S&P Global Ratings

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Research Update:

Veolia Affirmed At 'BBB/A-2' With Stronger Business Position; Outlook Stable

April 20, 2023

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Rating Action Overview

- French water, waste, and energy group Veolia's successful merger with Suez has enhanced its market positioning since the group now benefits from a larger scale (revenue of €42.9 billion in 2022), enhanced geographic diversification, and a higher contribution from stable regulated water operations.
- The group delivered strong operating and financial performance in 2022 and maintained adjusted funds from operations (FFO) to net debt close to 20%, which was above S&P Global Ratings' expectations, thanks to strong organic EBITDA growth and a cost efficiency program.
- In light of Veolia's stronger business position and better stability of cash flows we have lowered our financial ratio requirement for its 'BBB' rating to adjusted FFO to net debt between 18% and 23% (from 20%-25%).
- We also revised our management and governance score to satisfactory from fair to reflect strong execution of the integration of Suez staff and activities.
- We therefore affirmed our 'BBB/A-2' issuer credit ratings on Veolia Environnement S.A.
- The stable outlook indicates that we estimate Veolia's adjusted FFO to debt will remain at about 20% in 2023, and that the capital allocation of the 2024-2026 strategic plan will support these metrics and focus on the portfolio of regulated and contracted water, waste, and energy activities.

Rating Action Rationale

We view the merger with Suez as successful considering the time taken to execute, the completion of the integration process in all geographies, and the delivery of cost synergies ahead of schedule. Veolia has closed the merger with Suez within a year without major setbacks, showing strong execution skills. The group executed all antitrust divestitures amounting to €10.9 billion of cash inflows: €8.0 billion from the sale of New Suez to a Meridiam-led consortium; €2.2 billion equivalent for the sale of U.K. assets as required by the U.K. competition authority body; and €660 million of proceeds from divestitures required by the European Commission. Following the conclusion of the takeover and after the proceeds received from disposals, the group's net reported debt increased to about €18.1 billion from €9.5 billion a year ago.

Veolia demonstrated its ability to manage human resources and retain talent despite the initial hostile nature of the takeover. Staff and activities of the acquired part of Suez were integrated in all geographies within six months, with evidence of strong commitment of the new employee base and a strong subscription rate to the 2022 employee share plan (employees held 6.5% of Veolia's capital at end-2022).

The group has integrated Suez SA's senior unsecured bonds and its legacy hybrid bonds. The integration of hybrid bonds (total of €1.1 billion net of €500 million refinancing) followed a successful consent solicitation to bondholders. We now consider Veolia's stock of hybrids to amount to €3.6 billion, benefiting from intermediate equity content as per our criteria thanks to harmonized terms and conditions.

We revised Veolia's management and governance score to satisfactory from fair. Aside the merger with Suez, the group has demonstrated strong execution capabilities in achieving its own strategic goals while posting a good set of financial results in 2022. The group has indeed been able to achieve its cost efficiency program one year early (€929 million cumulated in three years until 2022 versus a target of €1 billion in four years). At the same time, it has streamlined its portfolio to focus on strategic priorities (municipal water, municipal energy, and hazardous waste), through a successful asset rotation program (€2.4 billion of acquisitions versus €2.6 billion of disposals over 2020-2022). Finally, we believe the merger with Suez was well managed from human resources perspective, evidenced by the absence of disruptive loss of expertise.

In a year of transformation, the group has delivered strong 2022 operating, commercial, and financial performance. Veolia's reported EBITDA rose by 7.2% to about €6.2 billion, on an organic basis, at constant scope and foreign exchange rate versus combined 2021 Veolia and Suez. This growth was driven by the benefits of Veolia's cost efficiency plan (€371 million in 2022 cost reduction), the generation of cost synergies from the Suez integration (€146 million) and effective pass-through of inflation thanks to pricing control and tariff indexation. The increase in profitability also stemmed from the combination of good volumes and strong price increases boosted by the energy prices (benefiting particularly Energy activities) as well as recyclate prices (supporting Solid Waste performance).

Earnings in 2022 demonstrated the benefit of the group's indexation of tariffs. 70% of the group's revenue is indexed to inflation, while tariffs are also indexed to energy prices. This allowed the group to preserve, outside the cost savings plan, profit margins over the year despite the inflationary environment. All businesses contributed to sound operating and commercial performance, except for China, demonstrating the resilience of Veolia's business model.

Veolia has strengthened its business risk profile thanks to larger scale and a higher contribution from water operations that we view as stable and predictable cash flow sources. Thanks to Suez's integration, the Veolia group exhibits higher geographic diversification, greater exposure to lower risk countries, and a larger contribution from municipal water and contracted waste (see chart 1).

The group has reinforced its water activities (about half of group's 2022 EBITDA) thanks to:

- The integration of regulated municipal water activities in the U.S. (No. 3, by revenue) and Chile (No. 1), which we view as highly predictable in terms of cash flows. This complements strong market positions in Europe;

- The combined platform in Water Technologies, with the integration of Suez WTS, where the group offers value-added services (like desalination, separation technologies, ultrapure water through nanofiltration) with high return associated and strong growth potential for municipalities and industrial sectors (oil and gas, microelectronics, mining).

The municipal water activities, which operate either under long-term concessions (in Europe, mostly France, Spain, Czech Republic); full ownership; or perpetual concessions, help to strengthen Veolia's business risk profile, as they represent the largest share of the water business (36% of total 2022 EBITDA or €2.9 billion). These activities benefit from strong cash flow visibility thanks to supportive regulatory frameworks (U.S., Chile) or strong protective features against inflation (with automatic indexation), covering incurred costs and capital expenditure (capex). Residual volume risk is balanced by the fact that volumes of water distributed are mostly insensitive to macroeconomic trends. Indeed, volumes are supported by demographic growth, water scarcity dynamics, water quality, and new pollution treatments.

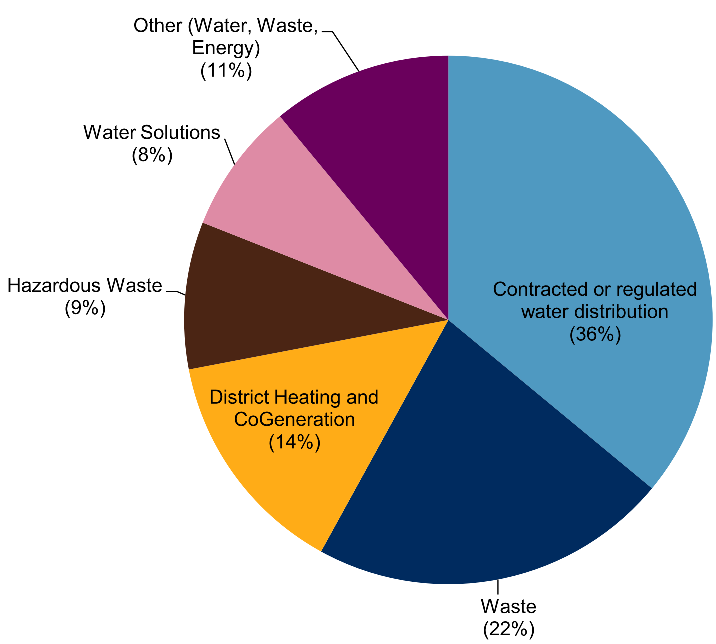
Veolia benefits from enhanced market positioning in Waste and Energy activities, including district heating.

- After the merger with Suez, we view Veolia as stronger in its Waste business (33% group's 2022 EBITDA) thanks to larger scale and build-up of leadership positions in both solid waste (No. 1 in U.K. and Australia, and No.2 in France and Germany) and hazardous waste (No. 1 in Europe, No. 3 in the U.S., No. 1 in the Middle East). In addition, half the solid waste portfolio (about 10% of the group's 2022 EBITDA) is contracted with municipal customers based on an inflation indexation mechanism and relatively stable resilient volumes. We continue to view the remaining commercial and industrial waste portfolio as riskier with exposure to price fluctuation (recyclate price) and with volume cyclicity (with correlation to the economic cycle).
- Veolia has also reinforced its positions in Hazardous Waste (9% of group's EBITDA), one of group's key growth pillars, where it has built high barriers to entry (network of 300 treatment sites in 29 countries with permits associated), in markets with strong growth potential driven by depollution need and more stringent regulation for Veolia's clients sector (Pharma, Chemicals, Oil and Gas notably). This segment will probably represent a higher share of Waste business going forward as there are many ongoing projects due to be commissioned in the next three years (in the U.S., Germany, Middle East, and Asia). The group signed a 30-year contract to exploit two hazardous waste centers with the Abu Dhabi National Oil Company (ADNOC), corresponding to a backlog worth €1.2 billion, and 70% of volumes being covered by the client.
- District heating networks, spread across Poland, Hungary, Germany, and Czech Republic also contribute to support business risk by adding strongly resilient cash flows, with tariff set as cost plus with an indexation to fuel costs. In the case of Poland (about 30% of revenue generated by district heating networks), we view these earnings as regulated, with ERO acting as the authority supervising tariffs, little profitable substitution notably for individual heating in still high energy prices context. We estimate that the EBITDA contribution from these networks, excluding the Chinese market and cogeneration revenue, is equal to about 10%-14% of the group's EBITDA in 2022 (see chart 1).

To reflect Veolia's stronger business model, we are relaxing our guidance for FFO to net debt to the 18%-23% range for a 'BBB' rating from 20%-25%. We expect the group's credit metrics will stabilize in 2023 with EBITDA growth compensated by a debt increase on the back of growth capex. The negative cash flow equation is driven by capex of about €3.5 billion per year (out of which €1.7 billion for maintenance) and dividends amounting to about €1.1 billion, while we expect EBITDA to increase by €300 million per year. We expect the group's adjusted FFO to debt to reach 19%-20% and adjusted debt to EBITDA to be below 4.0x in 2023. We are monitoring cash flow leakages related to minorities since about 18% of total equity from the group comes from noncontrolling-interests.

We view Veolia's financial policy supportive of a solid 'BBB' rating with leverage at about 3.0x. While the group will next year detail its capital allocation over 2024-2026, the group's shareholders and management team remain committed to financial discipline in line with leverage below 3.0x. We believe that Veolia is well positioned to benefit from long-term trends of circular economy, water treatment, recycling, and decarbonization. As such, we expect growth to be balanced across its portfolio with water remaining the largest contributor (about 48% of the group's EBITDA) over the coming years. At this stage, we consider that the group will focus on organic growth and that any mergers or acquisitions will be funded by an equivalent asset rotation program to allow the group to streamline its contracts and geographic exposure.

Veolia's 2022 EBITDA split by segment



Source: Company disclosures.

Outlook

The stable outlook on Veolia reflects our expectation that the group will maintain a balanced portfolio of activities with municipal water and district heating operations contributing close to

50% of the group's business. We forecast the group's reported EBITDA will grow by mid-single digits on an organic basis, thanks to Suez cost synergies and solid revenue growth in all its markets on the back of enhanced business positioning. The stronger business risk profile translates into lower requirements for the rating level: now adjusted FFO to debt above 18% versus above 20% previously. The stable outlook factors in the expectation that Veolia's adjusted FFO to debt will remain at about 20% in 2023, and that the capital allocation of the 2024-2026 strategic plan will support these metrics.

Upside scenario

We could revise Veolia's outlook to positive if we gained clarity over the next strategic review covering 2024-2026 and should the company continue strengthening its financial risk profile. This could happen if the group's capital allocation led to a higher-than-anticipated return on investments and debt-financed growth investments remained contained so that the group's adjusted FFO to debt increased to about 23% and adjusted debt to EBITDA was below 4.0x on sustainable basis.

Downside scenario

We would lower the rating on Veolia should we expect the company were not able to sustain adjusted FFO to debt above 18% in the long term. This could notably stem from the group engaging in higher debt-funded acquisitions than expected or from lower operating performance in its more macroeconomic-sensitive waste activities.

Company Description

Veolia Environment operates worldwide within three main businesses: Water Services, Waste Services, and Energy Services; Water Services being the core business of Veolia since inception in 1853. Since 2003, the group has increased its projects in waste (especially hazardous waste in Asia). In 2022 Veolia acquired Suez, increasing its worldwide presence and enhancing its strong positioning throughout all its business lines in all geographies.

In 2022, Water Services represented 49% of EBITDA, Waste Services 34%, and Energy Services 17%. Geographically, 23% of EBITDA came from France, 40% from Europe (excluding France), and 37% from the rest of the world.

- The water business integrates drinking water and wastewater activities, such as water distribution, water and wastewater treatment, industrial process water, and manufacturing of water treatment equipment and technologies.
- The waste solutions business collects, processes, and disposes household, commercial, and industrial wastes.
- The energy services business produces renewable energy comprising heat and electricity generated primarily from waste. It also incorporates district heating, cooling networks, thermal and multi-technical services.

At year-end 2022, Veolia reported revenue of €42.9 billion, EBITDA of €6.2 billion, and net debt including IFRS16 of €18.1 billion.

Our Base-Case Scenario

Assumptions

- In 2023, high revenue growth in water technologies (notably in the U.S.) should be coupled with significant project execution in hazardous waste, and with strong earnings of its cogeneration plants (benefiting from hedges at the high energy price level of 2022).
- Stable EBITDA margin after IFRIC 12 and principal payments on operating financial assets at about 13%-13.5%, with the water business continuing to contribute around 50% of EBITDA.
- Annual cost savings of €350 million combined with €280 million of additional cost synergies with Suez expected in 2023.
- Tax rate for the group of 25% from 2024.
- Growing cash interest paid in line with refinancing at higher interest rates in the current market conditions.
- Annual capex of about €3.5 billion of which 50% is maintenance capex. Further capex will be driven by asset rotation opportunities.
- Ordinary dividends increasing in line with net income at about €1.1 billion in 2023 and €1.3 billion in 2024.

Key metrics

Veolia Environnement S.A.--Key metrics

	--Fiscal year ends Dec. 31--			
(Bil. €)	2020a	2021a	2022a	2023f
EBITDA reported (after IFRIC 12)	2.9	3.4	6.0-6.1	6.4-6.5
EBITDA*	3.2	3.6	5.7	5.8-5.9
Debt*	16.2	13.0	22.3	22.3-22.7
Capital expenditure*	1.7	1.7	2.8	3.5
Dividends*	0.4	0.6	1.1	1.1-1.2
FFO to debt* (%)	14.9	22.8	19.7	19.4-19.8
Debt to EBITDA* (x)	5.2	3.6	3.9	3.8-4.0

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

Liquidity

We assess Veolia's liquidity as adequate, in line with our forecast that sources of liquidity will exceed uses above 1.2x (closer to 1.5x) over the next 12 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. We view that the group has no commitment to maintain ratios in line with our "strong" liquidity assessment in the future.

Principal liquidity sources as of Dec. 31, 2022:

- About €10.4 billion in available cash or highly liquid money market funds.
- About €6.4 billion of available committed credit lines maturing beyond 12 months, including €3 billion and €2.5 billion multicurrency syndicated loans maturing respectively in May 2024 and April 2026.
- Our forecast for FFO of about €4.4 billion for the next 12 months.

Principal liquidity uses as of Dec. 31, 2022:

- Debt repayment of about €2.6 billion and commercial paper of about €3.9 billion.
- Our estimate of €3.5 billion in annual capex, including expansion capex.
- Annual dividends of about €1.1 billion-€1.2 billion.

Issue Ratings--Subordination Risk Analysis

Capital structure

Veolia's debt currently comprises senior unsecured debt (mostly bonds) and €3.6 billion of hybrids. All the debt including the hybrids are at Veolia's level, so we apply no notching.

Analytical conclusions

We rate Veolia's financial debt at the same level as Veolia's current stand-alone financial debt, namely 'BBB'. The hybrids are rated two notches below at 'BB+'.

Ratings Score Snapshot

Issuer Credit Rating	**BBB/Stable/A-2**
Business risk:	Strong
Country risk	Low Risk
Industry risk	Low Risk
Competitive position	Strong
Financial risk:	Significant
Cash flow/leverage	Significant (medial)
Anchor	bbb
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)

Issuer Credit Rating	BBB/Stable/A-2
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bbb

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

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- 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
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Ratings List

Ratings Affirmed

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