FITCH AFFIRMS KELDA FINANCE'S BOND AT 'BB+'

Fitch Ratings-London-04 July 2017: Fitch Ratings has affirmed Kelda Finance (No.2) Limited's (Kelda; HoldCo) Long-term Issuer Default Rating (IDR) at 'BB' and senior secured rating at 'BB+'. The Outlook on the Long-term IDR is Stable. A full list of rating actions on Kelda and its subsidiaries is available at the end of this commentary.

The affirmation reflects our expectation for Kelda group's weak dividend cover, which is mitigated by reduced structural subordination of Kelda's debt as a result of the deleveraging of its operating company Yorkshire Water Services Limited (Yorkshire Water; OpCo), the continued availability of the committed liquidity facilities, and adequate credit metrics in terms of leverage and post-maintenance and post-tax interest cover ratio.

The ratings also take into account the solid operational and regulatory performance of Yorkshire Water (see separate rating action commentary "Fitch Affirms Yorkshire Water's Senior Secured Debt at 'A/BBB+'; Outlook Stable" dated 04 July 2017 on www.fitchratings.com), the main operating subsidiary of the group, as well as the structurally and contractually subordinated nature of the holding company financing at the Kelda level.

KEY RATING DRIVERS

Deleveraging Weakens Dividend Cover

Fitch expects weaker dividend cover at the Kelda group as a result of the financial restructuring implemented by management at OpCo. We believe this will allow the company to retain more flexibility in its capital structure by reducing leverage and decrease financing costs, and should place the company in a better position to confront challenges rising from the price control starting in April 2020 (AMP7). In our view, the restriction on dividends upstreamed by OpCo is due to management's prudent approach to reducing leverage, as opposed to contractual or operational constraints; curtailed dividends from Kelda also mitigate increased debt service.

The forecast reduced leverage at OpCo is initially achieved through a cash injection comprising GBP195 million of proceeds from bank loans raised in May 2017 by the Kelda group, and by restricting dividend distributions from OpCo to the Kelda group. Unless the price review (PR19) outcome is anticipated to be sufficiently favourable, OpCo expects to upstream dividends to cover only Kelda group's debt service and inter-company loan payments to OpCo. In that case, no dividend distributions will be made from Kelda to its shareholders post-debt service.

Reliance Upon OpCo's Dividends

OpCo is the sole cash flow source for Kelda; therefore, Kelda and FinCo's debt service relies upon dividends from Yorkshire Water. OpCo's dividends could be constrained by higher-than-covenanted OpCo leverage, which is now a decreasing risk, low annual RPI used to index revenue, and the regulated asset value (thereby constraining debt capacity to pay dividends) and general cash flow demands such as capex. However, we do not currently envisage any of these factors will lead to constrain dividends.

Largely Adequate Credit Metrics

We forecast dividend cover to be below the agency's rating guidelines of 2.5x from 2018 to 2020. Although the incremental debt increases the consolidated leverage of the Kelda group, we expect it to reduce to below 85% by 2020 given the expected deleveraging at OpCo, which is in line with our rating guidelines. We forecast average post-maintenance and post-tax interest cover (PMICR) at around 1.2x for AMP6, which is slightly above our rating guidelines.

Reduced Subordination
In our opinion, the expected weak dividend cover is mitigated by the reduction in subordination of Kelda's bondholders' and shareholders' commitment to the restructuring. As Yorkshire Water leverage reduces, the subordination of Kelda's bondholders also reduces, as OpCo is further away from lock-up covenant levels. Kelda's bank debt and FinCo's guaranteed bondholders are subordinate to the rights of Yorkshire Water's bondholders. Additionally, OpCo's covenanted financing structure could limit the dividends it upstreams and there is a statutory (and contractual) limitation on the pledging of its assets to any creditors.

Incremental Debt at HoldCo
The GBP460 million of debt at the holding level represents less than 8% of RAV and incurs an annual finance charge of around GBP23 million. The reduced dividend stream from OpCo expected for the remainder of the price control will still allow servicing of the debt. Kelda group also has in place GBP30 million of committed undrawn liquidity facilities. We see modest refinancing risk presented by the maturity of the GBP200 million bond in February 2020 due to management's prudent approach in managing liquidity. We expect refinancing plans to be in place well in advance of the bond's maturity.

DERIVATION SUMMARY
Kelda is a holding company of Yorkshire Water Services Limited (Yorkshire Water; class A debt (A/Stable); class B debt (BBB+/Stable)), one of the regulated, monopoly provider for water and wastewater services in England and Wales. The higher rating compared to peers such as Greensands UK Limited (B+/Stable) and Kemble Water Finance Limited (BB-/Stable) reflects Yorkshire Water's better financial and regulatory performance. No Country Ceiling, constraints affect the rating. Parent/subsidiary Linkage is applicable but given the structural and contractual ring-fence structure of the group it does not impact the ratings.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for Yorkshire Water include:
- Regulated revenues in line with the final determination of tariffs for April 2015 to March 2020, ie assuming no material over- or under-recoveries
- Cumulative operating expenditure outperformance of GBP56 million in nominal terms over the five-year period
- Retail costs in line with allowances
- Non-regulated EBITDA of around GBP2.5 million per annum
- Retail price inflation of 3.1% for FY17, and 3% thereafter up to 2020
- Capex and Infrastructure renewal expenditure outperformance of GBP140 million in nominal terms over the five-year period.
- Around GBP2 million of EBITDA reduction per annum from FY18 as a result of the sale of the non-household retail business
- No outperformance related to Outcome Delivery Incentives as the company has deferred them to AMP7.

In addition, for Kelda Finance we assume:
- Incremental debt at holding company level to remain at GBP460 million.
- An annual finance charge at the holding company level of between GBP23 million-GBP25 million.

RATING SENSITIVITIES
Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Upside is limited unless Yorkshire Water and Kelda materially reduce regulatory gearing and dividend cover improves materially.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

- A material decline of dividend cover below 2.5x on a sustained basis due to operational underperformance while Yorkshire Water is continuing to retain dividends upstreamed to HoldCo to aid reduction of leverage at Yorkshire Water.
- Group gearing above 85% and PMICR below 1.1x on a sustained basis.
- A marked reduction in RPI on a sustained basis that may further reduced the dividend upstream from Yorkshire Water.
- Marked deterioration in operating and regulatory performance of Yorkshire Water or a material change in business risk of the UK water sector.
- Unavailability of the GBP30 million committed revolving credit facility.

LIQUIDITY
As of 31 March 2017, the holding company had available a GBP30 million undrawn, committed revolving credit facility with maturity in October 2022. The next debt maturity is GBP200 million in February 2020.

FULL LIST OF RATING ACTIONS
Kelda Finance (No.2) Limited
--Long-term IDR affirmed at 'BB', Stable Outlook
--Senior secured rating affirmed at 'BB+'
Kelda Finance (No.3) PLC
---GBP200 million bonds, 5.75%, February 2020, guaranteed by Kelda Finance (No. 2) Limited, senior secured rating affirmed at 'BB+'
Kelda Finance (No.3) PLC (FinCo) is the financing vehicle for Kelda, which guarantees the issued bonds together with its parent, Kelda Finance (No.1) Limited.

Contact:

Principal Analyst
Vincent Race
Analyst
+44 20 3530 1862

Supervisory Analyst
Victoria Munarriz
Associate Director
+44 20 3530 1419
Fitch Ratings Limited.
30 North Colonnade
London E14 5GN

Committee Chairperson
Josef Pospisil
Managing Director
+44 20 3530 1287

Summary of Financial Statement Adjustments -
- Consolidated EBITDA excludes exceptional operating costs relating to flooding event
- Consolidated Cash interest is adjusted to reflect pay-down provisions on some index-linked swaps
- Consolidated Debt and interest cost are adjusted to reconcile with the amounts published in the company's investor report

Media Relations: Adrian Simpson, London, Tel: 203 530, Email: adrian.simpson@fitchratings.com.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Criteria for Rating Non-Financial Corporates (pub. 10 Mar 2017)
https://www.fitchratings.com/site/re/895493
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)
https://www.fitchratings.com/site/re/886557