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Research Update:

Environmental Services Group Veolia Affirmed At 'BBB/A-2' On Improving Profitability And Credit Metrics; Outlook Stable

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Overview

- We forecast that Veolia Environnement's profitability will continue to strengthen, supported by cost cutting and organic growth.
- We believe the group's 2016-2018 strategic plan is well on track and supports the group's credit quality.
- We are therefore affirming our 'BBB/A-2' ratings on Veolia.
- We are also raising our Greater China regional scale issue rating to 'cnA' from 'cnA-', correcting an error in the application of our criteria.
- The stable outlook reflects our anticipation that the group will consolidate its profitability and credit metrics in the coming years while self-financing its capital expenditures and dividends.

Rating Action

On May 26, 2016, S&P Global Ratings affirmed its 'BBB/A-2' long- and short-term corporate credit ratings on environmental services group Veolia Environnement S.A. The outlook is stable.

We also affirmed the 'BB+' rating on Veolia's junior subordinated debt.

In addition, we have raised our Greater China regional scale issue rating on the CNY500 million bond due June 2017 to 'cnA' from 'cnA-'. This corrects an error in the application of our criteria, "Standard & Poor's National and Regional Scale Mapping Tables," published Jan. 19, 2016.

Rationale

The rating affirmation reflects our view that Veolia will continue to improve its earnings and profitability. 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 over 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. We believe Veolia's management's favorable track record in carrying out such plans is supportive. In addition, we believe Veolia's leaner group structure and management organization allows for better control of business units and cash flow circulation within the group. 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. Veolia's numerous commercial successes, notably in strategic growth markets (oil and gas, circular economy, hazardous pollution, dismantling, and innovative solutions for cities), give credit to the company's growth strategy and pipelines and supports our expectations of 2%-3% organic annual revenue growth. We also expect growth to be enhanced by bolt-on acquisitions to complement the geographic footprint and/or the range of expertise, as is the case with U.S.-based nuclear service provider Kurion in 2016.

Veolia's strong business risk profile continues to be underpinned by the group's leading worldwide positions in water and waste, recurring revenues from long-term municipal contracts that pose minimal volume and performance risk, and wide diversification in terms of customers, contracts, and geography. The strong structural growth drivers for environmental services globally provide additional support. We notably believe that circular economy and energy efficiency efforts from both municipal and industrial clients are megatrends that Veolia is well positioned to capture. We also believe that the group's positioning toward more complex and higher added-value services allows for improved margins, better resource allocation, and less competition. Our expectation of improving profitability thanks to cost cutting also supports our strong business risk profile assessment, although we recognize that a large part of the efficiencies will need to be passed through to customers. Offsetting factors are: local authorities' increasing bargaining powers, which have structurally impaired Veolia's historically high margins in core markets, such as water in France; the waste business' exposure to economic cycles, fuel, and raw material price volatility; and the energy business' exposure to weather conditions and energy prices.

We continue to assess Veolia's financial risk profile as significant, based on the group's credit metrics, notably adjusted funds from operations (FFO) to debt of 21.2% at year-end 2015, including the intermediate equity content we assigned to the junior subordinated debt in 2015. We believe the group's financial discipline, particularly with regards to free cash flow generation, is positive. This includes self-funding of investments and dividends. Management's prudent and proactive liability management also support our view on the group's financial risk profile. We now benchmark Veolia's financial risk profile against the 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 so that they represent less than half of revenues, while environmental services to industrials will grow and rebalance the customer portfolio equally between municipalities and industrials.

In our base case for Veolia, we assume:

- Revenue growth of 2%-3% over 2016-2018, driven by international activities and growth in industrials.
- EBITDA margin improving by 100-150 basis points over the period, driven by cost-cutting efforts of about €200 million per year.
- Investments of more than €1.6 billion per year.

- The acquisition of Kurion in 2016.
- A €345 million loan repayment from Transdev in 2016.
- Minimal equity content from 2016 for the hybrid bonds, compared with intermediate previously.

Based on these assumptions, we forecast that over 2016-2018, Veolia will generate neutral or positive discretionary cash flow, and its adjusted debt level will remain fairly stable, excluding foreign currency effects. In addition, we forecast that its adjusted FFO-to-debt ratio will exceed 20% over 2016-2018.

We have revised our assessment of the equity content of the hybrid bonds to minimal from intermediate from 2016 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 above the targets we set for the 'BBB' rating and therefore believe there is little incentive for the company to replace the instrument after the first call date in April 2018.

Liquidity

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.

Based on our estimates as of Dec. 31, 2015, we factor into our liquidity assessment for the next 12 months the following principal liquidity sources:

- About €3.9 billion in available cash or highly liquid money market funds.
- Nearly €3.9 billion of available committed credit lines maturing beyond 12 months, including a €3 billion multi-currency syndicated loan maturing in 2020.
- Our forecast of cash flow from operations of about €2.5 billion.
- €345 million in proceeds from Transdev.
- €700 million from issuance of a convertible bond in March 2016.

This compares with principal liquidity uses as follows:

- Debt repayment of about €4.3 billion.
- Our estimate of €1.7 billion in nondiscretionary capital expenditures.
- Acquisitions amounting to €365 million.
- Dividends of about €611 million.

Outlook

The stable outlook reflects our anticipation that the group will continue improving its profitability and credit metrics in the coming years while self-financing its capital expenditures and dividends. It reflects our view that Veolia will boast credit metrics commensurate with its 'BBB' rating on a sustainable basis, such as an adjusted FFO-to-debt ratio comfortably above 20%

over 2016-2018.

Downside scenario

The rating on Veolia could come under pressure if the company's 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.

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
- 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

Ratings List

Ratings Affirmed

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

Upgraded

	To	From
Veolia Environnement S.A.		
Senior Unsecured	cnA	cnA-

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.