

# MOODY'S

## RATINGS

### **Rating Action: Moody's changes Canal de Isabel's outlook to positive; affirms Baa1 rating**

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26 Mar 2024

Madrid, March 26, 2024 -- Moody's Ratings (Moody's) has today changed the outlook of Canal de Isabel II, S.A. (Canal) to positive from stable. Concurrently, the Baa1 long-term issuer rating, baa1 Baseline Credit Assessment (BCA) and Baa1 senior unsecured rating were affirmed.

The rating action follows Moody's change in outlook on the Baa1 rating of the Comunidad Autonoma de Madrid to positive from stable, on 21 March 2024. For more details on the rationale for the Comunidad's outlook change, please refer to the press release <https://ratings.moodys.com/ratings-news/417381>

#### RATINGS RATIONALE

##### RATIONALE FOR POSITIVE OUTLOOK

The change in the outlook to positive reflects the positive outlook on the Comunidad Autonoma de Madrid (Baa1 positive) and the likelihood that Canal's rating will be upgraded if the rating of the Comunidad Autonoma de Madrid is upgraded. This also reflects an expectation that the company will maintain a relatively low debt burden with its Funds from operations (FFO)/Net Debt ratio remaining above 25% on a sustained basis.

##### RATIONALE FOR RATING AFFIRMATION

Today's rating affirmation is underpinned by Canal's strong financial profile at the current rating level. Despite Moody's expectation that the company's consolidated operating margin will decline to around 25% by the end of 2024, down from 35% in 2019-20, the reduction remains manageable in the context of Canal's robust financial metrics and strong liquidity position.

From the end of 2016 and after several extensions, the regional government of Madrid decided to freeze Canal's water tariffs until at least December 2024. This decision, coupled with the inflationary pressure on the company's cost base, will

continue to translate into a gradual erosion of the company's profitability. Furthermore, over the next twelve months the company's capital requirements are anticipated to remain above historical levels, at around EUR350 million, albeit subject to possible delays.

Despite these negative trends which will accelerate cash absorption, Moody's anticipates that Canal will maintain a robust financial profile. Specifically, the company's good liquidity position will underpin a FFO/Net Debt ratio above 25%, at least of the next twelve months. This expectation is further bolstered by an assumption of a prudent financial policy, with future dividend distributions broadly aligned with the historical payout of 65%.

Given its 100% ownership by the Comunidad Autonoma de Madrid and other local municipalities, Canal is considered a Government-Related Issuer under Moody's rating methodology, with High dependence and High support scores. However, the current Baa1 rating does not incorporate any uplift from Canal's Baseline Credit Assessment (BCA) of baa1, given the BCA is currently positioned at the same issuer rating level as its supporter, the Comunidad Autonoma de Madrid.

Canal's social risk is S-4 because the company has historically faced adverse decisions and political interference, primarily driven by public concerns over tariff affordability. This is evidenced by the freeze in tariffs that has been in effect since 2016. However, Moody's acknowledges Canal's enhanced track record of conservative financial policy and balanced liquidity management, also demonstrated by the robust cash reserves accrued in recent years. Moreover, the weaknesses in the company's internal controls, which led to lengthy legal investigations involving the former management in Colombia and Spain and resulted in the loss of control of its main Latin American subsidiary, Triple A, in 2018, have lessened. This has further reduced the company's exposure to risks related to governance. Consequently, the ESG Governance issuer profile score was revised to G-3 from G-4. The overall credit impact score of Canal remains at CIS-3. This reflects various mitigating factors, such as the regulated nature of its activities and the likelihood of extraordinary support from the Comunidad Autonoma de Madrid, which limit the impact of social risks on the rating.

More specifically, Canal's rating is supported by (1) the company's low business risk as the monopoly provider of essential water and wastewater services in the region of Madrid; (2) a supportive regulatory regime, which is codified in regional legislation, and a 50-year concession agreement; (3) the track record of an adequate recovery of operating and capital spending; and (4) the company's modest financial leverage.

Canal's rating also reflects (1) the credit quality and strong linkages with the Comunidad Autonoma de Madrid, which besides the possibility of extraordinary support, could also translate into additional operational, regulatory or political pressure; (2) sustained negative pressure on profitability, due to prolonged tariff freezes in the face of higher operating costs and (3) increasing capital expenditure

requirements which could potentially absorb the existing financial flexibility.

## LIQUIDITY

Canal exhibits a good liquidity profile. As at 31 December 2023, Moody's estimates that Canal held around EUR446 million in cash and cash equivalents. Furthermore, the company has access to around EUR102 million of committed bilateral 364-day liquidity facilities, fully undrawn at the same date.

Canal's major debt maturities are associated with the EUR500 million bond due in February 2025, accounting for 73% of its consolidated debt. Alongside its existing cash reserves, Canal benefits from strong banking relationships and is anticipated to have good access to funding ahead of the potential refinancing requirements. Canal's remaining maturities are evenly distributed. Around 26% of the existing debt relates to intercompany debt provided by the Ente Publico Canal de Isabel II funded via bank loans. The other remaining debt of the group is in the subsidiaries operating in Latin America.

## FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Canal's rating could face upward pressure if the Comunidad Autonoma de Madrid is upgraded, provided that (1) its financial profile remains strong, such that the FFO/ Net Debt ratio remains above 25%, on a sustained basis; (2) the company maintains sound liquidity and (3) social risks are not considered as having a discernible negative impact on the rating.

Any deterioration in the ratings or outlook of the Comunidad Autonoma de Madrid would likely result in a corresponding adjustment of Canal's rating and/or outlook.

Canal's BCA could face downward pressure if (1) the company's business risk profile were to increase significantly due to, for example, adverse regulatory developments or evidence of additional significant political interference; or (2) the company's financial risk profile were to deteriorate materially, such that FFO/Net Debt would fall consistently below 20%.

## PRINCIPAL METHODOLOGIES

The methodologies used in these ratings were Regulated Water Utilities published in August 2023 and available at <https://ratings.moodys.com/rmc-documents/406788>, and Government-Related Issuers methodology published in January 2024 and available at <https://ratings.moodys.com/rmc-documents/406502>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of these methodologies.

## PROFILE

Canal is the monopoly provider of water collection, abstraction, supply, sanitation and other water and wastewater related services in the region of Madrid. The group is also responsible for the provision of integrated water services in the municipalities of Caceres (Extremadura) and Lanzarote (Canary Islands). Aside from the Spanish operations, which accounted for nearly 100% of consolidated EBITDA at the end of 2022, Canal provides water-related services, including metering and commercial management of water supply and treatment operations in Latin America, primarily in Ecuador and the Dominican Republic.

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For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on <https://ratings.moodys.com/rating-definitions>.

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