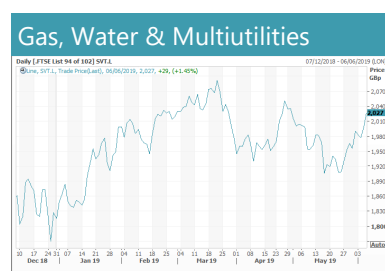




06 June 2019



Source: Refinitiv

### Market data

EPIC/TKR	SVT
Price (p)	2,053
12m High (p)	2,100
12m Low (p)	1,758
Shares (m)	237
Mkt Cap (£bn)	4.9
EV (£bn)	10.7
Free Float	100%
Market	Main

### Description

Severn Trent supplies 4.3m homes and businesses as a regulated water and sewerage company, privatised in 1989. The ongoing price review – AMP 7 – and possible re-nationalisation are the two key issues.

### Company information

CEO	Liv Garfield
CFO	James Bowling
Chairman	Andrew Duff

Tel: 07889806578

[www.severntrent.com](http://www.severntrent.com)

### Key shareholders

Black Rock	7.80%
Reef Real Estate	4.34%
Aberdeen Standard Inv.	3.94%
Legal & General Inv. Man.	3.48%
Maple-Brown Abbott	3.32%
Lazard Asset Man.	3.10%

### Diary

13 Jun	Ex-dividend date
17 Jul	AGM
19 Jul	Div. payment date
21 Nov	Interim results for 2019/20

### Analysts

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## SEVERN TRENT

### An Ofwat fast-tracker

Severn Trent (SVT) is one of 10 water companies privatised in 1989, of which just three remain publicly quoted. SVT supplies 4.3m homes and businesses with clean water and sewerage services. Its base is in the Midlands; following the acquisition of Dee Valley, it now has a Welsh business, Hafren Dyfrdwy. The water sector is now in the throes of a key price review – the new pricing formula will apply as from April 2020. Ofwat has awarded 'fast-tracker' status to SVT, enabling it to secure a better deal than its peers – a dividend cut in 2020/21 is possible. Re-nationalisation by an incoming Labour Government is also a risk.

- **Strategy:** SVT seeks to deliver its £700m+ annual water investment programme, including the Birmingham Resilience Project, as efficiently as possible, whilst improving customer service. SVT is also at the centre of a major new Midlands-based house-building programme, requiring large water infrastructure expenditure.
- **Water/sewerage:** The core business – delivering clean water and sewerage services to its defined customer base – is key. The ongoing price review is undoubtedly far tougher than its predecessor. SVT's well-received 2018/19 full-year results showed inherent core business strength, contributing £527m of PBIT.
- **Valuation:** SVT's quoted valuation is £4.9bn. The prime valuation parameter is its Regulated Asset Value (RAV), which was £9.3bn at March 2019. It is this figure that is used – as the denominator – by Ofwat to calculate its price determination: indirectly, it sets the scope for dividend growth.
- **Risks:** Currently, water companies face two major risks: i) the price review – as a 'fast-tracker', SVT is better placed than many of its peers: focus will be on its dividend growth potential after 2019/20; and ii) possible re-nationalisation by an incoming Labour Government – any shareholder compensation could be meagre.
- **Investment summary:** SVT's finances, despite net debt of £5.8bn, remain strong. Importantly, to boost its dividend growth potential, it has built up £177m of ODIs (Outcome Delivery Incentives) to use in the 2020/21-2024/25 regulatory period. Political concerns are also weighing heavily on utility sector share prices. 2020/21 figures below are primarily illustrative, given uncertainties on the AMP 7 outcome.

### Financial summary and valuation

Year-end Mar (£m)	2017/18A	2018/19A	2019/20F	2020/21F
Turnover	1,696	1,767	1,825	1,829
Operating costs (underlying)	-1,156	-1,193	-1,240	-1,289
PBIT (underlying)	540	574	585	540
PBT (reported)	301	385	373	321
EPS (p) (underlying)	120.5	145.8	155.1	131.8
DPS (p)	86.6	93.4	100.1	103.1
Dividend cover	1.39	1.56	1.55	1.28
Net debt (m)	5,357	5,834	6,300	6,750
Yield	4.2%	4.5%	4.9%	5.0%
P/E (x)	17.0	14.1	13.2	15.6

N.B. there have been some accounting restatements in

Source: Hardman &amp; Co Research

## Background

### *Privatised in 1989*

The 10 former Water Authorities were controversially privatised in 1989, with Thames, Severn Trent and United Utilities (formerly North West Water) being the largest.

### *Just three remain publicly quoted*

Of these 10 companies, only three remain publicly quoted. Along with Severn Trent, United Utilities and Pennon, which owns South West Water, make up the quoted water sector.

Like all water companies – apart from those in Scotland and Northern Ireland, which remain in the public sector – Severn Trent, as an effective monopoly supplier, is dependent upon the five-year price review to determine its future revenue base.

### *Ofwat's deep review*

Ofwat assesses – in considerable detail – the finances of each water company and its ongoing operating and capital costs to prescribe a price formula, which is set to last for five years. The current price review, AMP 7, will apply as from April 2020.

### *Quinquennial price reviews*

Since privatisation in 1989, the five-year pricing formulas have become increasingly testing; simultaneously, debt levels have risen to accommodate very substantial investment expenditure – and the negative cash flows that result.

Investment levels have continued to rise, with Severn Trent investing an average of ca.£650m per year. The Birmingham Resilience Project, a key programme, was the largest AMP 6 single project in the water sector.

More generally, Severn Trent's five-year record is a steady one, showing real progress, especially in terms of managing its debt effectively – but challenges remain.

### *'Fast-tracker' status puts Severn Trent ahead of the game*

Furthermore, having been accorded 'fast-tracker' status by Ofwat, Severn Trent is ahead of most of its peers, although both quoted water stocks, United Utilities and Pennon (the owner of South West Water), are the only other 'fast-tracked' companies.

## 2018/19 full-year results

### *Impressive results*

Severn Trent has recently announced its full-year results for 2018/19, which were generally impressive and therefore well-received. Notable progress was reported on the debt financing front, with a sharp reduction in interest costs. Highlights were as follows:

- ▶ Underlying PBIT of £574m, an increase of 6.3% on 2017/18.
- ▶ A 21% increase in underlying earnings per share – 145.8p compared with 120.5p in the previous year. Reduction in the effective average interest rate by 60bps to 3.9%.
- ▶ A 7.9% full-year dividend increase; this is based on a 4% annual real growth uplift.
- ▶ A total of £177m of ODIs (Outcome Delivery Incentives), which will buttress dividend cover in AMP 7.
- ▶ The maintenance of the lowest average combined bills in England – at £354 per household per year.
- ▶ Investment expenditure in 2018/19 of £769m.

- ▶ Good progress on renewable energy self-generation – the 50% target should be reached during this financial year.

## Re-nationalisation

### *A real threat*

For the first time since the utility privatisation programme of the 1980s and early 1990s, the water and electricity networks companies face a real threat of re-nationalisation if there were a General Election and an incoming Labour Government won a sufficient majority to enable it to honour its manifesto commitment to re-nationalise these companies.

In effect, Labour's declared policy is to establish regional water businesses, which would be publicly owned.

For shareholders, there would be some compensation, although its level is highly debatable. The Labour Party has confirmed that the amount would be set by Parliament and that it would be paid in gilt-edged stock rather than in cash.

### *The Railtrack precedent*

Despite serious legal constraints, the Human Rights Act 1998 and several Investment Treaties, notably in Asia, shareholder compensation is expected to be meagre. There are some precedents, such as Railtrack, which was re-nationalised in 2001. In this case, the compensation eventually paid out was ca.15% of Railtrack's peak market value.

## Finances

### *Net debt/RAV at ca.60%*

For a utility, Severn Trent's finances are robust – and far better than those of Thames, whose net debt level is close to double that of Severn Trent. In its 2018/19 full-year results, Severn Trent confirmed net debt of £5.8bn, which represented just over 60% of its Regulatory Asset Value (RAV).

In recent years, Severn Trent's dividend policy has been progressive. This factor drove up its share price, prior to more widespread market concerns about the financial impact of AMP 7 and the profound political uncertainties associated with Brexit that could propel the Labour Party into government – and a utility re-nationalisation programme.

### *Dividend up by RPI+4%*

In 2018/19, Severn Trent raised its annual dividend by 7.9%, based on its long-standing AMP 6 policy of RPI+4% annual increases.

For this year, Severn Trent has recently reiterated its dividend growth guidance of at least RPI+4%, which is expected to give rise to a full-year dividend of 100.08p.

### *New ballgame after 2019/20*

After 2019/20, the regulatory review outcome will be the key determinant of future dividend policy. A dividend cut could be accompanied by a commitment of decent progressive dividend growth; alternatively, a low dividend cover could persist, with modest dividend growth thereafter. Once the financial outcome of AMP 7 is known, Severn Trent will be in a position to set out its longer-term dividend growth expectations.

### *Formidable ODIs ballast*

However, Severn Trent's formidable carry-forward of ODIs into AMP 7, now worth £177m, provides very real financial ballast; they can be deployed progressively during 2020/21 and 2024/25, thereby obviating the need for a dividend cut.

*Front-loaded price cuts*

With respect to price cuts in the 2020/21 to 2024/25 period, Severn Trent's business plan confirmed its intention to reduce average prices by 5% over the five years; the proposed price cuts are expected to be somewhat front-loaded

## Five-year performance

*Solid performance*

The table below shows how Severn Trent has performed in recent years. The overall record is very solid, although there was a dividend cut in 2015/16 to reflect the tougher regulatory regime of AMP 6, compared with its AMP 5 predecessor. The data was extracted from Severn Trent's 2018 Annual Report; there have been some re-statements subsequently, which account for minor variations in the 2017/18 figures.

### Five-year financial summary

Year-end Mar (£m)	2017/18	2016/17	2015/16	2014/15	2013/14
Turnover	1,694	1,638	1,754	1,801	1,757
PBIT (underlying)	541	520	503	540	524
PBT	302	328	303	148	319
EPS (underlying) (p)	121.0	115.7	102.1	107.02	92.5
Dividends (ex-special) (p)	86.6	81.5	80.7	84.9	80.4
Dividend cover (x)	1.4	1.4	1.3	1.3	1.2
Net debt	5,357	5,082	4,823	4,753	4,475

Source: Hardman & Co Research

# Notes

# Notes

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