

# Research

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## Research Update:

# MDU Resources Group Inc. And Subsidiary 'BBB+' Corporate Credit Ratings Affirmed, Outlook Revised To Negative

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## Research Update:

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## Overview

- MDU Resources Group Inc. announced that it has reached purchase and sale agreements on the majority of its exploration and production business expected to close before year-end 2015.
- We are affirming our 'BBB+' corporate credit ratings on MDU Resources Group Inc. and Centennial Energy Holdings Inc.
- We are revising the outlook to negative from stable. The negative outlook reflects our expectations that funds from operations (FFO) to debt could weaken to the lower-end of the range for the significant financial risk profile category, reflecting FFO to debt consistently below 23%.
- We assess Centennial Energy Holdings, 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 outlook on subsidiary Cascade Natural Gas Corp. remains stable because it meets the provisions and conditions to be considered an insulated subsidiary.

## Rating Action

On Nov. 30, 2015, Standard & Poor's Rating Services affirmed its 'BBB+' corporate credit ratings on MDU Resources Group Corp. and subsidiary Centennial Energy Holdings Corp. and revised the outlook to negative from stable.

## Rationale

The negative outlook reflects our expectation for weakening financial measures pro forma for the sale of MDU's E&P assets contained in its wholly owned subsidiary Fidelity Exploration and Production Co. We have reassessed the business risk to be at the higher-end of the "satisfactory" category versus the lower-end where it was previously, reflecting the much higher proportion of regulated operations; nevertheless, at the same time, we are revising our assessment of financial risk to "significant" from "intermediate," largely offsetting the benefits to the business risk profile. Our analysis incorporates our expectations that FFO to debt will decline from over 30% at the end of 2014 to about 25% in 2015 and 2016 and that debt to EBITDA will be approximately 3x over the next two years.

We have revised our comparable ratings analysis (CRA) assessment to positive from stable reflecting the company's strategic decision to disproportionately grow its lower-risk regulated utility businesses. Following the sale of the more volatile E&P business, we expect that the regulated businesses will exceed 45% of the consolidated company. The positive CRA provides a one notch uplift to the ratings.

We view MDU's business risk profile as "satisfactory," per our criteria. MDU is a diversified company currently operating in four main business segments: utilities, pipelines, construction services, and construction materials. Our assessment reflects 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. The business risk profile benefits from the stability of MDU's regulated utilities and pipeline business, which we expect will contribute a greater portion of earnings and cash flows to the company as a whole resulting from the sale of the company's more volatile E&P segment.

The business risk profile also incorporates the significant earnings and cash flow contribution from its largely unregulated Centennial segment, which will consist of the construction materials (Knife River Corp.), construction services, and unregulated pipeline units.

An improving housing market and favorable federal and state infrastructure funding have aided Knife River, a midsize construction materials company. Knife River has benefitted from higher construction workloads as well as improved margins in its asphalt, oil, and ready-mix concrete product lines. As of Sept. 30, 2015, the company's construction materials backlog increased to \$533 million compared with \$476 million a year ago. The company's construction services business continues to build its backlog after completing several higher-margin large projects this past year. The construction services backlog as of Sept. 30, 2015, increased to \$458 million compared with \$348 million last year.

MDU's utilities segment services approximately 1 million customers in eight states. Cascade Natural Gas Corp. distributes natural gas in Oregon and Washington. Great Plains Natural Gas Co. distributes natural gas in western Minnesota and southeastern North Dakota. Intermountain Gas Co. distributes natural gas in southern Idaho. Montana-Dakota Utilities Co. generates, transmits, and distributes electricity and distributes natural gas in Montana, North Dakota, South Dakota, and Wyoming. We forecast continued growth in the utilities segment at a 5% to 7% compound annual growth rate over the next several years.

We consider MDU's financial risk profile to be "significant" compared with our previous assessment of "intermediate," as defined under our criteria. We expect the company's credit ratios to weaken following the sale of the historically higher margin but more volatile E&P segment. Nevertheless, we expect the increase in stable earnings and cash flow from the regulated utilities and pipeline businesses to help stabilize credit measures. We expect

FFO to debt of approximately 20% to 25% and debt to EBITDA of about 3x over the next 24 months. MDU announced that it will use proceeds from the sale of its E&P segment, expected to be approximately \$450 million, to reduce total debt levels.

Our base case forecast assumes:

- Capital spending of approximately \$578 million in 2015, \$360 million in 2016.
- Dividends of approximately \$143 million in 2015 and \$146 million in 2016.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted FFO to debt of 20% to 25% in 2015 and 2016.
- Adjusted total debt to EBITDA of approximately 3x.

## **Liquidity**

We view MDU's stand-alone liquidity as "adequate" and expect cash sources to exceed uses by more than 1.2x over the next 12 months.

Principal liquidity sources include:

- Cash of \$88.6 million as of Sept. 30, 2015
- Availability of \$394 million under credit facilities'
- FFO of \$510 million to \$525 million in 2015 and \$460 million to \$480 million in 2016, and
- Proceeds and anticipated tax benefits of \$450 million from the sale of its E&P business.

Principal liquidity uses include:

- Capital spending of \$578 million in 2015 and \$360 million in 2016.
- Dividend payments of approximately \$143 million in 2015 and \$146 million in 2016.

## **Outlook**

The negative outlook reflects the potential for a downgrade reflecting weaker financial measures and our expectations that the regulated businesses will remain below 50% of the consolidated company for the next three years following the sale of the E&P business.

### **Downside scenario**

We could lower the ratings if FFO to debt weakens to the lower end of the range for the significant financial risk profile category, reflecting FFO to debt that is consistently below 23%. This could occur if the company's capital spending material increases or is disproportionately financed with debt, or market conditions in the construction businesses materially decline. We could also lower the ratings if the non-regulated businesses grow such that we expect the stability provided by the utilities to be meaningfully offset by the more volatile non-regulated businesses.

## Upside scenario

We could revise the outlook to stable if we expect average FFO to debt to consistently remain above 23%. This could occur if the company can continue growth in the construction services businesses while maintaining current debt levels.

## Ratings Score Snapshot

**Corporate Credit Rating: BBB+/Negative/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)
- Comparable rating analysis: Positive (+1 notch)

## Related Criteria And Research

### Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 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
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, 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 For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

## Ratings List

Ratings Affirmed; Outlook Revised

	To	From
MDU Resources Group Inc.		
Centennial Energy Holdings Inc.		
Corp Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2

Rating Affirmed

MDU Resources Group Inc.	
Centennial Energy Holdings Inc.	
Commercial Paper	A-2

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