SEVERN TRENT

‘Quality matters in volatile and uncertain times’

‘The World has turned: but which way?’ Update, March 2009

Macro economic conditions uncertain: global capital flows unpredictable.

- Recession has arrived, depression remains a risk.
- Most recent data suggest that the recession in the UK is likely to be the deepest for many decades.
- It may be relatively short in duration, with positive growth resuming in mid-2010.
- 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.
- Domestic demand has changed as investors have switched out of equities and government bonds to corporate bonds.

RPI deflation expected in 2009

- The January 2009 BoE forecast for CPI inflation continued to predict a rate of around 1% on a 2-year horizon.
- RPI is much more volatile and will be negative through 2009 – deflation.
- RPI could rise sharply as interest rates start to rise in 2010 and the effect of the currency depreciation and VAT increases apply.
- Alternatively a long term “Japanese style” period of deflation and recession could persist.

Short term volatility in key indicators

- Capital markets remain volatile, long term trends are difficult to predict today.
- Markets are very illiquid, as banks are unwilling to hold significant trading inventories of bonds.
- From 2007 onwards debt capital markets repriced corporate risk but this has intensified since Oct 2008.
- Spreads (over benchmark indices) rose in 2008; however they have been tightening in more recent months as a result of strong demand for corporate bonds from retail funds as well as the asset purchase programme of the BoE.
- Credit quality differentiation persists between single-A and BBB credits – access remains in doubt for lower rated companies.

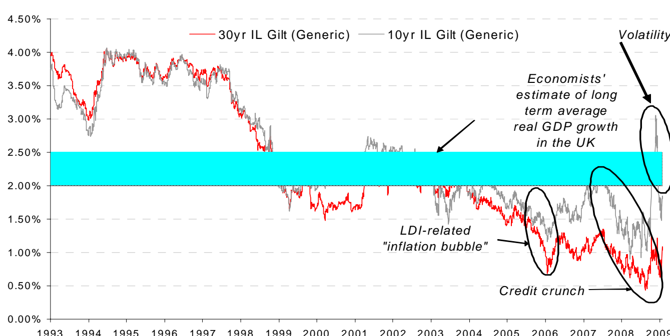
Short term dislocation from medium and long term trends

- The UK economy will likely benefit from increased domestic demand following monetary easing and the substantial reduction in the value of sterling, aiding exports and domestic producers (versus more expensive imports).
- Long term growth and higher inflation could both result from Government policies.
- Bond markets remain open: banks have cut back lending and alternative sources of capital are limited.
- Current yields of between 6%-7% on new bond issues look more like long-run equity yields and are proving attractive to bond investors.
- Given lower short term interest rates, and investor preferences, UK utilities (including water companies) have been issuing bonds with short maturities, which do not naturally match the long term investments that they are required to make. This potentially stores up refinancing risks in the future.
- Access to both bond and bank financing has become significantly more restricted for corporates since the beginning of the Credit Crunch and so issuers have typically taken every opportunity presented by the bond markets to raise funds (even when the price, by historical standards, is high and the funds are carried at a cost on the balance sheet).

‘‘Risk free rate’’ looking riskier and uncertain; cost of equity rising

- Short term risk free rates are down, longer-term real risk free rates are up.
- There is significant volatility in the “risk free rate”. The effect of the wall of government borrowing which is likely over the next months and years will inevitably exert significant upward pressure on the real risk-free rate as will the current preference of investors to buy corporate debt in the short to medium term.
- Quantitative easing and associated gilt purchases by the Bank of England could reduce gilt yields and hence the “risk free rate” in the short term, but inflationary pressures may cause them to rise later.
- The cost of equity has risen substantially in response to uncertainty and company share issuance.

Real yields – 10 and 30 year gilts



Source - HSBC

RISK FREE RATE RISING BUT VOLATILE

- There is significant volatility in the “risk free rate”.
- The effect of increased government borrowing is likely to exert upward pressure on the risk-free rate
- On the other hand, downward pressure may result over the next two years from a low growth, low inflation environment.
- Quantitative easing adds further uncertainty as the Government intends to buy back gilts for new liquidity.
- Risk free rates may fall in the short term and rise later as inflation returns.

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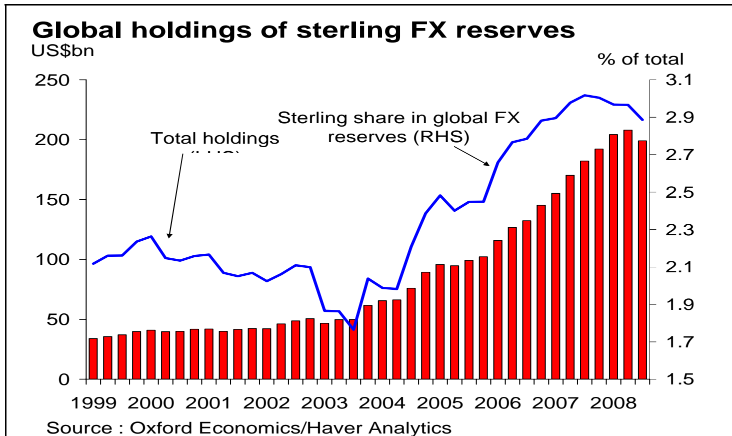
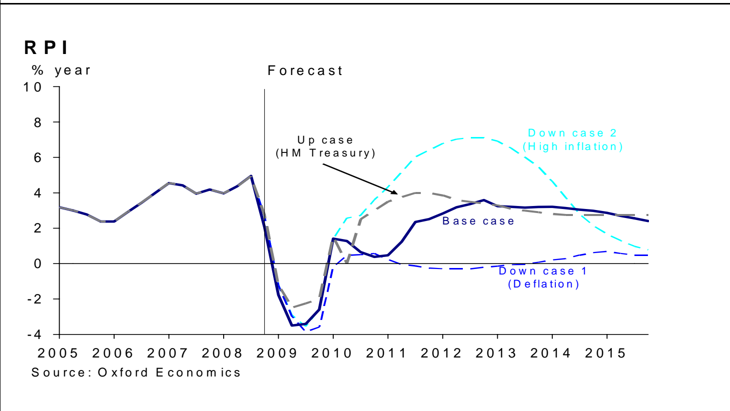


UK SHARE OF WORLDWIDE RESERVES FALLING

- Foreign inflows into UK bond markets have slowed as concerns about future UK interest rates and recession fears rise.
- The decline in commodity and energy prices has reduced trade and foreign government surpluses which were previously invested.
- Furthermore, doubt remains about the future behaviour of UK pension funds.

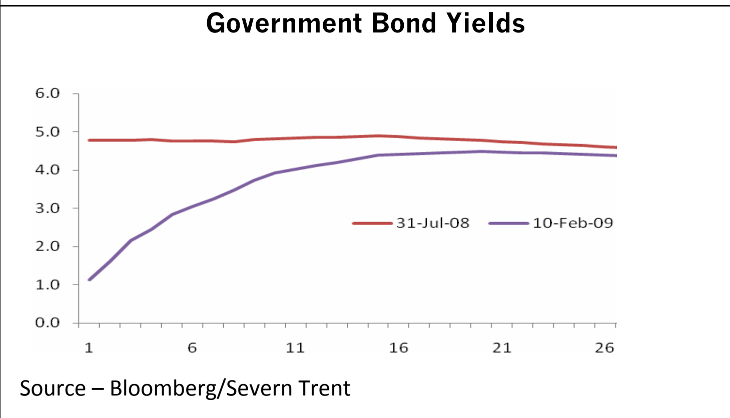
......RPI LIKELY TO BE NEGATIVE FOR NEXT 12 MONTHS

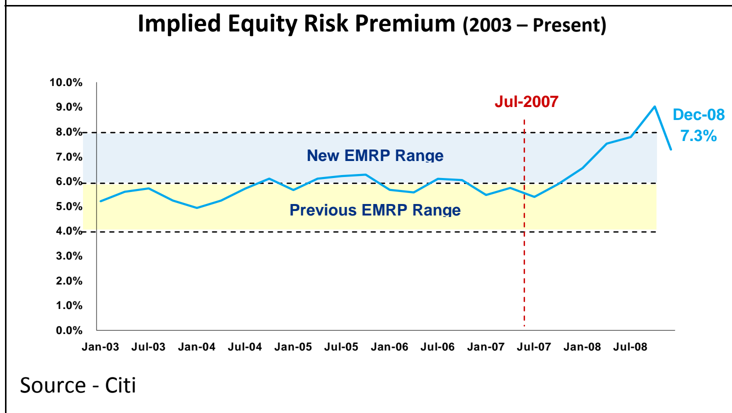
- There is a substantive risk of deflation over the next two years if the recent reductions in interest rates are not effective in spurring demand.
- RPI is more volatile as a result of the recent falls in mortgage and energy costs as well as in VAT – each of these will reverse sharply with the recovery of the economy.
- Oxford Economics illustrate a range of possible inflation scenarios over the next five years.



GOVERNMENT BOND YIELDS LOWER AT SHORT END

- Short end yields have collapsed since the summer of last year
- This has led corporates, including utilities, to raise finance in maturities up to approximately 12 years





EQUITY IS BECOMING MORE EXPENSIVE

- This source of finance has become significantly more expensive.
- Since July 2007, the implied EMRP has risen from 5.4% to 7.3% today, having peaked at 9.0% in Oct. 2008 and has remained above 6% since October 2007
- The current premium to RCV for water companies is significantly lower than during the majority of AMP4.
- Capital allocation decisions for new equity are more acute

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