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Research Update:

MDU Resources Group Inc. And Subsidiary 'BBB+' Corporate Credit Ratings Affirmed; Outlook Stable

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Overview

- MDU Resources Group Inc. announced it is exploring the sale of its exploration and production (E&P) business.
- We are affirming our 'BBB+' corporate credit ratings on MDU Resources Group Inc. and Centennial Energy Holdings Corp.
- We assess Centennial Energy Holdings Corp., a wholly owned subsidiary of MDU Resources Group, as a core subsidiary of MDU, with the same corporate credit rating as the parent company.
- The stable outlook reflects our expectation that the ratings on MDU and Centennial are unlikely to change during the outlook period.

Rating Action

On Nov. 10, 2014, Standard & Poor's Ratings Services affirmed its 'BBB+' corporate credit ratings on MDU Resources Group Corp. and subsidiary Centennial Energy Holdings Corp. The outlook is stable.

Rationale

The affirmation reflects our expectation that if the company were to complete a sale of its E&P business, the impact on its "satisfactory" business risk would be neutral. Although MDU's business risk assessment would benefit from the higher proportion of regulated earnings following the sale of the more volatile E&P business, the transaction would reduce business diversity and place greater dependence on the nonregulated construction business. In addition, we expect financial measures to remain consistent with our current financial risk assessment of "intermediate." The current ratings on MDU also incorporate the company's improving construction business operations, with increasing revenues, margins, and backlog. Nevertheless, we believe this business will continue to be very volatile and cyclical. Although the company is rebalancing its E&P portfolio toward more profitable oil production, its small scale of operations and the inherent volatility of the E&P industry remain weaknesses in the overall rating.

We view MDU's business risk profile as satisfactory. MDU is a diversified natural resources company currently operating in three main business segments: utilities and pipelines, E&P, and construction services and materials. Our assessment is based on the diversity of its business operations and the relative stability of its regulated operations, which provide steady and predictable cash flows. This business diversity currently provides a one-notch uplift to the ratings. We consider the company's individual segments weaker because of their limited scope of operations. The business risk profile benefits from the stability of MDU's regulated utilities and pipeline businesses, which together contributed about 30% of earnings for the past 12 months ended Sept. 30, 2014.

The business risk profile also incorporates the historically significant earnings and cash flow contribution from its largely unregulated Centennial businesses, particularly the Fidelity Exploration & Production Co. and Knife River Corp. units.

An improving housing market and favorable federal transportation funding have aided Knife River, a midsize construction materials company. Knife River has benefitted from higher construction workloads as the U.S. economy has improved, as well as stronger margins in its asphalt, oil, and ready-mix concrete product lines, due to a lower cost structure and increased public spending. As of Sept. 30, 2014, the company's backlog in its construction materials and contracting business was $476 million, compared with $525 million a year ago, and consists primarily of public works (about 87%). The construction services backlog on Sept. 30, 2014, was $348 million, compared with $433 million a year ago.

The company's E&P business is fairly modest, with year-end 2013 reserves of 484 billion cubic feet equivalent (roughly 45% natural gas, 82% proved developed, and a proved developed reserve life of about 6.5 years). Thanks to its position in the Bakken region and Paradox Basin, the company has been able to focus on increasing its liquids production, which accounted for about 61% of total production for the quarter ended Sept. 30, 2014, compared with only 18% in 2008.

We consider MDU Resources' financial risk profile "intermediate," due to the relatively steady cash flows from the company's utilities business and its largely stable credit measures. Consolidated credit measures are currently in line with our expectations and the rating category. For the past 12 months ended Sept. 30, 2014, adjusted debt to EBITDA was 2.5x and funds from operations (FFO) to total debt was 32.4%. These measures are relatively stable and remain largely unchanged from previous periods. We expect MDU Resources to generate EBITDA of about $950 million in 2014 under our base case scenario. Given its commitment to maintaining a solid balance sheet, we expect MDU Resources to manage capital spending and acquisitions to maintain FFO to total debt in the 35% area and debt to EBITDA in the 2.5x area. However, if natural gas prices fail to materially improve from current levels and/or the construction business operating results weaken, credit measures could deteriorate over the next 12 months.

The company's capital spending in recent years has exceeded its internally generated funds as a result of increased investments in its utilities and E&P businesses. We expect the company will continue to invest heavily over the next few years, and it will be cash-flow negative in 2014 and 2015. Although these investments will ultimately lead to increased revenue and cash flow, it is not likely to affect operational and financial performance until 2015 and thereafter.

Our base case forecast assumes (not including the impact of the potential sale of E&P business):

- Capital spending of about $1.1 billion in 2014 and $950 million in 2015 (includes both growth and maintenance capital spending),
- Dividends of about $130 million per year, and

This results in the following credit measures:

- Adjusted FFO to debt of about 30%-35% in 2014 and 2015, and
- Adjusted total debt EBITDA of about 2.5x through 2015.

Liquidity

We view MDU's stand-alone liquidity as "adequate" under Standard & Poor's corporate liquidity methodology. We expect cash sources to exceed uses by more than 1.2x over the next year. On Sept. 30, 2014, MDU had about $233 million in cash and $615 million available under its various credit facilities.

Principal liquidity sources include:

- Cash of $233 million on Sept 30, 2014,
- $615 million available under credit facilities, and
- FFO of $800 million to $850 million in 2014 and 2015, according to our estimate.

Principal liquidity uses include:

- Capital spending of $1.1 billion in 2014 and $950 million in 2015, and
- Annual dividends of about $135 million.

Outlook

The stable outlook reflects Standard & Poor's expectation that MDU Resources Group Inc. will maintain its moderate financial policies, which have helped offset the volatility of its unregulated businesses. In addition, the sale of the E&P business is not expected to affect ratings, because the increase in stable, regulated earnings is offset by lower business diversity and greater exposure to the construction business.

Upside scenario

We do not expect positive rating actions over the next 12 months, given the current high proportion of unregulated earnings, low natural gas prices, and the volatile industry conditions for its E&P and construction-related businesses. An upgrade would most likely require evidence of improved stability of profitability of cash flows following the Fidelity transaction combined with stronger financial performance.

Downside scenario

We could lower the ratings if FFO to debt fell below 30% for a prolonged period, which could happen if the company were to implement a more aggressive financial policy, or the currently positive market conditions for the construction business materially declined.

Ratings Snapshot

Corporate Credit Rating: BBB+/Stable/A-2

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb

Modifiers
- Diversification - Portfolio Effect: Moderate (+1 notch)

Related Criteria And Research

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Building Materials Industry, Dec. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Oil And Gas Exploration And Production Industry, Dec. 12, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Ratings List

Ratings Affirmed

MDU Resources Group Inc.
Centennial Energy Holdings Inc.

Corporate Credit Rating	BBB+/Stable/A-2

MDU Resources Group Inc.
Centennial Energy Holdings Inc.

Commercial Paper	A-2

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