MOODY'S

Rating Action: Moody's downgrades American Water and American Water Capital Corp. to Baa1 from A3; outlooks stable

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Approximately $6.3 billion of long-term debt affected

New York, April 01, 2019 -- Moody's Investors Service ("Moody's") downgraded the long-term Issuer Rating of American Water Works Company, Inc. (American Water) and the senior unsecured debt issued by its financing vehicle American Water Capital Corp. (AWCC) to Baa1 from A3 reflecting a consolidated financial profile that will continue to weaken over the next 12-18 months. Moody's also affirmed AWCC's P-2 short-term commercial paper rating. The outlooks for both companies are stable.

RATINGS RATIONALE

"American Water's financial profile is declining due to debt-funded capital spending and growing shareholder dividends amidst near-term cash flow pressures from tax reform" said Ryan Wobbrock, Vice President -- Senior Credit Officer. "These trends will push the ratio of funds from operations (FFO) to net debt to around 14% at the same time that structural subordination of holding company debt has increased, with approximately 25% of total debt at the holding company" added Wobbrock.

The financial profile of the company has steadily declined since 2014 with free cash flow deficits and debt issuance having outpaced cash flow growth, as the company took on nearly $6.5 billion of capital spending. For example, free cash flow deficits have grown at a compound annual growth rate (CAGR) of around 62%, debt has grown at over 9% CAGR and FFO at roughly a 6% CAGR. For most of this time, the company was benefitting from bonus depreciation, which resulted in no cash tax payments. However, 2017 federal tax reform undid these benefits, which has also contributed in key ratios declining, such as funds from operations (FFO) to net debt dropping from 18% in 2014 to 16% in 2018 and retained cash flow (RCF) to net debt falling from 15% in 2014 to just above 12% in 2018.

Over the next 12-18 months, we expect these ratios to be around 14% and 10%, respectively, as the company spends around $1.7 billion in capital investments, pays a dividend of about $350 million and generates about $1.4 billion in funds from operations on a last twelve month basis. These are below the grid scoring ranges outlined for A rated companies in our Regulated Water Utilities rating methodology. American Water is not planning any equity issuance over the next five years to help fund over $8.0 billion of capital spending and dividend growth of about 10% per annum.

The financial decline has come despite improved cost recovery provisions across American Water's regulatory footprint, including several infrastructure riders and trackers that make cost recovery more certain and reduce regulatory lag, which support the company's stable outlook. The strong regulatory support for operating and capital expenditure cost recovery continues to be a qualitative benefit for the company, since we estimate that over 60% of annual capex is placed into rate base each year.

American Water's Baa1 unsecured credit profile is underpinned by its market position as the largest US investor-owned water utility holding company and strong regulatory and operational diversity across 16 states.

Factors that could lead to an upgrade

American Water could be upgraded if consolidated FFO to net debt were to return to levels consistently above 15%. Reduced holding company leverage and the improved credit quality of its two primary subsidiaries in Pennsylvania and New Jersey would also help to provide ratings lift.

Factors that could lead to a downgrade

FFO to net debt or retained cash flow to net debt around 12% and 7%, respectively, could place downward pressure on American Water's rating. Similarly, continued growth in holding company leverag or any materially adverse regulatory developments or operational set-backs could also lead to a downgrade.

Downgrades:

..Issuer: American Water Capital Corp.

.... Issuer Rating, Downgraded to Baa1 from A3

....Senior Unsecured Regular Bond/Debenture, Downgraded to Baa1 from A3

..Issuer: American Water Works Company, Inc.

.... Issuer Rating, Downgraded to Baa1 from A3

..Issuer: Berks County Industrial Development Auth., PA

....Senior Unsecured Revenue Bonds, Downgraded to Baa1 from A3

..Issuer: California Pollution Control Financing Auth.

....Senior Unsecured Revenue Bonds, Downgraded to Baa1 from A3

..Issuer: Illinois Development Finance Authority

....Senior Unsecured Revenue Bonds, Downgraded to Baa1 from A3

..Issuer: Illinois Finance Authority

....Senior Unsecured Revenue Bonds, Downgraded to Baa1 from A3

..Issuer: Indiana Finance Authority

....Senior Unsecured Revenue Bonds, Downgraded to Baa1 from A3

..Issuer: MARICOPA COUNTY INDUSTRIAL DEVELOPMENT AUTHORITY, AZ

....Senior Unsecured Revenue Bonds, Downgraded to Baa1 from A3

..Issuer: Owen (County of) KY

....Senior Unsecured Revenue Bonds, Downgraded to Baa1 from A3

Outlook Actions:

..Issuer: American Water Capital Corp.

....Outlook,Changed To Stable From Negative

..Issuer:American Water Works Company, Inc.

....Outlook,Changed To Stable From Negative

Affirmations:

..Issuer:American Water Capital Corp.

....Senior Unsecured Commercial Paper, Affirmed P-2

The principal methodology used in these ratings was Regulated Water Utilities published in June 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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