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FirstGroup downgrade threat to rail bidding

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FirstGroup faces possible exclusion from future rail bids should it lose its investment grade credit rating, under changes to franchising rules being considered by the government.

The change adds further impetus to the highly dilutive £615m rights issue announced by the bus and rail operator this week.

Tim O'Toole, chief executive, said the rights issue was necessary to retain the company's investment grade credit rating, which stands one level above junk at triple B minus with Fitch and Standard & Poor's.

People familiar with the situation said that new rail franchising rules under consideration by the government, in the wake of the West Coast fiasco, could make an investment grade credit rating a requirement for any bidder.

The mooted move is part of the government's overhaul of the whole franchising process, under which changes are being drawn up to deter overbidding and protect taxpayers from default.

Although a final decision has not been made, some analysts and rail industry executives are anticipating a company's credit rating could become an issue in the bidding for future government rail contracts.

"It is increasingly probable that the industry is moving towards rail bidding requiring investment grade balance sheets," said Damian Brewer, transport analyst at RBC Capital Markets.

One senior rail industry executive said the issue had been raised by Department of Transport officials but it was unclear whether it would become a requirement.

In addition, FirstGroup, the UK's biggest rail operator, told investors that a credit downgrade would have led to a £50m jump in financing costs, triggered largely by higher debt repayments. A junk rating would have made it more expensive for FirstGroup to bid for rail contracts and would have led to lower investments in the bus fleet, the company said.

The other three UK-listed transport groups – Go-Ahead, National Express and Stagecoach – all have low investment grade credit ratings similar to FirstGroup.

In contrast, the foreign, state-controlled bidders eyeing the market, including France's SNCF and Hong Kong's MTR, enjoy top-level credit ratings.

Any move to impose a requirement for an investment grade credit rating on bidders could pose problems for Virgin Rail, the joint venture between Sir Richard Branson's Virgin Group and Stagecoach. Virgin Group has no credit rating and it is unclear whether the joint venture would be covered by the one held by Stagecoach.

FirstGroup did not return calls for comment. Investors continued to react negatively to the cash call on Tuesday, sending the shares down just over 1 per cent to close at 153.70p in London.

The announcement of the heavily discounted, fully underwritten share issue was accompanied by the scrapping of the group final dividend and the resignation of Martin Gilbert, FirstGroup's long-serving chairman.

On Wednesday, the government is hosting a rail franchising open day for bidders and suppliers in a bid to put the damage of the West Coast bidding process behind it. Simon Burns, transport minister, said it would "highlight opportunities from the new rail franchising programme."