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Research Update:

U.K.-Based Yorkshire Water Financing Vehicle Kelda Finance (No.3) PLC 'BB-' Rating Affirmed; Outlook Stable

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Overview

- Kelda Finance (No.2) Ltd. (KF2), together with Kelda Finance (No.3) PLC (KF3)--both part of the Kelda Finance Group--have raised £195 million of debt, which has been injected into its regulated operating company, Yorkshire Water Services Ltd. (YWS). KF3's increase in leverage is mostly mitigated by the resulting improved headroom at Yorkshire Water, which reduces the risk of cash flow lockup for KF3. As a result, we view this transaction as broadly neutral for KF3's creditworthiness.
- We are therefore affirming our 'BB-' corporate credit rating on KF3. We are also affirming our 'BB-' issue rating on the £200 million guaranteed secured notes issued by KF3. The recovery rating remains '3', indicating recovery prospects of 50%-70%.
- The stable outlook on KF3 reflects our opinion that Kelda Finance Group will continue to receive ongoing sufficient dividends from YWS, and that YWS will maintain adequate headroom under its covenants to avoid any dividend lockup. The stable outlook also reflects KF3's retention of headroom under its financial covenants and maintenance of an adequate liquidity buffer.

Rating Action

On July 7, 2017, S&P Global Ratings affirmed its long-term corporate credit rating on U.K. water utility financing company Kelda Finance (No.3) PLC (KF3) at 'BB-'. The outlook is stable.

At the same time, we are affirming our 'BB-' issue ratings on KF3's guaranteed secured notes. The recovery rating on the notes remains '3', indicating our expectation of 50%-70% recovery prospects in the event of a payment default.

Rationale

The 'BB-' rating on the KF3 reflects the structural subordination of KF3 to the ring-fenced financing group (RFFG) around U.K.-based regulated utility Yorkshire Water Services (YWS). KF3 almost entirely depends on upstream distributions from YWS to service its own debt.

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

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.

KF3 exhibits strong stand-alone financial ratios even after the £195 million increase in leverage. Because the additional leverage improves YWS' headroom under its covenants since the proceeds have been downstreamed to YWS, potential cash flow available to Kelda is improving. We therefore continue to 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, which will 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 (starting in 2020). This is in order to preserve financial stability before the new cost of capital is known and integrated into the business plan.

The rating on KF3 is constrained by the risk of cash flow interruption. We expect YWS to sustain at least a 10% decline in EBITDA without breaching its dividend lockup financial covenants. However, we assess that YWS would breach the covenant in the hypothetical event of a 20% drop in EBITDA. This is unlikely to happen, however, given the strong regulatory framework in place and high predictability of future earnings.

We believe that KF3's creditors face liquidity risk, despite its £30 million 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.

In our view, the rating on KF3 is affected by refinancing risk because of the concentration of debt maturities, well above 20% in a single year. Despite better-spread maturities following the new debt issuance (£265 million due in 2020, £50 million due in 2024, and £145 million due in 2027), we continue to consider the concentration of maturities to be high.

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 period of next 12 months, starting from March 31, 2017.

Principal liquidity sources are:
- About £30 million of cash inflow from YWS;
- A £30 million undrawn RCF; and
- No forecast cash retention at Kelda Finance Group (including KF3 and Kelda Finance (No.2) Ltd. [KF2]).

Principal liquidity uses are:
- Dividend payments of £8 million from Kelda Finance Group to the ultimate equity holders; and
- Approximately £25 million of interest costs.

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.

We do not assess liquidity as stronger than adequate 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 of YWS to increase its dividend distributions.

We continue to expect Kelda to remain compliant with its covenant requirements:
- Total net debt to regulated capital value test set at 95%.
- Interest coverage (post maintenance capital expenditure) of 1.05x.

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 viewed liquidity as 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 KF2'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 KF2's £30 million RCF is no longer available, if a drawdown is outstanding, if the liquidity headroom narrows, 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.

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 debt volatile and sensitive to small changes in the debt and valuation in the event of a default, which limits the rating outcome. 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 lockup 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 12-18 months after the lockup 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.
- Nominal recovery prospects are 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 £509 million*
- --Recovery expectations: 50%-70%

*All debt amounts include six months' prepetition interest.

Related Criteria

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses , Feb. 24, 2016
- Criteria - Corporates - General: Methodology: Holding Companies That Own Corporate Securitizations And Structurally Enhanced Debt Transactions, Feb. 24, 2016
- Criteria - Corporates - Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Kelda Finance (No. 3) PLC	
Corporate Credit Rating	BB-/Stable/--
Senior Secured	BB-
Recovery Rating	3(65%)

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.