

Severn Trent Plc.

Recommendation: Buy

3/19/2021

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Summary

Severn Trent Plc. (Severn) operates in the United Kingdom's (UK) highly regulated water supply and sewage industry. Severn is one of 11 regional suppliers licensed by the Water Services Regulation Authority (Ofwat),¹ and is one of the three publicly traded water utilities operating in the UK. Severn has a strong track record of performance and was one of only three companies to receive a fast-track on their asset management plan period 7 (AMP7) business plan. This fast-tracking was rewarded with a 10bps increase in allowed return on regulated equity. I believe Severn is a good fit for Middlefield Group's new sustainable fund (AGR.UN) given:

1. A growing dividend linked to inflation
2. Ambitious targets for future environmental improvements and sustainability
3. Growth in its unregulated green power business driven by government policy generated tailwinds
4. Continued success in meeting outcome delivery incentives.

At present Severn Trent Plc. offers a 4.03% dividend yield and is trading at 13.4x EV / EBITDA multiple on a proforma basis with its existing cap stack. This is inline with its UK water peers, making Severn an attractive option for mandates seeking stable income through sustainable and green investments.

Company Background

Severn Trent Plc. primarily operates in the regulated water and waste water industry (~88% of 2020 revenues). It also disaggregates revenue into two other operating segments: business services (12%) and corporate (<1%). The majority of Severn's revenues (~97%) are generated from regulated operations, with the remaining portion from Severn's Green Power business. Since AMP7, Severn's stock has traded with 1.3% volatility, yielding a total return of 3.41% (Fig.1).

Severn's operations cover a large region of England and Wales (Hafren Dyfrdwy subsidiary), proving both wholesale and retail customers with potable water. The regulated water and waste water industry involves treating raw water for supply as potable water and then subsequently removing and treating waste water. Severn maintains their pipe supply network and is responsible for absorbing the costs of leaks and maintaining the main supply lines. The Bioresources division (~5% of 2020 revenues) trades and treats sewage 'sludge' in an effort to 'stimulate a circular economy'.² This involves turning 'sludge' into bio-fertilizer

Ticker	SVT LN
Share Price	2500
52-Wk L / H	2148 - 2593
YTD Total Return	+3.41%

Proforma Shares Out	238.89
Market Cap.	5,972
+ Debt	6,531
- Cash	46
Enterprise Value	12,457

FY20A EV / EBITDA	13.1x
FY21E EV / EBITDA	13.4x

LTM Yield	4.03%
FY21E Yield	4.06%

Dividend frequency	Semi
1mo. avg volume	0.444

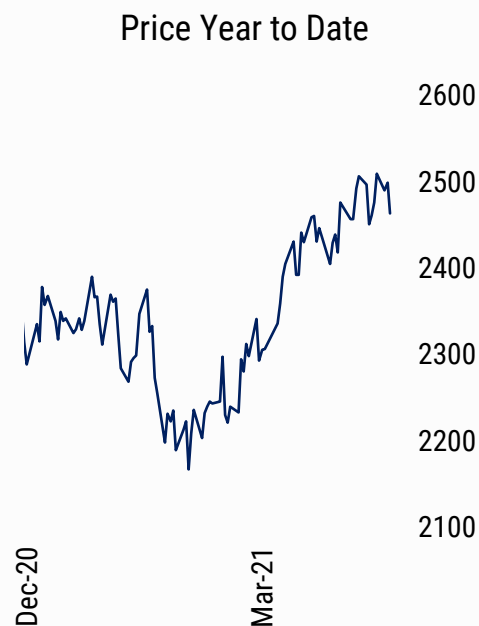


Fig.1 Severn Trent Plc.'s price performance over the last year

¹ <https://www.ofwat.gov.uk/regulated-companies/ofwat-industry-overview/licences/#wssl>

² Severn Trent website, Bioresources

and extracting methane gas for power generation. From self-produced methane fuel, Severn generated roughly half of their operating energy needs in 2020.³

In 2018 Severn Trent acquired Agrivert; the foundation of their unregulated Green Power business. Accounting for 2.8% of revenues, Green Power involves composting and recycling both food and green biowaste. Through anaerobic digestion the composted waste is turned into fertilizer and methane gas for power generation and sale into the grid. This is Severn's fastest growing segment with 80% year over year turnover growth.

Severn Trent Plc. is headquartered in Coventry, United Kingdom and has 52 subsidiaries of which 51 are fully owned and 5 are located outside of the UK for service operations such as insurance and government consultations.⁴

³ Severn Trent 2020 Directors Report

⁴ Severn Trent 2020 Annual Report

1. Stable dividend growth linked to inflation

Over the last 10 years, Severn Trent Plc. has grown its dividend consistently at a CAGR of 3.46% (Fig. 2). During this time, Severn has provided nearly twice the dividend growth over United Utilities Plc. (United), which is Severn's largest direct public competitor. Over the last three- and five-year periods, Severn's dividend has grown 6.4% and 3.9% over United's 3.0% and 2.4% respectively.

In asset management plan period six (AMP6), Severn's dividend policy targeted a minimum growth rate of inflation plus a 4% base, using the retail price index (RPI) to calculate inflation.⁵ As Severn has moved into AMP7 (2020-2025) they adjusted their dividend policy to reflect the more commonly accepted and robust consumer price index including housing (CPIH) measure. This is in line with Ofwat's move towards using CPIH as their inflator for estimating regulated values in their price review 19 final determinations (PR19 FD)⁶.

Historically the wedge between RPI and CPIH based inflation is around 1% (Fig. 3).⁷ Severn's AMP7 dividend policy is set such that the minimum dividend growth rate will be set at the inflation rate determined from CPIH.⁸ Management has provided full year dividend guidance of 101.58p (assuming CPIH growth of 1.5%), 40.63 of which has been paid out on January 1st 2021 and the remaining 60.95p going ex. dividend on June 10th 2021.⁹

Given this guidance the 2021E dividend is expected to grow despite the recent switch to using CPIH as a growth basis.

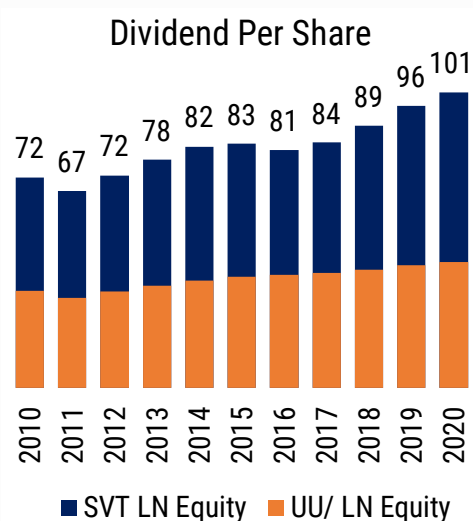


Fig. 2 Severn Trent Plc's historical dividend per share growth compared to United Utilities. Severn has provided twice the growth of United.

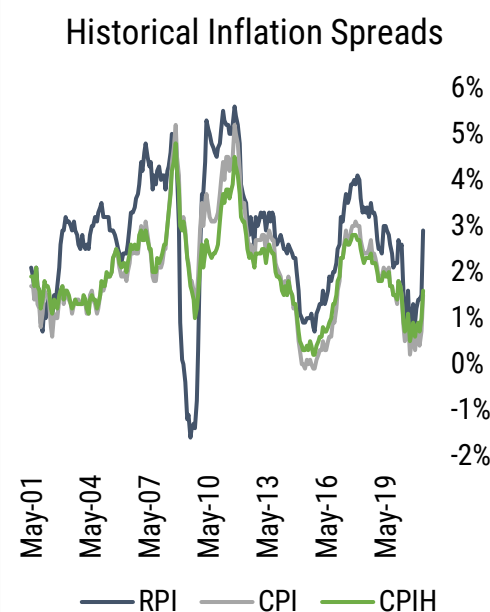


Fig. 3 Comparison between RPI and CPI measures of inflation.

⁵ Severn Trent, Strategic Report 2019

⁶ PR19 Final Determinations for Severn Trent Water, Ofwat

⁷ UK Statistics Authority, A Consultation on the Reform to Retail Prices Index Methodology

⁸ Severn Trent, Q3 Trading Update and AMP7 Dividend Policy

⁹ <https://www.severntrent.com/investors/financial-calendar-and-regulatory-news/>

2. Sustainability and environmental leadership supported by Ofwat

Ofwat's AMP7 is highly focused on delivering improvements to both the environment and customers. Severn Trent Plc. has collaboratively set ambitious targets with Ofwat to improve the environment in the following areas:

- Improve 500km of river
- Create the UK's first bathing quality rivers¹⁰
- Decarbonize water resources to provide 109 Ml per day of 'new' water
- Repair/replace supply pipes; reducing leakage and improving operational efficiency
- Reduce carbon emissions at water treatment facilities

Ofwat has granted an additional investment allowance of ~£861 million for UK water companies to assist with a green economic recovery. Severn has received the lion's share of Ofwat's additional allocation (Fig. 4), which is a 15% uplift over the expenditure allowances set forth in PR19 FD. Half of any cost overruns incurred by Severn will be passed onto the customer. Successful completion of AMP7 environmental targets will continue to make Severn the leading UK water company for sustainability.

Given the need for additional financing to complete the AMP7 environmental objectives, Severn Trent Plc. has successfully requested an allowance from Ofwat to increase customer bills. Currently Severn has the second lowest customer rates in UK (Fig. 5),¹¹ and has demonstrated that its customers would be in support of a £6 – £7.99 average bill increase from 2020 to 2025.¹² Ofwat has agreed to this increase which is to start gradually given lingering effects of COVID-19. By increasing bills, Severn can maintain their BBB+/Baa1 credit rating target while raising additional financing to meet their environmental objectives. Currently Severn is considered investment grade based on its probability of default IG2 rating.

In October 2020 Severn Trent Plc. was awarded four-star status by the Environment Agency. Four-star status reflects the highest level of environmental performance, and historically Severn has received this rating in 2013, 2015 and 2017.¹³ Only two UK water companies were awarded four-star status in 2020, the other being the privately owned Wessex Water. Of Severn's publicly traded peers, United Utilities Group Plc. (UU/ LN Equity) received an award for dealing with serious pollution incidents. South West Water, which is owned by Pennon Group Plc. (PNN LN Equity), received the lowest possible score of one-star. Pennon has never scored above two-stars.¹⁴ Severn Trent is the most sustainable and environmentally responsible investment option in UK water.

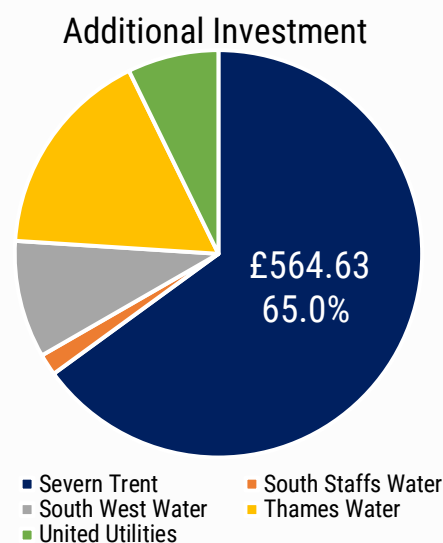


Fig. 4 Ofwat allocation of additional investment allowances for companies to achieve Green Economic Recovery goals throughout AMP7

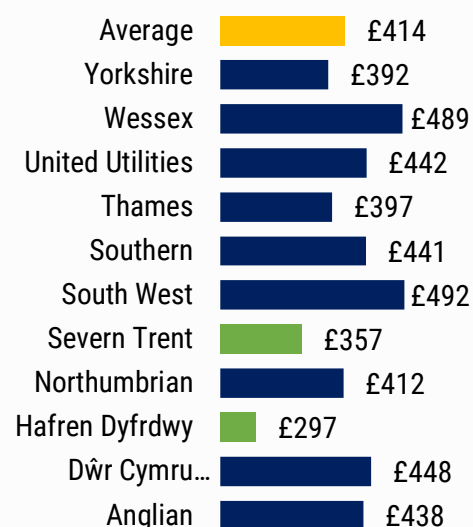


Fig. 5 Average annual water prices for UK Suppliers

¹⁰ Severn Trent, Creating Bathing Rivers

¹¹ <https://www.discoverwater.co.uk/>

¹² Ofwat, Green Economic Recovery: Draft Decisions May 2021

¹³ Severn Trent, Severn Trent awarded top environmental grade

¹⁴ Environment Agency, Report for 2019

3. UK recycling targets are a boon for Severn's growing Green Power business

Food waste has become a major environmental concern for the UK. The Waste and Resources Action Programme estimates 9.5 million tonnes of food waste are generated per annum. This is equivalent to > 25 million tonnes of greenhouse gas emissions.¹⁵ The UK government has set a 50% food waste reduction target by 2023.¹⁶ In conjunction with this target, on May 2021 the government revealed a plan to provide regular food waste collection across England by 2023.¹⁷ Currently food waste collection is performed in accordance to local council rules, which have left many households without proper or frequent recycling options.¹⁸

Severn Trent Plc.'s Green Power business is the largest producer of renewable energy from food waste in the UK.¹⁹ This makes it well positioned to add capacity since local authorities will be mandated to contract for increased food and biowaste haulage as 2023 approaches. Severn is currently recruiting for municipal contract management and human resources, signaling preparation for further growth.²⁰

Green Power has high growth potential and management has indicated that they are well positioned to capitalize on increased curbside pickups.²¹

¹⁵ <https://wrap.org.uk/taking-action/food-drink/actions/action-on-food-waste>

¹⁶ [HM Government, A Green Future: Our 25 Year Plan to Improve the Environment](#)

¹⁷ [GOV.UK, New plans unveiled to boost recycling](#)

¹⁸ [Daily Mail, End to recycling post code lottery! Government reveals plans for weekly food waste collections across England from 2023.](#)

¹⁹ [Severn Trent, Green Power](#)

²⁰ [Severn Trent, Green Power, Careers](#)

²¹ [Severn Trent Half Year 2020/21 Results](#)

4. Continued outperformance on outcome delivery incentives

Ofwat specifies comparative and common performance commitments across all UK water companies. Bespoke commitments proposed by Severn Trent Plc.'s business plans are also determined during Ofwat price reviews. Successfully improving performance in each committed area results in allowed revenue gains for Severn which can be carried forward into subsequent asset management plan periods. Severn has carried forward £191 million of customer outcome delivery incentive (ODI) rewards from AMP6 to AMP7. Currently Severn is on track to continue delivering performance with at least £50 million ODI rewards expected by management in FY21E.²² JPMorgan predicts that Severn will continue to achieve £50 million ODI rewards on an annual basis through AMP7 and predicts yields of 4.2% and 4.3% in FY22 and FY23E respectively.²³

At 2420 GBp JPM believes Severn is trading at fair value, a 4.1% discount to the current price.

²² Severn Trent, [Trading update for the period 1 October 2020 to 4 February 2021](#)

²³ JPMorgan Cazenove Europe Equity Research – UK Water, April 29th 2021, Pavan Mahbubani

Valuation & Risk Profile

Severn Trent Plc. presents an interesting opportunity for income portfolios to benefit from stable yields with targets linked to inflation. This lower bounded growth provides some assurance of dividend maintenance in real terms. Severn is one of the few UK utility companies to receive the highest recognition for their sustainability and environmental improvements, making it an ideal investment opportunity for mandates seeking both yield and sustainability.

I believe that Severn Trent Plc. is fairly valued at its current forward EV / EBITDA multiple which is inline with its historical premium to peer UK water companies (Fig. 6).

Using a blended approach that combines relative valuation (Table 1) and with a sensitized historical premium analysis (Table 2), **I determine Severn's risk-to-reward profile to be -29% to +13% and recommend waiting for an entry at a lower price (~2300 GBp) to reflect a more neutral risk-to-reward profile.**

The full operating model and supporting data is available for download [here](#)

- | | |
|------------------|---|
| Catalysts | <ul style="list-style-type: none"> • Unexpected outperformance on outcome commitments announced • Gearing reduction |
| Risks | <ul style="list-style-type: none"> • The defined benefit pension remains underfunded. Deficit repair could be costly if the UK experiences an inflationary environment. Management continues to hedge against inflation, interest rates and cross currency risks associated with debt through the use of swaps. • Threats of flooding present a significant risk towards maintaining exemplary sustainability status and achieving AMP goals. Outcome commitments and ODI rewards may suffer if significant expenditure is required to cleanup and repair damages from flooding |

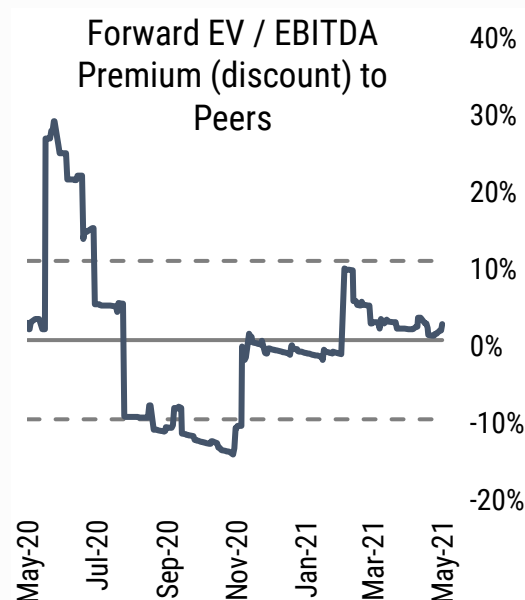


Fig. 6 Severn's Forward EV / EBITDA premium (discount) to peers over the last year. Average premium with 1 standard deviation bands shown. The most recent datapoint indicates a small historical premium of 0.8%

Multiple	CY1 Peer Average	Premium (discount)
EV / EBITDA	13.1x	-6.1%
EV / Sales	7.3x	13.8%

Table 1 Relative valuation for blended risk-reward analysis.

		EV / EBITDA Premium				
		-9.4%	-4.2%	0.9%	6.0%	11.2%
EBITDA	803	-47%	-38%	-28%	-19%	-10%
	846	-38%	-29%	-19%	-9%	1%
	890	-29%	-19%	-9%	2%	12%
	935	-20%	-9%	2%	12%	23%
	982	-11%	1%	12%	24%	35%

Table 2 Historical premium analysis sensitization using proforma EBITDA values from the operating model.

Sources: All charts and data are sourced from Bloomberg L.P. and the author unless otherwise stated.

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Appendix

Public Comparable Companies

(in millions of GBP, except unit data)

Ticker	Name	Market Cap	Enterprise Value	EV / EBITDA		EV / Sales		ROE	ROIC	LTM Ratios		Yield	Beta
				CY1	CY2	CY1	CY2			D / E	Gearing		
PNN LN Equity	Pennon Group PLC	4,411	4,319	12.5x	12.4x	6.8x	6.8x	87.0%	1.2%	103.6x	-3%	3.55%	0.33
UU/ LN Equity	United Utilities Group PLC	6,711	14,758	13.6x	13.1x	7.8x	7.8x	3.7%	1.5%	316.0x	74%	4.41%	0.48
Average				13.1x	12.7x	7.3x	7.3x	45.4%	1.3%	209.8x	35%	3.98%	0.40
SVT LN Equity	Severn Trent PLC	5,972	12,357	13.4x	13.1x	6.8x	6.6x	10.1%	2.5%	517.3x	84%	4.08%	0.51