How Veolia's Bid For Suez May Transform Its Credit Profile

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Key Takeaways

- We expect to gain greater clarity on Veolia's proposed acquisition of Suez during the second half of this year but, for now, our base-case scenario is that Suez could become a fully owned subsidiary of Veolia from 2022.
- In our view, integrating Suez would reinforce Veolia's already strong business profile as a France-based transnational water, waste, and energy management company, backed by Veolia's strategy to restore its balance sheet if its bid is accepted and the acquisition goes through.
- If Veolia's bid is not accepted, we believe Veolia could increase its stake in Suez, becoming the majority shareholder and fully consolidating Suez, in which case our business risk assessment would be similar to that under a full takeover situation.

Veolia Environnement S.A.'s (BBB/Stable/A-2) purchase of a 29.9% stake in global water and waste group Suez S.A. (not rated) in October 2020 set the stage for its February 2021 bid to acquire all of Suez's equity. Assuming the acquisition and integration of Suez happen in 2022, S&P Global Ratings anticipates that the enlarged group's business risk profile would be more solidly anchored within the strong category, according to its criteria. This is because we see Suez's activities as slightly less volatile than Veolia's, owing to its geographic and business mix, including a higher proportion of water operations.

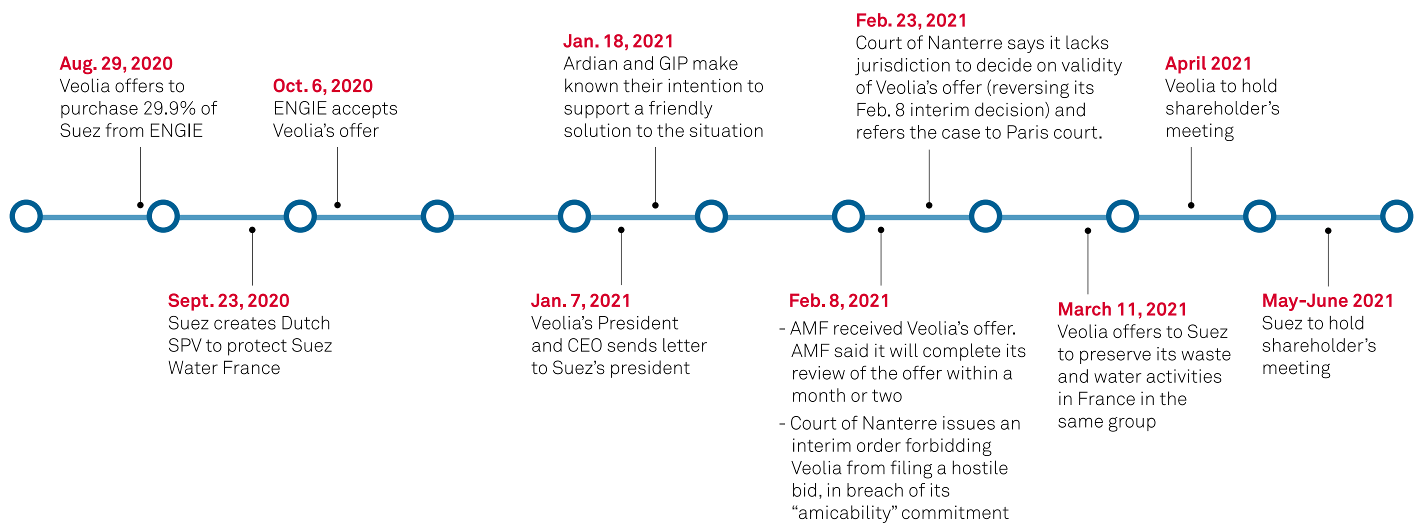
Adding Suez would turn Veolia into a global leader in water, environment, and energy solutions, therefore the combined group would benefit from a stronger market position and greater diversification. What's more, Veolia's management has shown its ability to integrate new businesses and deliver on synergies and planned disposals. At this stage, based on our preliminary assessment, we consider what Veolia group's geographic and product mix might look if it includes Suez, and how this might affect its finances, creditworthiness, and growth prospects.

Operational And Legal Uncertainties Imply A Lengthy Acquisition Process

Following Veolia's submission of a tender offer to the AMF (Autorité des Marchés Financiers) on Feb. 8, 2021, to take over the remaining 70.1% of Suez, we revised our base case for Veolia to include the possible full integration of Suez. We currently see Veolia as committed to maintaining its current creditworthiness and able to keep our adjusted funds from operations (FFO) to debt metric above our 20% threshold after the acquisition (see "French Utility Company Veolia Affirmed At 'BBB/A-2' On Proposed Takeover Of Suez; Outlook Stable," published Feb. 22, 2021, on RatingsDirect).

Chart 1

Veolia Environnement Transaction Timeline



AMF--Autorité des marchés financiers. GIP--Global Infrastructure Partners.
Source: S&P Global Ratings. Copyright © 2021 by Standard & Poor's Financial Services LLC. All rights reserved.

Although our outlook on Veolia is stable, our ratings on both of Suez's U.S.-based rated water subsidiaries--Suez Water Resources and Suez Water New Jersey--are on CreditWatch negative. We expect to resolve the CreditWatch over the next several months as the outcome of the acquisition proposals becomes clear (see "Suez Water Resources LLC Ratings Placed On CreditWatch Negative Amid Parent Acquisition Proposals," published Jan. 26, 2021). Our review will include an analysis of the potential impact of the change in ownership, the companies' resulting financial profiles, and any asset sales following the transaction.

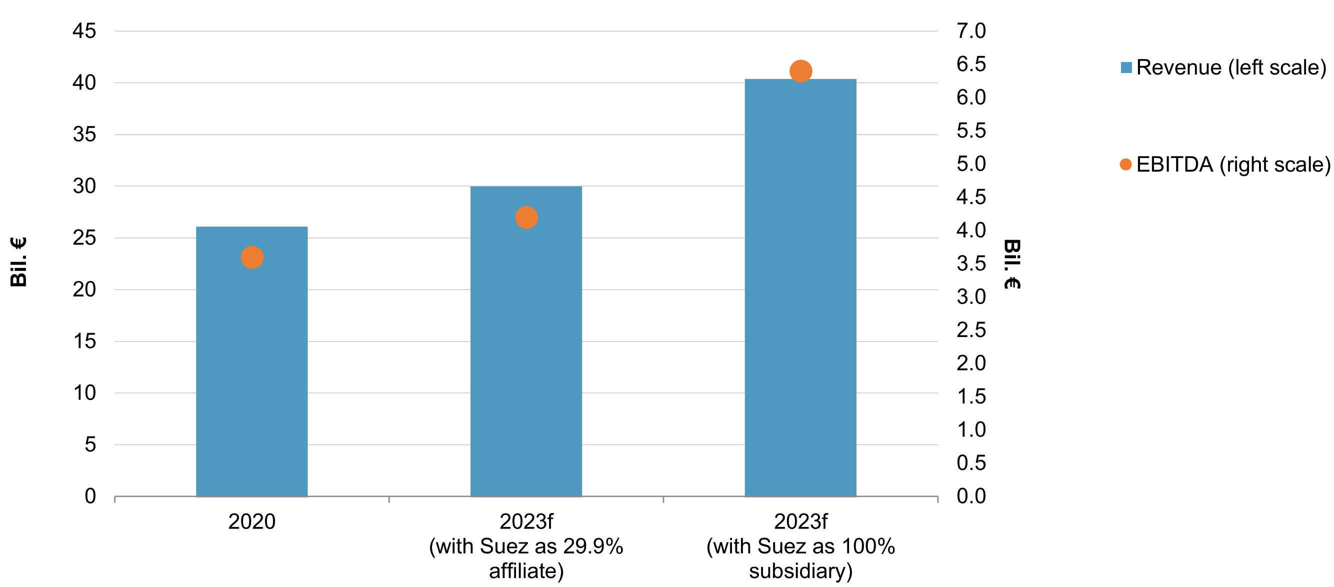
Should a full takeover not succeed, we believe Veolia would increase its stake in Suez and become the majority shareholder. If this were to happen, we believe Veolia could fully consolidate Suez, in which case our business risk assessment would be similar to that under a full takeover situation. However, Veolia might conceivably amend its planned remedy measures accordingly, particularly regarding the capital increase and disposals, to maintain credit metrics in line with the current rating, notably with S&P Global Ratings-adjusted FFO to debt above 20%.

Suez Will Enhance Veolia's Scale And Revenue Diversity

We believe that, overall, Suez's geographic and business mix is less risky than Veolia's, notably thanks to operations in lower-risk markets and a larger share of contracted water and waste activities. We estimate that Suez's inclusion would increase the Veolia group's size to about €6.5 billion after disposals in 2023 from about €3.6 billion EBITDA in 2020. The combined group would also have stronger market positions and increased diversification. Both Veolia and Suez are considered global leaders in environmental services, but even combined, represent less than 2% of the fragmented global waste and water market. At a time when macroeconomic trends are becoming more favorable for the sector globally and consolidation is poised to accelerate, joining forces is likely to be positive. In addition, the enlarged group would enjoy greater geographic diversification and increased opportunities to manage portfolio arbitrage and optionality, barring major adverse events.

Chart 2

Veolia Group Revenue And EBITDA Forecasts

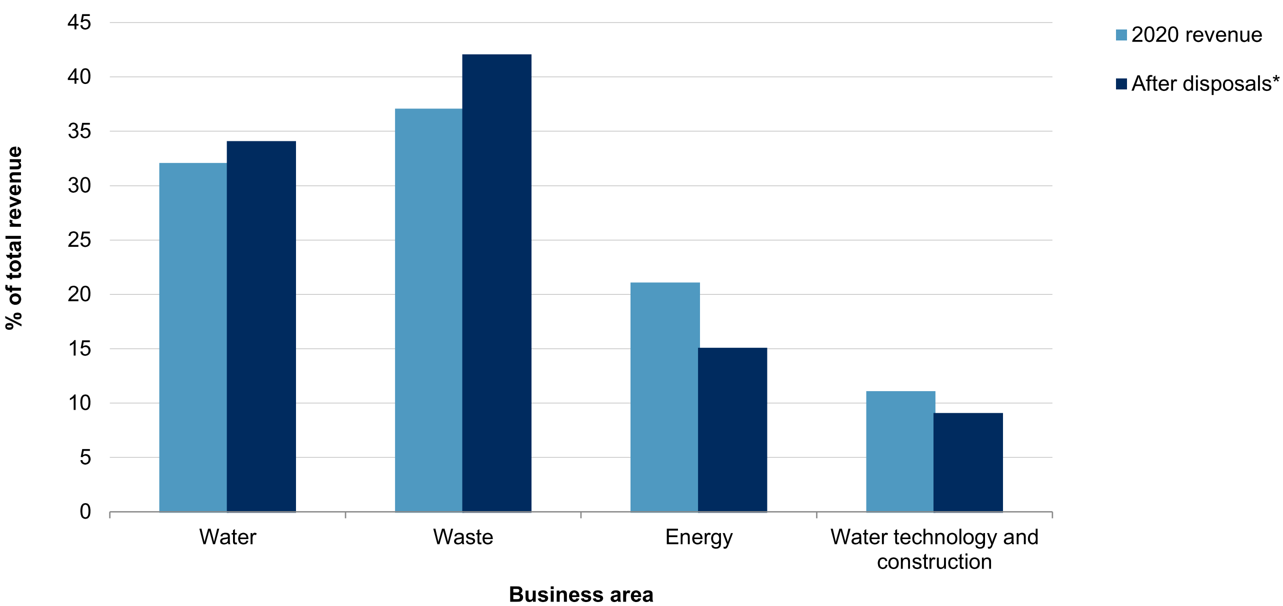


f--Forecast. Source: S&P Global Ratings.

If Veolia succeeds in acquiring Suez and completes asset disposals as part of its remedy measures, we expect the group to benefit from long-term contracted water distribution operations in highly rated countries such as France, Spain, and the U.S. After the consolidation of Suez, water services would represent about 34% of Veolia's revenue compared with 32% previously (see chart 3), the share of waste would increase to 42% from 37%, and the contribution from energy solutions would decrease to 15% from 21%. In terms of geography, the combined group would have a larger presence in low-risk regions, including North America, Europe, and Asia; and less exposure to country risk in Central and Eastern Europe, which currently weighs slightly on Veolia's business profile. Veolia considers key strategic assets to be Suez's Spanish and Chilean water assets, and regulated water assets in the U.S.; as well as its waste management assets in the U.K. and Australia. If Suez were to divest any of these assets, we believe Veolia would reserve the right to withdraw its public tender offer, at which point we would reassess the group's business risk profile.

Chart 3

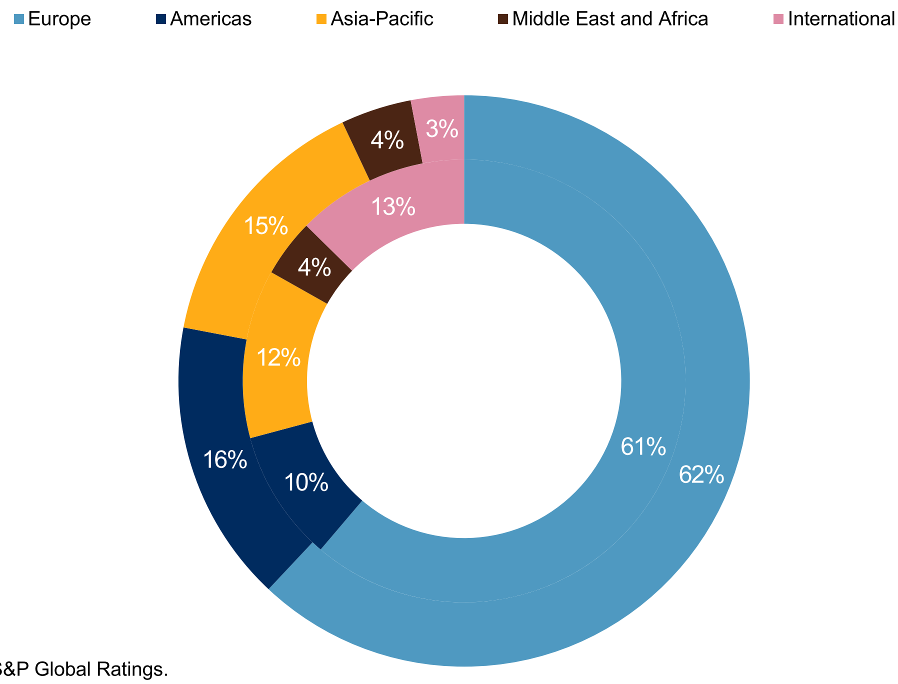
After Disposals More Of Veolia's Revenue Would Come From Waste Operations



*Based on 2020 revenue. Source: S&P Global Ratings.

Chart 4

Veolia Revenue Split By Geography 2020
(Inner circle = 2020 revenue, Outer circle = 2020 revenue after asset disposals)



Source: S&P Global Ratings.

Planned Disposals Won't Alter Business Risk Materially

Given the size and complexity of the acquisition, Veolia would need to undertake several remedy measures, which, however, are unlikely to erode its strong business risk profile. Separately, Suez and Veolia have already announced a series of disposals to restore their respective balance sheets. If the full acquisition of Suez goes ahead, the combined group will also need to manage antitrust risk by selling specific parts of the business. This would include Suez's profitable French water business, for which a sale is already planned, backed by an agreement between Veolia and French infrastructure fund Meridiam that is valid until December 2024. The remaining disposals will primarily come from international waste assets, and other international assets carefully selected mainly for anti-trust reasons.

On its own, Suez has planned two waves of disposals to rotate assets, focusing on the water and recycling businesses. As of March 12, 2021, Suez had completed the first wave, which generated about €2.3 billion in proceeds (see table 1). Wave two should bring in a further €2 billion, some of which Suez intends to use for acquisitions, such as minority stakes in Chinese subsidiaries Suez NWS and Suyu in the first quarter of this year.

Veolia has repeatedly declared that it considers certain assets of Suez to be strategically critical to its offer and will challenge any disposal of these assets by Suez while the offer remains on the table. These include Suez's water activities in Spain, Chile, and the U.S., and its waste assets in the U.K. and Australia.

On Jan. 7, 2021, the president and CEO of Veolia indicated these assets as strategic in his letter to Suez's president.

Table 1

Suez's Disposal Program As Of March 12, 2021

	Wave 1 (under way)	Wave 2 (not completed)
Businesses	OSIS R&R	N/A
	R&R Europe	
	Sweden AquaSure Water*	
	ESSAL Water	
Proceeds (bil. €)	2.3	~2.0
Impact on Suez's 2019 statements (bil. €)		
Revenue	(1.8)	(1.2)
EBITDA	(0.2)	(0.2)
Capital expenditure	(0.1)	(0.1)

*Already completed. Source: Company statements. N/A--Not applicable.

Lower Business Risk Doesn't Immediately Translate Into Lower Rating Benchmarks

At this stage, if the takeover of Suez is successful, the group's business positioning improves as we anticipate, and the envisaged disposals are well under way, we could consider lowering our ratio thresholds for our 'BBB' rating on Veolia. We expect risks related to the implementation of Veolia's remedy measures to diminish only by the end of 2022. Before then, integration and execution risks will be quite high, given the transformative nature of the Suez acquisition and Veolia's need to push through its plan to restore the balance sheet. On top of this, another year of uncertainties related to the COVID-19 pandemic may weaken some businesses.

Veolia's credit metrics look set to stay in line with the ratings regardless of the Suez acquisition

Veolia's financial policy is geared toward a solid investment-grade rating ('BBB-' or higher) with reported net debt-to-EBITDA ratios below 3x, which is almost equivalent to the S&P Global Ratings' adjusted FFO-to-debt ratio above 20% commensurate with the current rating. To maintain such ratios, Veolia has anticipated the need to take significant remedy measures, including disposals, hybrid issuance, capital increases, or a share exchange. We expect that Veolia's and Suez's disposal programs, including for anti-trust purposes, will be finalized more than two years after a full takeover, that is, not before year-end 2023 if Veolia fully acquires Suez this year. The disposal plan includes:

- Suez's French water operations, for which Veolia has already signed an agreement with Meridiam.

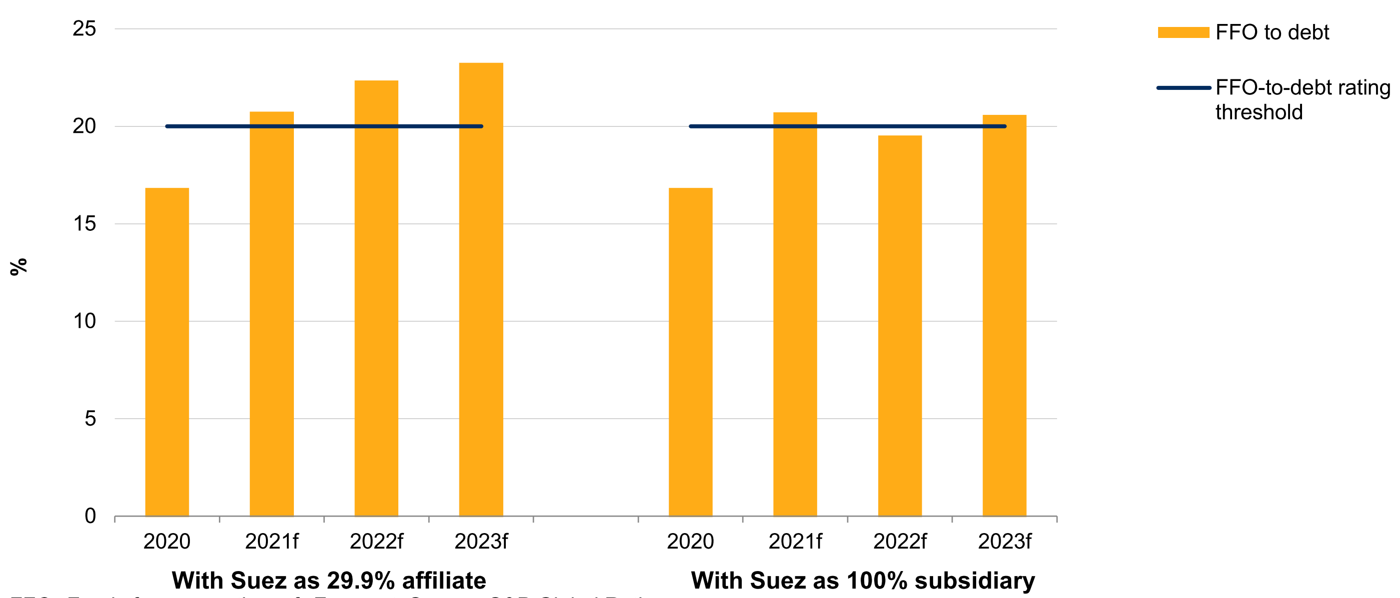
- Waste and recycling businesses.

We also expect the post-acquisition Veolia group to restore its balance sheet through a capital increase or share exchange; the amount of which will vary depending on what the group decides is needed to maintain ratios commensurate with its internal targets. In addition, in our base-case scenario, we do not assume Veolia will use U.S. tax loss carryforwards equivalent to about €450 million. Overall, we see Veolia as being in a good position to maintain S&P Global Ratings-adjusted FFO-to-debt ratios higher than 20% until 2023.

Last year, Veolia invested about €1 billion to purchase district heating assets in Prague and Budapest from EP Infrastructure (see "EP Infrastructure Could Gain Headroom In Its Credit Metrics After Divesting District Heating Assets," published Sept. 7, 2020), in addition to acquiring the 29.9% stake in Suez for €3.4 billion. As a result, its reported net debt increased to €13.21 billion from €10.68 billion in 2019, with reported leverage (net debt to EBITDA) increasing to 3.6x from 2.7x. Reported net debt was higher than we expected because Veolia delayed certain disposals until 2021, notably those related to the district heating assets in Prague.

Chart 5

Veolia's Leverage Remains Rating Commensurate
Whether Suez remains an affiliate or becomes a subsidiary



FFO--Funds from operations. f--Forecast. Source: S&P Global Ratings.

The combined group will have a well-spread debt maturity profile, with no structural subordination concerns

Veolia's debt currently comprises senior unsecured debt (mostly bonds) and €2.0 billion of hybrids. If we include Suez's debt in our structural subordination analysis, based on year-end 2020 information (excluding Suez's €1.6 billion hybrid bonds and IFRS16 leases), the amount of priority debt would represent about 45%-50% of total debt. Therefore, once Suez is integrated into the Veolia group, we believe its financial debt would qualify to be rated at the same level as Veolia's current stand-alone financial debt, namely 'BBB'.

In our base case, we treat Suez's existing €1.6 billion perpetual hybrids (as of Dec. 31, 2020)--with the first call dates seven years after issuance and further call dates every five years afterward--as 100% debt. This is because the step-up margin is a cumulative 100 basis points over 12 years compared with the 25 years stated in our criteria. However, we believe that, if Suez is consolidated, Veolia would refinance the €1.6 billion hybrids on Suez's books.

Table 2

Suez S.A.'s Hybrid Instruments

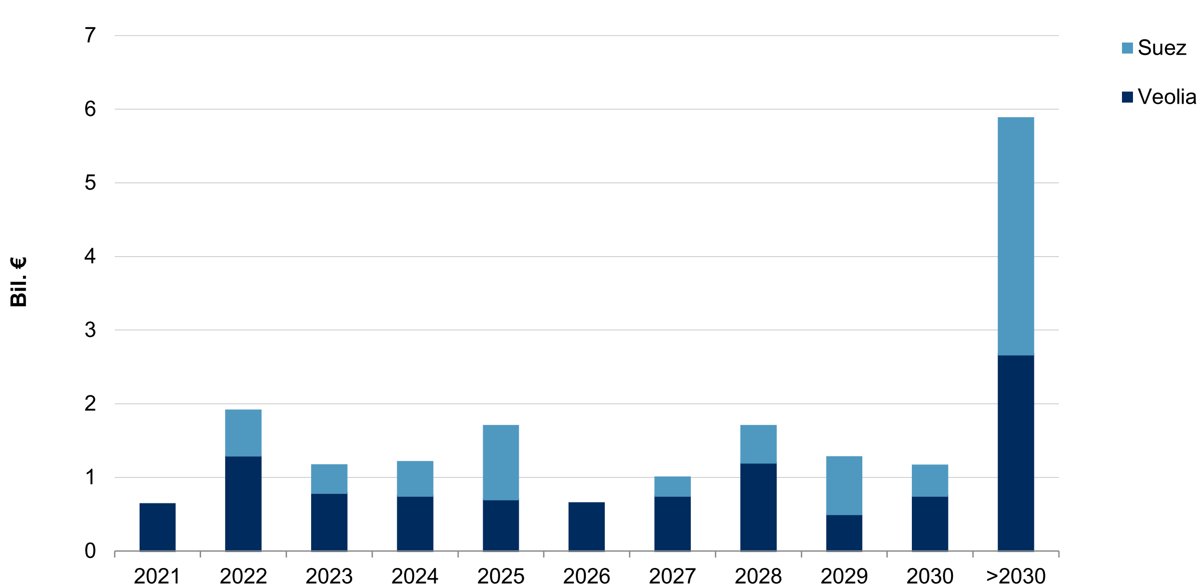
Issue Date	Amount (mil. €)	Coupon (%)	Step-up periods	Purpose
June 2014	500	3.0	--	--
March 2015	500	2.5	First step-up: 7 years	--
April 2017	600	2.9	Every 5 years afterward	Secure funding for the acquisition of GE Water
September 2019	500	1.6	--	Redeem 2014 issued Hybrids

Source: Company statements.

The consolidation of Suez's financial debt doesn't have a significant impact on Veolia group's debt maturities, which we would still consider to be well distributed, with no large repayments falling due in the medium term.

Chart 6

Veolia And Suez Combined--Bond Maturities



f--Forecast. Source: S&P Global Ratings.

Potential Hurdles Could Complicate Management And Governance Before Closing

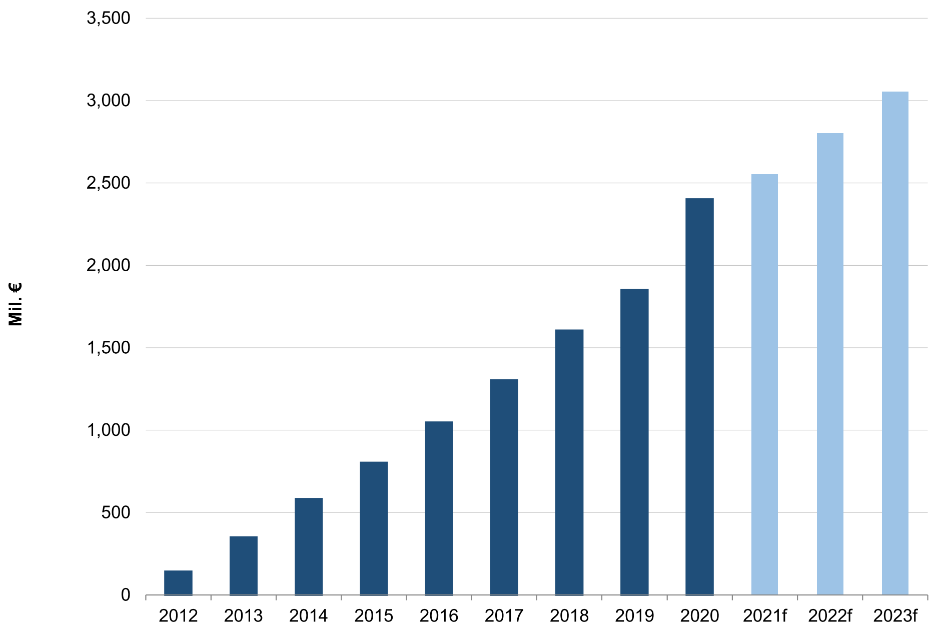
We now regard Veolia's management and governance as fair rather than satisfactory, since we foresee several potential stumbling blocks related to the takeover offer, which is considered hostile (see "French Utility Company Veolia Affirmed At 'BBB/A-2' On Proposed Takeover Of Suez; Outlook Stable," published Feb. 22). We understand that Suez's management and board remain opposed to Veolia's takeover of the company. This has led to ongoing legal disputes and operational challenges, including the temporary suspension of Veolia's voting rights by a French court (later reversed by another court decision), and the transfer of Suez's French water activities to a Netherlands-based foundation. The latter could complicate the future disposal of such assets, a key part of Veolia's plan to comply with anti-trust constraints.

Although we do not believe these actions currently inhibit Veolia from proceeding, we see increased uncertainties and potential delays at least until Suez's stakeholders vote at the next annual general meeting (expected for May or June 2021). Even if the stakeholders sanction the acquisition, we do not expect it will take effect before the end of 2021, with the cash payment likely to take place in 2022; the transaction is subject to European antitrust approval, which we understand could take nine to 15 months.

Against this backdrop, we acknowledge Veolia's track record of optimizing its group. Veolia's management team has in the past been able to restore the company's balance sheet, even under challenging operating conditions, such as during its 2012-2019 transformation. In recent years, it has streamlined the group, including through extensive cost-cutting and synergies, to improve profitability. In our view, Veolia should be able to replicate these efforts with the combined group, notably on IT, purchasing, and operating efficiency measures. Veolia's action plan, if implemented successfully, could realize annual synergies of about €500 million in four years from an expected €250 million in cost savings each year, assuming a resolution of the current hostility between the two groups' top management.

Chart 7

Veolia's Cumulative Cost Savings Program



f--Forecast. Source: S&P Global Ratings.

Veolia's Performance In 2021 Should Be Much Stronger Than Last Year's

Veolia's weak 2020 performance stemmed mainly from the pandemic's effect on its waste and energy operations, including a €59 million foreign exchange impact on EBITDA. Revenue decreased by 4.1% for waste and 2.0% for energy year on year. However, a slowdown in the construction sector, notably in the second quarter as a result of the pandemic, squeezed revenue and delayed construction activities. In addition, despite the tough operating conditions, Veolia's capital expenditure remained high at €2.15 billion, in line with its 2019-2023 strategic plan, compared with €2.20 billion in 2019. Nevertheless, Veolia's fourth-quarter results were stronger than for fourth-quarter 2019, with EBITDA up 4.2%, continuing the positive trend in the third quarter of 2020 when EBITDA rose 1.7%.

We expect Veolia's EBITDA will surpass €4.0 billion this year, thanks to the normalization of operating conditions in the waste and energy businesses. This figure excludes Veolia's 29.9% stake in Suez, which will be accounted for as an equity affiliate, and is higher than the €3.6 billion of EBITDA reported in 2020, which was down versus €4.0 billion in 2019. Even without acquiring the remaining 70.1% of Suez, the recovery of EBITDA, coupled with an expected reduction in net debt to below €12.0 billion, should keep Veolia's credit metrics consistent with the current rating, with net debt to EBITDA below 3x in 2021 corresponding to adjusted FFO to debt above 20% (see "French Utility Company Veolia Affirmed At 'BBB/A-2' On Proposed Takeover Of Suez; Outlook Stable," published Feb. 22, 2021).

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Related Research

- Strong Expected Performance For Veolia In 2021 Should Offset Weaker 2020 Results, Feb. 25, 2021
- French Utility Company Veolia Affirmed At 'BBB/A-2' On Proposed Takeover Of Suez; Outlook Stable, Feb. 22, 2021
- Ratings On Six European Integrated Utilities Affirmed Amid Accelerated Energy Transition; One Outlook Now Negative, Feb. 17, 2021
- The Energy Transition And The Diverging Credit Path For European Utilities, Feb. 16, 2021
- The Energy Transition And What It Means For European Power Prices And Producers: January 2021 Update, Jan. 27, 2021
- Suez Water Resources LLC Ratings Placed On CreditWatch Negative Amid Parent Acquisition Proposals, Jan. 26, 2021
- France-Based Utility Veolia Environnement's Proposed Junior Subordinated Hybrid Notes Rated 'BB+', Oct. 14, 2020
- French Utility Veolia To Offset €3.4 Billion Stake Purchase In Suez With Remedy Measures, Oct. 6, 2020
- French Utility Veolia Environnement 'BBB' Rating Affirmed After €2.9 Billion Bid For 29.9% Stake In Suez; Otlk Stable, Sept. 1, 2020
- Veolia Environnement S.A., June 10, 2020
- French Utility Veolia Environnement S.A. Affirmed At 'BBB' Despite COVID-19 Operating Uncertainty; Outlook Stable, March 27, 2020

This report does not constitute a rating action.