
12 FEB 2016 2:54 PM EST

Fitch Affirms Black Hills Ratings at 'BBB+'; Upgrades SourceGas to 'BBB'

Fitch Ratings-New York-12 February 2016: Fitch Ratings has affirmed the Long-term Issuer Default Rating (IDR) for Black Hills Corporation (BKH) at 'BBB+' following the completion today of the company's acquisition of SourceGas Holdings LLC (SGH, not rated by Fitch). BKH's ratings have been removed from Rating Watch Negative and assigned a Negative Rating Outlook. Fitch previously placed the company on Negative Watch on July 13, 2015.

Simultaneously, Fitch has upgraded the Long-term IDR for SourceGas, LLC (SGL), SGH's operating subsidiary, to 'BBB' from 'BB+'. SGL's ratings have been removed from Rating Watch Positive and assigned a Positive Rating Outlook. Finally, Fitch has affirmed the Long-term IDR for Black Hills Power, Inc. (BHP) at 'BBB+'. The Rating Outlook is Stable. A complete list of rating actions follows at the end of this release.

The affirmation of BKH's IDR reflects the company's improved business risk profile as a result of the SGH acquisition, expectations for an improving trend in pro forma credit metrics, and better than expected merger regulatory approvals set by the state regulatory commissions.

The Negative Rating Outlook primarily reflects the increased leverage associated with the SGH acquisition; however, BKH's Outlook could be revised to Stable following a successful outcome in the pending cost of service gas proceedings. Implementation of a cost of service gas program would

provide a beneficial uplift to BKH's business risk profile and mitigate the downward rating pressure caused by the company's weaker pro-forma credit metrics. Fitch expects state regulatory rulings in the third quarter of this year.

SGL's Positive Rating Outlook reflects Fitch's expectation that the company's debt would be refinanced at the BKH level before maturity. SGL's Long-term IDR would then be equalized with BKH's.

The \$1.89 billion purchase price includes the assumption of approximately \$760 million of debt at closing. Permanent financing consists of \$255 million of common equity, \$299 million of equity linked securities, and \$550 million of unsecured debt. The \$554 million equity component of acquisition financing is modestly less than the \$575 - \$675 million that Fitch originally expected. Additionally, BKH announced that it has entered into a definitive agreement to sell a 49.9 percent member equity interest in a 200-MW natural gas-fired power plant from its IPP portfolio for \$215 million, the proceeds from which would be used to reduce leverage. The sale is expected to close around April 1.

KEY RATING DRIVERS

Increased Leverage: BKH's leverage increased materially in the near term, as a result of the SGL acquisition. Pro forma FFO adjusted leverage is approximately 6.6x, pressuring credit metrics at the current rating level. Although BKH's financial metrics will remain weak as a result of increased leverage associated with the acquisition, Fitch expects consolidated FFO adjusted leverage to strengthen to 4.5x by 2018. Leverage is expected to benefit from a combination of EBITDA growth due to the timely recovery of utility investments under rate rider mechanisms, anticipated synergies, and debt reduction.

Improved Business Risk Profile: The SGH acquisition is positive for BKH's business risk profile, increasing the regulated utility business mix to approximately 87% of consolidated EBITDA, from 80% previously. The acquisition also increases BKH's utility customer base by 55%, to more than 1.2 million, strengthening the company's existing footprint in Colorado, Nebraska, and Wyoming, while expanding its service territory into Arkansas. BKH's regulated electric and natural gas utility

operations now span eight states, all of which allow for pass-through of commodity and/or purchased power costs, with several of the states allowing other riders or recovery mechanisms that enhance timely recovery of expenses and invested capital.

GRC Moratoriums: As a condition of receiving regulatory approvals for the SGH acquisition, management has agreed to general rate case (GRC) stay-out provisions in AR, CO, NE, and WY ranging from zero to three years, depending on the regulatory jurisdiction. The GRC moratorium allows for the realization of potential synergies over the next two years and does not preclude increases in the various rate recovery riders.

Cost of Service Gas Program: BKH's proposed cost of service gas program would be beneficial to credit quality and would largely offset the risk associated with the increased leverage from the SGH acquisition. If approved by state regulators, the cost of the service gas program would materially lower the risk of BKH's natural gas exploration and production business while also adding stability to the utilities' fuel costs. BKH's utilities would procure 50% of their annual gas consumption through long-term contracts tied to the company's natural gas production costs. BKH recently submitted cost of service gas regulatory filings in CO, IA, KS, NE, SD, and WY, and the SGH acquisition roughly doubles the amount of natural gas that could be contracted under this program.

A successful outcome in the cost of service gas proceedings would mitigate the one-notch downward pressure arising from the SGH acquisition. Fitch expects regulatory hearings to commence in the first half of this year. If approved, BKH expects to spend roughly \$50 million on the program during the second half of this year and \$100 million on the program in each of the next two years.

Shift in Oil and Gas Strategy: BKH's oil and gas strategy would be centered around its utility cost of service gas program, a notable shift from the prior focus on unregulated exploration and production activities. BKH has meaningfully reduced its planned capex in the Mancos and Piceance shale basins over the next two years, as the current commodity price environment does not support drilling fundamentals. The company's planned oil and gas capital spending for 2016 and 2017 has decreased by 89%, to \$24 million total, from \$242 million previously.

Increased Capex Needs: BKH plans to spend roughly \$2 billion on capex through 2019 with approximately 80% of that amount at the regulated utilities. The projected capex spend currently excludes the proposed cost of service gas program and will be primarily focused on new generation, transmission, and distribution investments at the electric and gas utilities. Due to looming regulations under the EPA's Clean Power Plan, future electric generation needs are likely to be in the form of new natural gas-fired power plants and on small-scale wind and solar renewable projects. Capex at the gas utilities is primarily focused on pipeline replacement programs, typically subject to automatic recovery mechanisms. Fitch expects BKH to remain FCF negative through the forecast period and has assumed a balanced mix of debt and equity financing.

SGL:

Acquisition by BKH: Fitch considers the acquisition by BKH to be positive for SGL's credit quality, given BKH's stronger financial profile, larger scale and scope of operations, and better financial flexibility as a publicly-traded entity. Fitch expects BKH to consolidate SGL's debt under BKH and its operations under its utility holdings subsidiary, Black Hills Utility Holdings, Inc., as BKH did when it acquired the Aquila natural gas utilities in 2008. The constraints on credit quality that SGL previously faced as a subsidiary of a leveraged holding company with private equity ownership would be alleviated by the acquisition by BKH. SGL is expected to benefit from operational efficiencies and financial synergies as well as improved consolidated leverage metrics and enhanced access to capital.

Low-Risk Utility Business: SGL conducts its regulated natural gas distribution businesses in four states: Arkansas, Colorado, Nebraska, and Wyoming. Regulated activities account for more than 90% of gross margin and are supported by several regulatory mechanisms that reduce earnings and cash flow volatility. Commodity costs are a straight pass-through to customers via recovery mechanisms, riders allow for recovery of capital investment for system upgrades for meter and pipe replacement, and Arkansas, SGL's largest state of operations, employs weather normalization.

KEY ASSUMPTIONS

Fitch's key assumptions within the rating case for BKH include:

- Constructive regulatory environment across all jurisdictions;
- Successful integration of businesses;
- Excludes the cost of service gas program;
- Capex of \$2.1 billion through 2019.

RATING SENSITIVITIES

BKH:

Positive: Future developments that may, individually or collectively, lead to a stabilization of ratings at the current level include:

- Constructive outcome in the pending cost of service gas program regulatory proceedings;
- Total adjusted debt/EBITDAR and FFO adjusted leverage at 4.0x or below.

Negative: Future developments that may, individually or collectively, lead to a negative rating action include:

- An unfavorable outcome in the pending cost of service gas program regulatory proceedings;
- Expectations for FFO adjusted leverage to remain above 4.5x through the forecast period;
- A weaker business risk profile from larger investments in the oil and gas business, outside of a cost of service gas program.

BHP:

Positive: A positive rating action is not expected at this time.

Negative: Unexpected adverse regulatory decisions; FFO fixed-charge coverage sustained below 4.75x and total debt/EBITDAR sustained above 3.75x.

SGL:

Positive: The refinancing at the BKH level of SGL's remaining long-term debt before maturity would result in an equalization of the IDRs at SGL and BKH.

Negative: A negative rating action at SGL is unlikely barring an unexpected change in the post-acquisition capital structure.

LIQUIDITY

BKH had \$391 million of liquidity available under its \$500 million unsecured revolving credit facility, including \$39 million of unrestricted cash and cash equivalents as of Sept. 30, 2015. The credit facility can be upsized to \$750 million with the consent of the lenders and matures in June 2020. The credit facility is subject to a maximum debt-to-capitalization ratio covenant of 65% as of Sept. 30, 2015, and BKH was in compliance with a debt-to-capitalization ratio of 57%. BKH's \$500 million bank credit facility contains covenants that trigger cross-default if BKH or its subsidiaries fail to make timely payments of debt obligations. BKH's long-term debt maturities are expected to be manageable through the forecast period.

FULL LIST OF RATING ACTIONS

Fitch has affirmed the following ratings:

Black Hills Corporation (BKH):

- Long-term IDR at 'BBB+';
- Senior unsecured debt at 'BBB+';
- Junior subordinated debt at 'BBB-';
- Short-term IDR at 'F2'.

The Rating Outlook is Negative.

Fitch has affirmed the following ratings:

Black Hills Power, Inc. (BHP):

- Long-term IDR at 'BBB+';
- First mortgage bonds at 'A';
- Short-term IDR at 'F2'.

The Rating Outlook is Stable.

Fitch has upgraded the following:

SourceGas, LLC (SGL):

- Long-term IDR to 'BBB' from 'BB+';
- Senior unsecured notes to 'BBB+' from 'BBB-'.

The Rating Outlook is Positive.

Contact:

Primary Analyst

Daniel Neama

Associate Director

+1-212-908-0561

Fitch Ratings, Inc.

33 Whitehall St.

New York, NY 10004

Secondary Analyst

Kevin L. Beicke, CFA

Director

+1-212-908-0618

Committee Chairperson

Philip W. Smyth, CFA
Senior Director
+1-212-908-0531

Media Relations: Alyssa Castelli, New York, Tel: +1 (212) 908 0540, Email:
alyssa.castelli@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria

Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage
(pub. 17 Aug 2015)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](http://fitchratings.com/understandingcreditratings) . IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEBSITE 'WWW.FITCHRATINGS.COM'. PUBLISHED RATINGS, CRITERIA AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE 'CODE OF CONDUCT' SECTION OF THIS SITE. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES.

DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

ENDORSEMENT POLICY - Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the [EU Regulatory Disclosures](#) page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.