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Summary:

Kelda Finance (No. 3) PLC

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Summary:

Kelda Finance (No. 3) PLC

Credit Rating:	BB-/Stable/--

Rationale

The 'BB-' rating on holding company Kelda Finance (No. 3) PLC (KF3) reflects the differentiated credit quality between it and the ring-fenced financing group (RFFG) around U.K.-based regulated utility Yorkshire Water Services (YWS). The differentiation reflects the structural subordination of KF3 to the RFFG and the fact that it depends on upstream distributions from the RFFG for essentially all of its cash flow to service its own debt.

YWS' primary activities are the treatment and distribution of water, as well as the collection and treatment of wastewater in the Yorkshire region. The company serves about 5.0 million customers and 135,000 businesses.

We consider YWS to be a different group from KF3. This is because YWS has independent directors on its board, there are no cross-default provisions to entities outside the RFFG, all transactions with entities outside the RFFGs have to be completed on an arm's-length basis, and the RFFG creditors have a security interest over the RFFG's assets. YWS also is prohibited from merging, reorganizing or changing its organizational documents.

Nonetheless, given KF3's reliance on distributions from YWS, we derive the rating on KF3 by notching down from YWS' stand-alone credit profile of 'bbb'. This is because, while YWS benefits from structural enhancements designed to reduce the risk of nonpayment of scheduled debt service payments, these, in turn, increase the risk of default at the KF3 level as cash flow payments from YWS can be stopped earlier and more easily than for standard corporate groups.

The main credit drivers behind the rating include:

- KF3's comparatively stronger stand-alone financial ratios thanks, in our view, to its lower leverage and cost of debt. We expect KF3's ratio of debt to available cash to remain below 1.5x and the ratio of available cash flow to holding company interest to stand above 10x through to 2020 (the end of the current regulatory period [AMP6] set by U.K. water regulator Ofwat).
- We expect that YWS will continue to distribute sufficient dividends to KF3 in order to cover the scheduled debt service payments. We note, however, that YWS has reduced the dividend payments to Kelda, pending the cost of capital determination for the next regulatory period. This is in order to preserve the financial stability before the new cost of capital is known and integrated into the business plan.
- We assess the risk of cash flow interruption as a negative factor because we assess that the U.K.-based fully-regulated utility business would not withstand a 20% drop in EBITDA. We consider this unlikely to happen, however, given the strong regulatory framework in place and high predictability of future earnings. We would expect YWS to sustain at least a 10% decline in EBITDA without breaching its dividend lock-up financial covenants.
- We assess liquidity risk for KF3 as higher, despite its £30 million revolving credit facility (RCF), because the liquidity facility is not mandatory in nature and the drawdowns from it are limited by the presence of a clean-down provision that somewhat restricts the availability of the liquidity facility, in our view.

- We assess KF3 negatively on refinancing risk because of the concentration of debt maturities, well above 20% in a single year. We do not consider this risk to be mitigated by its lower leverage because of its higher liquidity risk, as detailed above.

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 under its covenants to avoid dividend lockup. We also anticipate that Kelda Finance Group will maintain adequate liquidity headroom and its ratios of debt to available cash flow below 1.5x and available cash flow to interest above 10x.

Downside scenario

We could take a negative rating action on KF3 if the headroom under YWS' covenant ratios, particularly the interest coverage ratios, narrowed and we no longer considered it adequate. We could also downgrade KF3 if the likelihood of a dividend lockup at YWS increased, for example, due to operating difficulties at YWS or adverse regulatory decisions.

Another trigger for a negative rating action on KF3 is a revision of YWS' business risk profile or a downgrade of YWS, the source of KF3's income. This is because a downgrade of YWS would indicate that a dividend lockup was more likely to occur.

Finally, we could take a negative rating action on KF3 if its £30 million RCF is no longer available, if a drawdown is outstanding, if the liquidity headroom narrowed, or if KF3 fails to maintain debt to available cash flow below 1.5x and available cash flow to interest above 10x.

Upside scenario

We view an upgrade as unlikely in the short-to-medium term due to KF3's aggressive financial structure and the potentially volatile nature of the dividend payments from YWS.

Liquidity

We assess KF3's liquidity as adequate, reflecting our forecast that KF3's sources of liquidity will cover its uses by more than 1.2x over the next 12 months starting March 31, 2017.

Principal Liquidity Sources	Principal Liquidity Uses
• About £30 million of cash inflow from YWS; • A £30 million undrawn RCF; and • No forecast cash retention at Kelda Finance Group.	• Dividend payments of £8 million from Kelda Finance Group to the ultimate equity holders; and • Kelda's interest cost of approximately £22 million.

Debt Maturities

KF3 has no upcoming debt maturities, operating expenditures, or working capital needs due to its status 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 has sound relationships with its banks, and a good business standing, which supports it in raising funds in credit markets.

However, we restrict our liquidity assessment due to the nonmandatory nature of the liquidity facility as well as its clean-down provision, the dependence on the distributions from YWS to which Kelda is subordinated, and the currently limited headroom for YWS to increase its dividend distributions.

Covenant Analysis

The bond documentation includes a negative pledge clause and restrictions on acquisitions and disposals.

The bank facility agreement includes a clean down clause regarding the RCF: if the borrower and obligors have less than €30 million cash on balance sheet, the borrower may only draw an amount equal to the amount of cash on balance sheet for five successive business days (then it has to repay the RCF drawing). In addition, at least three months must elapse before such a situation occurs again. There is no restriction for drawing on the RCF up to an amount which is lower than the amount of cash on balance sheet.

The event of default in the bank facilities agreement includes a cross acceleration and a nonpayment cross default with regards to the notes and the securitization. The bond's events of default notably include nonsatisfaction of a financial covenant, the termination of a standstill period at the YWS level other than by a waiver or remedy of default, nonpayment cross-default and cross-acceleration (on an amount above £10 million), and material adverse change.

Both bond and loan documentations include two financial covenants:

- Total net debt to regulated capital value (RCV) test set at 95%; and
- Interest cover (post maintenance capex) of 1.05.

Financial covenants (as of March 31):

- Total net debt to RCV (%): 95.0 (limit), 80.6 (2017F), 83.04 (2018F), 82.16 (2019F), and 79.01 (2020F)
- Interest cover, post maintenance capex (x): 1.05 (limit), 1.25 (2017F), 1.17 (2018F), 1.52 (2019F), and 1.59 (2020F)

F--Forecast.

Additional protection is provided by the dividend lock-up feature. As long as any of KF3's bonds are outstanding, no payments of any dividend to equity holders or other distribution (by way of intercompany loan or otherwise) will be made, other than the permitted distribution, at any time. These include:

- When the ratio of total net debt to RCV at the date the payment is made is more than 92.5%;
- If any drawing is made under the liquidity facility; and
- If an event of default has occurred, or if a trigger event has occurred at the YWS level.

Permitted distribution includes a payment of a dividend or any other distribution that shall not exceed £0.75 million in any financial year and any payment on account of any tax liabilities.

Recovery Analysis

Key Analytical Factors

- 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 structurally enhanced debt (SED) group, YWS, and the notes' subordination to the existing debt at YWS. We consider the security package to be relatively weak, given that it comprises share pledges where the operating company assets have been pledged in favor of the SED lenders.
- We consider that the abovementioned factors make the recovery prospects for the holding company's debt volatile and sensitive to small changes in the debt and valuation in the event of a default, which limits the rating outcome. We think that recovery prospects are also highly sensitive to the potential impact from market-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 2018, with debt to RCV reaching 85%. We then forecast a payment default at the YWS holding company level about 12-to-18 months after the lock-up at the YWS level, assuming that the company is still able to service the 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 £354 million being available for holders of the guaranteed secured debt. From this we deduct enforcement costs of about £25 million, leaving net equity value of £329 million available for secured creditors. We calculate recovery assuming outstanding debt of £308 million, including 85% drawings under the £30 million RCF and with six months of prepetition interest added to the debt balance.
- Recovery prospects are numerically higher than the indicated range of 50%-70%, but we maintain the recovery rating at '3' to reflect the sensitivity of the recovery prospects to variations in our assumptions.

Simulated Default Assumptions

- Year of default: 2020
- Stressed regulated asset value at default: £6.4 billion
- Jurisdiction: U.K.

Simplified Waterfall

- Net asset value to KF3 debtholders: £354 million
- Enforcement costs: About £25 million
- Net value available to KF3 debtholders: About £329 million
- Senior secured debt claims: About £308 million*
- --Recovery expectations: 50%-70%

*All debt amounts include six months' prepetition interest.

Related Criteria And Research

Related Criteria

- Criteria - Corporates - Recovery: Methodology: Jurisdiction Ranking Assessments - January 20, 2016
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers - December 07, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - General: Methodology: Holding Companies That Own Corporate Securitizations And Structurally Enhanced Debt Transactions - February 24, 2016
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions - June 25, 2013
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses - February 24, 2016
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- Criteria - Corporates - Project Finance: Project Finance Framework Methodology - September 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Transaction Structure Methodology - September 16, 2014

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