SEVERN TRENT

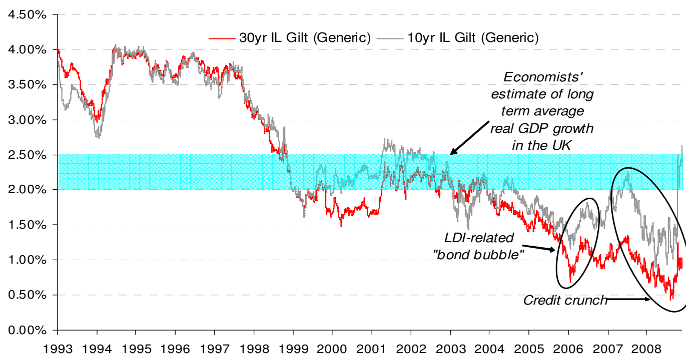
‘Quality matters in volatile and uncertain times’

‘The World has turned: but which way?’ Update, November 2008

This note should be read against the backdrop of our document ‘The World has turned: but which way?’ published in August 2008 which set out our views on the macro-economic factors which have driven the cost of capital over recent years, and where the factors might lead in the future.

- **Macro economic conditions uncertain: global capital flows unpredictable.**
- **Capital markets more volatile, long term trends difficult to predict today.**
- **Cost for debt and equity higher; price risk aversion has risen.**
- **Real risk free rate up.**
- **Credit quality differentiation more pronounced than in August.**
- **Market access spasmodic and unpredictable even for better quality credits.**
- **Cost of borrowing in the debt markets has risen dramatically.**
- **Banks cut back lending and other sources are limited.**

Real yields – 10 and 30 year gilts



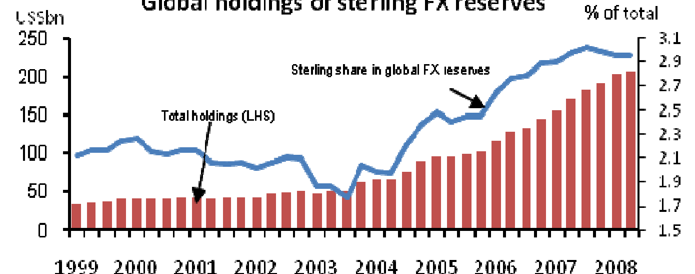
Source - HSBC

RISK FREE RATE RISING

- There is significant volatility in the risk free rate. An initial flight to quality (on inflation and corporate default worries) depressed yields. This has been counterbalanced by subsequent weakening demand from both foreign and domestic buyers, (as a result of concerns of recession in the UK) enhancing yields.
- The effect of increased government borrowing is likely to exert upward pressure on the risk-free rate and potentially crowd out other borrowers in the overall market.
- On the other hand, downward pressure may ensue over the next two years from a low growth, low inflation environment.

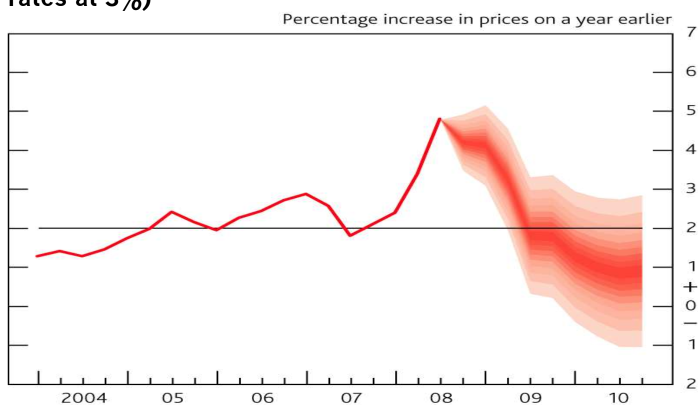
UK SHARE OF WORLDWIDE RESERVES FALLING

- Foreign inflows into UK bond markets may have slowed over the last few months as concerns about future UK interest rates and recession fears have disquieted overseas investors.
- Future international flows remain uncertain given the deterioration in the global economy and financial system. Changes in such flows would inevitably impact the UK economy.
- Furthermore, doubt remains about the future behaviour of UK pension funds which in the past few years have driven down yields on ILG bonds through significant purchases to match long-dated liabilities.



Source : Oxford Economics/Haver Analytics

CPI inflation projection (based on constant nominal interest rates at 3%)



Source – Bank of England (November 2008 Report)

SHARP INFLATION DROP- BUT OUTLOOK UNCERTAIN

- The November 2008 BoE forecast for CPI inflation based on market interest rate expectations predicted an inflation rate of around 1% on a 2-year horizon. This is 1% below the MPC’s 2% mandated target. As a result short term interest rates are likely to fall during 2009 as the MPC seeks to avoid a serious and sustained undershoot of its inflation target.
- UK inflation peaked in Q3 2008 and will head sharply lower over the next year. The uncertainty is how much and how quickly, given the associated fall in the value of sterling.
- There is also a substantive risk of deflation over the next two years if the recent reductions in interest rates are not effective.

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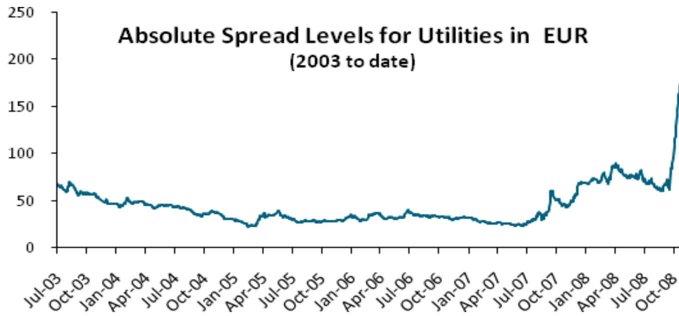


Source – BNP Paribas

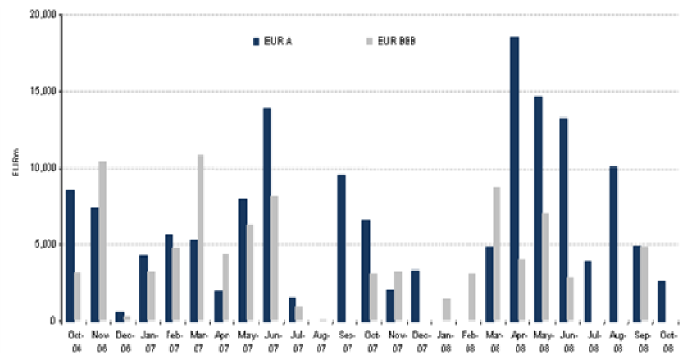
DEBT SPREADS SHARPLY HIGHER SINCE 2007

- Since 2007 debt capital markets have been repricing corporate risk but this has intensified significantly in the last two months.
- Any initial fall in real risk-free rates (see above) has been overwhelmed by an unprecedented widening of corporate spreads.
- Oxford Economics believes that corporate borrowing spreads are likely to remain relatively elevated over at least the next couple of years as a result of increased default risk and the general premium demanded to hold corporate debt (over sovereign debt).
- The cost of hedging foreign currency debt has risen markedly recently as has the cost of carrying cash on the balance sheet in advance of spending plans.

NO ACCESS TO DEBT CAPITAL FOR ‘BBB’ COMPANIES

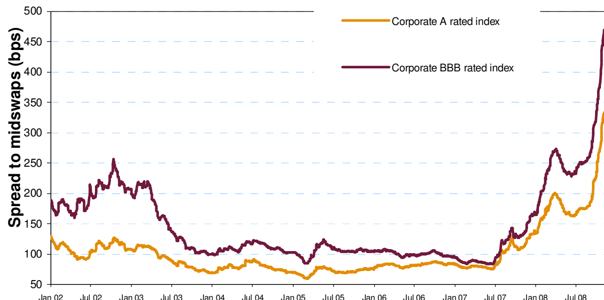
- Access to both bond and bank financing has become significantly more restricted since the beginning of the Credit Crunch. September 2008 effectively saw the bond markets closed to new issuers.
- That access is disproportionately affecting lower rated credits. Bond markets have been open for single-A issuers in 2008, whilst markets have at times been closed for BBB-rated credits over the last two years.
- “Retaining access to relatively low-cost financing is more important to water utilities than ever before, especially considering the difficult market conditions. Such access will be more easily facilitated if ratings within the sector remain healthy.” (S&P - 13 November 2008)

Single A versus BBB Corporate Issuance **(Oct 2006 – Oct 2008)**



Source - HSBC

Single A versus BBB Corporate spreads



Source – Barclays

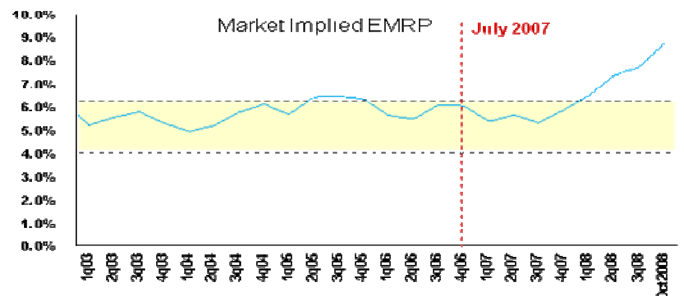
SECONDARY YIELDS HIGHER FOR ‘BBB’ COMPANIES

- The secondary spreads above gilts of bonds have widened considerably during 2008. ‘A’ rated bonds face a spread of 3.5%, compared to less than 1% a year ago.
- In 2007, there was very little discrimination between the spread for ‘A’ and ‘BBB’ bonds. This gap is now around 1.3% and new issuance by ‘BBB’ rated issuers is rare.
- The cost (commitment fees) of bank facilities (where available) has increased materially over the last few months

EQUITY IS BECOMING MORE EXPENSIVE

- Following the 40% fall (from 2007 peaks) of equity values, this source of finance has become significantly more expensive.
- Since July 2007, the implied EMRP has risen from 5.4% to 8.75%. It has now been above 6% for about a year. There is uncertainty whether this higher cost is here to stay or a short-lived distortion.
- As an obvious consequence of the fall in equity values, the current premium to RCV for water companies is significantly lower than during the majority of AMP4.

Implied Equity Risk Premium **(2001 – Present)**



Source - Citi

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