

**Rating Action: Moody's downgrades Canal de Isabel's ratings to Baa2; maintains negative outlook**

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07 Jun 2019

Madrid, June 07, 2019 -- Moody's Investors Service ("Moody's") has today downgraded to Baa2 from Baa1 the long-term issuer rating and the senior unsecured rating of Canal de Isabel II, S.A. (Canal). The outlook remains negative.

**RATINGS RATIONALE**

The rating action reflects a weakened financial profile arising from a change of policy by Canal's main shareholder, the Comunidad Autonoma de Madrid (Baa1, stable), which has resulted in a diminished liquidity position, despite the risk of a substantial early repayment of the EUR500 million senior unsecured bonds due in February 2025 (the Bonds).

In particular, the action follows the decision on 09 May 2019 by the shareholders of Canal to distribute a EUR128 million dividend which reversed a previous informal agreement to withhold the payment, which has reduced Canal's available cash resources. This decision also signals a weakening of the company's consideration of creditors' interests in its conduct of its financial policy.

Moody's understands that a pool of contingent bank facilities totalling EUR170 million was approved by the company's board ahead of the dividend distribution. However, these facilities are uncommitted at this stage and the company is still exposed to a potential lack of liquidity if an acceleration of a substantial number of the Bonds were to materialize. Although the issuer's banking relationships are considered strong, the immediacy and availability of the contingent facilities is also unclear and Canal's ability to draw under the additional lines of credit will have to be periodically renegotiated with the lenders.

The view of Canal's standalone credit quality expressed as a baseline credit assessment (BCA) has also been revised to ba1 from baa3 to reflect the above risks. As of 04 June 2019, Canal has around EUR381 million of liquidity resources comprising EUR258 million of cash and cash-equivalents and a EUR122 million committed bilateral facility renewed to December 2019. This represents a significant reduction in Canal's liquidity compared to a total of EUR497 million of liquidity resources available at the time of Moody's latest rating confirmation on 10 April 2019. Nevertheless, the ba1 BCA remains supported by Canal's solid operational performance, limited volume risk in its Spanish operations, and low debt leverage.

The agency continues to be informed that the bondholders' commissioner has not received any communication from the bondholders with respect to a possible prepayment of the Bonds. However, a high level of unpredictability persists as to whether the Bonds will be accelerated and in which aggregate amount. In fact, absent an agreement with the bondholders, they will continue to maintain an individual right to require an early redemption payment until the Bonds' contractual maturity of February 2025. This right derives from an event of default covenant triggered under the term and conditions of the Bonds which followed the loss of control of Canal's main Latin American subsidiary, Triple A de Barranquilla (Triple A) in October 2018 and the subsequent decision of the General Prosecutor of Colombia to proceed with the request to finalize the expropriation on 04 April 2019. This situation continues to pose material uncertainty around the company's future financial obligations. The current lack of committed liquidity resources available to cover the entirety of the Bonds at any point prior to scheduled maturity in these circumstances is not commensurate with an investment grade BCA.

Canal's Baa2 rating continues to incorporate two notches of rating uplift from the BCA to reflect Moody's expectation that, notwithstanding the company's inadequate liquidity position, extraordinary support from the Comunidad Autonoma de Madrid will continue in future. This view is further supported by an assumption of high support and high dependence under the agency's Government-Related Issuer methodology.

**OUTLOOK**

The outlook remains negative, reflecting (1) the current lack of visibility over the number of bondholders that would demand repayment (if any) as well as the timing of this decision, (2) the company's current reliance on

short-term liquidity facilities and other uncommitted resources to cover payment demands that might occur until the final maturity of the bond and (3) Canal's need to retain cash against a potential demand of early redemption which may constrain the company's ability to make strategic decisions to support or increase future earnings.

#### WHAT COULD CHANGE THE RATING UP

The rating outlook could be stabilized if there was clarity around the timing and amount of the financial implications resulting from the ongoing legal process in Colombia and if Canal was able to demonstrate that these costs would not result in a material detrimental impact on its business and financial profile.

In light of the current negative outlook, upward rating pressure on Canal is unlikely in the near future. Any upgrade of Canal's rating would require (1) increased evidence of extraordinary support provided by the Comunidad Autonoma de Madrid, in the form of an explicit commitment to provide sufficient liquidity to the company in order to meet any potential full acceleration of the Bond; or (2) the reaching of an agreement with the bondholders that will remove uncertainty around Canal's future obligations; both subject to the company maintaining a solid financial profile and a satisfactory liquidity position.

#### WHAT COULD CHANGE THE RATING DOWN

Negative pressure on Canal's rating could arise if some of the bondholders demand an early redemption of their Bonds and the company's liquidity position were to remain inadequate with the lack of an explicit commitment from the shareholders to provide timely and sufficient liquidity when needed.

Any deterioration in the ratings or outlook of the Government of Spain and the Comunidad Autonoma de Madrid would likely result in a corresponding adjustment of Canals rating/or outlook.

The methodologies used in these ratings were Regulated Water Utilities published in June 2018, and Government-Related Issuers published in June 2018. Please see the Rating Methodologies page on [www.moodys.com](http://www.moodys.com) for a copy of these methodologies.

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