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Research Update:

Georgia Global Utilities Upgraded To 'BB-' On Improved Water Regulation Assessment And Strong Metrics; Outlook Stable

February 17, 2023

Rating Action Overview

- Given the regulatory track record of more than five years, the timeliness of cost recovery, and the independence of the regulator, we have improved our assessment for Georgian water operations to adequate from adequate/weak.
- In turn, we view Georgia Global Utilities JSC (GGU)'s operations more positively, which is reflected in a stronger business risk assessment of fair (albeit weaker than peers in the same category), and now compare its financials with the medial volatility table.
- We therefore raised our long-term issuer credit rating on GGU to 'BB-' from 'B+'.
- The stable outlook indicates that an upgrade is unlikely until we see improving liquidity and a clear plan to refinance the $164 million shareholder loan maturing in August 2024. It also reflects our expectation of continued strong metrics, with funds from operations (FFO) to debt of 19%-22% over 2022-2023, but negative discretionary cash flow (DCF) to debt due to uncertainties around new majority owner FCC Aqualia's dividend policy and investment plan.

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Rating Action Rationale

We now see the Georgian regulatory framework for water operations as somewhat supportive. The framework is currently in the final year of its fourth regulatory period (2021-2023) supervised by the Georgian National Energy and Water Supply Regulatory Commission (GNERC), which has operated independently since its formation in 1997. The framework followed a parametric formula from May 2015 until December 2017, after which the regulator designed a new formula for the 2018-2021 regulatory period with remuneration set via a revenue-cap regulatory cost base (RCB) methodology with incentive-based (CPI-X) regulation on controllable operating expenditure and recovery of capital expenditure (capex). We now view the framework as more transparent than a few years ago and more inclined toward utilities' financial stability. Operating costs weigh on our assessment because they can be recovered only after the regulatory period ends (currently three years). Although one mitigating factor is that with a 10% deviation of the correction component compared with the allowed revenue of the current year, the regulator is obliged to recalculate tariffs in advance (see "Georgian Water Regulatory Framework: Somewhat Supportive," published Feb. 17, 2023, on RatingsDirect). In our view, the framework is somewhat supportive, but we believe the noninvestment grade sovereign rating on Georgia (BB/Stable/B) weighs on its stability compared with similarly assessed frameworks including those in Israel (AA-/Stable/A-1+), Croatia (BBB+/Stable/A-2), and Romania (BBB-/Stable/A-3).

We expect the somewhat supportive framework to enable FFO-to-debt stabilization to about 19%-22% over 2022-2023 and potential for growth over the new regulatory period (2024-2026). Based on the stable nature of regulated operations, we forecast GGU's reported EBITDA will reach about Georgian lari (GEL) 130 million-GEL140 million over 2022-2023 and FFO of GEL90 million-GEL100 million. In addition, Georgian infrastructure requires heavy maintenance and improvements to ensure reliability and safety, since much of its was built under the Soviet Union. As a result, we expect GGU to enter another investment cycle with investments higher than GEL150 million per year over 2023-2024, although we believe these will be recovered through higher tariffs over 2024-2026--like in 2021-2023 when we saw a 47.8% price increase for commercial customers and a 52% increase for residential customers. Combined with limited dividend distributions until the end of the regulatory period, we forecast GGU's adjusted FFO to debt will remain at about 19%-22% and negative DCF to debt over 2022-2023. Uncertainties related to the new tariffs for the upcoming 2024-2026 regulatory period and the investment plan and dividend policy at FCC Aqualia's level prevent us from expecting strong financial improvements from 2024. We expect GNERC to publish a draft of the new regulation methodology in summer 2023, with the final methodology published before year end.

We view GGU as a moderately strategic subsidiary for FCC Aqualia, which provides one notch of uplift to GGU's stand-alone credit profile. Since October 2022, GGU has been 80% owned by FCC Aqualia and 20% owned by Georgia Capital (GCAP). We believe GGU exhibits significant features that qualify it for one notch of uplift for extraordinary support from FCC Aqualia including:

- GGU operates in line with FCC Aqualia's business of water distribution and supply;
- It operates a regulatory asset base (RAB)-based water supply network that provides stable cash flows and therefore is unlikely to be sold in the medium-to-long term;
- GGU will be fully consolidated into FCC Aqualia and represent 10%-15% of FCC Aqualia's EBITDA over the next two years;
- A long-term strategy will be jointly defined at the GGU level by FCC Aqualia's management and GGU's personnel; and
- FCC Aqualia is committed to supporting GGU, as demonstrated by the intercompany loan signed to repay the bond.

The lack of a clearly defined and transparent financial policy and strategy at GGU prevent us from viewing it as more than strategic for FCC Aqualia. Should we see a track record of support, the extension of a shareholder loan, or a refinancing of the intercompany loan at the group level in addition to a defined and supportive financial policy, we could review our assessment of GGU's importance within the FCC Aqualia group.

We view GGU's capital structure as pressured by the short-term intercompany loan and skewed toward foreign currency debt. Although the refinancing of GGU's $250 million, 7.75% bond due 2025 with a $164 million intercompany loan due 2024 provided by FCC Aqualia is positive for its ratios, we believe the loan's short length (two years) will pressure the utility's capital structure. That said, we understand there might be a commitment by the new owner to extend the loan's maturity, albeit not contractually signed. Moreover, GGU's interest will decrease to quarterly payments of $3.3 million (GEL9 million) from semiannual payments of $9.3 million (GEL25.3 million) that we believe can be covered by the electricity generation business under current conditions. Should electricity prices materially fall, we could see the utility as more exposed to foreign exchange risks, since its U.S.-dollar-denominated business might not fully cover coupon payments--however, this is not in our base case. We will reassess our base-case scenario in the coming months.

Outlook

The stable outlook indicates our expectation that GGU will continue reporting strong metrics, with FFO to debt of about 19%-22% over 2022-2023, but negative DCF to debt due to high investment requirements in Georgia and uncertainties around FCC Aqualia's dividend policy. It also takes into account that an upgrade is unlikely until we see improving liquidity, combined with a clear plan for the refinancing of the $164 million shareholder loan maturing in August 2024.

Downside scenario

A downgrade would stem from the company's financial policy becoming more aggressive, with higher-than-expected capex not mitigated by a timely increase in earnings or a more generous than currently expected shareholder remuneration policy. This would notably be the case if one of the aforementioned actions weakens the company's credit metrics, with adjusted FFO to debt declining below 15% over 2023-2024. A downgrade would also stem from the company's inability to secure timely refinancing of the shareholder loan from 80%-owner FCC Aqualia.

Upside scenario

Ratings upside is limited until liquidity improves and uncertainties around the refinancing of the shareholder loan, new financial policy, and new tariffs over 2024-2026 are resolved.

A positive rating action would stem from one or a combination of the following items:

- A clear financial policy, with notably capex and dividends allowing for continuously improving credit metrics.
- An improved liquidity position, with GGU having a clear plan for refinancing the $164 million shareholder loan from FCC Aqualia.
- A supportive regulatory framework in the new 2024-2026 regulatory period, with higher tariffs reflecting inflation and investments.
- Stronger group support than currently assessed.

Company Description

GGU is one of the largest privately owned utility companies in Georgia, which historically operated in the natural monopoly water utility business and electricity generation. Following the transaction between FCC Aqualia and GCAP, GGU is now mostly composed of the water utility segment that provides water supply and wastewater services to 1.4 million customers in Georgia's capital, Tbilisi, and its surrounding area as well as 149 megawatts (MW) of hydro power plants. The remaining generation capacity (71 MW operating) has been demerged and is fully owned by GCAP. GGU's annual EBITDA should reach GEL130 million-GEL140 million (€40 million-€50 million) in 2022-2023 and increase once the new regulatory period for water networks starts in January 2024.

Our Base-Case Scenario

Assumptions

- Revenue from the regulated water business is stable at about GEL170 million-GEL180 million, combined with about GEL30 million-GEL40 million of revenue from the electricity business, driven by higher prices over 2022-2023.
- EBITDA margin stays in the 60%-65% range.
- GGU's capex, totaling about GEL100 million-GEL105 million in 2022, increases in line with FCC Aqualia's expectations from 2023 to about GEL150 million-160 million annually.
- No dividends in 2022, with forecast dividends stable at GEL20 million beyond 2023. This is subject to GGU's updated dividend policy that will be defined by FCC Aqualia over 2023.

Key metrics

Georgia Global Utilities JSC--Key Metrics*

(Mil. GEL)	2020a	2021a	2022e**	2023f**
Revenue	166	237	200-220	200-220
EBITDA	96	160	130-140	130-140
EBITDA margin (%)	58.1	67.3	60-65	60-65
Funds from operations (FFO)	31	98	80-90	90-100
Capital expenditure	88	86	100-110	150-160
Dividends	20	20	0	20
Debt	835	835	400-420	500-510
Debt to EBITDA (x)	8.7	5.2	3.0-3.5	3.5-4.0
FFO to debt (%)	3.7	11.7	19-22	19-22
FOCF to debt (%)	4.4	6.4	10-15	(15)-10

*All figures adjusted by S&P Global Ratings. **From 2022, financial metrics represent the new GGU post transaction. a--Actual. e--Estimate. f--Forecast. FOCF--Free operating cash flow. GEL--Georgian lari.

Liquidity

We assess GGU's liquidity as less than adequate, since its sources will cover uses by about 0.9x over the next 12 months. This is subject to GGU's new financial policy and future capex program.

We incorporate in our analysis the higher capex as per FCC Aqualia's expectations, as well as the August 2024 maturity of the shareholder loan from FCC Aqualia. However, we understand there is a commitment from the shareholder to extend the maturity until GGU can refinance the loan on the capital market. We also note GGU's healthy relationships with local banks and supranational institutions. GGU has a proven track record of successful access to international capital markets.

We estimate that principal liquidity sources as of Jan. 1, 2023, include:

- GEL60 million-GEL70 million of cash and cash equivalents; and
- Our cash FFO estimate of GEL70 million-GEL75 million.

We estimate that principal liquidity uses for the same period include:

- Up to GEL150 million-GEL160 million of capex;
- No dividends in 2023 subject to the updated dividend policy to be set by FCC Aqualia; and
- No maturities until the shareholder loan comes due in August 2024.

Ratings Score Snapshot

Issuer Credit Rating	BB-/Stable/--
Business risk:	Fair
Country risk	Moderately High
Industry risk	Very Low
Competitive position	Fair
Financial risk:	Aggressive
Cash flow/leverage	Significant (medial volatility table)
Anchor	bb-
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Negative (-1 notch)
Financial policy	Neutral (no impact)
Liquidity	Less than Adequate(no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Neutral(no impact)
Stand-alone credit profile:	b+
Group credit profile	bbb-
Entity status within group	Moderately Strategic (+1)

ESG credit indicators: E-4, S-2, G-3

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Georgian Water Regulatory Framework: Somewhat Supportive, Feb. 17, 2023
- Georgia Global Utilities Upgraded To 'B+' From 'B' Post-Acquisition By FCC Aqualia; Outlook Positive, Nov. 9, 2022

Ratings List

Upgraded

	To	From
Georgia Global Utilities JSC		
Issuer Credit Rating	BB-/Stable/--	B+/Positive/--

Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914