Research Update:

Kelda Finance (No. 3) Outlook Revised To Neg, 'BB-' Rating Affirmed; Yorkshire Water Services Issue Ratings Affirmed

May 31, 2019

Rating Action Overview

- With the next regulatory period set to begin in April 2020, operating company Yorkshire Water Finance Ltd. (YWS) is under pressure to reduce leverage given the introduction of the high leverage sharing mechanism by the regulator Ofwat. YWS continues to operate with relatively limited headroom above the levels we deem commensurate with the issue ratings on its debt.
- As we believe that YWS is committed to maintaining the current ratings on its debt, we see a possibility that YWS will benefit from a capital injection from Kelda Finance (No. 3) PLC (Kelda), the holding group above the ring-fenced structure, as YWS inferred in the updated business plan it submitted to the regulator in April 2019. The amount of the capital injection will only be decided when the draft and final determination published by Ofwat.
- Although this would protect the issue ratings on YWS's debt, hence the stable outlooks on those ratings, it could result in additional debt at the Kelda level.
- In addition, we believe that refinancing risk has heightened for Kelda, considering that it needs to repay its £200 million bonds maturing in February 2020.
- As a result, we are revising the outlook on Kelda to negative from stable. At the same time, we are affirming the 'BB-' long-term issuer credit rating on Kelda.
- We are also affirming the 'A-' issue rating on YWS's class A debt, the 'BBB' issue rating on its class B debt, and the 'AA' issue rating on the senior secured bonds issued by YWS and guaranteed by Assured Guaranty Europe PLC. The outlook on all these issue ratings is stable.
- The negative outlook on Kelda reflects the risk that leverage will increase if Kelda issues additional debt to finance cash injections. The outlook also reflects the risk of lower dividends from YWS to Kelda Group over the next regulatory period, given challenging conditions at the operating company.

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Rating Action Rationale

Kelda Finance (No. 2) PLC (Kelda) is the holding company of Yorkshire Water Services Ltd. (YWS). YWS benefits from structural enhancements designed to reduce the risk of nonpayment of scheduled debt service payments. These, in turn, increase the risk at the Kelda holding level, which almost entirely depends on upstream distributions from YWS to service its own debt.

The revision of the outlook to negative on Kelda reflects YWS's limited financial headroom at the current ratings. With the next regulatory period set to begin in April 2020, YWS is under pressure to reduce leverage given the introduction of the high leverage sharing mechanism by the regulator Ofwat, and improve its operational performance. This, in our view, might incentivize Kelda to increase its leverage to finance cash injections at YWS. Capital injections were mentioned as a potential way to enhance YWS's financial resilience and improve its future credit metrics in the revised business plan that YWS submitted to the regulator in April 2019. There is still a high level of uncertainty as to whether YWS's business plan will be executed in its updated form. Like other U.K. water companies that Ofwat has placed in the "slow-track" category, the draft and final determinations for YWS are scheduled for July 2019 and December 2019, respectively.

The negative outlook on Kelda also reflects execution risk concerning the refinancing that Kelda needs to complete over the next few months. In our experience, a holding company's liquidity is paramount for continued debt service in case of an interruption by the operating subsidiary. In our current base case, we nonetheless factor in Kelda's sound relationship with its banks and good business standing and its ability to achieve this refinancing in due course.

Currently, YWS operates with relatively limited headroom above the levels we deem commensurate with the issue ratings on its debt, namely, weighted average S&P Global Ratings-adjusted funds from operations (FFO) to total debt of 6% for the subordinated debt (class B) and of 7% for the senior debt (class A). This takes into account the updated business plan that YWS submitted to the regulator in April 2019.

The affirmation of the issue ratings on YWS' debt reflects our expectation that despite challenging conditions in the new regulatory period, the operating group will maintain credit metrics commensurate with the issue ratings.

As it stands, we believe that the proposed high-leverage mechanism as currently defined by Ofwat for companies with gearing above 70% will likely apply to YWS over the next regulatory period AMP7, running from April 2020 to March 2025. This is because its debt-to-regulatory capital value (RCV) ratio is hovering around 76%, limiting the prospects for future deleveraging and a dividend outflow without a cash injection from its parent.

OutlookOn Kelda

The negative outlook on Kelda reflects the risk that leverage may increase if Kelda issues additional debt to finance capital injections. The outlook also reflects our expectations for lower dividends over the next regulatory period in view of challenging conditions at the operating level. Finally, the negative outlook reflects growing refinancing risk regarding the £200 million bullet maturity in February 2020.

Downside scenario

We could take a negative rating action if Kelda's leverage increases, for example because the group issues debt to finance a capital injection in the operating company. A negative rating action could also occur if dividend distributions from YWS to Kelda were to decline materially, leading to pressure on Kelda's ability to meet its obligations.

Additionally, we would downgrade Kelda if it failed to make progress to refinance its £200 million bullet maturity in the coming months.

Upside scenario

We could revise the outlook to stable once we get more clarity on the future capital structure of the group, including any potential capital injection, and when Kelda has completed the refinancing of its £200 million bonds due in February 2020.

Outlook On YWS Group

Our view of the YWS group's underlying credit quality reflects our expectation that its sole U.K. water operating subsidiary, YWS, will generate stable cash flows from its regulated activities and maintain adequate operating performance. We also expect the YWS group to maintain weighted average adjusted FFO to total debt of at least 6% and weighted average adjusted FFO to senior (class A) debt of at least 7% for the next two years, which we deem commensurate with the issue ratings.

Downside scenario

We could lower the issue ratings on YWS's debt if we see weaker operating performance or reduced profitability causing credit metrics to fall below our guideline of adjusted FFO to debt of 7% based on the senior debt (class A) only, and of 6% based on the senior and the subordinated debt (class B). This could happen, for example, if the group does not achieve its planned operating and capital expenditure efficiencies, or if it fails to meet its regulatory targets.

Upside scenario

Due to the limited headroom in the credit ratios and the high leverage allowed under the finance documents, we consider an upgrade unlikely in the near term.

Liquidity

Kelda Finance (No. 3) PLC

We assess Kelda's liquidity as adequate, reflecting our forecast that Kelda's sources of liquidity will cover its uses by more than 1.2x over the six months from March 31, 2019.

Principal Liquidity Sources

- £37 million of cash inflow from YWS;
- A £30 million undrawn revolving credit facility (RCF); and

- No forecast cash retention at the Kelda financing group, including KF3 and KF2.

Principal Liquidity Uses:

- No dividend payments from the Kelda financing group to the ultimate equity holders; and
- Approximately £25 million of interest costs.

Yorkshire Water Finance Ltd.

We now assess YWS's liquidity position as adequate compared with strong previously, reflecting our view that YWS's liquidity resources will exceed its funding needs by 1.2x in the next 12 months. Over the 12 months from March 31, 2019, we expect:

Principal Liquidity Sources

- A cash balance of about £20 million as of March 31, 2019;
- FFO of about £423 million;
- A committed RCF, of which the unused portion is £235 million; and
- £350 million of debt issued in April 2019.

Principal Liquidity Uses:

- Our expectation of capital spending of approximately £460 million;
- A contractual debt repayment of £327 million; and
- Dividends of £37 million to service debt and external costs at the Kelda financing group.

Issue Ratings - Recovery Analysis

Key analytical factors

- The recovery rating of '3' on the £200 million holding company senior secured notes is unchanged. Indicative recovery prospects on the notes, including the 2017 issues of £50 million and £145 million, 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 line with our previous analysis of closest peer Greensands (Southern Water), we do not account for the index-linked (IL) swaps. This is 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 sizable, and that the operating company would not default under

our default scenario, meaning these liabilities would not materialize.

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: 50%-70%

*All debt amounts include six months' prepetition interest.

Ratings Score Snapshot

Yorkshire Water Services Finance Ltd.

Issuer Credit Rating A-/Stable

Business risk: Excellent

- Country risk: Low
- Industry risk: Very low
- Competitive position: Excellent

Financial risk: Significant

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

Structural enhancements (+1 notch)

Class B debt

Issue credit rating: BBB/Stable

- Business risk: Excellent
- Country risk: Low
- Industry risk: Very low
- Competitive position: Excellent
- Financial risk: Significant
- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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 Transaction Structure Methodology, Sept. 16, 2014

- Criteria - Corporates - Project Finance: Project Finance Framework 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
- 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

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Kelda Finance (No. 3) PLC		
Issuer Credit Rating	BB-/Negative/--	BB-/Stable/--
Ratings Affirmed		
Kelda Finance (No. 3) PLC		
Senior Secured	BB-	
Recovery Rating	3(65%)	
YW Services Ltd.		
Senior Secured	A-	
Yorkshire Water Finance Plc		
Senior Secured	A-	
Senior Secured	BBB	
Subordinated	BBB	
Yorkshire Water Services Finance Ltd.		
Senior Secured	A-	
Senior Secured	AA	

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.capitaliq.com. All ratings affected by this rating action can be found on 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.