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Summary:

Kelda Finance (No. 3) PLC

Primary Credit Analyst:
Beata Sperling-Tyler, London (44) 20-7176-3687; beata.sperling-tyler@standardandpoors.com

Secondary Contacts:
Mark J Davidson, London (44) 20-7176-6306; mark.j.davidson@standardandpoors.com
Olli Rouhiainen, London (44) 20-7176-3769; olli.rouhiainen@standardandpoors.com

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Summary:

Kelda Finance (No. 3) PLC

Credit Rating:	BB-/Stable/--

Rationale

Business Risk

- Potential volatility of dividend payments from the whole business securitization of the regulated water and sewerage utility Yorkshire Water Services Ltd. (YWS).
- Absence of meaningful alternative sources of income to Kelda Finance (No. 3) PLC (KF3; the debt issuing vehicle at Kelda Finance Group) if YWS' securitization structure locks up.
- Relative predictability of the incoming cash flow streams from the operating subsidiary, YWS, indicated by our forecast of adequate headroom under YWS' covenant ratios. This is supported by the stability of the U.K.'s water sector regulatory framework, prudent financial policies, and a track record of YWS' management's conservative approach to liquidity management.

Financial Risk

- Policy of distribution of all cash flows available post debt service by YWS' holding company, Kelda Finance Group.
- Material refinancing risk due to the bullet nature of KF3's structurally junior debt.
- Very high consolidated leverage including debt within YWS' securitization structure, although leverage at KF3 is modest.

Outlook

The stable outlook on KF3 reflects our opinion that Kelda Finance Group will continue to receive forecast dividends from YWS, and that YWS will maintain adequate headroom to avoid lock-up under its covenants. We also anticipate that Kelda Finance Group will maintain its "aggressive" financial risk profile, with no cash retention within its structure, albeit with funds-from-operations (FFO)-to-debt ratios of above 20%.

Downside scenario

We would revise downward our assessment of KF3's business risk profile if in our view the likelihood of a dividend lock-up at YWS--which would restrict cash flows from YWS to Kelda Finance (No. 2) Limited (KF2; KF3's guarantor)--increased, due to for example, operating difficulties at YWS or adverse regulatory decisions. A downward revision of the business risk profile would likely lead us to lower the long-term corporate credit rating on KF3.

If we were to lower our rating on YWS, the source of KF2's income, this could also lead us to lower the rating on KF3. This is because a downgrade of YWS would indicate that a dividend lock-up is now more likely to occur. A one-notch downgrade of YWS could potentially lead to a multi-notch downgrade of KF3.

We could also take a negative rating action if KF2's £30 million liquidity facility is no longer available, if a drawdown is outstanding, or if Kelda Finance Group fails to maintain a FFO-to-total-debt ratio of above 20%.

Upside scenario

We view rating upside as unlikely in the short to medium term, due to the "aggressive" financial risk profile and the potentially volatile nature of the dividend payments from YWS.

Standard & Poor's Base-Case Scenario

Assumptions

- YWS, which is subject to a corporate securitization, will continue to meet financial covenants included in its debt documentation with a healthy cushion, and will therefore be able to distribute dividends to KF3.
- YWS will be able to upstream at least about £125 million-£150 million per year on average to KF2, while meeting its financial covenants.
- YWS will be able to upstream dividends, based on our economic forecast that the U.K.'s retail prices index (RPI) will be 2.8% in 2014 and 3.0% in 2015, allowing YWS to increase it prices as per its regulatory agreement.
- YWS will report flat operating margins, as costs are not increasing faster than revenues.
- A modest decrease in consolidated leverage at YWS and KF3 in 2014.
- YWS will likely not breach its lock-up covenants.

Key Metrics

	2013A	2014E	2015E
Dividend Distributions (YWS to KF2) (£ Mil.)	257.3	220-240	220-240
Adj. FFO to debt (%)*	60.4%	50-70%	50-70%

*Fully Standard & Poor's-adjusted. Based on our view of dividends that could be available from YWS to Kelda Finance Group without breaching dividend lock-up covenants over the next three years. The actual amount of dividends paid to KF2 is likely to be lower to reflect the cash needs of Kelda Finance Group, with excess liquidity kept at KF2 level rather than being upstreamed. **Kelda Finance Group + YWS. A--Actual. E--Estimated.

Business Risk

Our assessment of KF3's business risk profile as "fair" reflects our view of the relative predictability of the incoming cash flow streams to KF2 (as KF3's guarantor) from YWS. The largest component (about 70%) of these cash flows consists of dividend payments by YWS, with the remainder representing interest income on the intercompany loan to YWS. While we expect stable cash flow generation by YWS from its regulated monopoly water and sewerage business, the dividend distributions could stop if YWS breaches certain trigger covenants that would trap all cash within the YWS securitization structure for the benefit of its secured noteholders. We consider a risk of a dividend lock-up at YWS as relatively low in the short term. Under our base-case scenario, the YWS corporate securitization structure has more than 15% headroom under the lock-up covenants within the structure on all cash-flow based ratios, and about 5% headroom under the lock-up covenants regarding the senior regulated asset ratio. Under certain stress scenarios, we generally observe tightening ratios in the next regulatory period, AM6 (Asset Management Plan 6, starting fiscal year 2016). Under those scenarios that assume increased operating and/or capital costs and reduced weighted-average cost of capital, we envisage that a lock-up could potentially occur in 2016-2020. While interest income on the intercompany loans would be available even during a lock-up, in the absence of other sources of revenue, we consider that it would be insufficient to maintain debt service payments for a sustained period. There is no other cash available at Kelda Finance Group, given its policy of a 100% dividend payout ratio, other than the £30 million revolving credit facility (RCF). This would cover between one and two years' worth of interest on Kelda Finance Group's debt.

The risk of YWS triggering its lock-up covenants is mitigated by YWS' track record of a prudent approach to maintaining debt at a level lower than that allowed by the economic regulatory capital value (RCV) (80% versus 85%).

Financial Risk

We assess KF3's financial risk profile as "aggressive," reflecting our view of Kelda Finance Group's aggressive policy of distributing all cash flow that is available post debt service. The group's policy provides for no cash retention, despite the potential volatility of inflows from YWS and risks associated with the five-yearly regulatory review and tariff reset at YWS' regulated businesses, which could potentially affect YWS' ability to upstream sufficient dividends to make debt service payments by Kelda Finance Group.

We also note a material refinancing risk, given that Kelda Finance Group's debt has bullet maturities. In our view, the debt of a holding company--which is by its nature subordinated to the debt of the operating company--is more likely to suffer refinancing risk in adverse market conditions.

When analyzing KF3's covenant ratios, we focus on the liabilities of KF3, rather than the liabilities of the corporate securitization. This is because these are in effect taken into account in our lower assessment of KF3's business risk profile ("fair") compared with YWS' ("excellent"). However, we also consider the consolidated leverage including debt within YWS' securitization structure. Although we consider KF3's debt to EBITDA ratios as modest, ranging from 1.1x to 1.8x over the next five years, we believe that adjusted consolidated debt to EBITDA will be very high, at close to 9.0x, in financial year 2014.

Liquidity

We assess KF3's liquidity as "adequate," as defined in our criteria, reflecting our forecast that KF3's sources of liquidity will cover its uses by more than 1.2x over the next financial year.

Principal Liquidity Sources

- About £90 million of cash inflow from YWS;
- A £30 million undrawn RCF; and
- No forecast cash retention at Kelda Finance Group.

Principal Liquidity Uses

- Dividend payments from Kelda Finance Group to the ultimate equity holders of £77 million.

DebtMaturities And Covenants

KF3 has no upcoming debt maturities, operating expenditures, or working capital needs due to its nature as a holding company, which means that unforeseen cash outflows are limited. KF3 is able to restrict Kelda Finance Group's dividends if needed. In our view, KF3 also has sound relationships with its banks, and a good business standing, which supports it in raising funds in credit markets.

We anticipate that the company will maintain about 15% headroom under the operational covenants in YWS' debt documentation. In our view, YWS' financial policies are prudent enough to support our assessment of KF3's liquidity as "adequate," based on the combination of our forecast cash inflow from YWS and the available credit facility.

However, there is a "clean down" provision, which, if implemented, would require up to £30 million cash to be held at YWS. This could potentially restrict the RCF's availability.

Recovery Analysis

- The issue rating on the £200 million guaranteed secured notes issued by KF3 is 'BB-' with a recovery rating of '3' reflecting the noteholders' reliance on the equity value of Kelda's ownership of the ring-fenced corporate securitization, YWS, and the notes' subordination to the existing debt at YWS. We consider the security package as relatively weak, given that it comprises share pledges where the operating company assets have been pledged in favor of the securitization lenders.
- We consider that the abovementioned factors make the recovery prospects for the YWS holding company debt volatile and sensitive to small changes in the debt and valuation in the event of a default, which limit the rating outcome in our view. We believe that recovery prospects are also highly sensitive to the potential impact from mark-to-market liabilities on the index-linked swaps held by YWS, which could have an impact on the value of the YWS holding company equity.
- In order to determine recovery prospects, we simulate a hypothetical default scenario. Under our scenario, we assume that sufficient stress at the YWS level would lead to a lock-up of cash flows that we anticipate will occur in 2016, with debt to RCV reaching 85%. We then forecast a payment default at the YWS holding company level about 18 months after the lock-up at the YWS level, assuming that the £30 million liquidity facility allows the YWS holding company to service its debt during that period.
- We assume a sale of YWS' regulated water business via an enforcement of holding company share pledges at a 10% discount to the RCV. Allowing for debt to RCV of 85% at the YWS level, this leads to the YWS holding company's equity value of about £350 million being available for holders of the guaranteed secured debt. From this, we deduct enforcement costs of about £25 million, leaving a net equity value of £325 million available for secured creditors. Assuming outstanding debt of £310 million, including full drawings under the £30 million RCF and with six months of prepetition interest added to the debt balance, we see recovery prospects of 50%-70%.
- While recovery prospects are higher than the indicated range of 50%-70%, we maintain the recovery rating at '3' to reflect the sensitivity of the recovery prospects to any of our assumptions.

Related Criteria And Research

- Methodology For Considering Pre-Insolvency Structural Protections In Europe, Dec. 13, 2012
- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- Corporate Criteria--Parent/Subsidiary Links, Oct. 28, 2004

Additional Contact:

Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com