

Rating Action: Moody's confirms Canal de Isabel II's Baa1 ratings; negative outlook

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Madrid, April 10, 2019 -- Moody's Investors Service ("Moody's") has today confirmed the Baa1 long-term issuer rating and the senior unsecured rating of Canal de Isabel II, S.A. (Canal). The outlook on the ratings is negative. This concludes the review for downgrade that was initiated on 13 December 2018.

RATINGS RATIONALE

Today's confirmation of Canal's ratings reflects the actions that have been taken to protect the company's position despite the decision on 4 April 2019 by the General Prosecutor of Colombia to proceed with the request to finalize the seizure of the group's shares in its main Latin American subsidiary, Triple A de Barranquilla (Triple A), and the increased risk of an enforced early redemption of Canal's EUR500 million senior unsecured bond due in February 2025 (the Bond). It is not yet clear whether some or all of the holders of the Bond will seek early repayment of their outstandings. Moody's understands that to date the bond holders commissioner has not received any communication from the bond holders with respect to a possible prepayment of the bonds.

More particularly, the rating confirmation factors an enhanced level of support that Canal is expected to receive from its main shareholder, the Comunidad Autonoma de Madrid (Baa1 stable) to avoid a payment default if this becomes necessary. On 29 March, the Comunidad Autonoma informally agreed to delay receiving the planned EUR142 million dividend distribution to provide extra cash resources to meet any early redemption of the Bond. Moody's estimates that Canal currently has around EUR365m of cash taking into consideration this delayed dividend and a EUR122m existing committed short term facility, drawable in the current circumstances.

Nevertheless, Canal's liquidity situation is strained and the formalization of the expropriation request increases the company's exposure to an early repayment of a substantial amount of the Bond. It is not clear whether the Bond will be accelerated, and if so how much will be accelerated, which is a relatively unstable financial position in the context of the company's current liquidity and funding arrangements. Consequently, the view of Canal's standalone credit quality as expressed by a baseline credit assessment (BCA), has been revised to baa3 from baa1. Despite Canal's less certain liquidity position, Moody's expects the company to be able to meet its obligations, and this together with modest debt leverage and its core monopoly water and wastewater operations, provided under a supportive regulatory regime in the region of Madrid, underpins the company's baa3 BCA.

Under the terms and conditions of the Bond, Triple A is a material subsidiary and the finalization of the expropriation process triggers an event of default that would give bondholders the individual right to require an early redemption payment. Moody's understands a lengthy court process is now likely to begin before the expropriation could be eventually finalized. Notwithstanding the uncertain timing around the conclusion of this process, bondholders will remain entitled to exercise their right to request early repayment over time which, absent an agreement to the contrary, creates material uncertainty for Canal. Furthermore, the loss of Triple A is estimated to represent a reduction of around 10% of Canal's consolidated EBITDA.

Canal's Baa1 rating incorporates a BCA of baa3 and two notches of rating uplift to reflect Moody's expectation that extraordinary support from the Comunidad Autonoma de Madrid will continue in future as articulated by an assumption of high support and high dependence under the agency's Government-Related Issuer methodology. The baa3 BCA reflects uncertainty around the timing and extent of bondholder demands for early redemption and the current lack of committed liquidity sources sufficient to cover potential requirements should bondholders accelerate the entirety of the debt at any point prior to its scheduled maturity. The baa3 BCA is supported by the cash and liquidity facilities available to the company and the company is seeking to put in place an additional liquidity facility that would bring total cash and availability liquidity to a level sufficient to cover accelerated bond payments. These facilities are, however, short term and the potential for acceleration will exist until the maturity of the Bond in February 2025, creating the potential for a shortfall should the company be unable to renew the facilities or build additional cash reserves. The baa3 BCA remains

further supported by Canal's solid operational performance and limited volume risk in its Spanish operations and the company's long track record of an adequate recovery in operating and capital spending through tariffs remuneration.

OUTLOOK

The outlook on the rating is negative, reflecting (1) the current lack of visibility over the number of bondholders that would demand repayment (if any) as well as the timing of this decision, (2) the company's current reliance on short-term liquidity facilities to cover payment demands that might occur until the final maturity of the bond and (3) Canal's need to retain cash against a potential demand of early redemption which may constrain the company's ability to make strategic decisions to support or increase future earnings.

WHAT COULD CHANGE THE RATING UP

The rating outlook could be stabilized if there was clarity around the timing and amount of the financial implications resulting from the ongoing legal process in Colombia and if Canal was able to demonstrate that these costs would not result in a material detrimental impact on its business and financial profile.

Any potential upgrade of Canal's rating would be (1) contingent upon an upward movement in the rating of the Government of Spain and the Comunidad Autonoma de Madrid; and (2) subject to the company maintaining a solid financial profile and liquidity position.

WHAT COULD CHANGE THE RATING DOWN

Canal's rating could face downward pressure if the extraordinary support provided by the Comunidad Autonoma de Madrid were to be revoked to the extent that the company had insufficient liquidity to meet the prepayment obligation resulting from a substantial acceleration of the bonds, if this were to materialize.

Similarly, negative pressure on Canal's BCA could arise if the company liquidity position were to weaken so that the risk that the company will not be able to meet a potential bond obligation increases.

Any deterioration in the rating or outlook of the Government of Spain and the Comunidad Autonoma de Madrid would likely result in a corresponding adjustment of Canals rating/or outlook.

The methodologies used in these ratings were Regulated Water Utilities published in June 2018, and Government-Related Issuers published in June 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

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