

CREDIT OPINION

12 February 2019

Update

✓ Rate this Research

RATINGS

East Rand Water Care Company

Domicile	South Africa
Long Term Rating	Ba1
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

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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East Rand Water Care Company (South Africa)

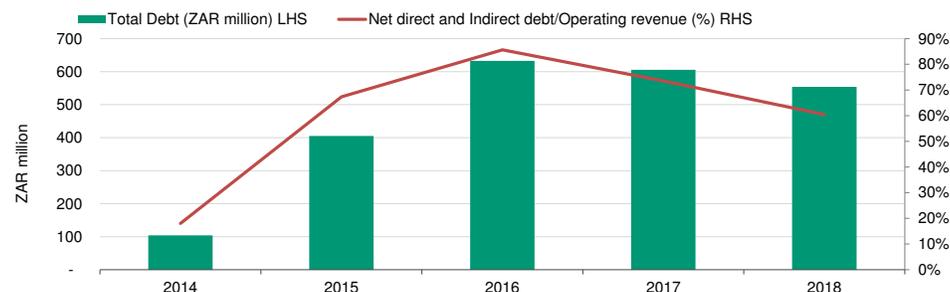
Update to credit analysis

Summary

The credit profile of [East Rand Water Care Company \(ERWAT, Ba1 stable\)](#) reflects the company's close financial and operational links with its support provider, the [City of Ekurhuleni \(Baa3 stable\)](#), which guaranteed 91% of ERWAT's debt as of 30 June 2018, as well as its legal status as a public-sector entity. The profile also reflects the company's good financial performance, track record of adhering to budget plans and its deteriorating liquidity.

High level of debt will likely continue to decline gradually

Exhibit 1



Sources: Moody's Investors Service & ERWAT Financials

Credit strengths

- » Strong support and close supervision from 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, though this is likely to continue to decline over the next three years
- » Weakening liquidity
- » Limited prospects for business diversification and expansion

Rating outlook

The stable rating outlook reflects our expectation that ERWAT will maintain its good financial performance and its debt will continue to decline gradually over the next three years, as its capital expansion plan will be financed by internally generated funds and capital transfers from its support provider.

Factors that could lead to an upgrade

We would consider upgrading ERWAT's rating if its debt fell substantially and its liquidity improved. ERWAT's rating could also be upgraded if its support provider's rating were upgraded.

Factors that could lead to a downgrade

Although a downgrade is currently unlikely given the stable rating outlook, any reduction in government support for ERWAT would likely lead to a downgrade. In addition, a downgrade of the City of Ekurhuleni's rating would require a corresponding change in ERWAT's rating.

Key indicators

Exhibit 2

Key Indicators

East Rand Water Care Company, (ERWAT)

	2014	2015	2016	2017	2018
Total Assets (ZAR million)	1,347.6	1,737.5	2,143.1	2,223.7	2,337.0
Operating margin (%)	35%	32%	32%	31%	33%
Surplus (Deficit) for the Year / Total income (%)	21%	13%	17%	16%	16%
Total Debt / Total Assets (%)	8%	23%	30%	27%	24%
Debt / Cash flow from operations (x)	1.8	35.9	8.1	100.2	6.3
Cash interest cover ratio (x) [1]	5.9	0.7	1.7	0.3	1.6
Current Assets / Current Liabilities (x)	0.6	2.3	2.4	1.5	1.1
[1] Cash flow from operating activities					

Source: Moody's Investors Service

Detailed credit considerations

High degree of support and supervision from City of Ekurhuleni

We consider ERWAT to be a government-related issuer (GRI). From a credit risk perspective, it is not meaningful 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](#) methodology published on 6 June 2018. We have positioned ERWAT's rating one notch below that of its support provider to reflect its debt not being fully guaranteed and the fact the City of Ekurhuleni controls other state-owned entities.

ERWAT derives 75% 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 5% of its revenue from capital grants. Other income, such as laboratory services, makes up the remaining 20% of total revenue. The City of Ekurhuleni approves ERWAT's capital expansion and borrowing plans, as well as its budget plans. As of 30 June 2018, 91% of ERWAT's total debt exposure benefited from explicit guarantees from 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.moody's.com for the most updated credit rating action information and rating history.

Public legal status and close integration with City of Ekurhuleni

ERWAT is a public company, majority-owned by 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 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 11% to ZAR966 million (\$73 million) in fiscal year 2018, ending 30 June 2018, largely because of an 18% increase in other income and a 12% increase in service charges. ERWAT derives most of its revenue from service charges for wastewater sewerage 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. ERWAT accrues other income from service agreements with private clients outside its jurisdiction. This business line, which contributes 20% of the company's total income, includes laboratory services and research and development 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 63% of operating expenditure in 2018.

ERWAT's revenue and expenditure structure is well established and, in our opinion, prospects are limited for any shift in its business model that could affect its revenue structure. ERWAT's monopolistic status as the sole provider of a municipal statutory service 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 in respect of financial governance and reporting. The City of Ekurhuleni does this through: (1) approving ERWAT's board members and appointing two city officials to serve on ERWAT's board; and (2) conducting the company's internal audit.

Very high debt, though this is likely to continue to decline gradually over the next three years

ERWAT's reported debt stock of ZAR554 million represented a very high 60% of operating revenue as of 30 June 2018. We expect ERWAT's debt to decline gradually over the next three years, however, because the company intends to finance its entire capital expenditure plans for 2019-21, amounting to ZAR370 million, from its own funds and through capital transfers. In addition, one of its loans will mature in fiscal 2020, contributing to the overall decline in debt. While we regard ERWAT's level of 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 ZAR87 million in fiscal 2018 from ZAR158 million the previous year. The decrease reflected the company's decision not to borrow and to fund a larger part of its capital spending from its own funds. The move led ERWAT's liquidity ratio to decline to 1.1x in fiscal 2018 from 1.5x in fiscal 2017. We expect ERWAT's liquidity to remain under pressure over the next three years as it continues to fund a large part of its capital spending from its own funds. In fiscal 2019, ERWAT expects to finance ZAR71 million of its ZAR121 million capital spending plan from its own funds, with the remaining ZAR50 million to be funded through capital grants. In the following two fiscal years, ERWAT's capital expenditure budgets of ZAR124 million and ZAR125 million, respectively, will be financed through capital grants of ZAR50 million in each year and the rest from internally generated funds.

Limited prospects for business diversification and expansion

ERWAT is 97% owned by Ekurhuleni Metropolitan Municipality, with the remaining 3% divided equally between the [City of Johannesburg \(Baa3 negative\)](#) and 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.

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 recognises that ERWAT plays a crucial role in fulfilling one of its statutory responsibilities. As such, 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.

Rating methodology and scorecard factors

The methodology used in this rating was [Government-Related Issuers](#) published on 6 June 2018.

Ratings

Exhibit 3

Category	Moody's Rating
EAST RAND WATER CARE COMPANY	
Outlook	Stable
Issuer Rating -Dom Curr	Ba1
NSR Issuer Rating	Aa3.za

Source: Moody's Investors Service

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