Summary:

Urenco Ltd.

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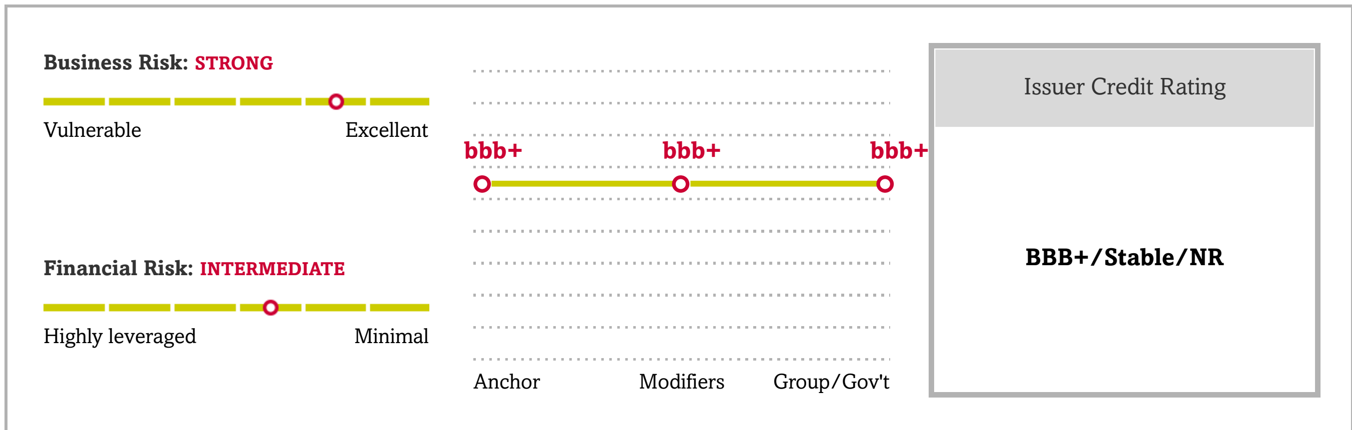
Summary:

Urenco Ltd.



Credit Highlights

Overview

Key Strengths	Key Risks
Large backlog that provides a high level of revenue predictability over the next three-to-five years.	Structural decline in demand for enriched uranium in most developed markets.
Competitive cost structure and low capex needs translating into healthy cash flows.	Operations in the uranium-enrichment niche industry with limited product diversification.
Supportive financial policy, including low pressure on dividends, no growth projects, and comfortable debt maturity profile.	Almost no presence in fast growth markets such as China.

The company's ability to replenish its backlog remains a key challenge.

As of Dec. 31, 2018, its backlog was €11.9 billion, having shrunk from €17.0 billion three years ago. We expect the backlog to continue shrinking over the medium term as most developed countries shift away from nuclear energy. In our view, the size and the nature of Urenco's backlog provide excellent visibility over the coming three-to-five years. This should allow the company enough time to adapt its business model to the changing environment. We believe that a key focus area for Urenco would be to increase its presence in markets like China, which continues to embrace nuclear energy, where the company currently has almost no presence.

Strong free cash flow will support further deleveraging in the coming years.

With low capex post completion of the Tails Management Facility (TMF) and relatively modest dividends, we expect Urenco to continue to generate positive discretionary cash flow (DCF; free operating cash flow after capital expenditure [capex] and dividends) over the next few years, at an average rate of about €300 million-€350 million per year. This should allow the company to reduce a good portion of its future liabilities, including repayment of maturing debt and ring-fencing some amounts for environmental liabilities. As of Dec. 31, 2018, the company's adjusted debt was €2.9 billion, and if it uses the DCF to mature its debt we expect adjusted funds from operations (FFO) to debt to be around 35% in the coming three years, compared to the 20% that is commensurate with the current rating.

Outlook: Stable

The stable outlook reflects Urenco's ability to continue building headroom at the current rating level, over the coming years, supported by a strong backlog and constrained spending.

In our view, the improved credit metrics and reduction in absolute debt should offset structural changes in the uranium enrichment industry, and the gradual deterioration in Urenco's business risk profile.

Under our base case, we project adjusted FFO to debt of about 30% in 2019, with some further improvement in 2020--above the 20% required for the current rating.

In deriving the outlook, we assume that the ownership structure will not change. We would view any potential future change as an event risk. That said, we do not factor any uplift for government support into the rating, so a change in the ownership structure would likely have a limited effect on the rating.

Downside scenario

With the current and projected headroom under the credit metrics, we view downside pressure as remote in the coming 12-24 months.

Nevertheless, we could lower the rating if the company continued to experience a decline in its backlog without making cost-structure or debt-level adjustments. For example, if we reassessed the business risk profile as satisfactory, down from strong, the company would need to maintain adjusted FFO to debt above 35% to support the current rating.

A revision of the business risk profile would take into account Urenco's capacity utilization over the short and medium term and its ability to replenish the backlog (volumes and prices).

Upside scenario

At this stage, we see very limited rating upside in the coming 12-18 months. Any positive rating action would need to be supported by an improvement in Urenco's key markets, which we do not see at the moment, coupled with management's continued commitment to prudent financial policies.

Our Base-Case Scenario

The nuclear enrichment industry has been under pressure for almost a decade with countries shifting away from nuclear energy. This has led to over-supply and high inventories of separative work units (SWUs), translating into low prices.

More recently, SWUs' spot prices have been on an increasing trend, up by about 25% from the lows of August 2018, driven by utility companies securing more inventory at low prices (inventories of SWUs declined by about 50% in

2017). That said, we do not believe the recovery in prices should be seen as a change in the overarching trend of a widening gap between the existing global production capacity and the decrease in demand.

In 2018, Urenco's revenues increased 1.6% year-on-year to €1.96 billion and reported EBITDA was down 4% year-on-year to €1.2 billion (against our expectation of around €1.1 billion). Higher volumes of SWUs and uranium compensated for average unit revenues broadly in line with 2017, while net fair value gains on uranium-related commodity contracts were a touch lower year-on-year. In terms of EBITDA, higher net costs of nuclear provisions together with higher operating expenses more than offset the margin impact from increased revenue.

We forecast a relatively stable EBITDA in 2019-2020 of $1.0 billion-$1.1 billion, supported by legacy contracts, with small additions from spot sales.

Assumptions

- Uranium and enrichment spot market prices to gradually improve from current levels over the next two years, but to remain historically relatively weak. The change in the prices will have a limited effect on the company's results over the short term, but more so on future results.
- A further gradual decrease in Urenco's order book in the next few years, from €11.9 billion at year-end 2018.
- A decline in revenues of 10%-15% in 2019, remaining relatively flat in 2020, as legacy contracts with higher pricing mature.
- EBITDA margin of about 61% on average in 2019-2020 (before potential impact of noncash provisions.
- Successful implementation of the company's cost-cutting program, which will achieve €300 million in cumulative cash savings across operational costs and capex by end-2019.
- Capex of about €200 million in 2019, compared to €183 million in 2018, contracting to about €120 million in 2020 after the commissioning of the TMF. Most of the capex post-TMF is run-rate replacement and maintenance.
- Dividend of about €300 million in 2019 and in 2020, in line with the company's financial policy and previous few years.
- No acquisitions, disposals, or share buybacks.
- No impact of the Brexit process on the company's operations.
- A small increase in the decommission provision from the €1.5 billion at end-2018.

Key Metrics

	2018A	2019E	2020E
EBITDA (bn. €)*	1.2	1.0-1.1	1.0-1.1
Reported net debt (bn. €)	1.4	1.0	0.8
FOCF (bn. €)*	1.0	0.6-0.7	0.5-0.6
DCF (bn. €)*	0.7	0.3-0.4	0.3-0.4
FFO/debt(%)*	32%	30-35%	34-37%
Debt/EBITDA(x)*	2.5x	2.5-2.7x	2.3-2.5x

*S&P Global Ratings-adjusted. Our main debt adjustments relate to the addition of the unfunded pension deficit (after tax) and unfunded asset-retirement obligations relating to depleted uranium disposal and plant and machinery decommissioning liabilities. We also deduct surplus cash. FFO--Funds from operations. DCF--Discretionary cash flow. A--Actual. E--Estimate.

Base-case projections

Lower financial debt and sizeable environmental liabilities to drive future adjusted debt level.

With strong cash flows, and limited need for growth capex post the completion of the TMF, we expect the company to produce DCF of about €0.3-0.4 billion per year in the coming years. We understand that the company plans to continue and direct the majority of the cash towards deleveraging. If assuming no new debt issuance in the coming years, the company will be debt free by 2023 (on a non-adjusted net debt basis). At the same time, we expect the

company to continue building a cash cushion to meet its €1.5 billion environmental liabilities.

Company Description

Urenco is a leading uranium enrichment services supplier to the civil nuclear industry. It serves over 50 utilities across 19 countries, contributing to the provision of low carbon electricity through nuclear generation. More than 90% of earnings stem from uranium-enrichment tolling services using low-cost-to-use centrifuge technology.

Urenco has a production capacity of 18.6 million SWUs per year, compared to about 7.5 million for peer Orano. It operates four plants in four countries (Germany, the Netherlands, the U.K., and the U.S.), which gives it flexibility of supply. The new U.K.-based TMF (commissioning expected in 2019) will allow Urenco to treat depleted uranium "tails" prior to final disposal, effectively providing in-house de-conversion services.

In 2018, Urenco's generated revenues of €1.96 billion, and S&P Global Ratings-adjusted EBITDA of €1.16 billion.

Urenco shares are held one-third by the U.K. government, one-third by the Dutch government, and one-third by German utilities RWE and E.ON.

Business Risk: Strong

We continue to assess Urenco's business risk profile as strong. This primarily reflects our view of the company's contracted revenues, and therefore highly predictable operating cash flows, at least in the short-to-medium term. We also view positively its high profitability levels and strong market position. Urenco's geographic, customer, and plant diversification also support our current business risk profile assessment. We note its limited business diversity, with a concentration in the nuclear-enrichment niche market, as a relative weakness.

Lower appetitive of developed countries for nuclear energy, with future demand driven by China and India.

In general, demand across developed countries has been contracting over the past decade, while developing countries are still aiming to increase their nuclear usage.

The structural change that was accelerated after the accident at the Fukushima nuclear power facility in early 2011 has pushed countries to hasten their shift from nuclear energy toward other sources, in some cases driven by social pressure. Germany, for example, as one of the world's largest nuclear markets, has committed to stop using nuclear power by 2022. Other countries, such as France and South Korea, have taken a less aggressive stance, but aim to reduce the proportion of nuclear in the overall energy mix.

North America remains fully engaged in nuclear power generation, yet we expect demand to remain slow in the near future as some players' financial difficulties will drive additional reactor closures.

On the other hand, we see an appetite to build nuclear capacity in China (next decade), India (within a longer time horizon), and other developing countries. For example, recently the Chinese regulator granted approval for opening nuclear plants. That said, we understand that some of the markets are not fully open to Western companies (such as

Urenco and Orano) and continue to favour domestic technology and services.

Backlog provides excellent visibility in the short-to-mid-term.

The relationships between nuclear power producers and uranium enrichment companies is usually formalized under long-term agreements, where the producers secures its feedstock for a certain price, while the service company (such as Urenco) benefit an excellent visibility, including a take-or-pay mechanism. We understand that spot purchases are less common, and the benefits from new contracts will flow into the company's profitability after a few years from signing the agreements.

As of Dec. 31, 2018, Urenco had a backlog of about €11.9 billion, covering up to 20 years, with an excellent visibility over the next three to five years, and decreasing visibility in the following years.

As a result of the shift in the energy profile in OECD countries, as well as soft prices, the company's backlog has shrunk by more than €5 billion since 2015 and is expected to decline gradually in the coming years, with increasingly negative effects on results over time.

Low risk from Brexit given extensive contingency planning.

Given Urenco's enrichment plant in the U.K. and flow of raw materials and products between the U.K. and Europe, as well as existing legislation, the Brexit process may undermine the company's ability to run its current operations.

However, we understand that Urenco's geographical diversity of plants, the recent new nuclear trade agreement between the U.K. and the U.S., and extensive contingency plans should address the potential risk (for example building adequate inventories, changing the flow of materials, and more).

Financial Risk: Intermediate

Our assessment of Urenco's financial risk profile is based on our core assumption that adjusted FFO to debt will be about 20% for the current rating. Other supportive factors include the company's ability to generate positive DCF and maintain relatively low reported net debt. Under our base case, we project adjusted FFO to debt of more than 30% in the coming years.

We understand that the company aims to strength its balance sheet to better reflect potential lower profitability and cash flow over the medium and long term. Thanks to healthy generation of discretionary cash flows, Urenco reduced its reported net debt by €1.2 billion in 2017-2018.

Supportive financial policy

In 2014, Urenco adopted a financial policy linked to a "solid investment grade" rating. As part of this policy, the dividends will be limited to 100% of the net income, until financial ratios comfortably exceed the minimum threshold for a high 'BBB' rating. Since 2014, the company has distributed to its shareholders about €300 million annually and we do not expect a material change in this in the coming years.

Modest capex after the completion of the TMF

With the completion of the €1.0 billion TMF (handling uranium tails) and low appetite for M&A and sizable organic growth projects in the near future, the company's capex budget will be limited to maintenance spending of around

€120 million per year starting 2020.

Further reduction of gross debt

As of Dec. 31, 2018, Urenco's adjusted net debt was €2.9 billion, consisting of a reported €1.9 billion gross debt and €1.5 billion of decommissioning liabilities, and cash on balance sheet of €0.5 billion.

Under our base-case scenario, we assume that the company will continue reducing its financial debt and may be debt free by 2023. In addition, we understand that the company is considering tackling its sizable decommissioning liabilities (for example, ring-fencing cash to address the liabilities over time).

Liquidity: Strong

We continue to view Urenco's liquidity as strong, reflecting the cash on balance sheet, and availability of funds under its committed credit facilities with maturity over 12 months. We calculate that liquidity sources to uses will be more than 1.5x for the 12 months started Jan. 1, 2019, as well as for the following 12 months.

Other factors underpinning Urenco's liquidity are the absence of financial covenants and its strong relationship with key banks, seen in the extended maturity under its €750 million revolving credit facility (RCF). We also factor in management's willingness to maintain this healthy liquidity profile, which is commensurate with our strong assessment.

Principal Liquidity Sources	Principal Liquidity Uses
We project the following principal liquidity sources for Urenco in the 12 months from Jan. 1, 2019: • Unrestricted cash of about €530 million; • FFO of about €850 million-€900 million; and • €750 million available under the committed RCF maturing in 2023 and currently fully undrawn.	We project the follow principal liquidity uses for Urenco over the same period: • No scheduled debt amortization in 2019. In January the company completed a €215.6 million tender offer for its 2021 Eurobonds; • Capex of about €200 million in 2019, completing the investment in the TMF; • Working capital outflows (including intra-year seasonal swings) of potentially up to €200 million annually; and • Dividends of €300 million in each of 2019 and 2020.

Covenant Analysis

There are no financial covenants in the debt documentation.

Government Influence

We consider Urenco to be a government-related entity, because the U.K. government owns one-third, the Dutch state one-third, and German utilities RWE AG and E.ON AG own the remaining third. Any transfer of Urenco's enrichment technology or change in its ownership requires the consent of the U.K., Dutch, and German governments, as per the Almelo Treaty, an intergovernmental agreement that led to the creation of Urenco in 1970.

Urenco's operations have so far been subject to the oversight and regulation of Euratom and the International Atomic Energy Agency. Post-Brexit, the U.K. will exit from the Euratom treaty and we understand that a replacement is being negotiated. This has created some uncertainty regarding the new U.K. nuclear oversight authorities.

Our rating on Urenco is based solely on our assessment of the company's stand-alone credit profile (SACP), with no notching for extraordinary state support. This reflects our opinion that there is a low likelihood of extraordinary government support, as we consider neither Urenco's ownership structure nor the Treaty of Almelo to be a basis for future timely and sufficient government financial support. The various parties--each of which might have different objectives or political considerations--would have to reach a consensus on how to proceed, and we see:

- Limited links with the owner governments. In our opinion, the governments do not drive commercial strategy, and the company's operation and financing are decided on a commercial basis; and
- Limited importance of Urenco to the national or local economies of the governments involved.

Environmental, Social, And Governance

The responsible management of the by-product of the enrichment services, the tails, is a key part of Urenco's commitment to uranium stewardship and sustainability. The company will use its U.K.-based TMF to deconvert the by-product of enrichment, depleted uranium hexafluoride, into a more chemically stable form, uranium oxide, for long-term storage until final disposal.

The company also has environment-related initiatives that cover energy efficiency, emissions, water usage, and waste.

Urenco is a mid-size employer of around 1,500 people and its social practices in relation to local communities are at least in line with industry standards. The company has a good safety record: it reported zero lost-time injuries in 2018, compared to three in 2017 and five in 2016.

Governance, in terms of disclosures and board and management processes, is at least on a par with other large players in the commodities space.

Issue Ratings - Subordination Risk Analysis

Capital structure

At March 31, 2019, Urenco's capital structure consisted of:

- Three senior unsecured eurobonds issued by Urenco Finance N.V., a special-purpose entity wholly owned by the parent company Urenco Ltd., and amounting to €1.53 billion. Of this, €534 million is due in February 2021, €500 million in August 2022, and €500 million in December 2024;
- €750 million senior unsecured RCF at the Urenco Ltd. level maturing in 2023, committed and fully undrawn; this would have the same seniority as all other unsecured debt; and
- ¥20 billion unsecured loan at the Urenco Ltd. level maturing in April 2038 and fully drawn at end-2018.

Analytical conclusions

There are no elements of subordination risk in Urenco's current capital structure. We rate the senior unsecured Eurobonds in line with the 'BBB+' issuer credit rating on Urenco Ltd.

As of Dec. 31, 2018, the company had €1.5 billion of asset retirement obligations, which we do not take into account in our subordination risk analysis.

We understand that the company will continue to reduce its gross debt over the coming years to address the structural changes in the market. This is unlikely to affect our subordination risk analysis.

Ratings Score Snapshot

Issuer Credit Rating

BBB+/Stable/NR

Business risk: Strong

- **Country risk:** Low
- **Industry risk:** Low
- **Competitive position:** Strong

Financial risk: Intermediate

- **Cash flow/Leverage:** Intermediate

Anchor: bbb+

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)

- **Management and governance:** Fair (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : bbb+

- **Likelihood of government support:** Low

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Midstream Energy Industry, Dec. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	**Intermediate**	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	**a-/bbb+**	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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