FitchRatings

# Fitch Affirms Canal's IDR at 'BBB+'; No Impact from Potential EoD

Fitch Ratings-Barcelona-02 April 2019: Fitch Ratings has affirmed Spanish water operator Canal de Isabel II, S.A.'s (Canal) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB+'. The Outlook on the Long-Term IDR is Stable.

The affirmation reflects the deconsolidation by Canal of Triple A Barranquilla (Triple A), its main operating company in Colombia, following the loss of its control in October 2018, and our assumption of a delay of the divestment plan of Canal's interests outside Madrid's region.

The Stable Outlook mirrors that of the Autonomous Community of Madrid (Madrid; BBB/Stable), the end of the water tariff freeze by 2020 and Canal's unchanged financial and dividend policy. The ratings are supported by Canal's low business risk profile, with the bulk of the company's earnings generated under long-term concessions in the region of Madrid.

Canal's EUR500 million bond could be in technical event of default (EoD) if the Colombian prosecutor decides to proceed with the asset forfeiture case, which may happen before 4 of April 2019. However, we do not expect any payment default considering Canal's sufficient liquidity and hence there is no impact on current ratings. We continue to view Canal's standalone credit profile (SACP) at 'A-'.

KEY RATING DRIVERS

Colombian Dispute: The Colombian prosecutor has argued that around EUR68 million of funds were channelled from Triple A to Inassa, its direct parent company which is 81.2%-owned by Canal, by virtue of a technical assistance contract between the two parties that was never carried out. In October 2018, the judge seized Triple A's shares as a precautionary measure for six months and the prosecutor has to decide before 4 April 2019 to either proceed with the asset forfeiture or dismiss the case.

In addition there are other four Colombian institutions that are currently investigating the technical assistance contract.

Implications on Bond: Under the EUR500 million bond terms (see below) the precautionary measure of Triple A's share seizure can be conservatively perceived as a technical EoD even if this is a temporary and preventive measure. However, no investor has exercised their related right so far and we do not currently expect the majority of bond investors to act on it (our rating case assumes early redemption of 20% of outstanding bonds). A case dismissal or no official response by 4 April 2019 would imply the lapse of the precautionary measure, which should see Canal regain control of Triple A.

In any case, Fitch's rating is based on the deconsolidation of Triple A's operations with no compensation over the next four years given the high uncertainty around the final resolution of the dispute.

Technical Event of Default: Triple A is included as a relevant subsidiary in the EUR500 million bond's documentation as it represented 13.7% of the total consolidated revenue in 2017, slightly above the required 10% threshold. In addition, the seizure of its shares would trigger a technical EoD under the 'government intervention' provision that would allow noteholders to request an early redemption of its notes.

The technical EoD on the bond would not trigger any other default on remaining debt instruments of Canal given the lack of both cross-default clauses and similar EoD clauses linked to a loss of control in Latam subsidiaries included in the loan documentation of the main remaining debt instruments.

Debt Service not Dependent on Colombian Activities: The EUR500 million bond debt service is not dependent on Colombian operations' cash flows. Madrid operations are comfortably servicing the coupon payment and could provide for the bond full repayment at its maturity in 2025. The company has low-risk profile and its leverage should remain below 3.0x on average for 2018-2022, which is low for its rating.

Sufficient Liquidity Cushion: Canal had EUR384 million readily available cash in hand at end-March 2019 and has an expected undrawn revolving credit facility (RCF) for EUR122 million by end-April. This results in a total amount of slightly above EUR500 million available liquidity, which would be sufficient to cover the full repayment of the outstanding bond. Canal's management has approved the build-up of an additional liquidity cushion to comfortably cover full repayment of the bond. As a result, we do not foresee a payment default on the EUR500 million bond even if it is fully redeemed early, which we see as highly unlikely.

Supportive Shareholder: Canal's ultimate shareholder, Autonomous Community of Madrid (Madrid; BBB/Stable), has agreed to delay the payment of the final 2017 dividend and the interim 2018 dividend for a total of EUR155 million, as a way to support Canal's liquidity. Although not assumed in our rating case, we expect that dividends may be further postponed if needed as Canal remains a fundamentally free cash flow (FCF)-generating business.

Low Business Risk: Canal's low business risk profile is supported by the revenue stability provided by a 50-year water concession agreement in Madrid's region that expires in 2062. For 2018, we expect EBITDA of around EUR446 million (92% of total) to be generated from regulated activities in Spain, while 6% is forecasted to come from regulated activities in Latin America, and the remaining 2% from non-regulated ancillary services.

Divestment Plan Likely Postponed: Canal's strategic plan to 2022 aims to divest all overseas interests (mainly Colombia and Brazil), concessions outside the Madrid region (Caceres and Lanzarote) and some real estate properties between 2019 and 2021. Fitch's updated rating case assumes the postponement of the disposals to beyond 2022, as ongoing investigations into fraud allegations could affect market interest and time of execution. We assume limited cash proceeds for the sale of the real estate property in Madrid. In the absence of material cash proceeds from divestments, we do not see further deleveraging through to 2022.

SACP Rating Maintained: We revised Canal's SACP to 'A-' last year based on the substantial deleveraging already achieved and our expectation of further deleveraging, on divestment plan proceeds. Postponement in the Latin America divestment will not change our view on the SACP.

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

DERIVATION SUMMARY

Canal is a water and sewage network operator, which, unlike most European peers, does not own its asset base. However, its investments are supported by its concession's value. Canal's leverage, adjusted for dividends, is well below other peers', such as Acea SpA (BBB+/Stable), Wessex Water Services Limited (BBB+/Negative) and FCC Aqualia (BB+/Stable), and hence the higher SACP. However, the company operates in a decentralised and less developed regulatory environment than in some other European countries, its Latam operations carry higher business and political risks and the rating is constrained by Madrid's.

In addition, as Canal does not own its 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 case of default. No Country Ceiling constraints affect the rating.

KEY ASSUMPTIONS

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

-Madrid's water tariffs frozen until 2019 and annually revised from 2020;
-Slightly decreasing volume of water billed over the next 4 years;
-Stable population and customer base;
-Deconsolidation of Triple A from September 2018;
-Divestments of real estate properties in Madrid at appraised value, from 2019 to 2020;
-Fixed costs linked to Fitch's CPI assumptions;
-20% of the EUR500 million bond noteholders exercising their option for an early bond repayment in 2019;
-Declining gross debt to EUR0.7 billion by 2022 and utilisation of the RCF to support the early repayment of the bond;
-Approval of an additional EUR150 million RCF rollover annually;
-Annual capex of around EUR240 million on average for 2018-2022;
-80% dividend pay-out based on individual accounts for Canal; 2017 final dividend and the 2018 interim dividend paid in 2020.

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, which could lead to an upgrade for Canal;
-Positive revision of the SACP 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. This may be due to a worse-than-expected operating environment, including regulatory changes or higher dividends.
-Failure to replenish liquidity with additional RCF or to annually roll over the existing ones.
-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

Liquidity position as of 20 March 2019 included EUR383.6 million of readily available cash (we adjust cash in Latam as restricted cash for the purpose of our liquidity analysis), and EUR106 million of available committed credit facilities. In addition, there are EUR16 million of credit lines already authorised by Canal's Board and approved by the lending banks' respective credit risk committees and are in the process of being formalised. That should yield an estimated total available liquidity of EUR505.6 million by mid-April 2019.

Debt maturing in 2019 is around EUR29 million. The EUR500 million bond, contractually maturing in April 2025, will be classified as current liability in the 2018 accounts of the company due to the risk of technical EoD according to the company. Finally, Canal is well-advanced in the process of requesting up to EUR150 million of an additional long-term RCF to comfortably cover a full repayment of its bond. We forecast Canal to generate FCF of EUR10.4 million for 2019 (after real estate disposal).

We assume the roll-over of the RCFs on a yearly basis. 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 similar to other Fitch-rated Spanish utilities, where its less sizeable long-term committed credit lines are seen in conjunction with the company's fundamental neutral-to-positive FCF.

Contact:

Principal Analyst
Maria Delia Linares
Analyst
+34 93492 9512

Supervisory Analyst
Pilar Auguets
Senior Director
+34 93 467 87 47
Fitch Espana S.A.
Avinguda Diagonal 601
08028 Barcelona

Committee Chairperson
Antonio Totaro
Senior Director
+39 02 8790 87 297

Summary of Financial Statement Adjustments - Fitch treats dividend payments as a fixed non-discretionary operating charge similar to a concession fee. Accordingly, we adjust Canal's FFO calculations by deducting dividends.

Media Relations: Adrian Simpson, London, Tel: +44 20 3530 1010, Email: adrian.simpson@thefitchgroup.com

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.
Applicable Criteria
Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Government-Related Entities Rating Criteria - Amended (pub. 29 Mar 2019)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

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