

## CREDIT OPINION

29 March 2018

### Update

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#### 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)

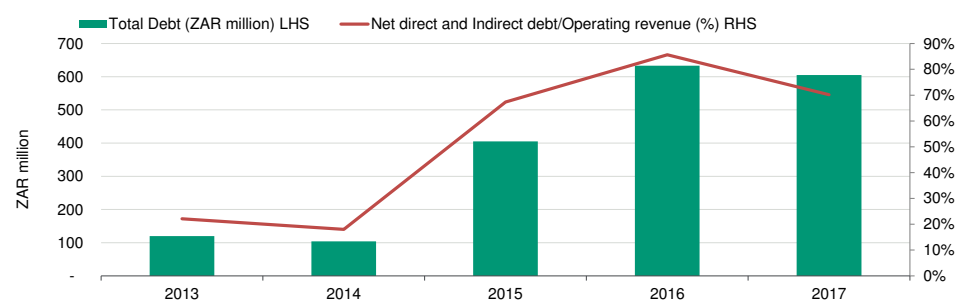
Update following rating confirmation and change in outlook to stable

### 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 the company's debt as of 30 June 2017, as well as its legal status as a public-sector entity. ERWAT operates under a clear public policy mandate from City of Ekurhuleni. The company's credit profile also reflects its good financial performance and history of strong budgetary results.

### ERWAT's debt levels are very high, but we expect them to gradually decline

Exhibit 1



Source: Moody's Investors Service & ERWAT Financials

### Credit strengths

- » High degree of support and supervision from City of Ekurhuleni
- » Public legal status and close integration with City of Ekurhuleni
- » Strong financial performance and conservative governance and management
- » Strong liquidity profile

### Credit challenges

- » Very high debt, though this is projected to decline in the next three years
- » Limited prospects for business diversification and expansion

## Rating outlook

The stable rating outlook reflects our expectation that ERWAT's debt will gradually decrease in the next three years as its capital expansion plan will be largely financed by capital transfers from its support provider, the City of Ekurhuleni.

## Factors that could lead to an upgrade

We would consider upgrading ERWAT's rating if its debt fell substantially and its liquidity profile improved further. ERWAT's rating could also be upgraded in the event of an upgrade of its support provider's rating.

## 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 be likely to lead to a downgrade. In addition, a downgrade of 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)

	2013	2014	2015	2016	2017
Total Assets (ZAR million)	1,207.7	1,347.6	1,737.5	2,143.1	2,265.8
Operating margin (%)	36%	35%	32%	32%	29%
Surplus (Deficit) for the Year / Total income (%)	20%	21%	13%	17%	19%
Total Debt / Total Assets (%)	10%	8%	23%	30%	27%
Debt / Cash flow from operations (x)	0.8	1.8	35.9	8.1	77.2
Cash interest cover ratio (x) [1]	17.2	5.9	0.7	1.7	0.4
Current Assets / Current Liabilities (x)	2.0	0.6	2.3	2.4	1.7
[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 City of Ekurhuleni because of the intrinsic operational and financial ties between the two. As a result, ERWAT's rating derives from the application of the approach for GRIs rated solely on support, as described in our [rating methodology for GRIs](#) published in August 2017. We have positioned ERWAT's rating one notch below that of its support provider to reflect the fact that its debt is not fully guaranteed and that Ekurhuleni controls other state-owned entities.

On 28 March 2018, we confirmed the long-term global-scale ratings of 10 South African regional and local governments (RLGs) and two GRIs, and changed the outlook on the ratings to stable from rating on review, including on ERWAT'S Ba1 long-term global-scale rating. The decision follows the potential improvement of the South African government's credit profile, as captured by Moody's recent decision to confirm South Africa's Baa3 government bond ratings and assign a stable outlook.

At the same time, the action did not affect ERWAT's long-term national-scale issuer ratings of Aa3.za.

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](http://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 ratings also incorporate ERWAT's monopolistic status as the only wastewater treatment company for Ekurhuleni Metropolitan Municipality, as well as its strategic role and close financial links with the metropolitan 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 the area's 19 wastewater treatment plants within the shareholder's area of jurisdiction.

ERWAT's management structure and governance reflect strong control by City of Ekurhuleni, which owns 97% of its shares. ERWAT derives 71% of its total revenue from service charges collected by City of Ekurhuleni and transferred to ERWAT in equal monthly installments, ensuring regular cash flow. A further 5% of its revenue is derived from capital grants. Other income, such as laboratory services, makes a 24% contribution to total revenue. City of Ekurhuleni approves ERWAT's capital expansion and borrowing plans, as well as its budget plan. As of 30 June 2017, 91% of ERWAT's total debt exposure benefited from explicit guarantees from Ekurhuleni.

**Strong financial performance and conservative governance and management**

ERWAT's total revenue increased by 16% to ZAR912 million (\$70 million) in the fiscal year ending June 2017, largely due to a 34% increase in other income and a 12% increase in service charges. ERWAT derives the majority 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 24% of the company's total income, includes laboratory services and research and development for other public-sector entities.

ERWAT's revenue structure is well established and, in our opinion, there are limited prospects 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 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 expenditure flexibility, accounted for 63% of operating expenditure in 2016.

ERWAT's administration system reflects its relatively conservative financial management. The parent municipality exercises oversight over both the company's strategic direction and compliance in respect of financial governance and reporting. City of Ekurhuleni does this through: 1) approving ERWAT's board members and having two of its members serve on ERWAT's board; and 2) conducting the company's internal audit.

### Strong liquidity profile

ERWAT's cash position declined to ZAR158 million in FY2017 from ZAR305 million the previous year. The decrease reflected the company's decision not to borrow and to fund a larger part of its capital expenditure from own funds. The move caused ERWAT's liquidity ratio to decline to 1.7x in 2017 from 2.4x in 2016, though its liquidity position remains strong. We expect ERWAT's liquidity position to improve because the company will fund its projected capital expansion largely from transfers (see below).

### Very high debt, though this is expected to gradually decline in the next three years

ERWAT's reported debt stock of ZAR605 million represented a very high 70% of operating revenue as of 30 June 2017. We expect debt to gradually decline in the next three years because ERWAT intends to finance its entire capital expansion plan of ZAR551 million from own funds and capital transfers. Nevertheless, the company's debt is in line with our expectations. While we regard ERWAT's debt levels as very high compared with its annual budget volumes, the company remains 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 proposed debt and the guarantee into ERWAT's rating.

### 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 \(Baa3 stable\)](#) and Lesedi Local Municipality. As such, its operating area is within its major shareholder's boundaries, and there is very little to no prospect of the company 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 it 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

In our assessment of ERWAT's credit profile, we apply our global rating methodology for [Government-Related Issuers](#), published in August 2017.

### Ratings

Exhibit 3

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

Source: Moody's Investors Service

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