FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Canal de Isabel at 'BBB'; Outlook Stable

Fri 23 Apr, 2021 - 9:08 AM ET

Fitch Ratings - Barcelona - 23 Apr 2021: Fitch Ratings has affirmed Canal de Isabel II, S.A.'s (Canal) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB'. The Outlook on the IDR is Stable.

The ratings of Canal are supported by its low-risk business profile, with most of its 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 the Autonomous Community of Madrid (Madrid; BBB-/Stable), and a conservative financial profile.

The Stable Outlook mirrors that on Madrid, Canal's largest shareholder, as the company's rating is constrained at one notch above that of the region. The company's Standalone Credit Profile (SCP) of 'bbb+' reflects the low leverage, resilient business model as proven by the limited impact of the coronavirus and the approved tariff freeze until 2021.

KEY RATING DRIVERS

Strong Standalone Credit Profile: 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%).

The SCP also factors in Canal's historical and going 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. The focus on the core Spanish business could ease these concerns.

IDR Reflects Parent Linkage: We assess the links between Canal and Madrid as weak-to-moderate under our Government-Related Entities (GRE) and Parent and Subsidiary Linkage (PSL) Criteria. This is based on weak-to-moderate legal and operating links, despite Madrid controlling position, including lack of guarantees, declining back-to-back funding; independent daily operations and treasury.

The presence of internal targets (on maximum indebtedness level, net debt/EBITDA ratio and dividend pay-outs) that limit cash extraction from Canal, is a key consideration in our approach of a maximum differential of one notch between the IDRs of Canal and Madrid, which constrains any rating upside for Canal. A rating action on Madrid will lead to a similar rating action on Canal.

Low Leverage: Canal has continued to reduce its indebtedness in line with the amortizing debt profile. In 2020 funds from operations (FFO) dividend-adjusted net leverage declined to 1.1x from 2.6x in 2019, further widening the company ample leverage headroom compared with our negative rating sensitivity of 5.5x for the 'BBB' rating. We expect leverage to remain low at about 1.7x on average for the 2021-2025, though above historical levels due to higher expected capex, combined with our more conservative assumptions for tariff increases and dividend distributions than those of the management.

Tariff Freeze Assumed Until 2023: Canal's tariffs have not increased since 2016. Madrid initially froze tariffs until 2019, but this was extended first to 2020 due to the expected delays in the company's capex plan and then to 2021 as a result of the pandemic. This shows political interference in tariff-setting, which is a negative factor for the Spanish regulatory water framework compared with other European jurisdictions, which benefit of an independent regulator and transparent tariff setting mechanisms. Management has shared with us a plan that includes inflation-based tariff increases beyond 2021. We conservatively assume that tariffs will remain frozen until 2023.

Limited Impact from Covid-19: The essential nature of Canal's service has supported a limited impact from the pandemic on its earnings. Fitch expects EBITDA to decline in around EUR45 million, or 10%, in 2020. This was due to a mix of effects related to Covid-

19, such as a decline in industrial and commercial volumes billed in Madrid, the reduction of the tourism in Lanzarote, the voluntary tariff bonuses (EUR5 million), and to a normalised climate conditions compared to a dry 2019, which had reduced volumes in the comparison.

Canal has incurred in additional costs related to Covid-19 (staff reinforcement, cleaning and disinfection and others), which were largely compensated by lower energy costs and postponement of services. Latam activity was also affected with contract cancelations and services reduction; however, with no relevant impact at EBITDA as contribution remains limited.

Capex to Ramp Up: Canal's growth plan has remained subdued in the past three years due to delays on the awarding of contracts related to the renewal of supply networks, which involved sizeable capex and complex documentation negotiated with contractors. However, Canal expects capex investment of EUR1.7 billion in 2021-2025, or about EUR310 million annually, which is over double the current level.

Capex Flexibility Retained: Flexibility in capex spending is retained, as delays would not affect the proper functioning of the network and would not imply any contractual breach or penalty. The plan includes the modernisation of the sewer networks, the standardisation of materials in the distribution network and smart meters installation.

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 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 to peers. Canal operates in a decentralised and less developed regulatory environment than some other European countries and its Latin American operations carry higher business, political risks and are the driver for negative corporate governance considerations.

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 rating.

KEY ASSUMPTIONS

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

- Madrid's water tariffs frozen until 2023 and annually revised from 2024 close to CPI.
-1% annual increase in volumes in 2021 and flat thereafter.
-Slight increase in population and customers.
-Divestments of real estate properties in Madrid at appraised value in 2023.
-Declining gross debt to EUR0.5 billion by 2025. EUR500 million bond maturing in 2025 is partially refinanced at maturity.
-Annual capex of about EUR310 million on average 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 could lead to an upgrade of Canal's IDR or an assessment or weaker links between the company and the shareholder.

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

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-Weaker cash flow generation leading to FFO dividend-adjusted net leverage above 5.5x on 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 December 2020 Canal's liquidity position comprises 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 seen in conjunction with the company's large cash available and fundamental neutral-to-positive FCF.

SUMMARY OF FINANCIAL ADJUSTMENTS

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

The rating of Madrid constrains Canal's rating at 'BBB'.

ESG CONSIDERATIONS

Canal de Isabel II, S.A.: Management Strategy: 4, Governance Structure: 4

Canal has an ESG Relevance Score of '4' each for 'Management Strategy' and for 'Governance Structure' due to the investigation of Spanish courts into the 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 America 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.

Except for the matters discussed above, 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

ENTITY/DEBT	RATING			PRIOR
Canal de Isabel II, S.A.	LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
• senior unsecured	LT	BBB	Affirmed	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

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Corporate Finance Utilities and Power Europe Spain

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