29 Apr 2020 | Rating Watch

Fitch Maintains Transport for London's 'AA-' IDR on Rating Watch Negative

Fitch Ratings-Barcelona-29 April 2020:

Fitch Ratings has maintained Transport for London's (TfL) 'AA-' Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) on Rating Watch Negative (RWN). The Short-Term Foreign-Currency IDR has been affirmed at 'F1+'.

Fitch has also affirmed TfL's GBP5 billion MTN programme's 'AA-' long-term foreign- and local-currency ratings and affirmed the ECP commercial paper programme's short-term foreign and local currency ratings at 'F1+'.

The recent outbreak of coronavirus and related government containment measures worldwide creates an uncertain environment for TfL in the near term. While TfL said on 24 April 2020 that the number of passengers on the underground (Tube) and rail network had plummeted by 95%, and by 85% on buses, material changes in revenue and cost profiles are occurring across services and are likely to continue in the coming weeks and months as economic activity suffers and government restrictions are maintained. Fitch's ratings are forward-looking in nature, and Fitch will monitor developments in the sector as a result of the virus outbreak in terms of their severity and duration, and incorporate revised base and rating case qualitative and quantitative inputs based on expectations for future performance and assessment of key risks.

Key Rating Drivers

Fitch placed TfL's IDRs on RWN on 1 April 2020, following the downgrade of the UK sovereign to AA-/Negative/F1+ on 27 March. TfL's 'a-' Standalone Credit Profile (SCP) - now three notches away from the government - leads to rating equalisation with the UK sovereign under our Government Related Entity (GRE) Criteria. This reflects the application of the four key rating factors under the strength of linkage and incentive to support factor. When the assessment of support is strong, the primary driver of the GRE's IDR is the rating of the supporting government. Nevertheless, equalisation only applies in this case while TfL's SCP remains 'a-'.

We have maintained the RWN as we consider it is still too early to determine a number of points. We currently assess the Support Track record and expectations key rating driver under the GRE Criteria as Strong. Depending on the funding support provided by the government this may impact on this assessment. Fitch will continue to assess the impact of the pandemic on TfL's SCP, and the funding support provided by government in light of the severe impact on TfL's operations and how this may mitigate any significant deterioration in TfL's financial profile. Additionally, it is still early to assess the longer term impact of the pandemic on the next five years performance.

Status, Ownership and Control Assessed as Strong

TfL's legal status is that of a statutory corporation subject to local government finance rules and as such it must produce a balanced budget each year. TfL is a functional body of the Greater London Authority (GLA) and reports to the Mayor of London, who is the chair of the board. The Mayor appoints the board members and develops and publishes a transport strategy reflecting national and local priorities. Since 2004, a prudential scheme for local authorities has been in place, allowing TfL to borrow up to authorised limits.

Support Track Record and Expectations Assessed as Strong

The UK government has expressed its support for TfL's long-term commitments in the latest funding settlement (from March 2017), although since April 2017 it no longer subsidises TfL's investment plan. This has included funding for not only the Elizabeth Line but also the extensive modernisation of tube services and stations and the transformation of the road network. Since April 2017, the investment grant has been replaced by an equivalent amount of around GBP1 billion business rates transferred to TfL by the GLA under a pilot scheme for further business rates devolution.

TfL's total grant receipts make up about a third of its total revenue. The financing package agreed for Crossrail between DfT, GLA and TfL in December 2018 to deliver the final stages of the project and open the Elizabeth Line as quickly as possible is evidence of further support from the UK government. A scalable and sustainable arrangement was designed to cover the initially estimated range of the capital cost overrun. Since then Crossrail have announced it may require up to GBP650 million more than the original funding package.

Socio-Political Implications of Default Assessed as Strong

Disruption would lead to significant political or economic repercussions. TfL is strategically important for London and overall for the UK economy. Around four billion journeys are made on TfL's network every year. TfL would be difficult to substitute in the short to medium term, with the transition process likely to lead to severe service disruption. Financial default would not necessarily materially affect the provision of service or hamper TfL's investment programme, but the political repercussions would be significant.

Financial Implications of Default Assessed as Very Strong

Fitch has assessed this as Very Strong. If TfL were to default, it would impair the availability and cost of borrowing for other GREs in the UK. The shock waves from such an event would result in a fundamental rethink of exposure to the public sector and would inevitably lead to a restriction on future lending. We believe the capital markets (28% of TfL borrowing), and the European Investment Bank (EIB; 28% of borrowing) would restrict funding.

Standalone Credit Profile

Fitch has assessed TfL's SCP under the Revenue Supported Debt Criteria at 'a-'. It is driven by Fitch's assessment of 'Strong' revenue defensibility, as despite its limited pricing power, TfL benefits from strong demand with a resilient revenue framework. Operating risks have been assessed as 'Midrange' considering the material capex in the near term. At FYE19 TfL's net adjusted debt/EBITDA was 8x according to Fitch's calculations.

On 16 March, based on government-provided scenarios, TfL estimated that there could be a 10% drop in total passenger income of up to GBP500 million from GBP4.8 billion the year earlier, which factored in a reduction in visitors due to the negative effect on airlines of severe travel restrictions, employees working from home, and an overall drop in demand due to government-imposed limitations on contact. The closure of schools (from 20 March) and the London lockdown since 23 March has exacerbated the situation. The government has said it will reimburse all local authorities for revenue lost as a result of the business rates holiday for retail, hospitality and leisure businesses. TfL therefore expects that it will continue to receive planned grants (including its business rates grant) in 2020-2021. TfL remains in discussions with the government about how the impact of the coronavirus will be managed.

Key Assumptions

Passenger reduction of between 40%-50% for FY2020/21, recovery to 15-20% below FY2019/20 figures for FY21/22, and return to FY19/20 figures for FY22/23.

Support from central government to cover any losses as a result of passenger reduction.

A slowing of capex for FY20/21 and FY21/22.

RATING SENSITIVITIES

Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

- A downgrade of the UK sovereign.

- A change in the assessment of the strength of linkage or incentive to support factors under the GRE Criteria.

- A sustained weakening in the Financial Profile of TfL's standalone assessment under the Revenue Supported Debt Criteria may also lead to a rating change.

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

- A upgrade of the UK sovereign.

Best/Worst Case Rating Scenario

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

TfL's liquidity is supported by ample access to external liquidity. TfL had a cash balance at end-March 2020 of GBP2.1 billion, sufficient to cover the short-term impact of the coronavirus. TfL's financial policies require it to keep a minimum cash balance equivalent to at least 60 days of operating expenditure (approximately GBP1.2 billion) to provide liquidity to absorb sudden financial shocks or unexpected events. TfL also aims to hold an additional GBP600 million risk buffer on top of this for strategic risks. TfL and other local authorities may borrow from the Public Works Loan Board (statutory body operating within the UK Debt Management Office), which provides easy and direct access to funding at very short notice. TfL also has GBP200 million of undrawn overdraft facilities and a history of issuing under its GBP2 billion commercial paper programme.

Summary of Financial Adjustments

- A positive adjustment has been made to Fitch-calculated EBITDA for all years, representing the difference between the total amount of revenue grants received and the total amount of grants allocated to revenue in the statutory accounts.

- From FYE18 non-ring-fenced business rates received from the GLA and used to fund capital have been reclassified to "Other Revenues considered as Turnover" from Capital Grants, since they could be used to fund operating expenditure if required.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

Public Ratings with Credit Linkage to other ratings

UK Sovereign

ESG Considerations
The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Transport for London; Long Term Issuer Default Rating; Rating Watch Maintained; AA-; RW: Neg
----; Short Term Issuer Default Rating; Affirmed; F1+
----; Local Currency Long Term Issuer Default Rating; Rating Watch Maintained; AA-; RW: Neg
----senior unsecured; Long Term Rating; Affirmed; AA-
----senior unsecured; Short Term Rating; Affirmed; F1+

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Additional information is available on www.fitchratings.com

Applicable Criteria

Government-Related Entities Rating Criteria (pub. 13 Nov 2019)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Status

Endorsement Policy

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