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RATING ACTION COMMENTARY

Fitch Upgrades Canal de Isabel II's IDR to 'BBB+' on Madrid's Upgrade

Thu 27 May, 2021 - 9:48 AM ET

Fitch Ratings - Barcelona - 27 May 2021: Fitch Ratings has upgraded Canal de Isabel II, S.A.'s (Canal) Long-Term Issuer Default Rating (IDR) and senior unsecured rating to 'BBB+' from 'BBB'. The Outlook on the IDR is Stable.

The upgrade mirrors a similar rating action on Canal's ultimate parent, the Autonomous Community of Madrid, to 'BBB' from 'BBB-' on 21 May 2021, reflecting that the IDR was constrained at one notch above the parent's. Following the rating action on Madrid Canal's IDR now stands at the same level of the company's Standalone Credit Profile (SCP), assessed at 'bbb+'

The ratings of Canal are supported by its low-risk business profile, with the majority of earnings generated by its regulated activities as a regional monopoly-asset operator and provider of water and sewerage services under long-term concession agreements in the region of Madrid, and by a conservative financial profile.

The Stable Outlook mirrors that on Madrid and also reflects the company's resilient business model, as proven by the limited impact of the pandemic, approved tariff freeze until 2021 and low leverage.

KEY RATING DRIVERS

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Madrid's control of Canal, including the lack of guarantees, declining back-to-back funding, and independent daily operations and treasury.

All the above, along with the presence of internal targets (on maximum indebtedness, net debt/EBITDA and dividend pay-outs) that limit cash extraction from Canal, are key considerations in our approach of a maximum differential of one notch between the IDRs of Canal and Madrid, and constrains rating upside for Canal.

Strong SCP: Canal's SCP is supported by a healthy financial profile and low business risk. Canal enjoys stable and visible revenue that is generated by its 50-year water concession agreement in Madrid, which expires in 2062. We estimate EBITDA of about EUR390 million in 2021, almost entirely generated from concession-based water activities in Spain (Latin America's EBITDA is expected at about 2%).

SCP also factors in Canal's historical and ongoing corporate-governance issues, leading to various judicial processes in Spain and Latin America, the loss of control of Triple A S.A., its main operating company in Colombia, and a less conservative liquidity policy than peers'. These risks are partly mitigated by its focus on the core Spanish business.

Low Leverage: Canal has continued to reduce its indebtedness in line with its amortising debt profile. Funds from operations (FFO) dividend-adjusted net leverage declined to 1.1x in 2020 from 2.6x in 2019, further widening the company's ample leverage headroom compared with our negative rating sensitivity of 4.8x for the 'BBB+' rating. We expect leverage to remain low on average at 1.7x for 2021-2025, though above historical levels due to expected higher capex, and our more conservative assumptions for tariff increases and dividend distributions than management's.

DERIVATION SUMMARY

Canal is a water and sewage network operator, but unlike most European peers does not own its asset base. However, its investments are supported by its concession value. Canal's leverage, adjusted for dividends, is well below that of other peers, such as Acea SpA (BBB+/Stable), Wessex Water Services Limited (BBB/Stable) and FCC Aqualia, S.A. (BB+/Positive), although we give leverage a lower weight in the overall assessment compared with peers.

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 Canal's ratings.

KEY ASSUMPTIONS

- Madrid's water tariffs frozen until 2023 and annually revised from 2024 at close to CPI.

-1% annual increase in volumes in 2021 and then flat through to 2024.

-Slight increase in population and customers for the next four years.

-Divestments of real-estate assets in Madrid at appraised value in 2023.

-Declining gross debt to EUR0.5 billion by 2025. EUR500 million bond -is partially refinanced at maturity in 2025.

-Annual capex on average at about EUR310 million for 2021-2025.

-About 80% dividend pay-out based on consolidated accounts for Canal.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-An upgrade of Madrid (or an assessment or weaker links between the company and the shareholder) together with a positive revision of the SCP, could lead to an upgrade of Canal's IDR.

-The SCP could benefit from a perceived improvement of the corporate-governance issues that have affected the company.

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a sustained basis would be negative for the rating. This may be due to a worse-than-expected operating environment, including regulatory changes, or higher dividends.

-Negative rating action on Madrid could trigger a similar action for Canal, provided that the strength of the links between the two continues to allow for a maximum one-notch differential.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Healthy Liquidity: As at end-2020 Canal's liquidity position comprised EUR430 million of readily available cash (excluding EUR3 million of cash in Latin America) as well as an undrawn committed revolving credit facility (RCF) of EUR132 million maturing in December 2021, which is renewed annually. Canal's total available liquidity of EUR563 million compares with short-term debt of only EUR39 million. We forecast small positive free cash flow (FCF) of about EUR45 million in 2021.

We assume that the RCF will roll over on a yearly basis. Canal is subject to the Madrid Budgetary Law, which requires high-level authorisation to approve long-term committed credit lines. We view Canal's liquidity position as adequate when its smaller short-term credit lines are viewed in conjunction with the company's large cash available and fundamental neutral-to-positive FCF.

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Fitch treats dividend payments as a fixed non-discretionary operating charge similar to a concession fee. We adjust Canal's FFO calculations accordingly by deducting dividends.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Canal's rating is linked to the rating of its parent, the Autonomous Community of Madrid, based on GRE and PSL considerations.

ESG CONSIDERATIONS

Canal has an ESG Relevance Score of '4' each for "Operational Execution of Management Strategy" and for "Governance Structure" due to the investigation of Spanish courts into previous management's acquisitions in Brazil, and the Colombian General Prosecutor's seizure of Triple A's shares. These indicate failures in internal controls related to acquisitions and corporate-governance standards, although Latin American EBITDA was only 10% of the group's total (before deconsolidation of Triple A from September 2018). This has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

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Isabel II, S.A.	IDR			Outlook Stable
• senior unsecured	LT	BBB+	Upgrade	BBB

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Parent and Subsidiary Linkage Rating Criteria (pub. 26 Aug 2020)

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Canal de Isabel II, S.A.	EU Issued, UK Endorsed

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