



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

FITCH RATINGS ANALYSTS

Primary Rating Analyst
Pilar Auguets
Senior Director
+34 93 467 8747
Fitch Ratings Espana. S.A.U.
Av. Diagonal 601
Barcelona 08028

Secondary Rating Analyst

Maria Delia Linares
Senior Analyst
+34 93 492 9512

Committee Chairperson
Antonio Totaro
Senior Director
+39 02 879087 297

MEDIA CONTACTS

Adrian Simpson
London
+44 20 3530 1010
adrian.simpson@thefitchgroup.com

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

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

DISCLAIMER

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory). FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

COPYRIGHT

Copyright © 2019 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are

retail clients within the meaning of the Corporations Act 2001
Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see <https://www.fitchratings.com/site/regulatory>), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

Endorsement Policy

Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Fitch Updates Terms of Use & Privacy Policy

We have updated our Terms of Use and Privacy Policies which cover all of Fitch Group's websites. [Learn more.](#)