FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings - Barcelona - 27 May 2022: 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.

Canal ratings 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 (Madrid; BBB/Stable). Canal Standalone Credit Profile (SCP) is assessed at 'bbb+'.

The ratings also reflect our view of increased regulatory risk for Canal due to a protracted tariff freeze, despite increasing cost pressure from stagflation. We have tightened Canal's debt capacity by 0.5x to reflect the worsened business risk profile, albeit with no impact on the ratings given ample headroom under current leverage sensitivities.

The Stable Outlook mirrors that on Madrid's IDR and also reflects the company's resilient business model, the perceived improvement of its corporate governance and a conservative financial policy.

KEY RATING DRIVERS

Protracted Tariff Freeze: Canal's tariffs have not increased since 2016. Madrid initially froze tariffs until 2019, but has since extended it three times, first due to delays in the company's capex and lately, as a result of an uncertain economic environment. We

assume that tariffs will remain frozen until end-2024. This is driven by Madrid's record of tariff-setting interventionism, especially when the region's economy is under pressure, which is the case currently due to stagflation and the energy crisis.

Political Risk in Tariff-Setting: Canal is prone to political intervention from Madrid, which is its major shareholder but which also sets and approves its tariffs. This has limited Canal's ability to pass its costs onto customers. In contrast, other Fitch-rated private water operators in Spain have managed to partially pass on increasing costs to tariffs during the same period, while other European regulatory frameworks allow water operators to fully cover the costs incurred, with the added benefit of an independent regulator and transparent tariff-setting mechanisms. We thus deem the 'regulatory environment' risk factor has worsened for Canal, which we reflect in a tighter debt capacity by 0.5x but with no impact on Canal's SCP and IDR given ample headroom under current leverage sensitivities.

Falling Operating Margins: Canal's EBITDA margins (as calculated by Fitch) decreased about 6bp between 2018 and 2021 to 38%, as tariffs remained unchanged while operating costs rose continuously. The cost increases, in some cases above inflation, were largely linked to the implementation of the company's strategic plan (ie. supplies, services by third parties, technical assistance and R&D), a gradual increase in wages and higher electricity costs. We project margins to weaken further to around 34% in the next three years on high inflation and energy costs. Notwithstanding the EBITDA-margin drop, they still compare well with peers'.

Capex to Ramp Up: Canal's growth plan has remained subdued versus initial expectations, due to longer awarding periods linked to sizable and complex contracts and pandemic-related delays in the bidding process and works execution in 2020-2021. However, Canal expects capex to catch up in the next five years with a total investment of EUR1.6 billion (EUR320 million annually) in 2022-2026, which is more than double its current expense. In 2021, Canal awarded a contract for EUR350 million for the renovation of the supply water network in Madrid, its largest tender ever.

Capex Flexibility Retained: Flexibility in capex is retained, as delays would not affect the proper functioning of the network nor imply any contractual breach or penalty. Its capex plan includes the modernisation of its sewage networks, the standardisation of materials in distribution, smart meters' installation and the installation of photovoltaic plants to boost generation and self-consumption of clean energy.

Unchanged Parent and Subsidiary Linkage (PSL): Fitch continues to assess the linkage between parent Madrid and Canal as 'Consolidated +1' under our updated PSL Rating Criteria. As a result, Canal's IDR is one notch above Madrid's, in line with our previous

approach. However, sustained decision-making on tariff freezing, with negative financial impact on Canal, shows growing effective control and influence from the parent and reduces the relevance we grant to the company's stated financial policy, which has otherwise been consistently applied in the past.

Revised ESG Governance Scores: Risks related to historical corporate-governance issues and ongoing judicial processes in Spain and Latam have decreased and potential contingencies do not pose a material threat to Canal's credit profile, in our view. Moreover, Canal has made progress on the implementation of good governance practices and scaled back its operations in Latam. Its Latam operations are now not meaningful, with Fitch's EUR316 million EBITDA forecast for Canal in 2022 almost entirely generated from concession-based water activities in Spain (1% in Latam; largely linked to a concession in Ecuador).

As a result, we have changed the ESG relevance score for 'operational execution of management strategy' and 'governance structure' to '3' from '4'.

Leverage to Rise: Canal has continued to reduce its debt, in line with the amortising portion of its financial debt. This is due to strong cash flow generation despite margin pressure. In 2021 funds from operations (FFO) dividend-adjusted net leverage remained low at around 1.0x, compared with a tighter negative rating sensitivity of 4.3x (4.8x previously) for the 'BBB+' rating. We expect leverage to increase on average to around 2.8x on over 2022-2026, still low for the rating but above historical levels. The rise is driven by higher capex and our more conservative assumptions on tariffs, operating costs and dividend distributions versus management's guidance.

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. (BBB-/Stable), although we give leverage a lower weight in the overall assessment compared with peers.

Canal operates in a decentralised and less developed regulatory environment than some other European countries and its Latam operations carry higher business and political risks and were the driver of 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 ratings.

KEY ASSUMPTIONS

- Madrid's water tariffs frozen until 2024 and annually revised from 2025 to closely track CPI

- Average annual 0.3% increase in billed volumes to 2026

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

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

- Annual capex on average at about EUR320 million for 2022-2026

- About 70% 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, provided that the links with Canal are intact, together with an upward revision of Canal's Standalone Credit Profile (SCP), could lead to an upgrade of Canal's IDR

-The SCP may be revised higher on reduced regulatory risk (ie. tariff increase)

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

-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

-Closer linkage with Madrid, leading to an 'open' assessment of all the PSL linkage factors would lead to the alignment of Canal's IDR with that of Madrid (consolidated approach).

- Weaker cash flow generation leading to FFO dividend-adjusted net leverage above 4.3x 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.

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: At end-2021 Canal's liquidity position comprised EUR523 million of readily available cash (excluding EUR2.3 million of cash in Latam) as well as an undrawn committed revolving credit facility (RCF) of EUR104 million maturing in December 2022, which is renewed annually.

Canal's total available liquidity of EUR627 million more than covers short-term debt of only EU16 million and projected negative free cash flow of about EUR270 million for the next two years.

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.

ISSUER PROFILE

Canal is as an asset operator and a provider of water and sewage services operating in a regional natural monopoly in Spain with a low business risk profile. It is publicly owned by the Autonomous Community of Madrid (AC Madrid) (BBB/Stable) (82.4%), the City Council of Madrid (10%) and more than a hundred other municipalities in Madrid's (for the remaining 7.6%).

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.

ESG CONSIDERATIONS

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

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

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

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

Corporate Rating Criteria (pub. 15 Oct 2021) (including rating assumption sensitivity)

Parent and Subsidiary Linkage Rating Criteria (pub. 01 Dec 2021)

APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

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ENDORSEMENT STATUS

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

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