Research Update:

Transport for London Downgraded To 'A+/A-1' On Lower Ridership And Rising Debt; Outlook Negative

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Overview

- The COVID-19 pandemic has caused a drop of 90% in Transport for London's (TfL's) ridership and operating income over the past two months. On May 15, 2020, the U.K. government via the Department for Transport (DfT) provided a £1.9 billion financing package to contribute toward TfL's funding shortfall.
- We expect that following the COVID-19 lockdown, demand for TfL's services will recover slowly due to subdued activity in the international tourism, retail, and leisure sectors and increasing work-from-home trends.
- Structurally lower EBITDA generation and higher debt service obligations as a result of additional borrowing to fund the COVID-19-related revenue shortfall and Crossrail cost overruns will reduce TfL's debt service coverage and considerably increase its debt burden, in our view.
- We are therefore lowering our long-term issuer credit rating to 'A+' and our short-term issuer credit rating to 'A-1' on TfL. The outlook remains negative.

Rating Action

On May 22, 2020, S&P Global Ratings lowered to 'A+/A-1' from 'AA-/A-1+' its long- and short-term issuer credit ratings on London-based transport operator TfL. The outlook remains negative.

At the same time, we lowered to 'A+' our issue rating on TfL's senior unsecured debt.

Rationale

The downgrade reflects our expectation that TfL's debt service coverage will structurally weaken over the next two-to-three years, due to lower-than-previously-anticipated demand for its services and a higher debt burden. As a result of the social-distancing measures applied to arrest the COVID-19 outbreak, ridership on the London underground and buses has dropped substantially. We believe that beyond the COVID-19 lockdown, increasing work-from-home trends

and subdued activity in the tourism, retail, and leisure sectors will hinder the recovery of demand for TfL's services and, consequently, EBITDA generation. Combined with a higher debt intake to sustain the full impact of COVID-19, and significant capital commitments--such as Crossrail--the entity's debt burden will increase materially beyond our previous expectations.

We expect that over the next three years, ridership will not recover to historical levels of 4 billion passenger journeys per year. Over the past two months, as a direct effect of COVID-19, passenger numbers on TfL's underground network have fallen by around 95%, and those on the bus network are down 85%. We expect that after the lockdown, the steep drop in ridership will be followed by a gradual recovery due to slower economic development and subdued economic activity, increasing work-from-home trends, and a further delay to Crossrail. Our current base case for global air passengers (see "The Coronavirus Pandemic Could Reduce Global Air Passengers By Up To 30% In 2020," published March 17, 2020) assumes a full recovery only in 2023, which will reduce TfL's revenue from leisure journeys. We recognize, however, that the situation is highly uncertain and fast-moving.

Our new base case assumes a decline of over 50% of TfL's operating revenue in the fiscal year (FY) ending March 31, 2021, 15% in FY2022, and 10% in FY2023, compared with our previous projections. We believe the group has a limited ability to reduce service expenditure to match its revenue loss, because it continues to run approximately 80% of services across its network, and because the DfT's support is contingent on keeping a high level of services operating. TfL's decision to furlough 25% of staff will reduce its operating costs only marginally: an estimated cost saving of £16 million per month while the lockdown lasts.

We now expect the opening of the central section of the Elizabeth line will be delayed into 2022, although TfL is still targeting completion in 2021. The group has stopped all nonessential construction projects, including the Crossrail project, for which extraordinary funding has not yet been agreed with the government. We believe that TfL will meet its already-committed large-scale projects, but will now reconsider investments in new projects, and will reduce its overall capital expenditure (capex) ambitions.

Based on our calculations, we expect that TfL will require £3.2 billion of funding throughout FY2021, which will be covered by a combination of accumulated cash, extraordinary grants, and additional borrowings. TfL has already drawn significantly on its cash over the past two months to support operations. We estimate cash has decreased by about £900 million and now stands at around £1.2 billion, compared with £2.1 billion at the close of FY2020. We expect the remaining funding gap of £2.3 billion will be covered by the DfT's £1.9 billion financing package (comprising a £1.3 billion grant and £0.6 billion of borrowing from the Public Works Loan Board [PWLB]), and incremental borrowings of about £0.4 billion. Therefore we expect TfL's total borrowings for this fiscal year to reach £1.0 billion, with a further £1.3 billion in FY2022.

TfL's financial risk profile is constrained by its very high and rising debt burden. We expect total debt (including finance leases and operating leases) to reach £14.3 billion by FY2021; increasing further to £15.6 billion or 2x of total revenue by FY2022. A significant proportion of capital spending over this period 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.

We now expect structurally lower EBITDA generation and higher debt service obligations will strain TfL's debt service coverage. We expect its debt service coverage ratios will deteriorate given its current and evolving revenue and expense positions. We forecast debt service coverage will fall below 1x in FY2022 and FY2023, from 1.5x in FY2020. Higher debt service obligations are a result of additional borrowing contracted to fund the COVID-19 revenue shortfall and Crossrail cost overruns.

TfL's weakening demand is counterbalanced by its dominant monopoly position in London and its extremely resilient and diversified economy. The capital's population is still growing, and local per capita income (gross value added) is significantly higher than the national average. This, in combination with the very low risk associated with the global mass transit industry, underpins TfL's strong enterprise profile.

We expect that beyond the COVID-19 pandemic, TfL will restore its strong financial flexibility with a farebox recovery ratio exceeding 70%, one of the highest of the mass transit systems we rate globally. TfL has shown its ability to cut costs by over-delivering on its savings program since 2016, when London's mayor froze TfL's fares. We now forecast that it will increase fares by inflation plus 1% from 2021.

We consider TfL to be a government-related entity. In our opinion, there is a very high likelihood that the U.K. government via the DfT would provide timely and sufficient extraordinary government support to TfL in the event of financial distress. This extraordinary support framework has been showcased during the COVID-19 pandemic. We base our opinion on the following factors:

- TfL's very important role as a near monopoly providing essential transportation services in the U.K.'s capital region; and
- The very strong link between TfL and the U.K. government. Representatives of the DfT now attend TfL's board meetings, with oversight of its financials, business plan, and fare-setting policies. The central government, via the DfT, also sets incremental borrowing limits for TfL and provides ready access to reliable liquidity sources via the PWLB. In our view, a default of TfL would affect the reputation of the U.K. government and would impair U.K. local authorities' and other public sector entities' access to the market.

Due to strong extraordinary support from the U.K. government, the rating on TfL is two notches higher than its stand-alone credit profile.

Environmental, social, and governance (ESG) factors relevant to the rating action:

- Health and safety.

Table 1

Transport for London--Operating Performance

	--Year ended March 31--				
	2016	**2017**	**2018**	**2019**	**2020**
Total revenues (mil. £)	9,124.0	8,045.0	7,869.0	9,356.0	9,357.0
Passengers (mil.)	4,031.2	4,028.5	3,988.1	3,999.1	3,997.0
Staff	31,213	29,190	28,456	27,280	27,576*

*At the end of Q3.

Liquidity

We are lowering our short-term rating to 'A-1'. We believe TfL's liquidity will weaken compared with our previous base case, albeit remaining sound at about £1.2 billion. Cash to debt service will continue to decline and will dip below 1x on average beyond 2021, compared with 1.3x in FY2020. We anticipate that free cash to operating expenditure will decline further below 100 days over the forecast period.

Nevertheless, TfL's exceptional access to liquidity via the PWLB and capital market mitigates some of these risks, in our view. As a statutory body within the Debt Management Office, the PWLB lends to local authorities (including 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.

Table 2

Transport for London--Financial Summary

		--Fiscal year ended March 31--			
(Mil.£)	2016	2017	2018	2019	2020e
Operating revenues	6,697.0	6,763.0	6,559.0	6,716.0	7,044.0
Farebox revenues	4,587.0	4,694.0	4,643.0	4,854.0	4,970.0
Operating expenses before D&A	6,179.3	6,067.9	6,143.7	6,204.7	6,337.5
EBITDA	517.7	695.1	415.3	511.3	706.5
Cash and short-term investments	3,203.4	1,961.5	1,931.3	1,882.3	2,144.0
Financial debt*	10,591.5	11,350.3	12,010.8	13,066.4	13,512.3
Adjusted ratios					
EBITDA (DSC) coverage	0.8	1.0	1.4	2.0	1.5
Debt service carrying charge (%)	19%	19%	22%	18%	23%
Farebox recovery ratio (%)	74%	77%	76%	78%	78%
Financial debt to revenues	1.2	1.4	1.5	1.4	1.4
Financial debt to net revenues	20.5	16.3	28.9	25.6	19.1

e--Estimate. *Including financial leases and capitalized operating leases.

Outlook

The negative outlook reflects our view that TfL's financial profile is stretched, at a time of heightened risk, resulting from the economic uncertainty caused by COVID-19-related social-distancing measures, and the delivery of large capital projects.

We could lower the rating if, over the next 24 months, we observed signs of weakening in the willingness and ability of the U.K. government to provide extraordinary support to TfL. We could also lower the rating if the ridership recovery was significantly weaker compared with our base case, which would lead to higher debt and weaker liquidity.

We could revise the outlook to stable over the next 24 months if TfL managed to recover the demand for its services, including as a result of the Crossrail Elizabeth line opening, in line with our base-case scenario.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015

- Criteria | Governments | General: Mass Transit Enterprise Ratings: Methodology And Assumptions, Dec. 18, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- COVID-19 Impact: Key Takeaways From Our Articles, May 20, 2020
- United Kingdom 'AA/A-1+' Ratings Affirmed; Outlook Stable, April 24, 2020
- COVID-19: Emerging Market Local Governments And Non-Profit Public-Sector Entities Face Rising Financial Strains, April 6, 2020
- Greater London Authority Ratings Affirmed At 'AA/A-1+'; Outlook Negative, March 20, 2020

Bulletin: Strong Liquidity Will Allow Transport for London To Ride Out The Disruption From The Coronavirus Pandemic, March 18, 2020

- The Coronavirus Pandemic Could Reduce Global Air Passengers By Up To 30% In 2020, March 17, 2020

Ratings List

Downgraded

	To	From
Transport for London		
Issuer Credit Rating	A+/Negative/A-1	AA-/Negative/A-1+
Senior Unsecured	A+	AA-
Commercial Paper	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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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.

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