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 company'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 almost 250,000 customers. BKK is owned by 17 local municipalities (54.6%), Statkraft (43.4%), Tysnes Kraftlag (1.7%) and Etne Elektrisitetslag (0.35%).

Key metrics

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	15.5x	10.5x	7.6x	10.2x
Scope-adjusted debt (SaD)/EBITDA	2.9x	4.2x	5.3x	3.8x
Scope-adjusted FFO/SaD	28.4 %	8.8 %	11.1 %	21.3 %
FOCF/SaD	12.6%	21.9%	5.1%	6.9%

Rating rationale

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

The issuer rating continues to be supported by BKK’s business risk profile which includes low-cost, environmentally-friendly 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 telecommunications and district heating through companies in its ‘FEM’ segment. Furthermore, several associated companies on BKK’s balance sheet (almost NOK 4.5bn) provide a significant dividend contribution.

BKK’s financial risk profile is under some negative pressure at the moment. The EBITDA contribution from its monopolistic distribution segment and power production hedging has somewhat mitigated the underperformance of its hydro power segment this year. However, BKK’s leverage ratio is expected to spike in 2020 to above 5x due to the low-price environment for electricity in the region, returning to below 4x next year. Even if EBITDA is clearly affected, cash flow metrics remain healthy, helped by the Fjordkraft shareholding reduction in early July 2020, which generated around NOK 0.6bn in proceeds. Free operating cash flow (FOCF) thus remains positive and is not expected to move into negative territory in the medium term.

The liquidity situation is adequate if we compare available cash and undrawn credit lines (NOK 2.8bn) to short-term debt maturities (NOK 2.1bn) at Q1 2020. Nevertheless, 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 rating	BBB+/Stable
Short-term rating	S-2
Senior unsecured rating	BBB+

Analysts

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

Related Methodology

Corporate Rating Methodology, Feb 2020

Rating Methodology European Utilities, Mar 2020

Government Related Entities Methodology, Jul 2020

Scope Ratings GmbH

Haakon VII´s gate 6
N-0161 Oslo

Phone +47 21 623142

Headquarters

Lennéstraße 5
10785 Berlin

Phone +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 and positive FOCF generation, which will mitigate the temporarily spike in leverage in 2020. The recent disposal of the shares in Fjordkraft show that management is dedicated to preserving capital and increasing liquidity in a situation with a lower cash contribution from hydro power generation.

The Outlook further reflects our expectation that management will defer its previously increased growth ambitions for a while, focusing mainly on attaining a healthy financial credit profile in the short term. The Outlook also incorporates our expectation of continued majority ownership by the combined municipalities, and that dividend payments will be re-examined next year.

A positive rating action in the current environment is more unlikely, but could be warranted if BKK generates positive discretionary cash flow and deleverages, resulting in lower financial credit metrics, e.g. average Scope-adjusted debt (SaD)/EBITDA of 3x on a sustained basis.

A negative rating action could be warranted by substantially lower wholesale power prices, leading to negative 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
• Very profitable and cost-efficient hydropower production, with assets located in 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 large exposure to volatility in power prices • Ambitious investment plans, including 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 • Sustained weaker financial credit profile over time, e.g. negative FOCF and SaD/EBITDA well above 4x.

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	15.5x	10.5x	7.6x	10.2x
SaD/EBITDA	2.9x	4.2x	5.3x	3.8x
Scope-adjusted FFO/SaD	28.4 %	8.8 %	11.1 %	21.3 %
FOCF/SaD	12.6%	21.9%	5.1%	6.9%
Scope-adjusted EBITDA in NOK m				
EBITDA	3,056	2,254	1,820	2,397
Add: operating lease payments in respective year	8	-	-	-
Scope-adjusted EBITDA	**3,064**	**2,254**	**1,820**	**2,397**
Scope-adjusted funds from operations in NOK m				
EBITDA	3,056	2,254	1,820	2,397
Less: (net) cash interest per cash flow statement	-195	-214	-238	-234
Less: cash tax paid per cash flow statement	-534	-1,128	-674	-360
Add: depreciation component, operating leases	6	-	-	-
Add: other items (incl. dividends from associated companies)	175	-78	150	150
Scope-adjusted funds from operations	**2,508**	**834**	**1,058**	**1,953**
Scope-adjusted debt in NOK m				
Reported gross financial debt	10,065	10,515	10,865	10,702
Less: cash, cash equivalents	-1,618	-1,289	-1,522	-1,758
Add: cash not accessible	4	2	2	2
Add: pension adjustment	335	218	218	218
Add: operating lease obligations	41	-	-	-
Scope-adjusted debt	**8,826**	**9,446**	**9,563**	**9,164**
Liquidity				
Liquidity (internal and external)	2.0	1.4	2.0	1.2
Total available liquidity in NOK m	3,114	2,789	3,022	3,258

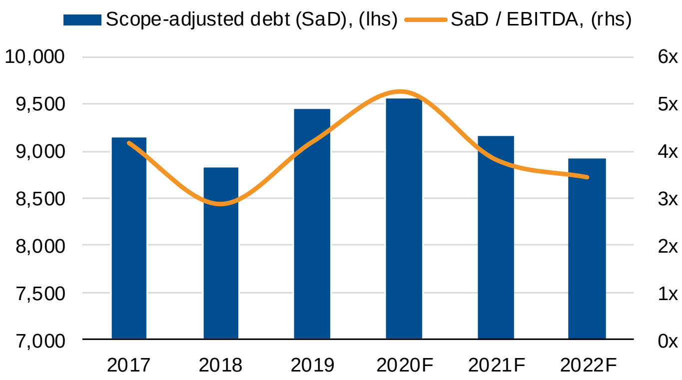
Operational developments since our last rating report

Hydropower contribution less dominant this year

BKK's full year 2019 results were slightly below our expectations, mainly due to lower hydropower generation output. This resulted in slightly higher leverage than expected. So far in 2020, leverage continues to be burdened by the significantly lower power prices achieved this year. The pressure on Nordic power prices stems from the significant hydrological surplus in Norway caused by high snow/water reservoirs. Although BKK's hedging activities have made a positive contribution to achieved prices in 2020 compared to spot prices, the forward price curve for 2021 is also coming down.

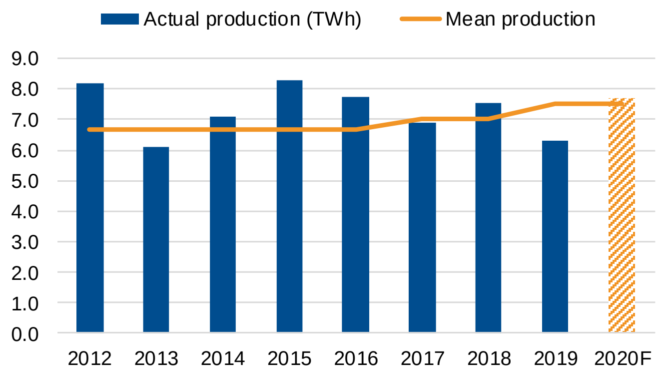
We expect the company to produce more hydropower electricity in 2020 (7.7TWh) than in 2019 (5.9TWh). However, we assume that the overall profitability margin will be weaker, and thus the greater volume will not compensate for lower prices. On the other hand, BKK's monopolistic distribution business is likely to increase going forward, and the normalised EBITDA contrition from this segment should be around 30% (up 5 pp from our previous assumptions).

Figure 1: Scope-adjusted debt (NOK m) and leverage (x)



Source: Scope estimates

Figure 2: Hydro-power production level (in TWh)



Source: Scope, company

Although BKK has been in an investment phase and has growth ambitions, it has been able to generate positive FOCF each year lately and is expected to continue to do so in the medium term. This year, the NOK 600m Fjordkraft share disposal helped FOCF, demonstrating the company's opportunistic approach to holding/disposing of shares.

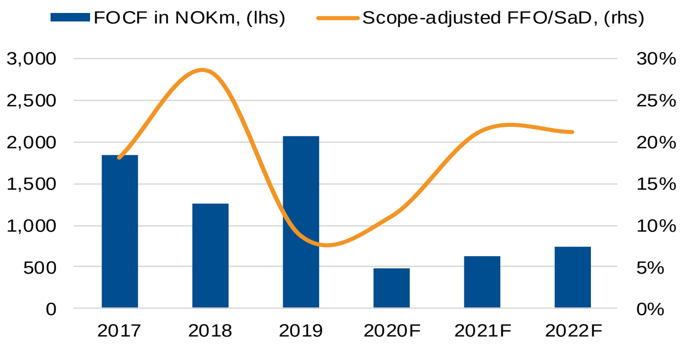
We assess BKK's liquidity as adequate despite rather high short-term debt maturities. At Q1 2019, the company had more than NOK 2.8bn in cash and undrawn credit lines compared to NOK 2.1bn in short-term debt. In addition, BKK's liquidity is supported by good access to banks and the domestic bond market. Our liquidity assessment takes into the account the 'hidden' value of its associate companies (NOK 4.5bn), which provide relatively attractive shares should BKK need/want to sell them.

Updated Scope forecast

We have updated BKK's financial performance forecast with new estimates for power prices and anticipated volumes, which are the main factors that differ in our previous forecast. BKK's other business segments have also been updated but are seeing smaller changes. Overall, we expect selected credit metrics in 2020 to be weaker than in 2019, with cash flow measures remaining positive.

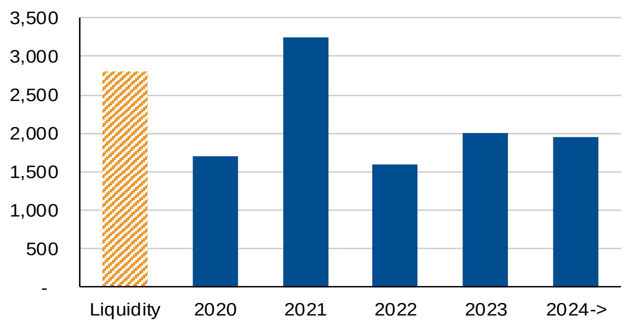
We foresee reduced event risk for BKK in the short term, as its growth ambitions (which include active participation in potential mergers and transactions in the Norwegian utility market) are deemed less likely to happen at the moment, than we anticipated last year. However, we believe that further grid efficiency and growth can be achieved in transactions without impacting the company's capital structure materially.

Figure 3: Cash flow development



Source: Scope estimates

Figure 4: Liquidity and debt maturity, at mid-2020 (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 average profitability and efficiency. We see BKK's financial risk profile as weaker than its business risk profile and note that it has deteriorated in the last twelve months. Thus, some negative rating pressure on the financial risk profile persists, mainly driven by higher leverage. Still, the company's record of delivering positive FOCF over the cycle provides comfort that its financial risk profile should return to less aggressive levels in 2021 based on the latest power price forward curves. BKK's possession of substantial liquid reserves in its associated company holdings also enables us to maintain the current issuer rating.

Supplementary rating drivers

We used our bottom-up approach to analyse BKK's parent support based on our Government Related Entity Methodology. The one notch-uplift assigned for the 54.6% municipality ownership in BKK has not changed. Thus, the issuer rating remains at BBB+, based on a standalone rating of BBB and a one-notch uplift for parent support.

We make no adjustment for financial policy. However, management publicly announced to its owners in late June this year that the dividend ratio for 2020 could be set below the policy of 70% in order to address the low-price environment and preserve the company's capital structure. We have incorporated this into our financial forecast, which positively affects credit ratios and our financial risk assessment.

Long-term and short-term debt ratings

The senior unsecured rating is in line with the issuer rating. The S-2 short-term rating reflects the company's sufficient short-term debt coverage and good access to banks and debt capital markets.

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

23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

London

3rd Floor
111 Buckingham Palace Road
UK-London SW1W 0SR

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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