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Ratings

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Summary:
Kelda Finance (No. 3) PLC

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Summary:

Kelda Finance (No. 3) PLC

Issuer Credit Rating	BB-/Stable/--

Rationale

The 'BB-' rating on Kelda Finance No3 PLC (KF3), a holding company above the ring-fenced financing group (RFFG) around U.K.-based regulated water utility Yorkshire Water Services (YWS), reflects the fact that KF3 almost entirely depends on upstream distributions from YWS to service its own debt. 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. Our opinion is that cash flow payments from YWS can be stopped earlier and more easily than for standard corporate groups and, therefore, the rating on KF3 is four notches below YWS' subordinated stand-alone credit profile of 'bbb'.

YWS' primary activities are the treatment and distribution of water, as well as the collection and treatment of wastewater in the Yorkshire region. It serves roughly 5 million domestic customers and around 140,000 businesses. Based on its RCV of £6.4 billion at March 31, 2018, YWS is a midsized company water and sewage utility similar to Southern Water and Anglian Water but much smaller than other structurally enhanced transactions such as Thames Water.

Refinancing risk constraints the ratings given that the debt maturities are highly concentrated (well above 20% in a single year). The next bond maturity is the £200 million bond due in 2020. Furthermore, there is risk of cash-flow interruption--that is, in a hypothetical scenario if YWS' EBITDA falls 20% or more--it will have to stop dividend payments to KF3 because they will most likely breach their dividend lockup financial covenant. We consider this unlikely to happen given the strong regulatory framework in place and high predictability of future earnings. We expect YWS to continue the dividend flow to KF3 under the stress case of a 10% EBITDA decline.

In our experience, a holding company's liquidity is paramount for the continued debt service in case of interruption from the operating subsidiary. We view KF3's liquidity position as weaker than the closest rated peer, Southern Water (Greensands) Financing PLC. This is because its £30 million revolving credit facility is not mandated in the finance documents and contains a clean-down provision, which restricts its availability.

KF3 exhibits stronger stand-alone financial ratios given its lower leverage and cost of debt compared to Southern Water Greensands. Although it raised £195 million of additional debt in 2017, it was injected into the regulated operating company YWS. The increase in leverage at the KF3 level was mostly mitigated by the improved headroom under covenants at YWS, which reduces the risk of cash flow lockup for KF3. We expect that YWS will continue to distribute sufficient dividends to KF3 to cover the scheduled debt service payments. That said, we anticipate lower dividend payments in absolute terms in the next regulatory period AMP7 (2020-2025) given the U.K. water regulator Ofwat announcements that the cost of capital for the next regulatory period will be lower (from 3.6% to 2.8% in terms of average inflation). We will assess the impact of regulation on YWS once we have YWS' business plan in September

2018 and Ofwat's draft determination in 2019.

We view YWS as an insulated group from KF3 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.

Outlook

Our stable outlook on KF3 reflects our opinion that Kelda Finance Group will continue to receive forecasted 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 would be 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 revolving credit facility (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 rating upside 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.

Our Base-Case Scenario

Assumptions	**Key Metrics**

Assumptions

- Revenues, EBITDA, and senior and subordinated debt as per our forecasts for YWS financing group (see "Yorkshire Water Services Finance," published on RatingsDirect. Revenues are primarily driven by regulated increases rather than economic growth.
- Debt with Kelda group consists of £260 million floating rate debt and £200 million fixed rate debt.
- No dividend to ultimate shareholders until the end of the current regulatory period apart from what is due costs and loan payments by the holding companies outside the YWS financing group.

Key Metrics

	2018A	**2019E**	**2020E**
Debt to available cash flow (x)	0.7	0.8-1.2	0.5-1
Available cash flow to interest (x)	29.1	15-20	20-30

A--Actual. E--Estimate.

Company Description

Kelda Finance (No. 3) is a special purpose entity and a financing vehicle of Kelda Finance Group, which itself consists of:

- KF3, the issuer of £200 million fixed-rate guaranteed senior notes, which are on-loaned to Kelda Finance (No. 2) Ltd. (KF2);
- KF2, which is a holding company of its operating subsidiary (OpCo), a regulated water and wastewater company (WASC), Yorkshire Water Services Ltd. (YWS); and
- Kelda Finance (No. 1) Ltd (KF1), a holding company of KF2.

Business Risk

KF2 and KF1 provide an unconditional and irrevocable guarantee for KF3's obligations under the notes. We consider YWS to be a different group from KF3 for the reasons mentioned above.

A chart showing KF3' position within the RFFG can be found in the report "Yorkshire Water Services Finance."

Non-regulated activities are limited and are linked to Yorkshire Water's regulated activities. They remain outside the RFFG.

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 12 months from March 31, 2018.

Principal Liquidity Sources	Principal Liquidity Uses
• £28.6 million of cash inflow from YWS; • A £30 million undrawn RCF; and • No forecast cash retention at Kelda Finance Group including KF3 and KF2).	• No dividend payments from Kelda Finance Group to the ultimate equity holders; and • Approximately £25 million of interest costs.

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 helps it raise funds in the credit markets.

We do not assess liquidity as stronger than adequate due to the non-mandatory 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.

Covenants

We continue to expect Kelda to remain compliant with its covenant requirements:

- Total net debt to regulated capital value test set at 95%. It stood at 82.7% at March 31, 2018.
- Interest coverage (post maintenance capital expenditure) of 1.05x. It stood at 1.32x at March 31, 2018.

Issue Ratings--Recovery Analysis

- The recovery rating of '3' on the £200 million HoldCo senior secured bond is unchanged. Indicative recovery prospects on the notes, including the 2017 issues of £50 million and £145 million notes, are 50%-70% (rounded estimate 65%).
- The recovery prospects are highly sensitive to small changes in the RCV haircut, as well as the subordinated and essentially unsecured position of the notes in the capital structure.
- 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.
- In our default scenario (in which the default year is 2020) we envisage sufficient stress at the YWS level that would lead to a lock-up of cash flows, which we anticipate will occur in 2018. We then forecast a payment default at the YWS HoldCo level about 18 months after the lock-up at the YWS level, assuming that there is enough liquidity to service the debt during that period.
- In line with our previous analysis of closest peer Greensands (Southern Water), we do not account for the index-linked (IL) swaps because we consider that a third party buyer could adjust its purchase price on the company to take into account the mark-to-market liabilities on the IL swaps if sizeable and that the OpCo would not be

defaulting under our default scenario, meaning these liabilities would not be crystalized.

Simulated Default Assumptions

Year of default: 2020

Stressed regulated asset value at default: about £7.0 billion

Jurisdiction: U.K.

Simplified Waterfall

- Net value available to Kelda debtholders after administrative expenses: about £335 million
- Senior secured debt claims: about £500 million*
- --Recovery expectations: 30%-50%

*All debt amounts include six months' prepetition interest.

Related Criteria

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- General Criteria: Guarantee Criteria, Oct. 21, 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 - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- 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: 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