S&P Global
Ratings

Research

Summary:
MDU Resources Group Inc.

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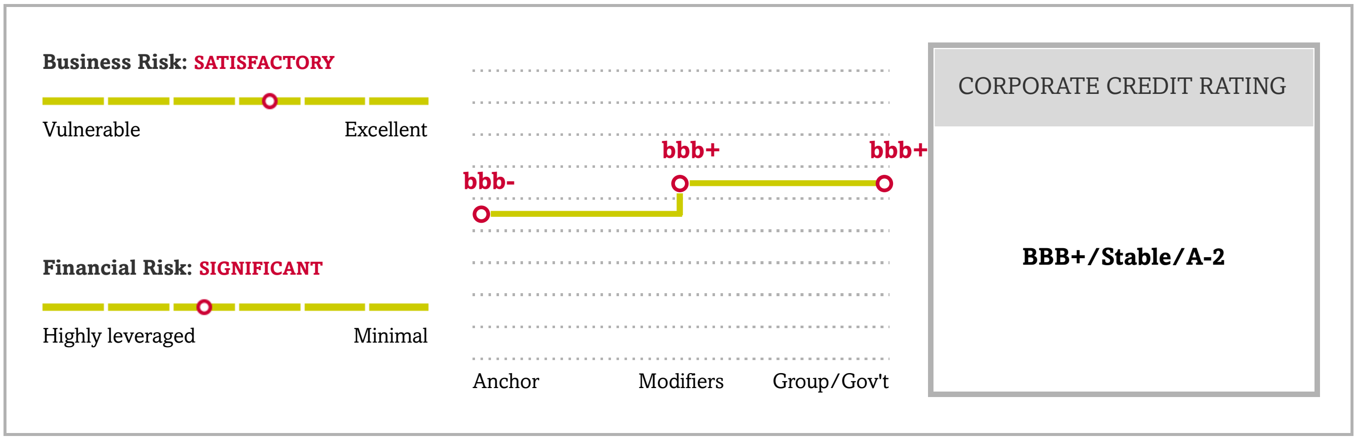

Rationale

Business Risk: Satisfactory	Financial Risk: Significant
• Slightly over half of operations in regulated utility and pipeline activities, with the remainder in the higher-risk construction materials and construction services businesses; • Effective management of regulatory risk at the utility level; and • Solid geographic and business diversity, with utility operations across eight states, construction material operations across 15 states, and construction services operations in a variety of markets across the U.S.	• Financial ratios measured against more-moderate benchmarks, because of our forward-looking view that lower-risk regulated utility and pipeline operations will consistently account for more than 50% of the consolidated company; • We expect financial measures to consistently reflect the higher half of the range for the financial risk category; and • Rising capital spending in 2018 at the company's regulated utilities.

Outlook: Stable

The stable outlook on Bismarck, N.D.-based MDU Resources Group Inc. reflects S&P Global Ratings' expectation that the regulated businesses will consistently remain above 50% of the consolidated company. The base-case forecast assumes that funds from operations (FFO) to debt will approximate 19%-21%.

Downside scenario

We could lower the ratings if the relative size of the regulated business drops to below 50% of consolidated MDU, or if FFO to debt weakens to the lower end of the range for the significant financial risk profile category, reflecting FFO to debt consistently below 15%.

Upside scenario

We could upgrade MDU if FFO to debt consistently improved to above 23% and the company were to maintain the size of the regulated businesses at more than 50% of consolidated MDU. This could occur if the company further improves the gross margins at its regulated businesses through better rate case outcomes and simultaneously has higher-than-expected growth at its construction materials business while the regulated businesses remain greater than 50% of the company.

Our Base-Case Scenario

Assumptions

- Continued use of existing regulatory mechanisms;
- Capital spending averaging about $465 million annually;
- Most capital spending is at the regulated utilities;
- Stable utility customer growth of about 1% annually;
- Dividend payments of more than $150 million annually; and
- Negative discretionary cash flow.

Key Metrics

	2016A	2017E	2018E
FFO to dept (%)	22.2	18-22	20-24
Debt to EBITDA (x)	3.2	3.0-3.5	3.0-3.5
FFO cash interest coverage (x)	6.9	6.0-7.0	7.0-8.0

A-Actual. E-Estimate. FFO- Funds from operations.

Business Risk: Satisfactory

Our assessment of MDU's business risk incorporates our combined view of its various businesses. Although the company has lower-risk regulated utility operations, the significant contributions from the more cyclical construction materials and construction services businesses weaken the company's business risk profile. MDU's four primary business segments consist of regulated utilities (40%), regulated pipelines (11%), construction materials (38%), and construction services (11%).

MDU's regulated utilities span across North Dakota, Idaho, Washington, Montana, South Dakota, Oregon, Wyoming, and Minnesota and serve about 145,000 electric and 925,000 natural gas customers. MDU demonstrates effective management of regulatory risk comparable to peers, and utilizes numerous tariff-setting mechanisms reducing regulatory lag, such as fuel and purchased power adjustments, various riders, rate cases, and decoupling. Following the sale of the Pronghorn natural gas processing plant at the end of 2016, the company's gas midstream operations consist entirely of lower-risk regulated pipelines, modestly diminishing the company's business risk.

Increasing the business risk at the company are the construction materials (Knife River) and construction services business segments. We view the passage of the federal five-year highway bill in 2015 and the need for infrastructure spending in the U.S. as potentially beneficial for the growth of Knife River's business. However, the incremental cyclicality and risk of the two businesses are higher than that of a pure-play regulated utility because the businesses are more susceptible to competition, pricing, and business cycles. Overall, we assess the company's business risk profile at the very high-end of the range for its category, compared to peers, reflecting the company's high percentage of lower-risk regulated utility businesses.

Financial Risk: Significant

We assess MDU's financial risk against more moderate benchmarks than those used for the typical corporate issuer, reflecting our forward-looking view that lower-risk regulated utility and pipeline operations will consistently account for more than 50% of the consolidated company. Under our base-case scenario of continued rate case increases, continued growth at the construction materials business, capital spending averaging about $465 million annually, and $100 million in proceeds from the sale of the Pronghorn facility, we expect FFO to debt of about 19%-21%.

Liquidity: Adequate

We assess MDU's liquidity as adequate to cover its needs over the next 12 months, even if consolidated EBITDA were to decline by 10%. We expect the company's liquidity sources will exceed its uses by at least 1.1x over the next 12 months, which is the minimum threshold for a liquidity assessment of adequate. Based on our stress scenario, we do not expect MDU would require access to the capital markets during that period to meet its liquidity needs. In our view, the company has the ability to absorb a high-impact, low-probability event with a limited need for refinancing. The company also benefits from sound bank relationships, good standing in the credit markets, and generally prudent risk management, all of which support our assessment.

Principal Liquidity Sources	Principal Liquidity Uses
• Credit facility availability of about $665 million; • FFO of about $490 million; and • Cash of about $40 million.	• Long-term debt maturities of about $170 million in 2018; • Capital spending of about $625 million in 2018; and • Dividend payments of more than $150 million.

Other Credit Considerations

Our issuer credit rating (ICR) on MDU benefits from its business-line diversification compared to its peers because it operates four different business segments that are not highly correlated with each other and each contribute at least 10% and not more than 50% of MDU's EBITDA. The ICR further benefits from our view that MDU's business risk profile is at the very high-end of the category due to the large proportion of lower-risk regulated utility operations at the company.

Ratings Score Snapshot

Corporate Credit Rating

BBB+/Stable/A-2

Business risk: Satisfactory

- **Country risk:** Very low
- **Industry risk:** Low
- **Competitive position:** Satisfactory

Financial risk: Significant

- **Cash flow/Leverage:** Significant

Anchor: bbb-

Modifiers

- **Diversification/Portfolio effect:** Moderate (+1 notch)
- **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+

- **Group credit profile:** bbb+

Issue Ratings

The short-term rating on MDU is 'A-2', based on the company's issuer credit rating.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Midstream Energy Industry, Dec. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Building Materials Industry, Dec. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Engineering And Construction Industry, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	**Significant**	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	**bbb-/bb+**	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-