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**Research Update:**

# Veolia Environnement Outlook To Negative On Earnings Pressure; Affirmed At 'BBB+'

**Primary Credit Analyst:**

Hugues De La Presle, Paris (33) 1-4420-6666; hugues\_delapresle@standardandpoors.com

**Secondary Credit Analysts:**

Beatrice de Taisne, London (44) 20-7176-3938; beatrice\_de\_taisne@standardandpoors.com

Alexandre de Lestrangle, Paris (33) 1-4420-7316; alexandre\_delestrange@standardandpoors.com

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## Research Update:

# Veolia Environnement Outlook To Negative On Earnings Pressure; Affirmed At 'BBB+'

## Rationale

On March 25, 2009, Standard & Poor's Ratings Services revised its outlook on French environmental services group Veolia Environnement S.A. (VE) to negative from stable. At the same time, we affirmed our 'BBB+/A-2' long- and short-term corporate credit and debt ratings on VE.

We also revised the outlook on VE's U.K. water subsidiary Three Valleys Water PLC to negative from stable, reflecting that we are only prepared to allow for a one-notch rating differential between Three Valleys and its parent; if we downgrade VE, then we will downgrade Three Valleys. At the same time, we affirmed the 'A-' long-term corporate credit and debt ratings on Three Valleys.

In addition, we revised the outlook on the senior secured notes issued by Hodgkins, for which the obligor is Metropolitan Biosolids Management LLC, to negative from stable, following the outlook revision on VE, and affirmed the notes at 'BBB+'.

The outlook revision reflects that VE's credit measures at the end of 2008 were somewhat below our expectations for a 'BBB+' long-term rating. In our view, they are unlikely to improve meaningfully in 2009, given ongoing pressures on earnings at the group's large waste business and VE's limited ability to generate discretionary cash flow despite its announced steep cut in capital expenditures.

The ratings on VE continue to be underpinned by its leading positions worldwide in water, which represented 44% of consolidated EBITDA in 2008; focus, except in waste, on public sector clients, from whom VE derives about 70% of its consolidated sales, generally under long-term contracts providing stable and recurring earnings; and extensive diversity by business, contract, and geography. Specifically, VE has leading positions worldwide in waste and energy services; the group's largest contract, the Berlin water contract, represents less than 2% of sales; and 60% of sales were generated outside France in 2008. Also supportive of the ratings is VE's recent shift toward a less capital-intensive and more credit-protective strategy.

The strengths are, however, partially offset by earnings pressures at the group's large and more cyclical waste business (33% of 2008 consolidated EBITDA) given this unit's exposure to industrial and commercial clients, which represent more than two-thirds of its sales. In addition, VE's financial profile is moderate, reflecting the group's primary focus until recently on growth and shareholder value, as well as its willingness to take on some highly capital-intensive contracts.

VE's 2008 results were in line with its much-revised guidance, but the group's 2009 earnings guidance is subdued, with management implicitly leaning toward EBITDA of €4 billion, or 4% below that of 2008. This reflects the pressures on Veolia's waste business, which is experiencing an about 10%

decline in industrial volumes. This may not be fully offset by likely growth at the group's three other businesses, which derive the bulk of their sales from more stable public sector customers. In this context, Veolia has stepped up its cost-cutting program with a view to achieving savings of €400 million by 2010.

Veolia has also further emphasised the credit-supportive strategy it started to implement at the end of last year. In particular, the group is focusing on cash generation, its key objective for 2009 being to achieve EBITDA minus capital expenditures of €2 billion. This assumes a substantial reduction in capital expenditures to €2 billion, net of disposals, compared to €3.6 billion in 2008. The group has also reiterated its objective of being slightly discretionary cash flow positive in 2009; current ratings factor in no significant acquisitions. We expect the parent company's 2008 dividend, payable in 2009, to remain stable compared to 2007, whereas previously management's intention was to increase it by 10%. Finally, the group has also increased its disposal program to €3 billion over 2009-2011, of which €1 billion to be completed by the end of this year. These disposals come on top of the €761 million already completed in 2008.

While we view all these announcements as credit-supportive, Veolia is, in our view, only likely to be marginally discretionary cash flow positive in 2009. Combined with earnings pressures, we consider that this means that the group's credit measures are unlikely to recover in 2009. VE's financial profile is currently at the low end of our expectations for the ratings, with funds from operations (FFO) to net debt of 16.8% at the end of 2008. By 2010 at the latest we expect key metrics to have improved more meaningfully than we believe is achievable in 2009.

### **Short-term credit factors**

The short-term rating is 'A-2'. We consider VE's liquidity to be adequate for the ratings with, at the end of 2008, substantial cash balances and amounts available under committed bank lines, and limited debt maturities over the next three years. The group's recent strategic shift, in particular its aim to be discretionary cash flow positive in 2009, also supports liquidity.

At the end of 2008, VE had about €3.2 billion of cash we understand to be immediately available, as well as a €4 billion backup line maturing in 2012 (of which €1,110 million is currently drawn), and €925 million of undrawn committed bilateral lines (of which €450 million matures in 2009 and which VE is currently seeking to renew, and the balance in 2010). None of VE's bank lines contain financial covenants or material adverse change (MAC) clauses, to our knowledge. In December 2008, VE's debt maturing over the following 12 months, that is until the end of 2009, stood at €3.6 billion, of which commercial paper for €922 million, overdrafts for €465 million, and receivable securitization for €374 million.

## **Outlook**

The negative outlook reflects VE's limited flexibility within the current ratings at a time when we consider its earnings and cash flow to be under

pressure.

We could lower the long-term ratings by one notch if the group's financial profile weakens further in 2009, most likely as a result of either a decline in operating earnings beyond the few percentage points factored into the current ratings, or lower disposals than management anticipates, which would not be offset by further cuts in capital expenditures. If we no longer believe in a significant improvement in the company's financial profile in 2010, we would also consider a downgrade.

Conversely, we could revise the outlook to stable if the group's financial profile improves to levels well in line with the ratings, especially coverage of adjusted net debt by FFO in the upper range of 15%-20%. This would likely entail a recovery in the group's operating performance and the pursuit of a less capital-intensive strategy.

## Ratings List

### Ratings Affirmed; Outlook Action

	To	From
Veolia Environnement S.A.		
Corporate Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2
Senior Unsecured	BBB+	BBB+
Commercial Paper	A-2	A-2
Three Valleys Water PLC		
Corporate Credit Rating	A-/Negative/--	A-/Stable/--
Senior Unsecured	A-	A-
Hodgkins		
Senior Secured*	BBB+/Negative	BBB+/Stable

\*Metropolitan Biosolids Management LLC is the obligor.

### Additional Contact:

Infrastructure Finance Ratings Europe; [InfrastructureEurope@standardandpoors.com](mailto:InfrastructureEurope@standardandpoors.com)

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