# Canal de Isabel II, S.A.

| Rating Type | Rating | Outlook | Last Rating Action |
|---|---|---|---|
| Long-Term IDR | BBB+ | Stable | Affirmed 2 July 2018 |
| Senior unsecured rating | BBB+ | | Affirmed 2 July 2018 |

Click here for full list of ratings

## Financial Summary

| (EURth) | Dec 2015 | Dec 2016 | Dec 2017P | Dec 2018F | Dec 2019F | Dec 2020F |
|---|---|---|---|---|---|---|
| Gross Revenue | 1,120,857 | 1,104,235 | 1,145,712 | 1,121,948 | 914,126 | 881,331 |
| Operating EBITDA [a] | 491,105 | 489,595 | 530,719 | 497,110 | 434,143 | 420,360 |
| Operating EBITDA Margin (%) | 43.8 | 44.3 | 46.3 | 44.3 | 47.5 | 47.7 |
| Funds Flow From Operations | 410,927 | 292,070 | 346,083 | 298,307 | 198,549 | 251,187 |
| FFO Fixed Charge Coverage (x) | 10.7 | 7.2 | 8.6 | 7.6 | 7.2 | 9.1 |
| FFO Adjusted Net Leverage (x) | 2.6 | 3.3 | 2.4 | 2.5 | 2.7 | 1.6 |

Note: 2017P: Preliminary; 2018F-2020F: Forecast
[a] EBITDA before infrastructure provision
Source: Fitch

Fitch Ratings affirmed Canal de Isabel II, S.A.'s (Canal) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB+' in July 2018. The Outlook on the Long-Term IDR is Stable.

The ratings are supported by Canal's low business risk profile as an asset operator and a provider of water and sewage services, with the bulk of its earnings generated under long-term concession agreements. The ratings take into account the company's strategic refocus and the gradual divestment in interests outside the Madrid region from 2019, our assumption of the end of the tariff freeze from 2020, and an improved liquidity position. Significant deleveraging will occur through 2022, which in turn is the main driver for an improvement in Canal's standalone credit profile (SACP) to 'A-' from 'BBB+'.

The Stable Outlook mirrors that of Autonomous Community of Madrid (BBB/Stable) and also reflects the overall stable regulatory and contractual framework for water concessions in Spain, and the maintained financial and dividend policy.

## Key Rating Drivers

**Low Business Risk:** Canal's low business risk profile is supported by the revenue stability provided by its 50-year water concession agreement in Madrid's region that expires in 2062. For 2018, EBITDA generated from regulated activities in Spain is expected at around 88%, while 10% is forecast to come from regulated activities in Latin America, and the remaining 2% relates to non-regulated ancillary services.

**Softly Regulated Water in Spain:** The decentralised regulatory environment for water companies in Spain is less robust and transparent than in some other European countries. It benefits from a full-cost-pass-through tariff mechanism and legal provisions under the concession agreements that protect the value of the investment. The regulatory and contractual framework is viewed as stable, with no impact from the recently published new Public Contracts Law in Spain. We believe that there is a higher risk of political interference in tariff-setting than in many other EU jurisdictions.

**Refocus on Madrid's Water Activities:** Canal's strategic plan to 2022, published in November 2017, reinforces the social approach of the company and focuses on the Madrid region. It contemplates the extension of social tariffs, with limited financial impact, the end of the tariff freeze by 2020, and the divestment in non-strategic businesses and geographies. We see the plan as overall supportive for Canal's credit profile. In our view, the refocus and transparency exercise is politically driven and largely aims to offset the reputational impact from the fraud allegations in which some Canal's ex-key management were involved in 2017.

**Non-Core to Divest:** The strategic plan aims to divest in all Canal's overseas interests (mainly Colombia and Brazil) and concessions outside the Madrid region (Caceres and Lanzarote), and some real estate properties between 2019 and 2021. If divestments are completed as planned, Canal would only operate in the Madrid region. As we did not provide any credit value to the limited diversification before, the move is not considered credit negative.

Some uncertainty is associated with the Colombian and Brazilian divestments, as political noise in those countries generated by the ongoing investigations into fraud allegations could affect market interest or delay timing of execution. However, our base case forecasts a block sale of the overseas investments by 2019 in line with the equity value, reflecting the impairments in Emissao (Brazil) in 2016 and 2017. EBITDA generated in Latin America is expected to be around 10% of the consolidated amount in 2018.

**Substantial Deleveraging to 2022:** We expect funds from operations (FFO) adjusted for dividends net leverage to improve substantially over the period (2022: 1.4x; 2017: 2.4x). This is largely due to the cash proceeds expected from divestments and the positive free cash flow profile before divestments. In addition, coverage ratios will benefit from the cancellation of expensive Latin American debt. We assume that Canal's conservative financial policy, with a net debt cap at EUR1.2 billion, net debt to EBITDA below 4.0x and dividend payout between 50% and 80% , will remain in place during the rating horizon or become stricter given the ample headroom against targets.

**Capex Flexibility Maintained:** Total capex of EUR1.3 billion to 2022 is due to new infrastructure (50%) and maintenance and network improvement (50%). Capex intensity (capex/revenues) will grow to an average of 23% in 2018-2022 (from 18% in 2014-2017). This is due to the divestment in lower capex-intensive activities in Latin America and the higher effort in maintenance and works related to the improvement of the distribution and sewage networks, which have a cost recovery throughout the whole life of the contract.

Capital and operating spending are decided based on the company's return on investment expectations rather than obligations; hence, there is flexibility if needed. Investments needed to fulfil EU directives, largely related to water treatment, are already completed.

**Upgraded SACP Rating:** We upgraded Canal's SACP rating to 'A-' based on the substantial deleveraging already achieved, with further deleveraging expected by 2022, and the resulting liquidity enhancement. The latter could be used to repay the EUR500 million bond at its maturity by 2025. Finally, failure in the execution of the Latin America divestment would not change our view on the SACP upgrade, as remaining planned divestments are easily disposable and deleveraging below the guidelines has already been achieved, in our view.

**Parent Linkage Constrains IDR:** Fitch assesses Canal's link to Madrid, its ultimate parent, to be weak under our GRE criteria. This, along with the existence of internal targets (agreed financial targets and maximum dividend pay-outs) that restrict cash extraction from Canal, give rise to a one-notch maximum differential of Canal's IDR from Madrid IDR. As such, Canal's IDR is currently constrained at the 'BBB+' level.

## Rating Derivation Relative to Peers

| Rating Derivation vs. Peers | |
|---|---|
| Peer Comparison | Canal is a water and sewage network operator which in contrast to most European peers does not own the asset base. However, its investments are supported by its concession's value. The company is well position relative to peers and has a low business risk profile compared to its wider corporate peer group. Canal's leverage, adjusted for dividends, is well below other peers such as Acea SpA (BBB+/Stable), Wessex Water Limited (BBB+/Stable) and FCC Aqualia, S.A. (BB+/Stable).<br>However, the company operates in a decentralised and less developed regulatory environment than in some other European countries and the rating is constrained by its ultimate parent Madrid (BBB/Stable). |
| Parent/Subsidiary Linkage | Government-Related Entities criteria and ultimately Parent and Subsidiary Linkage criteria are applicable. The final IDR rating is constrained at the level of 'BBB+' (parent rating plus one notch). The standalone credit profile of Canal is 'A-'. |
| Country Ceiling | No Country Ceiling constraint was in effect for these ratings. |
| Operating Environment | No Operating Environment influence was in effect for these ratings. |
| Other Factors | In addition, as Canal does not own the assets, it does not benefit from the one-notch uplift to the senior unsecured rating typically afforded to regulated network utilities which reflects above-average expected recoveries in a case of default. |

Source: Fitch

## Navigator Peer Comparison

| Issuer | | Business profile | | | | | | Financial profile | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Name | IDR/Outlook | Operating Environment | Management and Corporate Governance | Sector Positioning | Regulatory Environment | Asset Base | Operations | Profitability and Cash Flow | Financial Structure | Financial Flexibility |
| Canal de Isabel II, S.A. | BBB+/Sta | bbb+ | bbb | bbb+ | bbb | bbb | a- | bbb+ | a- | bbb |
| Acea SpA | BBB+/Sta | bbb+ | bbb+ | bb+ | bbb+ | bbb+ | bbb+ | bbb | a- | a- |
| Wessex Water Services Limited | BBB+/Sta | aa | a+ | bbb+ | a- | a- | a- | bbb+ | bbb | bbb+ |
| FCC Aqualia, S.A. | BB+/Sta | a- | bbb- | bb+ | bbb- | bbb | bbb+ | bbb- | bb | bbb- |

Source: Fitch

Importance Higher Moderate Lower

| Issuer | | Business profile | | | | | | Financial profile | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Name | IDR/Outlook | Operating Environment | Management and Corporate Governance | Sector Positioning | Regulatory Environment | Asset Base | Operations | Profitability and Cash Flow | Financial Structure | Financial Flexibility |
| Canal de Isabel II, S.A. | BBB+/Sta | 0.0 | -1.0 | 0.0 | -1.0 | -1.0 | 1.0 | 0.0 | 1.0 | -1.0 |
| Acea SpA | BBB+/Sta | 0.0 | 0.0 | -3.0 | 0.0 | 0.0 | 0.0 | -1.0 | 1.0 | 1.0 |
| Wessex Water Services Limited | BBB+/Sta | 5.0 | 3.0 | 0.0 | 1.0 | 1.0 | 1.0 | 0.0 | -1.0 | 0.0 |
| FCC Aqualia, S.A. | BB+/Sta | 4.0 | 1.0 | 0.0 | 1.0 | 2.0 | 3.0 | 1.0 | -1.0 | 1.0 |

Source: Fitch

Worse positioned than IDR In line with IDR Better positioned than IDR

## Rating Sensitivities

Developments That May, Individually or Collectively, Lead to Positive Rating Action:

- An upgrade of Madrid, together with stronger cash-flow generation leading to FFO adjusted for dividends net leverage below 4.0x on a sustained basis, could lead to an upgrade for Canal;
- An upgrade in the SACP rating to 'A' is unlikely due to the company's business profile, but a more predictable and supportive regulatory and political environment or sustained negligible leverage may be rating positive.

Developments That May, Individually or Collectively, Lead to Negative Rating Action:

- Weaker cash-flow generation leading to FFO adjusted for dividends net leverage above 5.0x and FFO fixed charge coverage below 4.0x on a sustained basis could lead to a negative rating action, due to a worse-than-expected operating environment including regulatory changes or higher dividends.
- A negative rating action on Madrid could trigger the same negative rating action for Canal, provided that the strength of the links between the two continues to allow for a maximum of one-notch differential.

## Liquidity and Debt Structure

**Improving Liquidity:** As of 31 December 2017, the company had EUR149 million of unrestricted cash and EUR138 million of available committed credit facilities maturing in December 2018 and expected to be renewed on a yearly basis. Without considering the short-term credit facilities, Canal's cash position is sufficient to cover around 24 months of debt maturities. An extension of liquidity credit facilities is contingent on further refinancing in 2018 and structurally constrained by legal limitations on long-term funding.

Canal is subject to the Region of Madrid Budgetary Law, which requires high-level authorisation to approve long-term committed credit lines. We view Canal's liquidity position as weaker than other Fitch-rated utilities in Spain as a result of its less sizeable committed credit lines. We consider cash in Latin American affiliates (EUR4.5 million) as restricted for liquidity purposes.

## Debt Maturities and Liquidity at FYE17

| **Liquidity Summary** | **Original** | **Original** |
|---|---|---|
| | | |
| (EURm) | 31 December 2016 | 31 December 2017 |
| Total Cash & Cash Equivalents | 98 | 153 |
| Short-Term Investments | 0 | 0 |
| Less: Not Readily Available Cash and Cash Equivalents | 0 | -4 |
| **Fitch-defined Readily Available Cash and Cash Equivalents** | **98** | **149** |
| Availability under Committed Lines of Credit[a] | 131 | 138 |
| **Total Liquidity** | **229** | **287** |
| Plus: Fitch Forecasted 2017/2018 FCF (post dividend) | 51 | 92 |
| | | |
| **Liquidity Score** | **2.7** | **15.2** |
| | | |
| **LTM EBITDA** | **490** | **530** |
| **LTM Free Cash Flow** | **35** | **173** |

Source: Fitch, Company filings
[a] With maturity by December 2017 and 2018 respectively.

| **Scheduled Debt Maturities** | | **Original** |
|---|---|---|
| | | |
| (EURm) | 31 December 2016 | 31 December 2017 |
| Current Year | 137.0 | 110.4 |
| Plus 1 Year | 106.0 | 47.3 |
| Plus 2 Years | 46.0 | 41.0 |
| Plus 3 Years | 39.0 | 38.8 |
| Thereafter | 755.0 | 719.2 |
| **Total Debt Maturities** | **1,083.0** | **956.7** |

Source: Fitch

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## Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- EBITDA CAGR of -5.0% for the period 2018-2022, mainly driven by relevant divestments in the period;
- Divestments comprising Canal Extensia (Latin American group) and concessions outside Madrid at book value and real estate properties at its appraised value, from 2019 to 2021;
- Madrid's water tariffs frozen until 2019 and annually revised from 2020;
- Slightly decreasing volume of water billed over the forecast period;
- Stable population and customer base;
- Fixed costs linked to Fitch's CPI assumptions;
- Declining Gross Debt to EUR0.7 billion by 2022; no new debt will be raised in the period;
- Capex of around EUR220 million on average for 2018-2022;
- 80% dividend pay-out based on individual accounts for Canal.

## Financial Data

| (EURth) | Historical | | | Forecast | | | |
|---|---|---|---|---|---|---|---|
| | Dec 2014 | Dec 2015 | Dec 2016 | Dec 2017P | Dec 2018F | Dec 2019F | Dec 2020F |
| **SUMMARY INCOME STATEMENT** | | | | | | | |
| Gross Revenue | 1,064,576 | 1,120,857 | 1,104,235 | 1,145,712 | 1,121,948 | 914,126 | 881,331 |
| Revenue Growth (%) | 2.9 | 5.3 | -1.5 | 3.8 | -2.1 | -18.5 | -3.6 |
| Operating EBITDA (Before Income From Associates) | 459,402 | 491,105 | 489,595 | 530,719 | 497,110 | 434,143 | 420,360 |
| Operating EBITDA Margin (%) | 43.2 | 43.8 | 44.3 | 46.3 | 44.3 | 47.5 | 47.7 |
| Operating EBITDAR | 475,548 | 509,404 | 505,255 | 547,364 | 513,755 | 450,788 | 437,005 |
| Operating EBITDAR Margin (%) | 44.7 | 45.4 | 45.8 | 47.8 | 45.8 | 49.3 | 49.6 |
| Operating EBIT | 240,585 | 269,222 | 263,476 | 302,519 | 265,819 | 213,913 | 200,366 |
| Operating EBIT Margin (%) | 22.6 | 24.0 | 23.9 | 26.4 | 23.7 | 23.4 | 22.7 |
| Gross Interest Expense | -38,646 | -30,975 | -36,102 | -32,202 | -28,169 | -15,442 | -14,327 |
| Pretax Income (Including Associate Income/Loss) | 218,930 | 236,979 | 241,915 | 272,691 | 241,347 | 240,624 | 234,120 |
| | | | | | | | |
| **SUMMARY BALANCE SHEET** | | | | | | | |
| Readily Available Cash and Equivalents | 30,206 | 156,569 | 98,879 | 148,636 | 156,666 | 288,936 | 433,365 |
| Total Debt With Equity Credit | 1,225,120 | 1,186,132 | 1,084,389 | 956,672 | 873,177 | 775,584 | 745,314 |
| Total Adjusted Debt with Equity Credit | 1,354,288 | 1,332,524 | 1,209,669 | 1,089,831 | 1,006,336 | 908,743 | 878,473 |
| Net Debt | 1,194,914 | 1,029,563 | 985,510 | 808,036 | 716,511 | 486,648 | 311,949 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **SUMMARY CASH FLOW STATEMENT** | | | | | | | |
| Operating EBITDA | 459,402 | 491,105 | 489,595 | 530,719 | 497,110 | 434,143 | 420,360 |
| Cash Interest Paid | -38,646 | -23,679 | -31,129 | -28,721 | -28,169 | -15,442 | -14,327 |
| Cash Tax | -13,577 | 4,615 | 17,059 | -12,900 | -7,761 | -21,324 | -6,369 |
| Dividends Received Less Dividends Paid to Minorities (Inflow/(Out)flow) | -2,000 | -2,000 | -2,000 | -1,170 | -1,170 | 0 | 0 |
| Other Items Before FFO | -155,743 | -60,820 | -183,788 | -144,217 | -162,953 | -199,763 | -149,858 |
| Funds Flow From Operations | 250,480 | 410,927 | 292,070 | 346,083 | 298,307 | 198,549 | 251,187 |
| Change in Working Capital | -27,433 | -26,744 | -38,462 | -2,741 | -18,576 | -5,289 | -1,637 |
| Cash Flow From Operations (Fitch Defined) | 223,047 | 384,183 | 253,608 | 343,342 | 279,731 | 193,260 | 249,550 |
| Total Non-Operating/Non-Recurring Cash Flow | 0 | 0 | 0 | | | | |
| Capital Expenditure | -179,972 | -247,689 | -205,139 | | | | |
| Capital Intensity (Capex/Revenue) | 16.9 | 22.1 | 18.6 | | | | |
| Common Dividends | 0 | 0 | 0 | | | | |
| Free Cash Flow | 43,075 | 136,494 | 48,469 | | | | |
| Net Acquisitions and Divestitures | -22,227 | -4,155 | -7,476 | | | | |
| Other Investing and Financing Cash Flow Items | 16,252 | 15,194 | 10,235 | -5,096 | 0 | 4,457 | 0 |
| Net Debt Proceeds | -29,521 | -21,170 | -110,294 | -133,682 | -83,495 | -97,593 | -30,270 |
| Net Equity Proceeds | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Total Change in Cash | 7,579 | 126,363 | -59,066 | 51,133 | 8,030 | 132,270 | 144,429 |
| | | | | | | | |
| **ADDITIONAL CASH FLOW MEASURES** | | | | | | | |
| FFO Margin (%) | 23.5 | 36.7 | 26.5 | 30.2 | 26.6 | 21.7 | 28.5 |
| | | | | | | | |
| **Calculations for Forecast Publication** | | | | | | | |
| Capex, Dividends, Acquisitions and Other Items Before FCF | -202,199 | -251,844 | -212,615 | -153,431 | -188,206 | 32,146 | -74,851 |
| Free Cash Flow After Acquisitions and Divestitures | 20,848 | 132,339 | 40,993 | 189,911 | 91,525 | 225,406 | 174,699 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Free Cash Flow Margin (After Net Acquisitions) (%) | 2.0 | 11.8 | 3.7 | 16.6 | 8.2 | 24.7 | 19.8 |
| | | | | | | | |
| **COVERAGE RATIOS** | | | | | | | |
| FFO Interest Coverage (x) | 7.5 | 18.3 | 10.3 | 13.0 | 11.5 | 13.8 | 18.4 |
| FFO Fixed Charge Coverage (x) | 5.6 | 10.7 | 7.2 | 8.6 | 7.6 | 7.2 | 9.1 |
| Operating EBITDAR/Interest Paid + Rents (x) | 8.6 | 12.1 | 10.8 | 12.0 | 11.4 | 14.0 | 14.1 |
| Operating EBITDA/Interest Paid (x) | 11.8 | 20.7 | 15.7 | 18.4 | 17.6 | 28.1 | 29.3 |
| | | | | | | | |
| **LEVERAGES RATIOS** | | | | | | | |
| Total Adjusted Debt/Operating EBITDAR (x) | 2.9 | 2.6 | 2.4 | 2.0 | 2.0 | 2.0 | 2.0 |
| Total Adjusted Net Debt/Operating EBITDAR (x) | 2.8 | 2.3 | 2.2 | 1.7 | 1.7 | 1.4 | 1.0 |
| Total Debt with Equity Credit/Operating EBITDA (x) | 2.7 | 2.4 | 2.2 | 1.8 | 1.8 | 1.8 | 1.8 |
| FFO Adjusted Leverage (x) | 4.5 | 3.0 | 3.6 | 2.8 | 2.9 | 4.0 | 3.1 |
| FFO Adjusted Net Leverage (x) | 4.4 | 2.6 | 3.3 | 2.4 | 2.5 | 2.7 | 1.6 |

Source: Fitch.

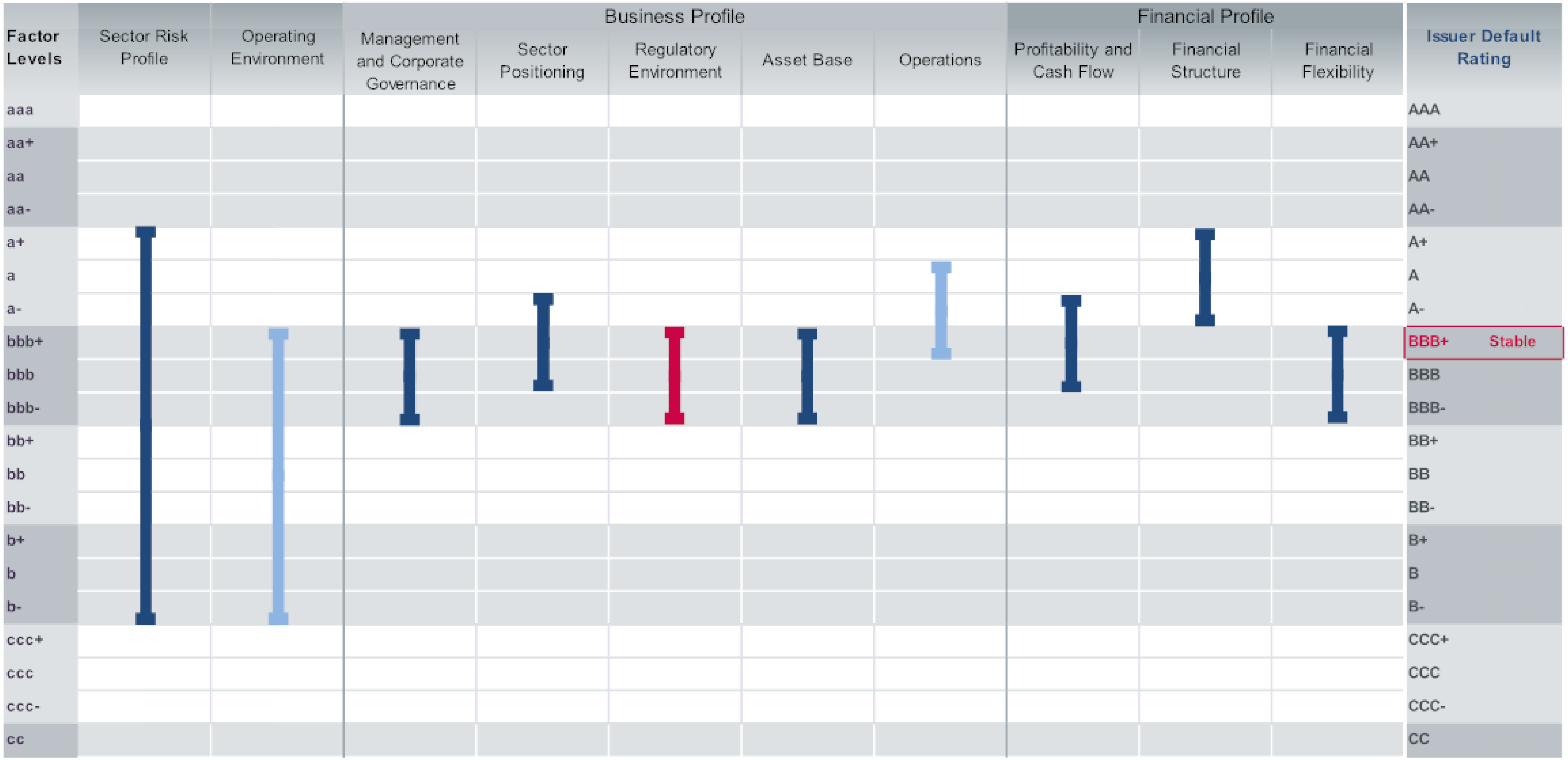
**How to Interpret the Forecast Presented**

The forecast presented is based on the agency's internally produced, conservative rating case forecast. It does not represent the forecast of the rated issuer. The forecast set out above is only one component used by Fitch to assign a rating or determine a rating outlook, and the information in the forecast reflects material but not exhaustive elements of Fitch's rating assumptions for the issuer's financial performance. As such, it cannot be used to establish a rating, and it should not be relied on for that purpose. Fitch's forecasts are constructed using a proprietary internal forecasting tool, which employs Fitch's own assumptions on operating and financial performance that may not reflect the assumptions that you would make. Fitch's own definitions of financial terms such as EBITDA, debt or free cash flow may differ from your own such definitions. Fitch may be granted access, from time to time, to confidential information on certain elements of the issuer's forward planning. Certain elements of such information may be omitted from this forecast, even where they are included in Fitch's own internal deliberations, where Fitch, at its sole discretion, considers the data may be potentially sensitive in a commercial, legal or regulatory context. The forecast (as with the entirety of this report) is produced strictly subject to the disclaimers set out at the end of this report. Fitch may update the forecast in future reports but assumes no responsibility to do so.

## Rating Navigator

# Canal de Isabel II, S.A.

**Corporates Ratings Navigator**
**EMEA Regulated Networks**



FitchRatings

# Canal de Isabel II, S.A.

**Corporates Ratings Navigator**
**EMEA Regulated Networks**

## Operating Environment

| | | | |
|---|---|---|---|
| a- | Economic Environment | bbb | Average combination of countries where economic value is created and where assets are located. |
| bbb+ | Financial Access | bbb | Average combination of issuer-specific funding characteristics and the strength of the relevant local financial market. |
| | Systemic Governance | a | Systemic governance (eg rule of law, corruption, government effectiveness) of the issuer's country of incorporation consistent with 'a'. |
| b- | | | |
| ccc+ | | | |

## Management and Corporate Governance

| | | | |
|---|---|---|---|
| a- | Management Strategy | a | Coherent strategy and good track record in implementation. |
| bbb+ | Governance Structure | bbb | Good governance record but board effectiveness/independence less obvious. No evidence of abuse of power even with ownership concentration. |
| bbb | Group Structure | bbb | Some group complexity leading to somewhat less transparent accounting statements. No significant related-party transactions. |
| bbb- | Financial Transparency | bbb | Good-quality reporting without significant failings. Consistent with the average of listed companies in major exchanges. |
| bb+ | | | |

## Sector Positioning

| | | | |
|---|---|---|---|
| a | Operation Type | bbb | Local or regional monopoly asset owners, regional monopoly asset operators. |
| a- | Non-Regulated Earnings (% of Total Earnings) | a | up to 10% |
| bbb+ | | | |
| bbb | | | |
| bbb- | | | |

## Regulatory Environment

| | | | |
|---|---|---|---|
| a- | Independence, Transparency, | bbb | Less transparent frameworks, with emerging track record and multi-year tariffs; exposed to political risk. Medium-term predictability. |
| bbb+ | Licensing, Ring-Fencing, Concessioning | bbb | Less demanding licensing and ring-fencing provisions; moderate concession renewal risk. |
| bbb | Cost and Investment Recovery | bbb | Tariff setting with challenge mechanisms that may limit efficiently incurred cost and investment recovery, with moderate regulatory lag. |
| bbb- | Volume and Price Risk | bbb | Moderate insulation from price and volume risk and revenue under-recovery. |
| bb+ | | | |

## Asset Base

| | | | |
|---|---|---|---|
| a- | Diversification | bbb | Limited diversification by geography without regulatory diversification; regional utility. |
| bbb+ | Critical Mass | a | Critical mass in one regulated asset; does not affect efficiency of operations (cost base, customer base, key personnel). |
| bbb | Asset Quality and Residual Life | bbb | Mid-range asset quality not affecting opex and capex requirements compared with peers. The residual life of regulatory assets is average. |
| bbb- | | | |
| bb+ | | | |

## Operations

| | | | |
|---|---|---|---|
| a+ | Performance Measures | a | Key performance measures in line with or above sector average and/or regulatory target. |
| a | Counterparty Risk | a | Low counterparty risk; high collection rates for water suppliers. Economy of area served provides structurally stable background. |
| a- | | | |
| bbb+ | | | |
| bbb | | | |

## Profitability and Cash Flow

| | | | |
|---|---|---|---|
| a | Return on Capital | bbb | Return on capital comparable with the regulatory benchmark. |
| a- | Volatility of Profitability | bbb | Stability and predictability of profit in line with utility peers. |
| bbb+ | Investment Cycle | a | Investment cycle position and dividend policy leading to broadly neutral free cash flow. High flexibility in smoothing capex plans. |
| bbb | | | |
| bbb- | | | |

## Financial Structure

| | | | |
|---|---|---|---|
| aa- | Lease-Adjusted FFO Gross Leverage | a | 4.5x |
| a+ | Lease-Adjusted FFO Net Leverage | a | 4.0x |
| a | Net Debt/Asset Base | a | 60% |
| a- | | | |
| bbb+ | | | |

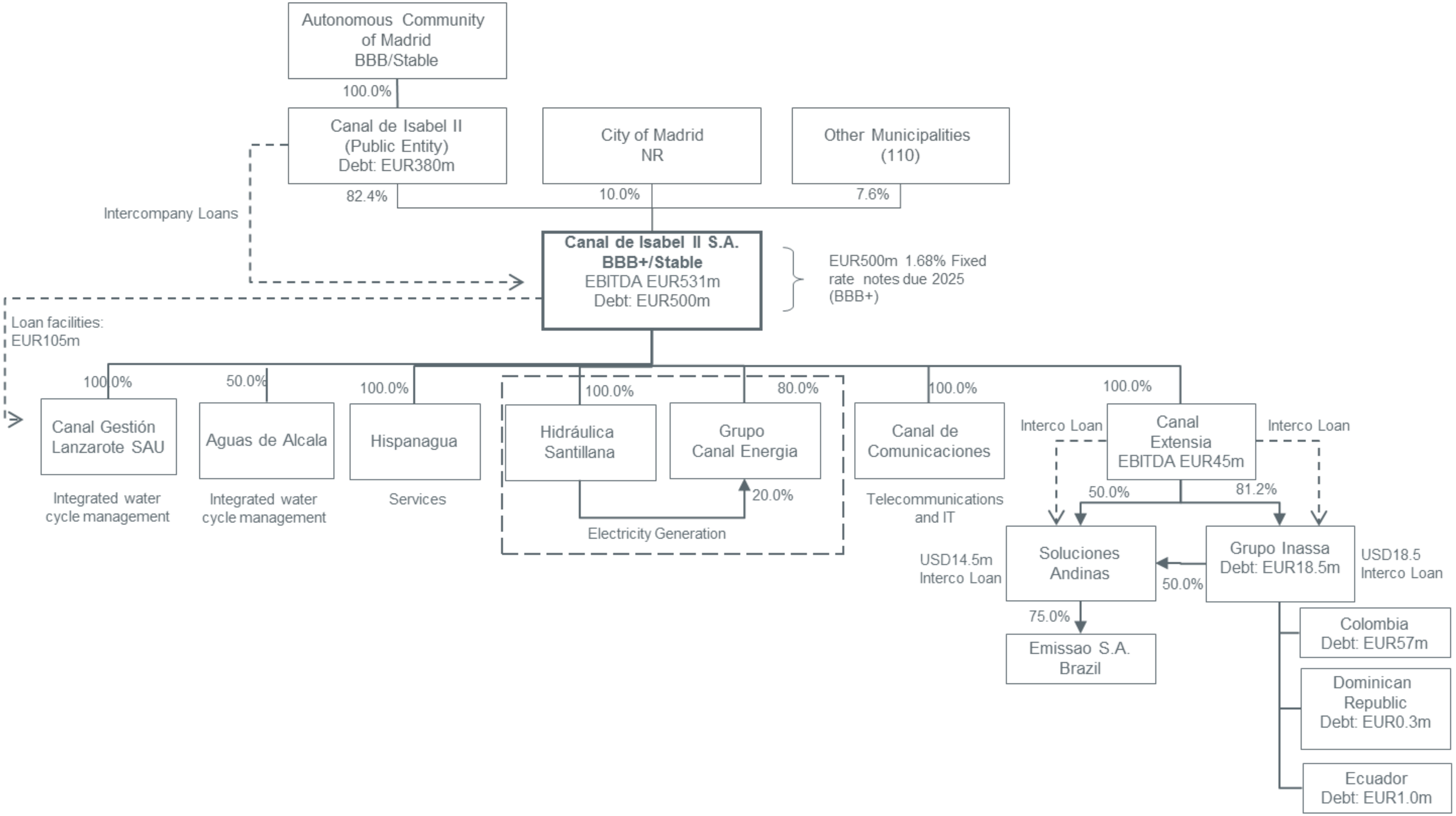
## Financial Flexibility

| | | | |
|---|---|---|---|
| a- | Financial Discipline | a | Clear commitment to maintain a conservative policy with only modest deviations allowed. |
| bbb+ | Liquidity | bb | Liquidity ratio around 1.0x. Less smooth debt maturity or concentrated funding. |
| bbb | FFO Fixed-Charge Cover | a | 4.5x |
| bbb- | FX Exposure | bbb | Some FX exposure on profitability and/or debt/cash flow match. Effective hedging. |
| bb+ | PMCR: (CFO - Maintenance Capex)/Interest | | n.a. |

**How to Read This Page:** The left column shows the three-notch band assessment for the overall Factor, illustrated by a bar. The right column breaks down the Factor into Sub-Factors, with a description appropriate for each Sub-Factor and its corresponding category.

Navigator Version: RN 1.44.3.0

## Simplified Group Structure Diagram




Source: Fitch from Company documentation. The chart does not include equity method consolidated stakes. Debt position and EBITDA as at December 2017P.

## Peer Financial Summary

| Company | Date | Rating | Operating EBITDA (Before Income From Associates) (EURm) | Funds Flow From Operations (EURm) | Operating EBITDA Margin (%) | FFO Fixed Charge Coverage (x) | FFO Adjusted Net Leverage (x) |
|---|---|---|---|---|---|---|---|
| Canal de Isabel II, S.A. | 2016 | BBB+ | 490 | 292 | 44.3 | 7.2 | 3.3 |
| | 2015 | BBB+ | 491 | 411 | 43.8 | 10.7 | 2.6 |
| | 2014 | BBB+ | 459 | 250 | 43.2 | 5.6 | 4.4 |
| Acea SpA | 2016 | BBB+ | 756 | 579 | 26.7 | 6.0 | 3.9 |
| | 2015 | BBB+ | 703 | 526 | 24.1 | 6.4 | 4.1 |
| | 2014 | BBB+ | 699 | 541 | 23.0 | 4.9 | 4.1 |
| Wessex Water Services Limited | 2017 | BBB+ | 330 | 241 | 62.8 | 4.8 | 6.3 |
| | 2016 | BBB+ | 335 | 254 | 64.4 | 5.0 | 5.9 |
| | 2015 | BBB+ | 348 | 276 | 64.4 | 5.8 | 5.5 |
| Aquanet S.A. | 2016 | BBB | 226 | 214 | 48.2 | 21.4 | 2.4 |
| | 2016 | BBB | 226 | 214 | 48.2 | 21.4 | 2.4 |
| | 2015 | BBB | 213 | 197 | 48.2 | 20.2 | 3.1 |
| | 2014 | BBB | 195 | 183 | 47.5 | 13.0 | 2.8 |
| FCC Aqualia, S.A. | 2017 | BB+ | 190 | 141 | 20.0 | 4.7 | 7.9[a] |
| | 2016 | | 184 | 147 | 20.0 | 4.6 | 3.2 |
| | 2015 | | 176 | 146 | 18.7 | 3.5 | 3.7 |

Source: Fitch
[a] Adjusted by EUR15.6 million of anticipated cash tax payments.

## Reconciliation of Key Financial Metrics

| (EUR Thousand, As reported) | 31 Dec 2016 |
|---|---|
| **Income Statement Summary** | |
| Operating EBITDA | 489,595 |
| + Recurring Dividends Paid to Non-controlling Interest | -2,000 |
| + Recurring Dividends Received from Associates | 0 |
| + Additional Analyst Adjustment for Recurring I/S Minorities and Associates | 0 |
| **= Operating EBITDA After Associates and Minorities (k)** | **487,595** |
| **+ Operating Lease Expense Treated as Capitalised (h)** | **15,660** |
| **= Operating EBITDAR after Associates and Minorities (j)** | **503,255** |
| | |
| **Debt & Cash Summary** | |
| **Total Debt with Equity Credit (l)** | **1,084,389** |
| + Lease-Equivalent Debt | 125,280 |
| + Other Off-Balance-Sheet Debt | 0 |
| **= Total Adjusted Debt with Equity Credit (a)** | **1,209,669** |
| Readily Available Cash [Fitch-Defined] | 97,503 |
| + Readily Available Marketable Securities [Fitch-Defined] | 1,376 |
| **= Readily Available Cash & Equivalents (o)** | **98,879** |
| **Total Adjusted Net Debt (b)** | **1,110,790** |
| | |
| **Cash-Flow Summary** | |
| **Preferred Dividends (Paid) (f)** | **0** |
| Interest Received | 2,333 |
| **+ Interest (Paid) (d)** | **-31,129** |
| **= Net Finance Charge (e)** | **-28,796** |
| **Funds From Operations [FFO] ( c)** | **292,070** |
| + Change in Working Capital [Fitch-Defined] | -38,462 |
| **= Cash Flow from Operations [CFO] (n)** | **253,608** |
| **Capital Expenditures (m)** | **-205,139** |
| **Multiple applied to Capitalised Leases** | **8.0** |
| | |
| **Gross Leverage** | |
| **Total Adjusted Debt / Op. EBITDAR* [x] (a/j)** | **2.4** |
| **FFO Adjusted Gross Leverage [x] (a/(c-e+h-f))** | **3.6** |
| *Total Adjusted Debt/(FFO - Net Finance Charge + Capitalised Leases - Pref. Div. Paid)* | |
| **Total Debt With Equity Credit / Op. EBITDA* [x] (l/k)** | **2.2** |
| | |
| **Net Leverage** | |
| **Total Adjusted Net Debt / Op. EBITDAR* [x] (b/j)** | **2.2** |
| **FFO Adjusted Net Leverage [x] (b/(c-e+h-f))** | **3.3** |
| *Total Adjusted Net Debt/(FFO - Net Finance Charge + Capitalised Leases - Pref. Div. Paid)* | |
| **Total Net Debt / (CFO - Capex) [x] ((l-o)/(n+m))** | **20.3** |
| | |
| **Coverage** | |
| **Op. EBITDAR / (Interest Paid + Lease Expense)* [x] (j/-d+h)** | **10.8** |
| **Op. EBITDA / Interest Paid* [x] (k/(-d))** | **15.7** |
| **FFO Fixed Charge Cover [x] ((c-e+h-f)/(-d+h-f))** | **7.2** |
| *(FFO - Net Finance Charge + Capit. Leases - Pref. Div Paid) / (Gross Int. Paid + Capit. Leases - Pref. Div. Paid)* | |
| **FFO Gross Interest Coverage [x] ((c-e-f)/(-d-f))** | **10.3** |
| *(FFO - Net Finance Charge - Pref. Div Paid) / (Gross Int. Paid - Pref. Div. Paid)* | |

*EBITDA/R after Dividends to Associates and Minorities
Source: Fitch, based on information from company reports.

## Fitch Adjustment Reconciliation

| (EUR Thousand, As reported) | Reported Values 31 Dec 16 | Sum of Fitch Adjustments | Other Adjustment | Dividends to Minorities | Cash Interest | Capital Grants | Adjusted Values |
|---|---|---|---|---|---|---|---|
| **Income Statement Summary** | | | | | | | |
| Revenue | 1,104,235 | 0 | | | | | 1,104,235 |
| Operating EBITDAR | 489,595 | 15,660 | 15,660 | | | | 505,255 |
| Operating EBITDAR after Associates and Minorities | 489,595 | 13,660 | 15,660 | -2,000 | | | 503,255 |
| Operating Lease Expense | 0 | 15,660 | 15,660 | | | | 15,660 |
| Operating EBITDA | 489,595 | 0 | | | | | 489,595 |
| Operating EBITDA after Associates and Minorities | 489,595 | -2,000 | | -2,000 | | | 487,595 |
| Operating EBIT | 263,476 | 0 | | | | | 263,476 |
| **Debt & Cash Summary** | | | | | | | |
| Total Debt With Equity Credit | 1,084,389 | 0 | | | | | 1,084,389 |
| Total Adjusted Debt With Equity Credit | 1,084,389 | 125,280 | 125,280 | | | | 1,209,669 |
| Lease-Equivalent Debt | 0 | 125,280 | 125,280 | | | | 125,280 |
| Other Off-Balance Sheet Debt | 0 | 0 | | | | | 0 |
| Readily Available Cash & Equivalents | 98,879 | 0 | | | | | 98,879 |
| Not Readily Available Cash & Equivalents | 0 | 0 | | | | | 0 |
| **Cash-Flow Summary** | | | | | | | |
| Preferred Dividends (Paid) | 0 | 0 | | | | | 0 |
| Interest Received | 8,440 | -6,107 | | | -6,107 | | 2,333 |
| Interest (Paid) | -31,129 | 0 | | | | | -31,129 |
| Funds From Operations [FFO] | 438,325 | -146,255 | 66,000 | -206,148 | -6,107 | | 292,070 |
| Change in Working Capital [Fitch-Defined] | -38,462 | 0 | | | | | -38,462 |
| Cash Flow from Operations [CFO] | 399,863 | -146,255 | 66,000 | -206,148 | -6,107 | | 253,608 |
| Non-Operating/Non-Recurring Cash Flow | 0 | 0 | | | | | 0 |
| Capital (Expenditures) | -176,814 | -28,325 | -66,000 | | | 37,675 | -205,139 |
| Common Dividends (Paid) | -206,148 | 206,148 | | 206,148 | | | 0 |
| Free Cash Flow [FCF] | 16,901 | 31,568 | | | -6,107 | 37,675 | 48,469 |
| **Gross Leverage** | | | | | | | |
| Total Adjusted Debt / Op. EBITDAR* [x] | 2.2 | | | | | | 2.4 |
| FFO Adjusted Leverage [x] | 2.4 | | | | | | 3.6 |
| Total Debt With Equity Credit / Op. EBITDA* [x] | 2.2 | | | | | | 2.2 |
| **Net Leverage** | | | | | | | |
| Total Adjusted Net Debt / Op. EBITDAR* [x] | 2.0 | | | | | | 2.2 |
| FFO Adjusted Net Leverage [x] | 2.1 | | | | | | 3.3 |
| Total Net Debt / (CFO - Capex) [x] | 4.4 | | | | | | 20.3 |
| **Coverage** | | | | | | | |
| Op. EBITDAR / (Interest Paid + Lease Expense)* [x] | 15.7 | | | | | | 10.8 |
| Op. EBITDA / Interest Paid* [x] | 15.7 | | | | | | 15.7 |
| FFO Fixed Charge Coverage [x] | 14.8 | | | | | | 7.2 |
| FFO Interest Coverage [x] | 14.8 | | | | | | 10.3 |

*EBITDA/R after Dividends to Associates and Minorities

Source: Fitch

## Full List of Ratings

| | Rating | Outlook | Last Rating Action |
|---|---|---|---|
| **Canal de Isabel II, S.A.** | | | |
| Long-Term IDR | BBB+ | Stable | Affirmed 2 July 2018 |
| Senior unsecured rating | BBB+ | | Affirmed 2 July 2018 |

## Related Research & Criteria

Corporate Rating Criteria (March 2018)

Corporates Notching and Recovery Ratings Criteria (March 2018)

Government-Related Entities Rating Criteria (February 2018)

Parent and Subsidiary Rating Linkage (February 2018)

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The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.