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Research Update:

Transport for London Rating Lowered To 'AA-' On Weakening Financial Strength; Outlook Stable

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Overview

- Transport for London (TfL) has an increasingly stretched financial profile as lower grants, high debt, and large capital expenditure requirements weigh on its cash balances.
- Furthermore, TfL faces uncertainty from the delivery of large capital projects and a drop in ridership.
- We are therefore lowering the issuer credit rating to 'AA-' from 'AA'.
- TfL continues to benefit from a very high likelihood of extraordinary support from the U.K. government, in our view.
- The stable outlook reflects our expectation that pressure on TfL's liquidity position will be balanced by ridership growth from the opening of the Elizabeth line and cost reductions.

Rating Action

On March 13, 2018, S&P Global Ratings lowered its long-term issuer credit rating on transport operator Transport for London (TfL) to 'AA-' from 'AA'. The outlook is stable. We also lowered our issue rating on TfL's senior unsecured debt to 'AA- from 'AA'.

At the same time, we affirmed the short-term rating at 'A-1+'.

Rationale

The downgrade reflects a deterioration in TfL's financial position. The loss of general purpose government grants from financial year (FY) 2019 (ending March 31) and the fare freeze that will remain in place until 2020 weigh on TfL's liquidity position. In addition, TfL is involved in large capital expenditure programs where cost and delivery timeline could be uncertain, although the Elizabeth line is expected to be delivered within the £14.8 billion funding envelope. It is our expectation that TfL will begin to incur operating costs related to the Elizabeth line in FY2019, before full-service revenues are realized from FY2021 onward. Nevertheless, we expect TfL to benefit from London's extremely robust business fundamentals, as a result of its fast-growing population, high employment, and wage levels more than 150% the national average. Furthermore, the impact on the rating is mitigated by our expectation that there is a very high likelihood of extraordinary support coming from the U.K. government, if needed.

TfL plays a very important role as a near monopoly providing essential transportation services in the U.K.'s capital region. We also believe there is a very strong link between TfL and the U.K. government, via the Greater London Authority (GLA). The Mayor of London plays a critical role in setting TfL's strategy and objectives and passes on retained business rates from the GLA that represent a significant part of TfL's revenues. The Mayor and the central government, via the Department for Transport (DfT), set the incremental borrowing limits for TfL, and the central government provides ready access to reliable liquidity sources via the Public Works Loan Board (PWLB). We believe that if TfL faced acute financial stress, the U.K. government--through the GLA--would likely extend the necessary support to TfL's operations and debt service. As a result, we believe there is a very high likelihood of government support, which we factor into our rating with a two-notch uplift to the stand-alone credit profile (SACP) of 'a'.

The latest passenger journey information indicates ridership will fall over FY2018, driven primarily by a 3% decline in passenger journeys on the London Underground. Nevertheless, we recognize that it is still too early to determine if this represents a short-term fluctuation or a prolonged decline, and we will monitor developments closely. Historically, TfL has benefited from very high ridership levels with over four billion journeys completed in FY2017, and ridership growth exceeding 8% over FY2012-FY2017. We expect the opening of services along the Elizabeth line (Crossrail), which will increase London's rail capacity by 10%, to support ridership growth over our forecast horizon. In addition, TfL's weekend night service on five lines (the Night Tube) has experienced strong uptake, with nearly 12 million journeys recorded since opening in 2016.

Bus services account for the largest passenger volume--exceeding 2.2 billion journeys in FY2017. Since 2015, bus ridership has declined yearly due to traffic delays and road congestion (exacerbated by construction projects and roadworks). While we expect a further decline in FY2018, TfL's efforts to reduce journey times has slowed the rate of decrease. The introduction of Unlimited Hopper fares (allowing passengers to make unlimited bus and tram journeys within one hour) in January 2018 could also improve uptake on bus journeys.

TfL benefits from London's still extremely strong and diversified economic fundamentals and its operations in a very low-risk industry. Population is growing rapidly, and local income (gross value added) per capita is significantly higher than the national average. Nearly 5.8 million people work in the capital, having risen from 5.1 million in 2012--a five-year historical growth rate of about 13.7%. We expect population and employment trends to continue supporting resilient demand for TfL's services, albeit there will be some uncertainty for London's economy related to the final Brexit deal between U.K. and the European Union.

We consider TfL's financial planning as credible and overall management and governance to be satisfactory. We also positively note TfL's capability to deliver large-scale capital projects--such as the Elizabeth line, which is 90% complete. The project remains broadly on schedule despite some delays on electrification of tunnels. Cost are not expected to exceed Crossrail's £600 million contingency pot, with the entire project remaining within the £14.8 billion funding envelope.

We will continue to monitor management's ability to adapt and respond to the pressures on TfL's financial profile. We take comfort in TfL's extremely high levels of transparency. Public stakeholders are able to access detailed financial and operational information that is updated on a regular basis, which TfL releases as per the Local Government Transparency code.

We expect TfL's EBITDA generation to decline significantly, to about £340 million in FY2018 and slightly over £100 million in FY2019 from about £690 million in FY2017. In our base case, we exclude the £960 million of business rates that replace the investment grant from FY2018 to calculate TfL's EBITDA. The weakening in operating financials stems from lower grants, with receipts from the DfT operating grant falling to zero from FY2019 from about £450 million in FY2017. This is exacerbated by the opening of the Elizabeth line, which will experience initial operating deficits as a result of operating costs rising before a corresponding growth in passenger numbers. We expect operating deficits on Crossrail to peak at about £160 million in FY2019 before generating operating surpluses from FY2021 onward.

At the same time, we anticipate TfL will strengthen its debt service capacity to about 1.25x over our forecast horizon from slightly above 1x in FY2017. This is due to TfL receiving a higher portion of retained business rates that, if required, can be used for debt service (we add the £960 million of business rates replacing the investment grant in our calculation of debt service coverage). Business rates can potentially be more volatile, and politically influenced. Under the current agreement between DfT, GLA, and TfL, it will receive business rates in lieu of the investment grant as per the previous grant funding settlement until FY2021.

In our opinion, TfL's debt burden remains very high and is likely to increase as it invests in its large capital program including the Elizabeth line, tube modernization, and capacity upgrades to support growing demand. Therefore, we expect total debt (including finance leases and operating leases, the latter of which we now capitalize) to reach £11.9 billion, or 1.5x debt to total revenues (including operating and capital revenues) by FY2018, increasing further to about 1.6x debt to total revenues by FY2021. A significant proportion of capital spending is on large-scale projects that have strategic importance--both to London and the national economy--thereby limiting TfL's ability to delay or cancel these projects once they are committed. While incremental borrowing limits are settled with the central government and the GLA during spending reviews, the use of short-term commercial paper and planned sale and leaseback of Elizabeth line trains could add volatility to its otherwise predictable debt profile.

We see continued pressure on TfL's flexibility to raise farebox revenues, resulting from the commitment to keep TfL-controlled fares frozen until December 2020. Nevertheless, TfL has made progress in its cost reduction program with overall savings for 2017/2018 expected to be £187 million above its original budget of £699 million. Further savings are expected from exiting costly legacy contracts, reducing management layers, and centralizing office locations. In addition, we believe TfL has the flexibility to raise capital income from its substantial estate, including commercial and retail real estate in central London. Taken together, TfL continues to demonstrate strong financial flexibility, resulting in a farebox recovery ratio among the highest of the mass transit systems we rate globally, although this is based more on its ability to cut costs than to increase revenues.

Liquidity

The short-term rating on TfL is 'A-1+'.

We still assess TfL's liquidity as strong, though it has deteriorated somewhat as a result of its weak internal cash generation, with free cash declining to about 50 days of operating expenditure in FY2018. Furthermore, while we expect cash balances to increase to about 80 days over FY2019, this is largely the result of an anticipated £800 million receipt from the sale and leaseback of Elizabeth line trains, while operating balances are expected to remain in deficit.

Nevertheless, TfL's exceptional access to external liquidity via the PWLB mitigates some of these risks, in our view. As a statutory body within the Debt Management Office, the PWLB lends to local authorities (and TfL) at short notice. In addition, TfL has a very strong track record of issuing own-name bonds on the capital markets. Hence, we do not view refinancing risk on TfL's commercial paper borrowings to be particularly high, and we have affirmed our short-term rating of 'A-1+'.

Outlook

The stable outlook reflects our view that TfL will see ridership growth through the opening of the Elizabeth line and improvements to buses. We also expect that pressure on TfL's liquidity position will be mitigated by the cost reduction program and farebox revenues from the Elizabeth line.

We could lower the rating if we anticipated a considerable weakening in TfL's growth prospects, potentially as a result of economic uncertainty or changes in consumer patterns, or if ridership growth from capacity increases is below our base case. Cost overruns on large capital projects or the failure to realize savings from the cost reduction program could have an adverse impact on TfL's cash reserves and debt service coverage, and add to the downward pressure on ratings. We could also lower the rating if we changed our view of TfL's importance for or link with the U.K. government.

We could raise the rating if TfL's internal cash generation capacity improved significantly, leading to a sustainably stronger liquidity position, and if ridership growth, particularly from the Elizabeth line, exceeded our current base-case expectation.

Related Criteria And Research

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Governments - General: Mass Transit Enterprise Ratings: Methodology And Assumptions - December 18, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For

Corporate Entities And Insurers - November 13, 2012

- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- No Stress: Rated LRGs In Europe, Canada, And Argentina Can Cope With Possible Interest Rate Rises, Jan. 29, 2018
- Research Update: Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, Oct. 27, 2017
- Greater London Authority Ratings Affirmed At 'AA/A-1+'; Outlook Remains Negative, Sep t . 29, 2017
- Sovereign Risk Indicators, Dec. 14, 2017. An interactive version is also available at http://www.spratings.com/sri.

Ratings List

	Rating	
	To	From
Transport for London		
Issuer Credit Rating		
Foreign and Local Currency	AA-/Stable/A-1+	AA/Negative/A-1+
Senior Unsecured		
Local Currency	AA-	AA
Commercial Paper		
Foreign and Local Currency	A-1+	A-1+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.