22 May 2020 | Downgrade

Fitch Downgrades TfL to 'A+'; Outlook Stable

Fitch Ratings-Barcelona-22 May 2020:

Fitch Ratings has downgraded Transport for London's (TfL) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'A+' from 'AA-'. The ratings have been removed from Rating Watch Negative and the Outlooks are Stable.

A full list of rating actions is detailed below.

The recent outbreak of COVID-19 and related government containment measures worldwide create an uncertain environment for TfL in the near-term. 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 for their severity and duration. Fitch will incorporate revised base- and rating-case qualitative and quantitative inputs based on expectations for performance and assessment of key risks on an ongoing basis.

Key Rating Drivers

Since our last rating action on 28 April 2020, the government has announced a support package that included extraordinary support grant and incremental borrowing from the Public Works Loan Board (PWLB - statutory body operating within the UK Debt Management Office). We are also now in a better position to make assumptions around the possible impact on TfL's finances over the next five years. Despite the extraordinary support grant we still see a negative impact on TfL's Standalone Credit Profile (SCP), which we have revised down to 'bbb+' from 'a-'.

TfL is rated on a top-down basis under our Government Related Entity (GRE) Criteria. When the assessment of support is strong, the primary driver of the GRE's IDR is the rating of the supporting government. This reflects the application of the four key rating factors under the strength-of-linkage and incentive-to-support framework. TfL's SCP is now four notches away from the UK government (AA-/Negative/F1+), which leads to a top-down minus one approach under the GRE Criteria.

GRE Criteria

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. In light of the severe financial impact of COVID-19 on TfL's finances, further discussions will be held with the Greater London Authority (GLA) and central government to enable TfL to deliver a revised budget for the remainder of the year. TfL is a functional body of the 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. Two central government representatives will now also be able to attend TfL's board meetings. 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 demonstrated its support for TfL in the most recent COVID-19 support package. Nevertheless, considering the support has come in the form of two-thirds grant, one-third debt this has led us to maintain our assessment for this factor as 'Strong' rather than 'Very Strong'. The government has supported 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 the Elizabeth Line, 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.

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. Pre COVID-19, around four billion journeys were 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 but would hamper TfL's investment programme, which in turn would mean significant political repercussions.

Financial Implications of Default Assessed 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 review of exposure to the public sector and would inevitably lead to a restriction on future lending. We believe the capital markets (28% of TfL's borrowing), and the European Investment Bank (EIB; 28% of borrowing) would restrict funding.

SCP

Fitch has assessed TfL's SCP under its Revenue Supported Debt Criteria at 'bbb+'. 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. We expect this to once again be the case through the cycle. Operating risks are assessed as 'Midrange' considering the material capex in the near-term. TfL's financial profile has been assessed as 'Midrange'. The funding shortfall in financial year to March 2021 due to the impact of the COVID-19 pandemic is expected to be covered by one-third borrowings and two-thirds grants. At FYE19 TfL's net adjusted debt/ EBITDA was 8x, according to Fitch's calculations. We expect this ratio will be volatile over the next five years. As such, and due primarily to the uncertain environment for TfL over year-two and -three in our rating case, we believe the financial profile is better assessed as 'Midrange'.

As a result of lockdown measures, passenger demand has declined 95% in journeys on London Underground, and 85% on London's buses. This has caused an overall operating income loss of around 90% including non-passenger incomes, such as advertising revenue. TfL's interim financial review presents a funding gap of up to GBP1.9 billion in the 1HFY21 and over GBP3.2 billion for the full year.

Key Assumptions

-Reduction in revenue of GBP4 billion for FY21.

-Additional grant from the government to cover losses in the form of two-thirds grant funding and one-third debt (rather than full grant as previously considered).

-Use of GBP0.8 million from strategic reserves for FY21.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- A multiple-notch downgrade of the UK sovereign.

- A change in the assessment of the strength-of-linkage or incentive-to-support factors under the GRE Criteria accompanied by a sustained weakening in the financial profile of TfL's SCP under the Revenue Supported Entities Criteria.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- An upgrade of the UK sovereign.

- Positive change in expected financial profile through the cycle, specifically a sustainable improvement of net adjusted debt/EBITDA ratio below 12x under Fitch's rating case.

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 the company 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's F1+ short term IDR reflects that of the UK Sovereign, as indicated for entities rated on a top-down basis.

TfL and other local authorities may borrow from the PWLB, which provides easy and direct access to funding at 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

TfL's ratings are linked to the UK sovereign's.

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; Downgrade; A+; RO:Sta
----; Short Term Issuer Default Rating; Affirmed; F1+
----; Local Currency Long Term Issuer Default Rating; Downgrade; A+; RO:Sta
----senior unsecured; Long Term Rating; Downgrade; A+
----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
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