Research Update:

Public Transport Company Rheinbahn AG Upgraded To 'AA' On Strengthened Link To Düsseldorf; Outlook Stable

June 24, 2019

Overview

- We think that the link between Rheinbahn and the City of Düsseldorf has strengthened due to an enhanced contractual framework established over the past two years.
- We believe there is an almost certain likelihood that Rheinbahn would receive extraordinary government support from Düsseldorf, if needed, given the company's critical role for and integral link with its government owner.
- Although Rheinbahn's sizable investment program will raise its debt stock and annual debt service and potentially erode liquidity, the public transport company will retain its extremely strong and unchallenged market position, benefiting from its quasi-monopoly and strong economic fundamentals in its catchment area.
- We are therefore raising our long-term rating on Rheinbahn to 'AA' from 'AA-' and affirming the 'A-1+' short-term rating.
- The outlook is stable.

Rating Action

On June 24, 2019, S&P Global Ratings raised its long- and short-term issuer credit ratings to 'AA' from 'AA-' on Rheinbahn AG, the City of Düsseldorf's public transport company. The outlook is stable. We affirmed the 'A-1+' short-term rating.

Rationale

Our credit analysis on Rheinbahn factors in our approach for rating government-related entities (GREs) and public transport providers. In particular, we incorporate our revised assessment that there is now an almost certain likelihood of timely and sufficient extraordinary support for Rheinbahn from Düsseldorf under a financial stress scenario.
We now assess the link between Düsseldorf and Rheinbahn as integral. The city's has full ownership of Rheinbahn, and we consider the chances of privatization or partial privatization of the public transport company as negligible over the coming years. Furthermore, over the past two years, the city and Rheinbahn have enhanced the contractual framework governing the public transport company. At the same time, we consider that Rheinbahn plays a critical role for Düsseldorf as the provider of public transport services within the city and several neighboring communities. The essential—and subsidized—nature of Rheinbahn's services, which we do not believe a private entity could undertake, underpins its critical role, in our view. We do not anticipate constraints to timely and extraordinary financial support outside the contractual framework. We assume that such funds would be readily available to Rheinbahn in a stress scenario, for example, through the city's holding company.

The enhanced and strengthened legal framework between Düsseldorf and Rheinbahn primarily aims at allowing the city to directly award public contracts to Rheinbahn, in line with EU competition regulation. In 2017, Düsseldorf and Rheinbahn signed a "domination agreement," effectively limiting Rheinbahn's autonomy and bringing it formally under the managerial authority of the city. In 2018, they signed a formal profit-and-loss transfer agreement, encompassing the previously established compensation payments by the city. Overall, we believe that Rheinbahn operates under an established legal framework, and we take into account the appropriate supervision of strategy and operations by city representatives.

We assess Rheinbahn's stand-alone credit profile (SACP) in the 'a' category, based on our view of the company's extremely strong enterprise risk and strong financial risk profiles. Rheinbahn's high annual debt service, in relation to current and expected own liquidity levels, and EBITDA still constrains the SACP. We note, however, that the company has increasingly diversified its external funding sources over the past few years.

Rheinbahn's enterprise risk profile will remain extremely strong, in our view. Rheinbahn benefits from very strong economic fundamentals in its catchment area, Düsseldorf, the state capital of Germany's largest state, North-Rhine Westphalia (NRW). Düsseldorf has expanded rapidly in terms of population and employment over the past few years, and we project growth will continue over our forecast horizon, translating to increasing commuter flow. Because the lull in ridership growth last year mainly relates to capacity constraints of the current vehicle fleet, we see good potential that Rheinbahn's higher investments primarily to adding new buses and trains will yield an increase in passenger numbers over the next few years. As we do for rated mass transit providers globally, we also factor in the benefits from our assessment of the public transport sector's very low industry risk. Operating revenues in the sector generally show low volatility, since susceptibility to economic cycles is very limited. At the same time, barriers of entry in the sector are high and competition generally poses low risk. In the case of Rheinbahn, the domination agreement helps to cement its quasi-monopoly position in the market, and we see marginal risk of private competitors entering the local market, even on a small scale. This translates into an extremely strong market position.

Moreover, we take into account our view of Rheinbahn's management and governance as satisfactory. This supports our overall assessment of the company's enterprise profile. We will continue to monitor developments in the company's strategy, as well as its responses to increased political demands and its focus on enhancing public transport attractiveness. We expect that management will successfully implement the ambitious investment program, also mandated by its government owner, while preserving strong standards for operating performance, for example regarding cost coverage.

We assess Rheinbahn's financial policies as strong compared with international peers', also weighing in the company's debt management policies and long-term capital planning.
Nonetheless, the company's efforts to meet rising demand for public transport will likely continue to constrain EBITDA levels. We also note the company's sizable investment program, mainly to replace a significant share of rolling stock at the end of its lifespan. The material expenses associated with both types of capital expenditure, mostly related to new buses, trains, and the network's infrastructure, are significant. Rheinbahn consequently has to incur higher debt and a considerable increase in annual debt service over the next years.

The increases of annual debt service are pronounced, also compared with the company's EBITDA and current levels of own liquid funds. Rheinbahn's reported total debt service increased by 50% year-on-year in 2018 to €77.9 million. We believe annual debt service will remain between €60 million and €70 million over the next years—except for 2020, which currently has slightly lower maturities. This affects our assessment of the entity's debt service coverage (debt service compared with EBITDA plus compensation payments), which will likely decrease to below 1x in all years, except 2020, from above 2x in 2016. This offsets the company's adequate liquidity management, leading us to cap the SACP—which results from the combination of the enterprise risk profile and the financial risk profile—at the 'a' category. Accordingly, we also expect debt levels to net revenues will remain at very high levels in an international comparison within our forecast horizon. Counterbalancing this development, we expect Rheinbahn to maintain a high degree of financial flexibility over the next few years. Overall, we believe that cost coverage will remain close to 80% over the next few years, which is very high by international standards. As such, our fare box recovery ratio—the fraction of operating expenses met by fare revenues (therefore slightly different from the cost coverage ratio)—will decrease only slightly over the next years, to above 73% from almost 80%. The debt service carrying charge (debt service as a percentage of all financial obligations due in a fiscal year) also remains at elevated, at about 17% (excluding 2020). However, we cannot rule out an upward trajectory of these figures over the next few years, because annual debt service could rise above projected levels.

**Liquidity**

The short-term rating is 'A-1+'. We consider Rheinbahn's access to external liquidity to be strong. The company has had uninterrupted access to European and German promotional and private banks, and we understand the company could access liquidity from the city, for example, via Düsseldorf's municipal holding company, if needed. Our liquidity assessment also takes into account available liquidity facilities of about €2.5 million and the still-elevated levels of available cash over the past three years compared to previously due to some asset sales. However, Rheinbahn has already started to disburse some of these own liquid funds, and we expect that these reserves will decrease further over the near future to cover own investments and to provide some dividend payouts to the city. This, given the current maturities in 2019 and 2020, translates into a cash-to-debt service ratio decreasing to below 1x and projected below 90 days available cash over the next years. Rheinbahn relies mostly on long-term borrowings and the largest share of outstanding financial debt will be maturing after 2021.

**Outlook**

The stable outlook reflects our view that Rheinbahn will retain its critical role for Düsseldorf and that the link between the two will remain integral. We currently project no change to the city's financial capabilities to provide extraordinary support to the entity.
Upside scenario

We could raise the ratings on Rheinbahn if we estimated that Düsseldorf's creditworthiness had improved, indicating enhanced capabilities to provide extraordinary financial support to Rheinbahn if needed.

Downside scenario

Conversely, we could lower the ratings if we anticipated adverse changes in the likelihood of extraordinary support from Düsseldorf, most likely reflecting a weakening of the link between the city and the public transport company. This could occur, for example, if we observed a partial retraction of the now established contractual framework between the city and Rheinbahn. We consider such a development as highly unlikely. Likewise, we would consider a negative rating action if we observed a deterioration in the city’s ability to support Rheinbahn.

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
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

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<td>Rheinbahn AG</td>
<td>AA/Stable/A-1+</td>
<td>AA-//Stable/A-1+</td>
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69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.
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