based on strong franchises in local markets across Europe, the U.S., and Southeast Asia. Except French competitor Suez Environment, no group has such global coverage and such leading positions in local markets, which are often fragmented. In our view, environmental services groups have strong structural growth drivers globally, including rising environmental concerns translating into more demanding regulations, and accelerating urbanization, drought, pollution, and among others. We also believe that circular economy and energy efficiency efforts from both municipal and industrial clients are megatrends that Veolia is well positioned to capture.

### Recurring and stable revenues from long-term contracts

Veolia has a high share of recurrent revenues from long-term contracts with local governments, which bears little volume and performance risk, and confers predictability to group earnings. Veolia derives about half of its EBITDA from local governments, typically under public service delegation contracts especially for water distribution and treatment or for cooling and heating networks. In its core domestic market, Veolia typically operates under long-term operations and maintenance contracts, whereby it operates assets, owned and financed by local authorities, and collects a tariff from customers. Water consumption and demand are not cyclical, and Veolia's risks are further mitigated by automatic indexation clauses covering the main variable costs. Moreover, heating networks have little sensitivity to economic cycles and most contracts have pass-through arrangements, albeit with some time lag.

### Little to no growth from European operations

These credit strengths are partly offset by structural pressure on profitability in core European mature markets. Over the past five years, from 2010 to 2015, Veolia's revenue growth (at constant consolidation scope and exchange rates) has been weak, ranging between negative 1.8% and 2.0%, pressured by the weak macro environment in Europe. Moreover, persisting dull economic conditions and low private/public spending in Europe have accentuated volume erosion in water and waste and increased price pressure from local governments. In addition, the growing expertise of local authorities, intense competition, and regulatory changes reducing the maximum duration of contracts, have translated into significant tariff cuts in renegotiations of water contracts in France. Yet, now that most of the large water concession contracts in France have been renegotiated, we do not expect any further significant deterioration in revenues from these activities, but rather a slight erosion over the next two years. Another weakness of the group's business risk profile is the waste business' exposure to economic cycles, fuel, and raw material prices, and the energy business' exposure to weather conditions and energy prices, which bring some volatility to group earnings and cash flow generation. In addition, a regulatory push by EU countries to develop environmental friendly sorting and recycling solutions, rather than burning or landfill, which traditionally had higher margins, has also reduced Veolia's margins.

### Focus on operating efficiencies and cost cutting efforts drives EBITDA growth

Veolia has significantly improved its financial position, cost base, and group structure over recent years, thanks to significant asset disposals and more than €800 million of cost cutting in 2012-2015. The group continues to have a strong focus on operating efficiency for the coming three years, with a new plan to cut costs for at least €600 million by 2018. The new plan will likely be derived mostly from improved operational efficiency (45%), followed by purchasing policy optimization (35%) and reduction of selling, general, and administrative costs (20%). We view Veolia's management's favorable track record in carrying out such plans as supportive. In addition, we think Veolia's leaner group structure and management organization allows for better control of business units and cash flow circulation within the group.

### Growth strategy targets high value services and products and a rebalancing of the customer base toward industrials

A global trend we see is that industrials in all business sectors seek to outsource environmental services that are not part of their core businesses. Veolia's strategy is now to increase the contribution of its industrial customers and to move toward more high-value services and products, while privileging asset-light models in certain circumstances to preserve cash flows and better share risks. We expect the share of industrial customers to represent about half of revenues going forward. We also think that the group's positioning toward these more complex and higher added-value services enables improved margins, better resource allocation, and less competition. Veolia's numerous commercial successes, notably in strategic growth markets (oil and gas, circular economy, hazardous pollution, dismantling, and innovative solutions for cities), underpin the company's growth strategy and pipelines and support our expectations of 2%-3% organic revenue growth annually. We also expect growth will be enhanced by bolt-on acquisitions to complement the company's geographic footprint and/or the range of expertise, as is the case with U.S.-based nuclear service provider Kurion and Chemours' sulfuric acid divisions in 2016, for $350 million and $325 million respectively. We expect these bolt-on acquisitions will be prudently financed with Veolia's operating cash flows and proceeds from disposals of noncore assets. At the same time, we also see Veolia's strategic adjustment toward emerging markets and industrial clients as somewhat dilutive of its business risk profile. This is notably because it exposes the group to more commercial and contractual risks, compared with water activities and heating businesses with municipalities.

## Financial Risk: Significant

### Improving credit metrics

We assess Veolia's financial risk profile as significant, based on the group's credit metrics. We forecast that its adjusted funds from operations (FFO)-to-debt ratio will exceed 20% over 2016-2018. Adjusted FFO to debt was 21.2% at year-end 2015, including the intermediate equity content we assigned to the junior subordinated debt in 2015. Yet, our assessment of the equity content of the hybrid bonds is now minimal, to reflect a lack of clarity about management's intention to replace the instrument or not. In our base case, we see credit metrics improving beyond the targets we set for the 'BBB' rating and therefore think there is little incentive for the company to replace the instrument after the first call date in April 2018.

### Control of cash flows after dividends and debt stability

We view the group's financial discipline, particularly with regards to free cash flow generation, as credit supportive. This includes self-funding of investments and dividends. We forecast that in 2016-2018, Veolia will generate neutral or positive discretionary cash flow, and its adjusted debt will remain fairly stable, excluding foreign currency effects. We also view positively the execution of the exit plan for Transdev. So far this year, this has resulted in proceeds from the partial disposal to Caisse des Dépôts (CDC) for €220 million and the repayment of a €345 million loan from Trandev to Veolia.

### Prudent and proactive liability management

Management's prudent and proactive liability management further support our view of the group's financial risk profile. This is reflected by the bonds the group issued in September 2016, including €500 million maturing in 2029 and €600 million maturing in 2023, with respective coupons of 0.9% and 0.4%. The group also has access to diverse instruments and markets, it issued a €700 million convertible bond in April 2016, and it was the first French issuer to issue a Panda bond in Greater China.

We now benchmark Veolia's financial risk profile against our standard volatility table, compared with medial previously, because we believe the contribution of Veolia's long-term concessions from French water activities and heating businesses will continue to decline. In our view, they will represent less than half of revenues, while environmental services to industrials will grow and rebalance the customer portfolio equally between municipalities and industrials.

## Liquidity: Strong

We assess Veolia's liquidity as strong. According to our projections, sources of funds will exceed uses by more 1.5x over the next 12 months and by more than 1.0x in the subsequent 12-24 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 | Principal Liquidity Uses |
| --- | --- |
| • About €3.4 billion in available cash or highly liquid money market funds as of June 30, 2016.<br>• Nearly €4 billion of available committed credit lines maturing beyond 12 months, including a €3 billion multicurrency syndicated loan maturing in 2020.<br>• Our forecast of annual cash flow from operations of about €2.5 billion.<br>• €220 million in proceeds from Transdev.<br>• €700 million from issuance of a convertible bond in March 2016. | • Debt repayment of about €2.9 billion.<br>• Our estimate of €1.7 billion in annual nondiscretionary capital expenditures.<br>• Acquisitions amounting to €600 million for Kurion and Chemours' sulfur products division.<br>• Dividends of about €600 million annually. |

### Debt maturities (as of June 30, 2016)

- 2017: €1,306 mil.
- 2018: €472 mil.
- 2019: €462 mil.
- 2020: €431 mil.
- 2021: €1,338 mil.
- Thereafter: €7.9 bil.

## Ratings Score Snapshot

### Corporate Credit Rating

BBB/Stable/A-2

### Business risk: Strong

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

### Financial risk: Significant

- **Cash flow/Leverage:** Significant

### Anchor: bbb

### Modifiers

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

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

**Stand-alone credit profile : bbb**

## Related Criteria And Research

### Related Criteria

- Standard & Poor's National and Regional Scale Mapping Tables, Jan. 19, 2016
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Environmental Services Industry, Feb. 12, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 1, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

**Business And Financial Risk Matrix**

| | Financial Risk Profile | | | | | |
|---|---|---|---|---|---|---|
| **Business Risk Profile** | Minimal | Modest | Intermediate | **Significant** | Aggressive | Highly leveraged |
| Excellent | aaa/aa+ | aa | a+/a | a- | bbb | bbb-/bb+ |
| **Strong** | aa/aa- | a+/a | a-/bbb+ | **bbb** | bb+ | bb |
| Satisfactory | a/a- | bbb+ | bbb/bbb- | bbb-/bb+ | bb | b+ |
| Fair | bbb/bbb- | bbb- | bb+ | bb | bb- | b |
| Weak | bb+ | bb+ | bb | bb- | b+ | b/b- |
| Vulnerable | bb- | bb- | bb-/b+ | b+ | b | b- |

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