FitchRatings

Fitch Affirms Canal's IDR at 'BBB+' despite Decision to Resume Dividend Payment

Fitch Ratings - Barcelona - 26 June 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 ratings at 'BBB+'. The Outlook on the Long-Term IDR is Stable. The Standalone Credit Profile (SCP) has been revised to 'bbb+' from 'a-' following the decisions taken in the last Board of Directors (BoD) meeting held on 9 May 2019.

The Long-Term IDR affirmation reflects Canal's sufficient liquidity to cover cash needs under our rating case, which includes a moderate amount of the company's EUR500 million notes being redeemed, and our expectation that the company would ultimately be able to satisfy the total cash demand in a remote scenario of a full bond redemption. We expect Canal's EUR500 million bond to remain in technical event of default (EoD) for a prolonged period with limited impact from potential management actions to resolve the issue, in our view.

The SCP revision reflects Canal's shift to a more shareholder-friendly management strategy and to a less conservative liquidity policy than European peers', which is no longer consistent with an 'a-' SCP. This is underlined by the decision taken by Canal's BoD in May 2019 to resume dividend distribution, notwithstanding insufficient cash and committed revolving credit facilities (RCF) to cover a full redemption of the company's EUR500 million bond, which is in EoD since October 2018.

Key Rating Drivers

Prolonged Technical EoD: Canal's EUR500 million bond will continue to be in technical EoD since the Colombian prosecutor decided to proceed with Triple A's shares forfeiture on 4 April 2019. We see limited impact from Canal's management actions to resolve the issue and little incentive from bondholders to request for full redemption of bonds in their possession in the current interest rate environment. We therefore see prolonged uncertainty over the bond amount that bondholders will ask to be redeemed before maturity and have assumed moderate cash needs in our base case scenario.

The company's auditor has classified the bond as short-term debt in the 2018 annual accounts. This reflects the bondholders' open window liquidity until the bond's maturity in February 2025.

Limited Impact from Management Actions: Canal's management is exploring various options to resolve the issue related to the Triple A's shares forfeiture and the bond's EoD. However, these actions have an uncertain timeframe, not always under Canal's control, and/or little probability of success, especially in a context of current low forward interest rates that do not incentivise bondholders to request full redemption.

Weakened Liquidity on Full Redemption: Decisions taken in the last BoD meeting have diminished Canal's liquidity position since April 2019, when we had assessed sufficient liquidity to cover full bond redemption with cash and a committed revolving credit facility (RCF). At present Canal could only cover around 70% of the EUR500 million bond with secured liquidity sources. The worsening in the last two months is due to the BoD's decision to restore dividend payment (EUR128 million already distributed in 2019) and not to formalise EUR170 million of credit facilities to replenish liquidity following the dividend payment.

Shift to Shareholder-Friendly Stance: We see the BoD's decisions as evidence of a shareholder-friendly management strategy and a less conservative liquidity policy than its similarly rated European peers', which is no longer consistent with a 'a-' SCP. We assume a normalised calendar of dividend payments going forward. Dividends have historically not been fully discretionary for Canal and consequently, we classify them as being above funds from operations. This rating approach is supported by the company's recent decision to resume dividend payment. Finally, we do not foresee major changes to the strategy arising from a newly elected BoD following regional and local election outcomes in Spain last May.

No Liquidity Risks in Fitch Rating Case: We see full redemption of the bond as a remote scenario and therefore it is not our rating case. Fitch rating case takes into account a moderate 20% bond redemption (or EUR100 million) up until the maturity of the bond in 2025 and conservatively, additional cash out-flows related to potential penalties linked to the judicial process in Colombia. In this rating scenario, liquidity is sufficient to cover all the cash needs and not a risk. Up until today, there has been no communication from the bondholders, Commissioner or any individual request to prepay the bonds.

No Payment Default: We believe that Canal would have the ability to ultimately raise sufficient funds to repay the bond in whole, if necessary. This is supported by our view of Canal's long and well-established relationships with banks, low business risk, a low leveraged capital structure, a fairly low amount of financing needed, a highly cash-generative business and flexibility around capex and dividends, although only temporarily for the latter.

Uncommitted RCF Ineligible for Liquidity: Canal's liquidity position in June comprised EUR250 million of cash in hand, EUR122 million of a committed RCF and EUR170 million of an uncommitted RCF based on commercial offers received from banks that are pre-approved by the respective risks committees but are subject to periodic renewals. The BoD only authorised the uncommitted RCF to be formalised if necessary to cover cash requests from bondholders, which will remain otherwise uncommitted. This is to avoid a commitment fee to cover an unforeseen scenario, according to Canal. We therefore do not view the EUR170 million RCF as eligible for liquidity purposes under our criteria.

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 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). However, 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.

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.

Governance risk factors related to operational execution and governance structure are contributing factors to our credit assessment of Canal but they have not driven a rating change. Spanish Courts' investigation into previous Canal's management acquisitions in Brazil, and Colombian General Prosecutor's seizure of Triple A's shares, indicate failures in internal controls related to acquisitions and corporate governance standards, though EBITDA from Latin American operations was only around 10% of Canal's EBITDA (before deconsolidation of Triple A).

Key Assumptions

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

-Madrid's water tariffs frozen until end-2019 and annually revised from January 2020;

-Slightly decreasing volume of water billed over the next four 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;

-Annual capex of around EUR240 million on average for 2018-2022; and

-Around 80% dividend pay-out based on individual accounts for Canal; 2017 final dividend and the 2018 interim dividend paid in 2019.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- A shift to a more bondholder-friendly strategy and conservative liquidity policy may trigger a positive revision of the SCP, with no impact on the Long-Term IDRs

-An upgrade of Madrid (BBB/Stable), together with a positive revision of the SCP, could lead to an upgrade of Canal's IDR

Developments That May, Individually or Collectively, Lead to Negative Rating Action

-Failure to replenish liquidity with committed RCF, to meet bondholder requests or to annually roll over the committed existing RCF

-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. This may be due to a worse-than-expected operating environment, including regulatory changes or higher dividends

-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 and Debt Structure

Potentially Stretched Liquidity: Canal's liquidity position as of 10 June 2019 included EUR250 million of readily available cash, and EUR122 million of available committed credit facilities until December 2019 to be renewed annually. This should yield an estimated total available liquidity of EUR372 million. In addition, we forecast small positive free cash flow for the remaining months of 2019. Debt maturing until December 2019 is limited to around EUR24 million.

The EUR500 million bond, contractually maturing in February 2025, has been classified as current liability in the 2018 accounts of the company due to the technical EoD. Finally, Canal has requested commercial offers for additional RCFs of up to EUR170 million, which are uncommitted and not eligible for liquidity purposes under our criteria.

We assume the roll-over of the committed RCFs 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 similar to other Fitch-rated Spanish utilities', where its less sizeable long-term committed credit lines are assessed in conjunction with the company's 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. Accordingly, we adjust Canal's FFO calculations by deducting dividends.

Sources of Information

Public Ratings with Credit Linkage to other ratings

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
Canal de Isabel II, S.A.	LT IDR BBB+ Affirmed	BBB+
	SCP bbb+ New Rating	
senior unsecured	LT BBB+ Affirmed	BBB+

Additional information is available on www.fitchratings.com

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Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018)
Government-Related Entities Rating Criteria (pub. 29 Mar 2019)
Corporate Rating Criteria (pub. 19 Feb 2019)

Additional Disclosures

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