BKK AS
Norway, Utilities

BBB+ STABLE

Corporate profile

BKK AS (BKK) is a Norwegian utility company, operating mainly in the southwestern part of Norway. The group's main activities are hydro power production and power distribution activities. It also offers broadband, district heating and other energy related services, and is a minority shareholder in several Norwegian utility companies. BKK Production generates around 7 TWh of hydro power annually, making it the fifth largest producer in Norway. The Distribution business has 200,000 customers and a grid network of more than 16,500 km. BKK is owned by 17 local municipalities (50.1%) and Statkraft (49.9%).

Key metrics

			Scope estimates	
Scope credit ratios	2016	2017	2018F	2019F
EBITDA/interest cover (x)	8.6x	9.2x	10.9x	10.6x
Scope-adjusted debt (SaD)/EBITDA	4.3x	4.2x	3.4x	3.2x
Scope-adjusted FFO/SaD	14.0 %	18.1 %	17.2 %	22.1 %
FOCF/SaD	3.0%	20.1%	8.2%	21.4%

Rating rationale

Scope Ratings assigns a corporate issuer rating of BBB+ to Norway-based BKK AS. The Outlook is Stable. Scope also assigns an S-2 short-term rating and a BBB+ long-term rating to the company's outstanding senior unsecured bonds.

BKK's business risk profile is positively influenced by its low-cost hydro power portfolio assets, above-average group profitability margins, its meaningful share of a power distribution business, as well as its direct and indirect diversification into power retail sales, telecommunications and district heating through its own and associated companies. Although most of BKK's main businesses are in a relatively small geographical area, Scope considers this to be mitigated by its monopolistic position in grid operations and secured utilisation of power generation assets. Scope notes BKK's exposure to a volatile power production segment, but also recognises its active hedging strategy which has helped to secure more stability in group profitability margins. Going forward, Scope expects BKK to grow both grid and power production segments, as the company is actively exploring potential structural transactions that could provide economy of scale and higher efficiency. BKK is already a minority shareholder in several associate companies (with a total book asset value of approximately NOK 5bn). Although no firm commitments have been made, Scope highlights potential event risk in the future, which could arise if a major transaction is entered into. Scope believes that management would prepare itself well in such event, and BKK has indicated its dedication to keeping its financial profile under control.

BKK's financial risk profile is improving, supported by the attainment of higher power prices, as well as recent asset divestitures (in particular the ongoing effects from the transfer of central grid assets to Statnett). Overall, we recognize that adjusted operating free cash flow has been positive, enabling the company to reduce its debt level and improve financial credit metrics over time. At present, the solid debt protection metrics are positive for BKK's overall financial risk profile, while its average Scope-adjusted leverage ratio, although improving, remains a constraint. Scope assesses BKK's liquidity as adequate, supported by good access to the bank and the bond market as well as

Ratings

Corporate ratings	BBB+
Outlook	Stable
Short-term rating	S-2
Senior unsecured rating	BBB+

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Related methodologies

European Utilities, January 2018

Government-Related Entity, July 2018

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sizeable liquid funds as of Q1 2018, which comfortably covers its planned investments and refinancing in the short term.

The BBB+ issuer rating on BKK reflects a standalone credit quality of BBB and a one-notch uplift based on Scope's assessment of the 17 Norwegian municipalities which act as one majority owner with both the willingness and ability (in accordance with Scope's Government Related Entity Methodology) to provide support if needed.

Outlook

The Stable Outlook reflects Scope's expectation that BKK's financial risk profile will prove more conservative than in the previous three years. The Outlook also assumes that BKK will continue to generate the majority of its EBITDA from its two main segments (hydropower production and distribution) and maintain its hedging strategy in power production.

The Outlook further reflects that BKK still has some major capex investment planned in the short term, counterbalanced by disposals and credit metrics which are expected to be more conservative than in previous years. We also assume that management will maintain its dedication to striving towards a healthy financial credit profile if it pursues an increased growth strategy. The rating outlook is also based on Scope's expectation that the combined majority of municipality owners will remain unchanged.

A positive rating action could be warranted if BKK continues its positive free cash flow generation after dividend payments and carries on deleveraging, resulting in improved financial credit metrics, e.g. Scope-adjusted debt (SaD)/EBITDA stabilising at around 3x on a sustainable basis.

A negative rating action would be possible if wholesale power prices achieved fell substantially, leading to negative free operating cash flow (FOCF) and weaker credit metrics, e.g. SaD/EBITDA of well above 4x on a sustainable basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Highly profitable and cost-efficient hydro power production, with assets located in a good geographical location with high precipitation • High group profitability margins vs peers, with active hedging strategy and meaningful share of distribution business stabilising volatility • Committed, long-term majority owners with clear willingness and capacity to provide support	• Relatively high exposure to the volatility in power prices • Still in a high investment period, which has historically put pressure on leverage • Somewhat lower average tenor and more front-loaded debt maturity profile than relevant peers

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Positive free cash flow after dividends leading to sustainable improved credit metrics (e.g. SaD/EBITDA stabilizing around 3x) • Increasing share of stable and more efficient grid businesses which could lead to better business risk profile rating	• Materially lower achieved wholesale power prices and reduced hedging that increases volatility • Sustainably weaker financial credit profile over time, e.g. negative FoCF and a SaD/EBITDA above 4x

Financial overview

			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018F**	**2019F**
EBITDA/interest cover (x)	8.6x	9.2x	10.9x	10.6x
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Scope-adjusted FFO/SaD	14.0 %	18.1 %	17.2 %	22.1 %
FOCF/SaD	3.0 %	20.1 %	8.2 %	21.4 %
Scope-adjusted EBITDA in NOK m				
EBITDA	2,428	2,187	2,611	2,459
Add: operating lease payments in respective year	0	0	0	0
Scope-adjusted EBITDA	2,428	2,187	2,611	2,459
Scope-adjusted funds from operations in NOK m				
EBITDA	2,428	2,187	2,611	2,459
Less: (net) cash interest per cash flow statement	-281	-238	-239	-231
Less: cash tax paid per cash flow statement	-449	-474	-1,060	-746
Add: depreciation component, operating leases	0	0	0	0
Add: other items	-246	176	230	230
Scope-adjusted funds from operations	1,452	1,651	1,542	1,712
Scope-adjusted debt in NOK m				
Reported gross financial debt	10,572	10,555	10,324	10,019
Less: cash, cash equivalents	-458	-1,815	-1,731	-2,637
Add: cash not accessible	29	1	0	0
Add: pension adjustment	240	370	370	370
Scope-adjusted debt	10,382	9,111	8,963	7,752

Business risk profile

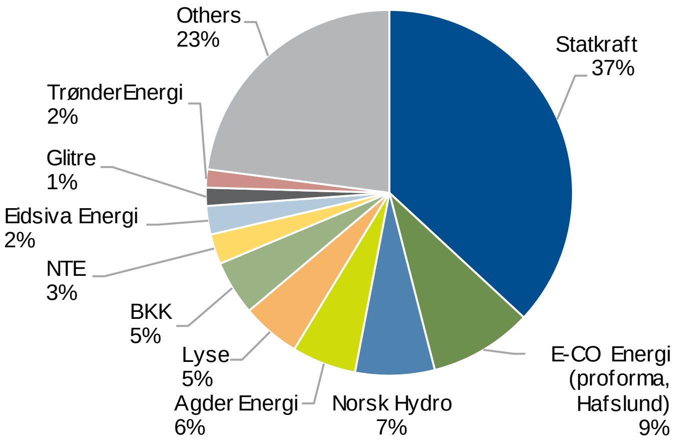
When assessing BKK's business risk profile, Scope analyses industry risk and competitive position separately, in accordance with our rating methodology for utilities.

Industry risk

Majority of EBITDA from power production

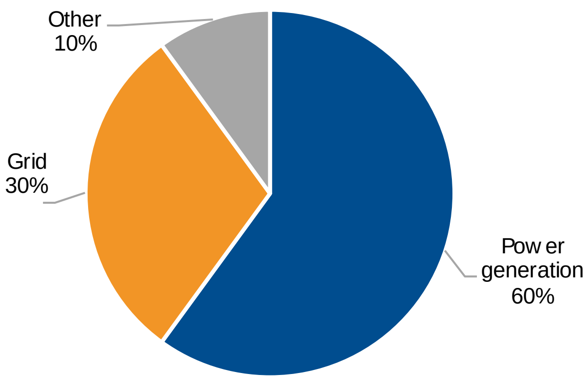
With BKK's EBITDA contribution mainly coming from power generation (approx. 60%) and the regulated grid (approx. 30%), these two segments largely dominate Scope's overall blended industry risk assessment of BBB for the company. In Scope's view, the European power generation market is generally characterised by highly cyclical features and medium entry barriers, while the regulated distribution business has low cyclicality and high entry barriers. In terms of BKK's district heating and telecommunications exposures as well as its shareholdings in other associate companies, Scope takes a neutral rating view with regard to the overall industry risk for BKK, but has assessed these businesses in more detail as part of its competitive position analysis.

Figure 1: Norway's main hydro generation companies



Source: Company reports, Statistics Norway (SSB), Scope

Figure 2: Normalised segment breakdown based on EBITDA



Source: BKK, Scope

Competitive position

Fifth largest hydro power generator in Norway…

BKK has a normalised production of about 7 TWh, which makes it the fifth largest power producer in Norway. It is, however, still relatively small in terms of the overall Nordic market. Nevertheless, we continue to highlight that size is not overly important when assessing the market position and credit quality of a hydro power utility. BKK's strong position within the merit order system, driven by the comparatively low marginal costs, is more important.

BKK's business risk profile is adequately supported by its access to hydro reservoir capacity, which covers around 45% of its average hydro production. This is not the highest among its Norwegian peer group, but is mitigated to some degree by BKK's geographical location in one of the highest precipitation areas in Norway. Thus, the risk of a very dry hydrological year is lower than for some peers.

…and second largest grid company

BKK's grid business contributes around 30% of EBITDA, serving 200,000 customers, split between private (55%) and corporate (45%) customers. As this monopoly business allows timely cost coverage, it is regarded as a robust cash flow source over time. Although we note that BKK scores lower on efficiency than some of its leading grid peers, cost-efficiency initiatives have been put in place and are currently giving positive effects.

Production and grid likely to grow larger

BKK's strategy is to grow, mainly in the production and distribution of renewable energy, with the aim to be among Norway's leading companies in these two fields.

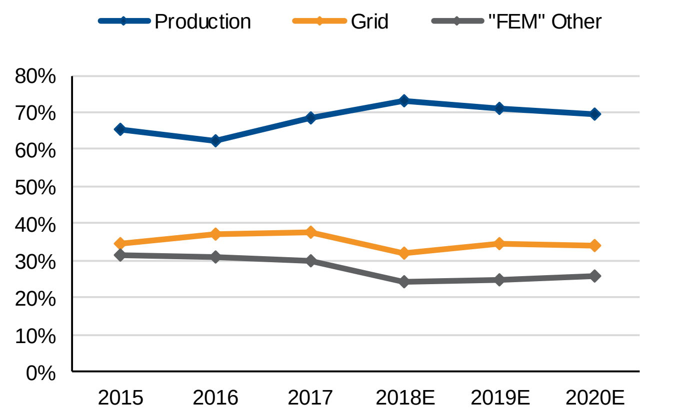
Lately, there have been small utility acquisitions (i.e. Tysnes and Etne), but we are also aware that larger strategic alliances through initiatives like Vestlandskraft are being discussed. These investments and potential structural transactions should provide economy of scale and higher efficiency, in Scope's view. We note that BKK is already a minority shareholder in several associate companies (with a total book asset value of approximately NOK 5bn), of which some could potentially be even closer partners. This could result in an evolving business profile structure with some event risk, but we believe that management is dedicated to keep its financial profile under control.

Diversification through associated companies and other utility-related businesses

Although Production and Distribution are the main segments, BKK has also indirectly diversified into power retail sales through its remaining holding in Fjordkraft (approx. 30%) and also into telecommunications and district heating through companies in its 'FEM' segment. The latter focuses more on the corporate market, while Fjordkraft concentrates on the retail market with approx. 1.3 million customers throughout Norway.

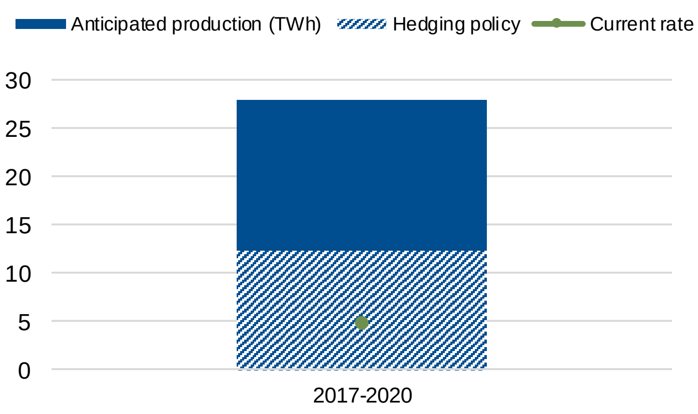
As BKK's main geographical focus is on Vestlandet in Norway for its production and distribution businesses, Scope considers its geographical diversification to be relatively limited. However, this is mitigated by its monopolistic position in grid operations and secured utilisation of power generation assets. With 28 fully owned hydro plants, Scope regards BKK's diversification within its power generation portfolio to be adequate, although we do note some concentration risk due the importance of the largest plants. The largest hydro power plant makes up approximately one-fifth of the group's annual production, while the three largest make up approximately 43% (combining their various assets/turbines).

Figure 3: EBITDA margin development per main segment



Source: BKK, Scope

Figure 4: Hedging policy for anticipated production 2017-2020



Source: BKK, Scope

Has achieved high group profitability margins without too much volatility

Fluctuating factors stemming from electricity generation volumes and achievable prices are present when assessing the overall profitability volatility of the BKK group. Nevertheless, we note that its active hedging strategy has been good for the overall group, combined with a healthy and stabilising grid business. Compared to peers, the BKK group is among the top Norwegian utility companies in terms of profitability – with an EBITDA margin of +/- 50% historically. Scope expects the EBITDA margin to stay in this range in the near term.

Active short-term hedging policy, with policy to stay within 0-44% of anticipated production volume in the next 48 months

In terms of the price and volume hedging of its hydro power production, BKK has a policy that opens up for 0-44% volume hedging of anticipated production in the next 48 months. At present, the group is at a rate of 17% for that entire period. In addition, starting in 2021, the company will enter into a bilateral agreement with Hydro, according to which it will deliver 500 GWh p.a. (7% of total production) from 2021 to 2030.

Financial risk profile

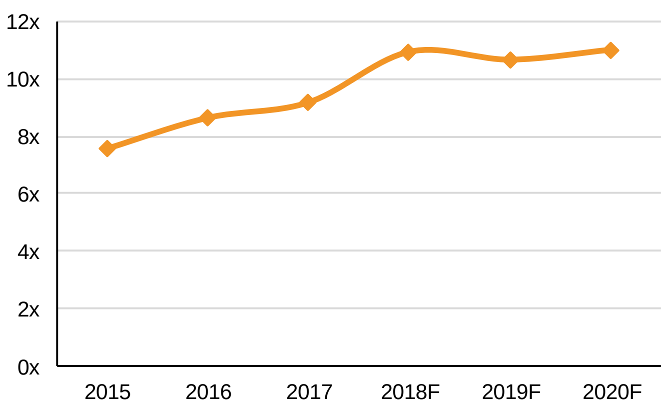
Gross capex affected by the ongoing Statnett – BKK agreement on central grid transfer

BKK is currently in a period of high investment, but has benefited from the improvement in power prices in recent years, allowing its leverage ratio to decline from the peak in 2015. Part of the recent high gross investment is related to the agreement signed between Statnett and BKK in 2016, in which BKK undertook to build new central grid network (Kollsnes – Mongstad – Modalen) for Statnett. The agreement also included the transfer of the central grid network owned by BKK, as new regulations only allow Statnett to own the central grid. The total value of the transaction is indicated in the NOK 4bn range, and affects the cash flow analysis for BKK between the financial years 2017-2019. In Q1 2018, the second part of this strategic transfer was completed, while the final transaction is expected to be carried out in 2019. Although BKK is compensated for its investments, it still needs to fund its commitments during the construction period. When completed, these exceptional cash flow movements will end, and the annual gross investment level in BKK will be reduced substantially.

Higher power prices together with asset sales & transfer have improved credit metrics

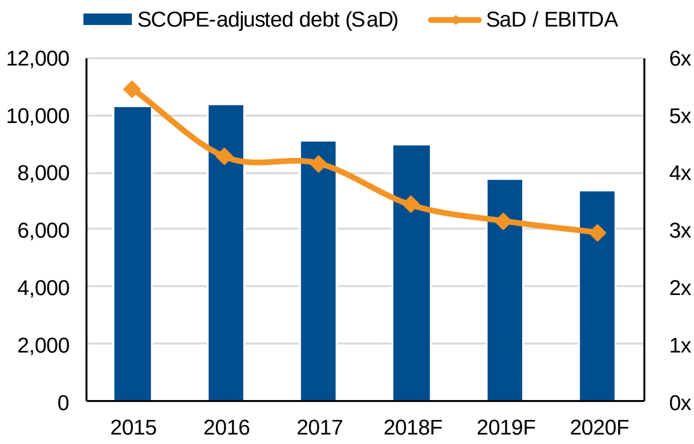
Scope recognises that the financial risk for BKK is limited in the agreement between Statnett. We have therefore focused on the net investment effects of this particular transaction in our assessment of BKK's financial risk profile. Overall, we acknowledge that adjusted FOCF has been positively lately, enabling the company to reduce its debt level and improve financial credit metrics over time. Currently, BKK's financial risk profile is supported by its solid debt protection metrics, while the 2016-2019 average Scope-adjusted leverage ratio remains a minor constraint. Looking beyond 2019 (i.e. subsequent to the final Statnett transaction), Scope sees the potential for further credit metrics improvement should the current forward power prices materialise.

Figure 5: EBITDA net interest coverage development



Source: BKK, Scope

Figure 6: Scope adjusted Debt / EBITDA



Source: BKK, Scope

Hydro power production unit to increase its EBITDA contribution in the short term

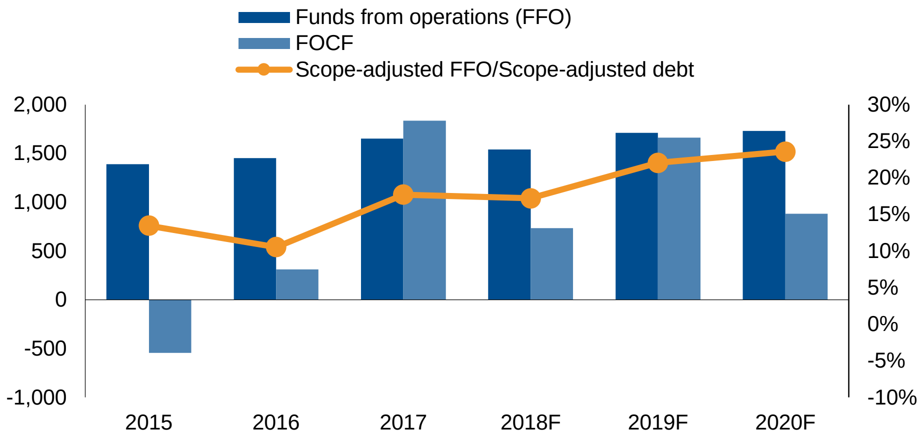
BKK's production business is the main profitability driver for the group. Still, we do see that the other businesses like district heating and telecom related services have acceptable margin and helps to diversify the profitability contribution to the overall group. Looking ahead, Scope's estimates indicate that the production unit will be an increasingly dominant profit driver during 2018, while the other businesses in BKK (collectively called FEM) and the grid business to gain some higher share of group EBITDA post 2019 again.

Stable and solid FFO, while FOCF shows volatility due to transactions

BKK has generated healthy and stable cash flows (defined as funds from operations) in the last few years and is expected to maintain this in the medium term. In addition to improved profitability and the Statnett transaction, the decline in debt levels as of Q1 2018 was also bolstered by the sale of shares in Fjordkraft following the IPO and the divestiture of Agua Imara to Norfund. Going further into 2018, capex levels this year are expected to be high due to the investment phase in the grid (in particular the central grid construction for Statnett). Thus, Scope expects the rapid de-leveraging to slow down towards YE 2018, but to reduce further when the final transfer to Statnett occurs in 2019.

Scope estimates that the BKK group will generate around NOK 1.7bn in running funds from operations (FFO) p.a. in a normal year following the completion of the Statnett deal. If we then assume NOK 0.8bn of investments p.a. for the group, Scope would expect BKK to have NOK 0.9bn available for debt repayment and dividends p.a. in the medium term. As a result, Scope notes that de-leveraging could continue, if the company does not use excess funds after dividend payment to pursue its growth ambitions. Scope has not included any potential mergers/acquisition investment in our forecast.

Figure 7: Cash flow development

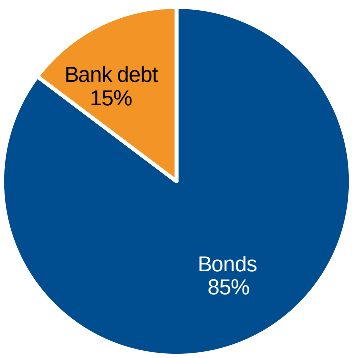


Source: Company, Scope estimates

Sufficient liquidity to cover upcoming demand

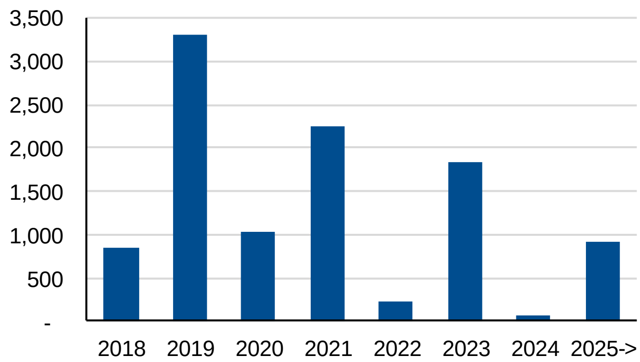
At the end of Q1 2018, the company had NOK 3.9bn in cash and NOK 1.5bn in undrawn credit lines, giving a total liquid position of NOK 5.4bn. This exceeds the NOK 2.6bn in short-term debt by a good margin. Although we know that the gross capex programme is material in 2018 and 2019, BKK has sufficient funds to cover it. Moreover, when assessing BKK's liquidity, Scope also notes the substantial value (approx. NOK 5bn) which its shares in associate companies provide. Although this figure is not included in liquid funds it gives the company flexibility with regard to its growth ambitions, by reducing the financial risk that potential mergers and acquisitions with other grid and production units might pose.

Figure 8: Funding structure, as of June 2018



Source: BKK, Scope

Figure 9: External debt maturity profile, as of June 2018



Source: BKK, Scope

S-2 short-term rating

In accordance with our rating methodology, all criteria justifying the assignment of an S-2 short-term rating for BKK are fully met.

Substantial amount of bonds issued on its own books

As seen in Figure 8, BKK is mainly funded through the domestic NOK bond market. The issuance mainly consists of 3 to 7-year maturities (in addition to money-market papers), but unlike most issuers, BKK holds a substantial part (currently around 60%) of its issued outstanding bond amount itself. Scope acknowledges the company's reasons for doing this, i.e. to increase liquidity, refinance though open market transactions and meet investor demands. Still, from a credit rating agency perspective, we still prefer even more evenly distributed and longer average debt maturity profile, given the long-dated asset profile. In summary, we assess BKK's liquidity as solid and deem refinancing risk to be minimal, supported by undrawn credit lines and better-than-average access to the Norwegian bond market at present, coupled with more than adequate liquid funds as of Q1 2018.

Supplementary rating drivers

Financial policy

Recent focus has been on improving financial risk profile and maintaining good access to loan market

Scope considers the group's financial strategy as neutral in our overall rating assessment. We do note that the company has the overall objective of ensuring that the group's risk profile should be reflected in a minimum credit rating of BBB+. With regard to financing policy, Scope would prefer a longer-dated maturity profile than the company has at present.

Ownership and parent support

One-notch rating uplift from BBK's standalone rating due to majority municipality owned structure

Although BKK does not have a single majority shareholder, we view the municipality shareholders as one, based on their collective strategy and interest in the company. The company's articles of association further set limits on who can own BKK and buy shares in the event of share transfers. The company's A shares can only be owned by municipalities or country municipalities in the region, while the C shares can only be owned by companies that are defined as 'government entities' in accordance with the industrial licensing act. These two share groups together represent two-thirds of the outstanding shares in BKK (i.e. as Statkraft owns the C shares), while the B shares are without ownership limits.

Uplift in line with new GRE Methodology and peers with similar ownership structure

We have used Scope's new GRE methodology to assign a one-notch uplift to BKK's standalone credit rating. The one-notch uplift to BKK for ownership is in line with other Scope-rated Norwegian utilities that have majority municipality ownership without explicit guarantees. Based on the new and more transparent GRE methodology, we assessed both the overall capacity and the likelihood of owners to provide support at 'medium', which included an evaluation of strategic importance, ease of substitution and default implications.

Scope has mainly focused on the municipality group and not Statkraft in this ownership assessment. Although Statkraft has been a supportive shareholder in BKK for a long time, we understand that the company is seeking to divest its shareholding at some point in time, in connection with the potential Vestlandkraft initiative or another structural transaction for BKK and its partners in Vestlandsalliansen for instance.

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