BKK AS
Norway, Utilities

SCOPE BBB+ STABLE

Corporate profile

BKK AS is a Norwegian utility company, operating mainly in the southwestern part of Norway. The group's main activities are hydropower production and power distribution. It also offers broadband, district heating and other energy related services, and is a minority shareholder in several Norwegian utility companies. Historically, BKK Production has generated around 7 TWh of power annually, while the Distribution business has more than 200,000 customers. As of June 2019, BKK is owned by 17 local municipalities (50.1%), Statkraft (47.9%), Tysnes Kraftlag (1.7%) and Etne Elektrisitetslag (0.3%). Following the Sunnfjord and Kvinnherad transactions, Statkraft's ownership share is expected to decline to around 44%, while the municipalities will own approx. 54%.

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	9.2x	15.5x	13.0x	12.8x
Scope-adjusted debt (SaD)/EBITDA	4.2x	2.9x	3.3x	3.2x
Scope-adjusted FFO/SaD	18.1 %	28.4 %	19.3 %	20.8 %
Free operating cash flow (FOCF)/SaD	20.0%	12.6%	15.6%	6.1%

Rating rationale

Scope Ratings affirms its BBB+ issuer rating on BKK, as well as its S-2 short-term rating and BBB+ senior unsecured rating. The Outlook is Stable.

The issuer rating continues to be supported by BKK's business risk profile which includes low-cost hydropower portfolio assets, a meaningful share of a power distribution business and above-average group profitability margins for a vertically integrated utility company. BKK's business risk profile is also supported by its diversification into power retail sales through its remaining holding in Fjordkraft (approx. 15%) and also into telecommunications and district heating through companies in its 'FEM' segment.

Following the latest merger between BKK and Sunnfjord Energi, BKK's reported amount of minority shareholdings is reduced. Still, with several other associated companies left on BKK's balance sheet (almost NOK 5bn), we anticipate that the company will continue to explore even larger structural transactions in the near future. Although no firm commitments have been made, we see potential event risk in the future. However, the current ratings have some headroom, given improved operating cash flow and the final payment of the Statnett transaction which is expected at the end of this year.

Over the last twelve months, BKK's financial risk profile has continued to improve, with its average leverage ratio (two-year historic and two-year forward looking) declining from 3.8x to 3.4x. We recognise that the pressure on BKK's financial risk profile is positive given the lower leverage at present, but are waiting for more evidence that leverage will stay below 3x due to the company's growth ambitions towards 2020. We have considered the company's greater exposure to power price changes than some of its peers (lower hedging), but this does not affect our assessment materially. We still deem the liquidity situation adequate at the moment, when comparing available cash and undrawn credit lines to debt maturities. However, we note that BKK has a somewhat lower-than-average debt tenor and a more front-loaded debt maturity profile than some of its relevant peers.

Ratings & Outlook

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

Lead Analyst

Henrik Blymke
+47 21 62 31 41
h.blymke@scoperatings.com

Related methodologies and research:

European Utility Methodology, March 2019

Corporate Rating Methodology, March 2019

Government Related Entities Methodology, July 2018

Scope assigns BBB+ issuer rating to BKK AS, August 2018

Scope Ratings GmbH

Haakon VII´s gate 6
N-0161 Oslo

Headquarters

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Outlook

The Stable Outlook reflects our expectation that BKK's financial risk profile will continue to be supported by good interest cover, positive free operating cash flow generation and leverage ratios at more conservative levels than in the past. The Outlook also reflects the fact that BKK currently generates two-thirds of its EBITDA from hydropower production, continues to be engaged in power distribution and maintains its hedging policy in the power production unit.

The Outlook further reflects management's continued commitment to attaining a healthy financial credit profile when pursuing an increased growth strategy. The Outlook also incorporates our expectation of continued majority ownership by the combined municipalities.

A positive rating action could be warranted if BKK continues its positive free cash flow generation after dividend payments and carries on deleveraging without negatively affecting potential expansionary growth ambitions, resulting in sustainably lower financial credit metrics than in the past, e.g. average Scope-adjusted debt (SaD)/EBITDA of 3x.

A negative rating action could be warranted by a major debt-financed acquisition/merger or substantially lower wholesale power prices, leading to negative free operating cash flow (FOCF) and weaker credit metrics, e.g. SaD/EBITDA of well above 4x on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Highly profitable and cost-efficient hydropower 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 municipality owners, with willingness and capacity to provide support	• Relatively high exposure to the volatility in power prices • Still in a high investment period and clear ambitions to take part in acquisitions and mergers to grow production and grid business • Somewhat lower average tenor and more front-loaded debt maturity profile than some relevant peers

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Positive discretionary cash flow leading to sustainable improvement in credit metrics (e.g. SaD/EBITDA stabilising at 3x or lower for a sustained period) • Increasing share of stable and more efficient grid businesses, which could lead to better business risk profile rating	• Materially lower wholesale power prices and reduced hedging that increases volatility • Sustainably weaker financial credit profile over time, e.g. negative FOCF and SaD/EBITDA well above 4x.

Financial overview

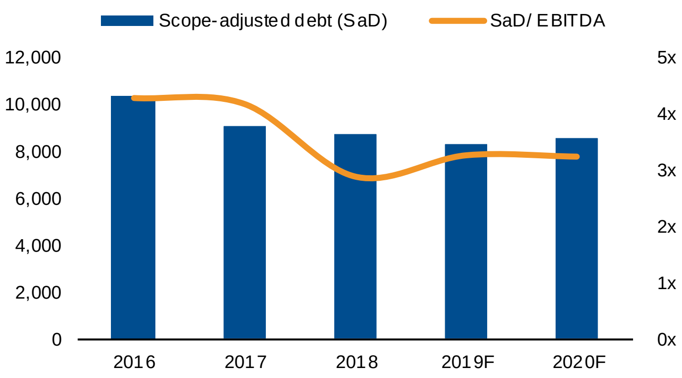
			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	9.2x	15.5x	13.0x	12.8x
SaD/EBITDA	4.2x	2.9x	3.3x	3.2x
Scope-adjusted FFO/SaD	18.1 %	28.4 %	19.3 %	20.8 %
FOCF/SaD	20.0%	12.6%	15.6%	6.1%
Scope-adjusted EBITDA in NOK m				
EBITDA	2,187	3,056	2,544	2,644
Add: operating lease payments in respective year	8	8	10	15
Scope-adjusted EBITDA	**2,195**	**3,064**	**2,554**	**2,659**
Scope-adjusted funds from operations in NOK m				
EBITDA	2,187	3,056	2,544	2,644
Less: (net) cash interest per cash flow statement	-238	-195	-193	-200
Less: cash tax paid per cash flow statement	-474	-534	-1,172	-942
Add: depreciation component, operating leases	7	6	6	8
Add: other items (incl. dividends from associated companies)	176	175	420	275
Scope-adjusted funds from operations	**1,658**	**2,508**	**1,605**	**1,786**
Scope-adjusted debt in NOK m				
Reported gross financial debt	10,555	10,065	9,343	9,418
Less: cash, cash equivalents	-1,815	-1,618	-1,471	-1,304
Add: cash not accessible	1	4	2	2
Add: pension adjustment	370	335	335	335
Add: operating lease obligations	40	41	116	154
Scope-adjusted debt	**9,151**	**8,826**	**8,324**	**8,605**
Liquidity				
Liquidity (internal and external)	1.9	2.0	1.2	2.5
Total available liquidity in NOK m	4,814	3,114	2,971	2,804

Operational developments since our previous rating report

Largest differences in hydropower segment

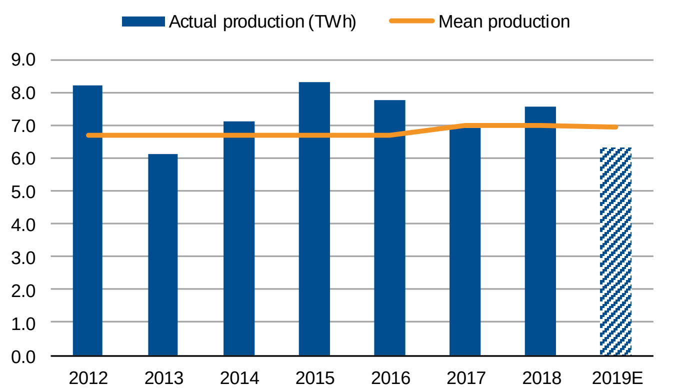
During 2018, BKK's financial risk profile improved and exceeded our expectations slightly, supported by higher power prices and hydropower production levels. With respect to the latter, 2018 was a volatile hydrological year, with record low precipitation levels in the summer and record highs during the autumn in BKK's production area. So far in 2019, the financial situation is still supported by the relatively high power price achieved, but the produced volume is down, and expected to be approximately 10% lower than in 2018. The distribution business and the other segments have developed more or less in line with our expectations.

Figure 1: Scope-adjusted leverage development (NOK m)



Source: Scope estimates

Figure 2: Hydropower production levels (in TWh)



Source: Scope, Company

Capex coverage is more than adequate

Even if BKK is still in an investment phase this year, with relatively high capex spending and additional cash outflow relating to the funding of the Sunnfjord Energi merger, we expect net cash flow (after dividend payments) available for debt repayment to be positive this year. This is because we expect the cash inflow from the Statnett transaction at the end of 2019 to help reduce net debt.

We assess BKK's liquidity as adequate despite rather high shorter-term debt maturities. At Q1 2019, the group had more than NOK 5bn in cash and undrawn credit lines compared to NOK 3.4bn in short-term debt. In addition, BKK's liquidity is supported by good access to banks and the domestic bond market.

Updated forecast

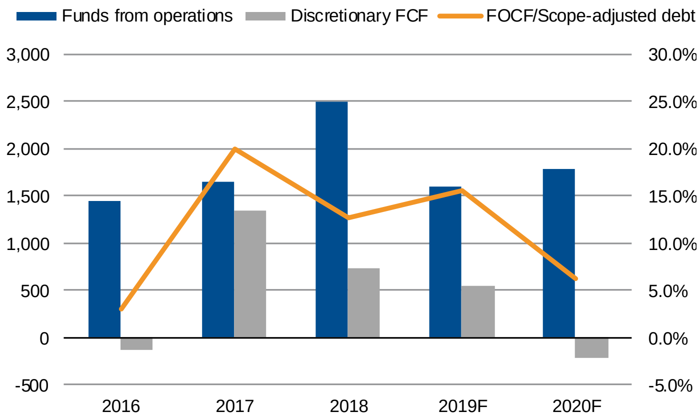
Leverage to increase, but not as much as we anticipated last year

We have updated BKK's financial performance forecast with new estimates for power prices and anticipated volume, which are the main factors that differed from our previous forecast. BKK's other business segments have also been updated, but are seeing smaller changes. Overall, we expect group credit metrics in 2019 to be weaker than in 2018, but still largely in line with our expectations last year.

Separately, we foresee increased event risk for BKK, due to its growth ambitions which include active participation in potential mergers and transactions in the Norwegian utility market. At present, our projections do not include any such major transactions, but we have incorporated Kvinnherad and Sunnfjord into our 2019 numbers.

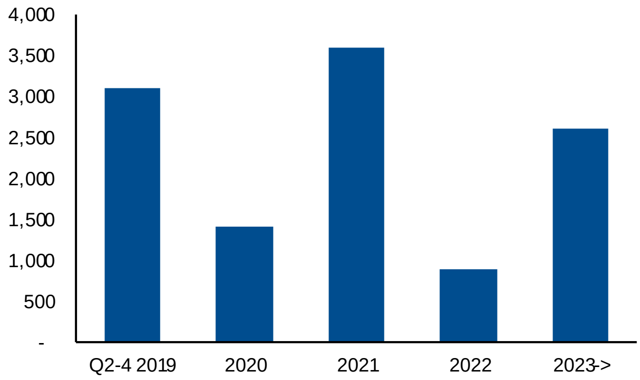
In order to reach its ambition of generating 10 TWh in 2020, the company still needs to add around 2.5 TWh of annual power generation to its portfolio (following the Sunnfjord transaction). We consider BKK's objective of more than doubling its power distribution customers by 2025 to be even more ambitious. However, more important than the actual figures here is the company's ambition to play a key role in the ongoing consolidation of the Norwegian utility industry, rather than focusing on reducing debt levels to a very conservative level. At the same time, BKK's prudent financial policy and current headroom mean that more aggressive growth should not overly jeopardise its financial profile rating.

Figure 3: Cash flow development (NOK m on LHS)



Source: Scope estimates

Figure 4: Debt maturity profile, as Q1 2019 (NOK m)



Source: Scope, Company

Summary of business and financial risk profiles

Overall there is no change in our business risk profile assessment of BBB+, which is supported by factors including BKK's high profitability and efficiency. We still see BKK's financial risk profile, assessed at BBB, as slightly weaker than its business risk profile. However, we recognise that there has been positive rating pressure on the financial risk profile lately. This positive pressure is constrained by our updated 2020 projections that show negative free cash flow after dividend payments and slightly higher leverage ratios than at present, coupled with the likelihood of further transactions in the short-to-medium term due to the company's growth ambitions.

Supplementary rating drivers

We have used our Government Related Entities methodology (bottom-up approach) to analyse BKK's parent support. The one notch-uplift assigned for majority municipality ownership of the company has not changed.

Short-term rating

We continue to assess the company's overall liquidity as adequate which justifies an affirmation of our S-2 short-term rating, in accordance with our methodology.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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