FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Outlook on Canal to Negative from Stable; Affirms at 'BBB+'

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Fitch Ratings - Barcelona - 27 Apr 2020: Fitch Ratings has revised Canal de Isabel II, S.A.'s Outlook to Negative from Stable while affirming the company's Long-Term Issuer Default Rating (IDR) at 'BBB+'. A full list of rating actions is detailed below.

The revision of the Outlook to Negative from Stable mirrors the revision of the Outlook to Negative from Stable of its ultimate parent the Autonomous Community of Madrid (BBB/Negative) on 20 April 2020 (see "Fitch Revises Outlook on Autonomous Community of Madrid to Negative from Stable; Affirms at 'BBB'" on www.fitchratings.com).

The affirmation of Canal's ratings reflects 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. It also reflects the company's low leverage compared with Fitch's negative rating sensitivity, and the manageable impact of the coronavirus crisis on the company's operations.

The ratings take into account a tariff freeze until 2021 and CPI-linked annual increases thereafter for Madrid's concession, Canal's loss of control over and deconsolidation of its main operating company in Colombia (Triple A de Barranquilla), and the postponement of divestment of Canal's interests outside the Madrid.

KEY RATING DRIVERS

Negative Outlook Reflects Parent Linkage: Canal's IDR reflects its Standalone Credit Profile (SCP) of 'bbb+', which we view as stronger than that of Madrid. The Negative Outlook is as a result of the revision of Madrid's Outlook to Negative. We assess Canal's links with Madrid as weak under our Criteria. This, combined with the existence of internal targets (agreed financial targets and maximum dividend payouts) that restrict cash extraction from Canal, leads to a single-notch maximum differential between Canal's IDR and that of Madrid, which constrains any rating upside for Canal.

Coronavirus Affects Water Volumes: The sharp drop in industrial and commercial consumption volumes is not offset by the increase in household volumes, and we expect this to lead to lower revenues and EBITDA in the financial year ending end-December 2020 (FY20). We assume that demand for Canal's operations in Spain will fall by around 9% (by volume) from the beginning of the lockdown (in mid-March) to August 2020, but will return to a normal level by end-2020. The fixed charges represent around 40% of the total water invoice.

Pandemic Pressure on Earnings: We have revised our rating case assumptions and forecast a decline in Canal's group EBITDA of around EUR53 million in FY20, compared to pre-crisis EBITDA. Early impacts of the coronavirus-induced lockdowns include drop in industrial and commercial demand, a shift in water consumption between groups of customers, and a range of payment subsidies to help customers who have lost jobs or suffered reduced income. We expect the impact to be more pronounced in Canal's operations in Spain, Lanzarote and Emissao.

Strong Standalone Credit Profile: Canal's strong Standalone Credit Profile is underpinned by its adequate financial profile and low business risk stemming from the stability of, and good visibility over, revenue that is generated through a 50-year water concession agreement in the region of Madrid, expiring in 2062. We expect EBITDA of about EUR450 million in 2019, with 97% generated from regulated activities in Spain, 2% from regulated activities in Latin America, and 1% from non-regulated ancillary services.

Tariff Increase Postponed: Canal's business plan contemplated an above-inflation tariff increase for 2020, but the management decided to postpone it for one year due to delays in capex execution, among other factors. The increase was based on higher operating costs due to the implementation of the strategic plan and because tariffs have not increased since 2016. It also included the impact of higher wages, chemical-supply costs, and research, development and maintenance costs. In our forecast we assume a tariff freeze until 2021 and increases linked to inflation from 2022.

Ample Leverage Headroom: We expect leverage to decline to around 2.0x by 2023 from the peak of 2.8x we had forecast for 2019, affording the company ample headroom compared with our negative rating sensitivity of 5.0x. This is based on our assumptions of normalised dividend distributions from 2020, tariff increases linked to inflation from 2022, limited proceeds from the disposal of real estate properties in Madrid, and the postponement of disposals of all overseas interests and concessions outside the Madrid region (Caceres and Lanzarote).

Capex Flexibility Retained: The management revised downwards it capex spending plan in December 2019, mainly due to delays around the awarding of contracts related to the renewal of supply networks, due to the ambitious nature of the capex programme and the complexity of the documentation negotiated with contractors. Total capex of EUR960 billion to 2023 is approximately split 50/50 between new infrastructure and maintenance and network improvements.

DERIVATION SUMMARY

Canal is a water and sewage network operator that does not own its asset base, unlike most European peers. However, its investments are supported by its concession value. Canal's leverage, adjusted for dividends, is well below those of peers such as Acea SpA (BBB+/Stable), Wessex Water Services Limited (BBB/Stable) and FCC Aqualia, S.A. (BB+/Stable). However, Canal operates in a decentralised and less developed regulatory environment than exists in some other European countries, and its Latin American operations carry higher business and political risks.

In addition, as Canal does not own its assets, it does not benefit from the single-notch uplift to the senior unsecured rating that Fitch typically gives to regulated network utilities, reflecting 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 2021 and annually revised from 2022 close to CPI

- 5% annual decrease in volumes in 2020 (9% from the start of the lockdown to August), 3% recovery in 2021 and flat thereafter

- Slight increase in population and customers

- Divestments of real estate properties in Madrid at appraised value in 2022

- Declining gross debt to EUR0.7 billion by 2022. No new debt raised over the rating horizon

- Annual capex of around EUR241 million on average for 2020-2023

- An around 80% dividend payout based on consolidated accounts for Canal

- EUR74 million of potential cost compensation or fines paid in 2022.

RATING SENSITIVITIES

Factors That May, Individually or Collectively, Lead to Positive Rating Action/Upgrade

A revision of the Outlook of Madrid to Stable from Negative will lead to the revision of the Outlook on Canal to Stable.

Factors That May, Individually or Collectively, Lead to Negative Rating Action/Downgrade

Significantly weaker liquidity, including failure to annually roll over the committed existing revolving credit facility (RCF)

Weaker cash flow generation leading to FFO net leverage (adjusted for dividends) above 5.0x on a sustained basis (although we could revise our sensitivity trigger once we can measure the impact of IFRS 16 following the publication of the 2019 accounts). This may be due to a worse-than-Fitch-expected operating environment, including regulatory changes or higher dividends.

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 single-notch differential (i.e. if there is lack of full legal ring-fencing).

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

Adequate Liquidity: As at 15 April 2020 Canal's liquidity position comprises EUR329 million of cash and cash equivalents and a EUR132 million undrawn committed RCF maturing in December 2020, which is renewed annually. We estimate that this should yield total available liquidity of EUR461 million. We forecast small positive free cash flow (FCF) of EUR75 million (after capex and dividend payments) in 2020.

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 similar to those of other Fitch-rated Spanish utilities, where its smaller long-term committed credit lines are seen 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. 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 the Autonomous Community of Madrid (BBB/Negative) affects (and currently constrains) the rating of Canal at 'BBB+'. We allow a maximum one-notch rating differential between the entities.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

Canal has an ESG Relevance Score of '4' for GEX (operational execution of management strategy) and an ESG Relevance Score of '4' for GGV (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, which indicate failures in internal controls related to acquisitions and corporate-governance standards, although Latin America EBITDA was only 10% of the group (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.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Canal de Isabel II, S.A.	LT IDR	BBB+	Affirmed
• senior unsecured	LT	BBB+	Affirmed

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Government-Related Entities Rating Criteria (pub. 13 Nov 2019)

Corporate Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

Sector Navigators-Addendum to the Corporate Rating Criteria (pub. 27 Mar 2020)

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

ENDORSEMENT STATUS

Canal de Isabel II, S.A.	EU Issued

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Corporate Finance Utilities and Power Europe Spain