Research Update:

The Go-Ahead Group PLC 'BBB-' Ratings Affirmed On Rating Headroom In Weak Operating Conditions; Outlook Stable

May 4, 2020

Rating Action Overview

- The restrictions on public gatherings and the stay-at-home and social-distancing orders in place in the U.K. and other countries to contain the spread of COVID-19 are likely to weaken the financial performance of U.K.-based transport operator The Go-Ahead Group PLC (Go-Ahead).
- We expect Go-Ahead to take significant cost-reduction and cash-preservation actions and to benefit from the support measures that the governments of the U.K. and other countries have introduced to ease the impact of the COVID-19 pandemic and ensure the continuity of bus and rail services.
- The drastic short-term reduction in passenger volumes and potential drop in earnings will likely weaken Go-Ahead's credit metrics in the short term. However, we believe that thanks to the rating headroom Go-Ahead has built up over the past few years and its high proportion of contractual revenues, it is in a good position to withstand the difficult operating environment.
- We are therefore affirming our 'BBB-' long-term issuer credit rating on Go-Ahead and our 'BBB-' issue rating on the company's senior unsecured debt.
- The stable outlook indicates our view that Go-Ahead's operating environment will remain challenging in the near term, but that its rating headroom and large proportion of contractual revenues will prevent its credit metrics from falling below the levels we deem commensurate with the 'BBB-' rating.

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Rating Action Rationale

The rating action reflects our view that Go-Ahead's credit metrics should remain commensurate with the ratings. Despite a fall in passenger volumes due to the COVID-19 containment measures, transport authorities' various revenue-support mechanisms and Go-Ahead's existing contracts should protect the majority of its earnings, although its cash flows will be under pressure in the short term. Measures that the U.K. government has introduced in an attempt to contain the spread of COVID-19 include country-wide school closures, stay-at-home and social-distancing orders, as well as a ban on public gatherings. These measures have led to a substantial reduction in passenger volumes. In some parts of the country, passenger volumes have dropped as much as by 90% in the past month, and we believe that this trend is unlikely to revert as long as the containment measures remain in place.

However, to secure the continuity of essential transport services across the country, the U.K. government has recently announced financial-aid mechanisms that should protect a large part of Go-Ahead's revenues. These include:

- The de-risking of the rail operations, which constitute over 70% of Go-Ahead's consolidated revenues. The government has taken on the risks associated with the drop in passenger volumes and cost overruns from the train operating companies, which will receive a management fee instead. (Go-Ahead runs two rail franchises, GRT and Southeastern);
- Continuing payments in the regional bus division (about 12% of consolidated revenues) through agreed concessionary revenue schemes and contractual arrangements. The bus services operators grant, aimed at compensating bus operators' fuel costs, will continue to be paid; and regional bus operators will receive payments under COVID-19 Bus Services Support Grant; and
- Transport for London's (TfL's) agreement to continue paying revenue as contracted for the London bus business, and similar arrangements for Go-Ahead's international bus businesses in Singapore and Ireland (15% of consolidated revenues). These bus operations will run on a no-net-loss no-net-gain basis, so that all savings will be returned to the respective authorities, which will continue to pay contractual revenues.

While these measures provide some support for Go-Ahead's topline, most aim to provide a minimum income to cover the cost base, rather than ensure a return. Therefore, and despite Go-Ahead's cost-cutting measures--including reducing the frequency of services and obtaining wage support from furlough schemes in the U.K.--we expect the company's earnings to decline. Its credit measures are therefore likely to come under pressure, but should remain in the ranges we deem commensurate with the current rating.

Go-Ahead has a sound balance sheet and has built up some rating headroom that could offset the impact of the COVID-19 containment measures on its financial profile. Go-Ahead's steady topline growth of 5%-7%, stable and healthy S&P Global Ratings-adjusted EBITDA margins in excess of 20%, and controlled capital expenditure (capex) and dividend distributions over the past couple of years have resulted in stable adjusted leverage of about 2.5x. This translates into funds from operations (FFO) to debt of more than 30%, which is comfortably in line with our threshold for the rating of more than 23%. In our view, this headroom should help prevent a significant increase in Go-Ahead's leverage and an erosion of its credit quality beyond our base case in the financial year (FY) ending June 30, 2020, and in FY2021. Furthermore, to prevent a material increase in leverage, the company is reviewing and could eventually stop nonessential capex and take additional measures if necessary. In addition, Go-Ahead is not proposing further dividend payments in FY2020.

Go-Ahead has ample liquidity, and its long-dated debt profile should allow for financial flexibility while there is short-term pressure on its earnings. Go-Ahead has a favorable debt maturity profile, with no debt due for repayment before 2024, when its £250 million unsecured notes mature. Go-Ahead's £280 million revolving credit facility (RCF) matures in July 2024, with a one-year extension option. Available liquidity, including the undrawn portion of the RCF, amounted to about £245 million as of March 12, 2020. We believe that these liquidity sources, combined with the cash-preservation measures the company is taking, should provide it with enough financial flexibility to withstand short-term pressure on cash flows.

Outlook

The stable outlook indicates our view that Go-Ahead's operating environment will remain challenging in the near term, but that its rating headroom and large proportion of contractual revenues will prevent its credit metrics from falling below the levels we deem commensurate with the 'BBB-' rating, including FFO to debt of more than 23% on a weighted-average basis.

Downside scenario

We would lower the ratings if the COVID-19 pandemic extends beyond midyear 2020 and the economic recession drags on, such that demand cannot begin to recover and the offsetting measures by the U.K. government and Go-Ahead itself--for example, harsher cost-cutting and cash-preservation measures--are insufficient, resulting in adjusted FFO to debt falling below 23% for a sustained period. We would also lower the ratings if, once demand rebounds, management prioritizes shareholder distributions rather than leverage containment, thereby putting the adjusted FFO-to-debt ratio at risk of falling below the rating-commensurate level.

Upside scenario

While unlikely in the next 12-24 months, we could upgrade Go-Ahead if its FFO to debt increased sustainably above 30%, combined with a financial policy that we believed would support this level over the longer term. This would likely happen if the effects of the pandemic and the resulting recession prove transitory, if passenger volumes recover easily and travel patterns normalize over FY2021, and if we believe that Go-Ahead will carry out its bid and shareholder-return strategies in a prudent manner.

Company Description

Go-Ahead is one of the leading bus and rail services providers in the U.K. It is the largest operator of London buses and provides regional bus services, predominantly in the south of England. The group also runs bus services in Singapore and Ireland, and recently won some rail contracts in Germany and Norway. The company operates two rail franchises in the U.K., GTR and Southeastern. Go-Ahead reported revenues of over £3.8 billion in FY2019, including revenues from its rail operations.

Our Base-Case Scenario

- A high-single-digit decline in consolidated revenues (excluding the rail division) in FY2020, and a potential further low-single-digit decline in FY2021. This is due to the recent sharp decline in U.K. bus passenger volumes as a result of the COVID-19 containment measures, but somewhat offset by substantial government support via a range of packages that vary by regulator.
- No direct risk to revenues from changes in underlying travel demand, as approximately 90% of total group revenues, including rail, are now contracted.
- A potential decline in revenues in the regional bus division of up to 15%-17% in FY2020, and a

further low-single-digit decline in FY2021, resulting from the following two factors:

- --About one-third of Go-Ahead's regional bus revenue derives from concessionary fare reimbursement by local authorities, and from contracts with public authorities in respect of concessionary fare revenue for passengers who receive discounted travel, socially desirable services, or school services. We expect bus operators to continue to receive this revenue.
- --Commercial revenues represent almost two-thirds of the regional bus division, and services are currently experiencing much lower passenger volumes than normal. The U.K. Department for Transport has confirmed bespoke funding for bus operators in England for a 12-week period from mid-March 2020. The Scottish and Welsh governments will also maintain revenue payments at largely similar levels to those before the pandemic.
- No material effect on revenues from the short-term change in passenger volumes in the London and international bus division. This is because TfL and the respective international transport authorities in Singapore and Ireland pay the revenues, which do not depend on passenger volumes. We understand that the level of these contractual revenues will not change, but that Go-Ahead will return any variable cost savings it achieves as a result of reduced service frequency to the authorities. We therefore expect operating profit in this division to remain relatively stable.
- Earnings contribution from the rail division to consolidated EBITDA, despite very low passenger volumes in the short term. This is because the government of the U.K.--where the majority of the division's revenues are generated--has recently announced robust support for the sector under the emergency measures agreements it has initially introduced for six months until September 2020. Go-Ahead operates two rail franchises in the U.K., one in Norway, and three in Germany, and similar arrangements are in place for Go-Ahead's German operations. We understand that the U.K. government will effectively take over U.K. rail franchises' revenue and cost risks by paying a management fee to rail operators. We also understand that under these terms, train operators will not have to provide extraordinary support to their train operating companies should they require liquidity injections. Furthermore, it is worth noting that the Southeastern rail contract that was recently awarded to Go-Ahead will fall under the U.K. government's announced emergency measures agreement for its full length (until Oct. 16, 2021, with the option to extend at the DfT's discretion until March 31, 2022).
- The furlough of about half of Go-Ahead's bus drivers in its regional bus division. Staff expenses are usually the largest cost item for bus and rail operators. The U.K. government has announced a coronavirus job-retention scheme whereby employers can claim 80% of their furloughed employees' usual monthly wages, up to a cap.
- A potential reduction in adjusted EBITDA--after our adjustments for the rail operations--of up to 20% in FY2020-FY2021 from the FY2019 level.
- Cash capex of about £80 million in FY2020, which is lower than expected.
- No further dividends payments and no acquisitions this year.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted FFO to debt of about 25%-27% in FY2020, down from about 35% in FY2019, with a potential recovery to 27%-30% in FY2021 and a more meaningful recovery thereafter.

Liquidity

We view Go-Ahead's liquidity as strong. Our assessment is supported by:

- The company's long-dated debt maturity profile, as its £250 million bonds mature in 2024;
- Our view that the company has well-established and solid relationships with its banks, and a generally high standing in the credit markets;
- The company's prudent and proactive approach to liquidity risk management. Go-Ahead recently curtailed its capex plans significantly for FY2021 and will not be paying any further dividends for FY2020;
- Our estimate that sources of liquidity will exceed uses by more than 3.25x, both in the 12 months to March 12, 2021, and to March 12, 2022; and
- Our forecasts that Go-Ahead's liquidity sources less uses will remain positive, even if our forecast for EBITDA were to decline by 50% in each of the next two years, and that such a decline will not result in a covenant breach.

Go-Ahead's principal liquidity sources for the 12 months from Dec. 28, 2019, will comprise:

- Unrestricted cash and liquid investments of about £110 million;
- About £135 million of availability under the RCF, which expires in July 2024, and which can be extended by one year; and
- Our forecast of FFO--before adjustments--of about £100 million-£150 million in next 12 months.

We estimate that Go-Ahead's principal liquidity uses over the same period will include:

- Immaterial debt maturities;
- About £50 million in cash capex, which is a material reduction from historical levels of £80 million-£110 million in the bus division over FY2018 and FY2019; and
- Low working capital requirements for the bus division, including intra-year swings, of up to £5 million.

We expect management to review both capex and dividend spending as operations normalize and the company has more visibility on earnings.

Covenants

Go-Ahead's RCF is subject to two financial maintenance covenants specifying net debt to EBITDA of no more than 3.5x and EBITDA interest coverage of no less than 3.5x. These covenants remain unchanged for the life of the agreements and are tested every half year. We forecast adequate headroom as of the end of FY2020 and future compliance under our base case. However, headroom is likely to shrink in the short term due to the significant pressure we anticipate on Go-Ahead's earnings.

Ratings Score Snapshot

Issuer credit rating: BBB-/Stable

Business risk: Satisfactory

- Country risk: Low
- Industry risk: High
- Competitive position: Excellent

Financial risk: Significant

- Cash flow/leverage: Significant

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: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Cyclical Industry, Feb. 12, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 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

Ratings List

Ratings Affirmed	
The Go-Ahead Group PLC	
Issuer Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-