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Research Update:

Black Hills Corp. And Black Hills Power Inc. Corporate Credit Rating Raised To 'BBB' On Improved Financial Measures

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Overview

U.S.-based multiple-utility energy company Black Hills Corp's. (BKH) financial measures have continued to substantially improve and its business risk profile has benefited from the company's strategic focus on its core utility business. The company has divested a significant portion of its unregulated businesses during the past 12-18 months.

We are raising our corporate credit ratings on BKH and its subsidiary Black Hills Power Inc. (BHP), to 'BBB' from 'BBB-'.

The stable outlook reflects our expectation that the company will continue to focus on its core regulated utility business and to manage its capital spending and distributions in order to maintain financial measures appropriate for the ratings. We also expect the company to manage its regulatory risk, enabling the regulated businesses to earn its allowed return on equity. Under our baseline forecast, we expect funds from operations (FFO) to debt of more than 18% and debt to EBITDA of about 4x

Rating Action

On July 24, 2013, Standard & Poor's Ratings Services raised its corporate credit rating on Rapid City, S.D.-based multiple-utility energy company Black Hills Corp. and its subsidiary Black Hills Power Inc., to 'BBB' from 'BBB-'. The outlook is stable. At the same time we raised the rating on BKH's senior unsecured debt to 'BBB' from 'BBB-' and the rating on BHP's senior secured debt to 'A-' from 'BBB+', which is based on a '1+' recovery rating.

Rationale

The upgrade reflects our assessment of the company's sustained improvement of its financial measures and improved business risk profile stemming from its strategic focus on its core utility operations, and effective management of regulatory risk. We expect the company to continue to focus on its core utility businesses and not significantly grow its unregulated operations.

Standard & Poor's bases its rating on Black Hills Corp. on the company's consolidated credit profile. This includes a business risk profile we view as "excellent" and a financial risk profile we deem "aggressive" under our criteria. Black Hills is a multiple-utility energy company that includes electric utility Black Hills Power Inc., electric and natural gas utility Cheyenne Light, Fuel, & Power Co. (not rated), other regulated utilities that are owned by Black Hills Utility Holdings Inc. (not rated) and operate as Black Hills Energy, and various unregulated businesses. Black Hills benefits from geographic and economic diversity, with utilities operating from Midwestern states to the Rocky Mountains. We expect that the company will effectively manage its operations and construction program so that financial measures remain in line with expectations at the current ratings.

Our rating on Black Hills reflects a mostly regulated utility strategy that includes ongoing capital spending and dependence on continuous and timely cost recovery. We project that this should support maintenance of cash flow measures and manageable debt leverage. We expect the company to manage its unregulated oil and gas exploration operations prudently and not to significantly increase the size of these operations beyond existing levels.

Our designation of Black Hills' business profile as excellent incorporates our assessment its strategy to be an energy company consisting mostly of regulated utilities that have more than 200,000 electric customers in Colorado, Montana, South Dakota, and Wyoming and more than 500,000 natural gas customers in Colorado, Iowa, Kansas, Nebraska, and Wyoming. Its market and regulatory diversity strengthens its credit quality, but the widely dispersed operations and numerous regulatory jurisdictions require diligent filing for rate recovery. In addition, Black Hills' business risk profile still reflects various risky unregulated energy ventures including an oil and gas exploration and production company, which accounts for roughly 10% of consolidated EBITDA and unregulated power generation, and coal mining. Although these businesses are unregulated, the power generation businesses in Colorado and Wyoming, and coal mining operations are mostly contracted with affiliate utilities or power plants, so we view them as having lower risk.

The company has been able to execute its strategy to improve its business risk profile by recently selling 85% of its Bakken and Three Forks shale assets for $243 million. The company used the proceeds to redeem $225 million of 6.5% senior unsecured notes due May 15, 2013. The company also sold its energy marketing business, Enserco Energy Inc., in 2012.

The consolidated financial profile, which we consider aggressive, reflects adjusted financial measures that are in line with the rating. Financial measures improved significantly through the first quarter of 2013 as the company incorporated cost recovery of the completed construction projects in Colorado into operating cash flow and also reduced debt with the proceeds from the sale of the unregulated assets. For the 12 months ended March 31, 2013, funds from operations (FFO) relative to total debt was 23.1%, total debt to total capital was 54%, and debt to EBITDA was 3.5x.

We expect that financial measures will weaken slightly over the next 12-18 months as capital spending increases with the construction of the Cheyenne Prairie Generating Station. We would expect for financial measures to improve when the plant is placed into operation in the fourth quarter of 2014 and capital investments are reflected in revenues. Our baseline forecast includes FFO to total debt of 18%, and adjusted debt to EBITDA of about 4x over the next 12 to 24 months, all in line with an aggressive financial profile. The consolidated adjustments for Black Hills reflect purchased-power obligations, operating leases, and pension-related items.

Liquidity

We consider liquidity "adequate" under our liquidity methodology, which categorizes liquidity in five standard descriptors. The company's projected liquidity sources -- mostly operating cash flow and available bank lines, exceed its projected uses, which consist mainly of necessary capital spending and debt maturities, by more than 1.2x. Black Hill's ability to absorb high-impact, low-probability events with limited need for refinancing, flexibility to lower capital spending or sell assets, its sound bank relationships, solid standing in credit markets, and generally prudent risk management also support our assessment that liquidity is adequate.

We base our liquidity assessment on the following factors and assumptions:
We expect Black Hills' liquidity sources, including cash, FFO, and parent credit facility availability over the next 12 months, to exceed uses by about 1.2x. Uses include necessary capital spending, working capital, debt maturities, and shareholder distributions.
Debt maturities are manageable during the next 12 months.
We believe liquidity sources would exceed uses even if EBITDA were to decrease by 15%.
In our assessment, Black Hills has good relationships with its banks and has a good standing in the credit markets, having successfully issued debt during a variety of credit market conditions.

For our liquidity analysis for the next 12 months, we assume $715 million of liquidity sources consisting of FFO and credit facility availability. We estimate liquidity uses of $600 million for capital spending, maturing debt, working capital, and shareholder distributions.

Black Hills' credit agreement includes financial covenants requiring a recourse leverage ratio no greater than 65%. As of March 31, 2013, the company was in compliance with the covenants.

Outlook

The stable rating outlook on Black Hills reflects our base case forecast level of adjusted FFO to total debt of 18% and debt to EBITDA of about 4x. Fundamental to our forecast is our expectation the company will continue to manage its regulatory risk, enabling the regulated businesses to earn its allowed return on equity. We also expect the company will continue to focus on its core utility business and not significantly grow its unregulated business. We could raise the ratings if financial performance improves above our base forecast, such that FFO to total debt is greater than 20% and debt to EBITDA falls below 4x on a sustained basis. We could lower the ratings if financial performance stalls or deteriorates, such that FFO to total debt falls to less than 14% and debt to EBITDA rises above 4.5x on a sustained basis. Such a scenario is unexpected but would most likely reflect a meaningful increase in capital investments in unregulated businesses that could strain both the business risk and financial risk assessments.

Related Criteria And Research

- Criteria - Corporates - Utilities: Collateral Coverage And Issue Notching Rules For ‘1+’ And ‘1’ Recovery Ratings On Senior Bonds Secured By Utility Real Property, Feb. 14, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria - Corporates - General: Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Criteria - Corporates - Utilities: Notching Of U.S. Investment-Grade Investor-Owned Utility Unsecured Debt Now Better Reflects Anticipated Absolute Recovery, Nov. 10, 2008
- Criteria - Corporates - Utilities: Key Credit Factors: Business And Financial Risks In The Investor-Owned Utilities Industry, Nov. 26, 2008
- Criteria - Corporates - General: 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Criteria - Corporates - General: 2008 Corporate Ratings Criteria: Ratios And Adjustments, April 15, 2008
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- Criteria - Corporates - Utilities: Assessing U.S. Utility Regulatory Environments, Nov. 7, 2007
- Criteria - Corporates - General: Corporate Criteria--Parent/Subsidiary Links, Oct. 28, 2004

Ratings List

Ratings Raised; Outlook Changed

	To	From
Black Hills Corp.		
Corporate Credit Rating	BBB/Stable/--	BBB-/Positive/--
Black Hills Power Inc.		
Corporate Credit Rating	BBB/Stable/--	BBB-/Positive/--
	To	From

Ratings Revised

	To	From
Black Hills Corp.		
Senior Unsecured	BBB	BBB-
Black Hills Power Inc.		

Senior Secured	A-	BBB+
Recovery Rating	1+	1+

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