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**Research Update:**

## Norway-Based Norges Statsbaner Downgraded To 'A-/A-2' On Weaker Credit Ratios After Rail Reform; Outlook Negative

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## Research Update:

# Norway-Based Norges Statsbaner Downgraded To 'A-/A-2' On Weaker Credit Ratios After Rail Reform; Outlook Negative

## Overview

- Norway transportation group Norges Statsbaner AS (NSB) has completed a demerger of its real estate company, and the maintenance, ticketing and sales operations, which were all transferred to, and are directly or indirectly owned by, the country's Ministry of Transport and Communication. The rolling stock used by NSB and most of NSB's debt has been transferred to Norske Tog AS, a newly created rolling stock company also owned by the Ministry of Transport and Communication.
- In our view, NSB's stand-alone credit quality has deteriorated. The company's cash flow coverage ratios have weakened as NSB will continue reporting operating lease liabilities comparable to the debt liabilities pre-reform levels, while its earnings generation capacity has decreased.
- We are revising down NSB's stand-alone credit profile to 'bbb-' from 'bbb+' and consequently lowering the long- and short-term corporate credit ratings on the NSB to 'A-/A-2' from 'A+/A-1'.
- The negative outlook reflects the risk of a one-notch downgrade if the company adopts more aggressive financial policies that result in funds from operations to debt falling sustainably below 20%.

## Rating Action

On May 5, 2017, S&P Global Ratings lowered its long- and short-term corporate credit ratings on Nordic transportation group Norges Statsbaner AS (NSB) to 'A-/A-2' from 'A+/A-1'. The outlook is negative.

## Rationale

The downgrade reflects our view that NSB's cash flow coverage ratios and earnings generation capacity have weakened as a result of the recently implemented rail reform. This led to the loss of what we saw as relatively low risk, higher-margin earnings from the real estate company, ROM Eiendom AS. The reform also resulted in NSB transferring its rolling stock and most of its debt in December 2016 to Norske Tog AS, a newly created rolling stock company. While NSB becomes a pure train and bus operator, it will also need to lease its rolling stock to support its operations. In our analysis, we treat the operating leases as debt-like obligations of NSB and assume that their contribution to debt leverage will be comparable to the level of debt transferred. Our base case indicates that NSB's ratios will remain at 22%-24%

in terms of S&P Global Ratings-adjusted funds from operations (FFO) to debt once NSB settles the last remaining maturity of Swiss franc (CHF) 325 million in November 2017. Given the increased exposure to more volatile earnings, this corresponds to our assessment of a significant financial risk profile.

We assume the credits metrics will continue to be supported by significant cash balances. As of March 31, 2017, NSB had Norwegian krone (NOK) 7.7 billion of cash and undrawn facilities, including a NOK5.7 billion contribution against an intercompany loan by ROM Eiendom that was repaid in January 2017.

If NSB adopted more aggressive financial policies following a review due in fall 2017, this could lead to weakening in the financial metrics.

Disposal of the real estate assets, which in our view supported the passenger train operations, has led to a higher share of the company's earnings being generated from what we consider as non-infrastructure activities. We now expect about 40% of NSB's EBITDA to originate from the potentially more volatile and less profitable bus, freight, and tourism businesses, compared with about 30% pre reform. To arrive at the same view of the credit quality when assessing businesses with a one third or higher share of more volatile cash flows, we would expect stronger financial metrics, in particular higher cash flow coverage ratios. The spin-out of ROM Eiendom has also reduced NSB's financial flexibility as it no longer has the opportunity to monetize real estate assets to service its debt. That said, NSB's obligations will now consist primarily of operating leases for the rolling stock from Norske Tog, and to a lower extent, pension liabilities.

We continue to view NSB's business risk profile as satisfactory. The introduction under the rail reform of the competitive tenders for provision of passenger rail services on the Southern and Northern lines from June 2019 and December 2019, respectively, will expose about 25% of NSB AS's revenue (12% of NSB Group's revenue) to competition. However, in addition to still operating passenger trains in at least six out of the eight geographical service areas in Norway, we believe NSB will be well positioned to compete for the first two tenders, and could remain a monopoly until around 2030. NSB has pre-qualified for the first tender. Our opinion is also supported by NSB's role as "an operator of last resort," which would be expected to take over from another operator if it defaults or is otherwise underperforming under the tendered contracts.

In our base case for the financial years 2017-2019 (ending Dec. 31) we assume:

- NSB will continue operating all passenger train services until June 2019 and win tenders one and two thereafter;
- Average EBITDA margin of about 17%;
- No more debt after November 2017;
- Debt-like obligations including operating leases and pension liabilities. Operating leases of NOK9.2 billion each year, calculated as net present value of future commitments in 2017-2028; and
- Debt-like obligations netted off by surplus cash of, on average, NOK3.4 billion each year.

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

- S&P Global Ratings-adjusted FFO to debt of 22%-24% (weighted average); and
- Adjusted free operating cash flow to debt of 16%-18% (weighted average).

We believe that after the reform, NSB will continue to benefit from a high likelihood of extraordinary government support in the event of financial distress.

We base our assessment on NSB's:

- Important role for the Norwegian government as the dominant nationwide transport provider. In our view, NSB fulfils key economic, social, and political objectives and benefits from a long track record as the sole public transport operator; and
- Very strong link with Norway, based on the state's 100% ownership of the company, the government's role in appointing NSB's board members and providing considerable ongoing financial support, and our expectation that NSB will not be privatized over the medium term.

## **Liquidity**

The short-term corporate credit rating is 'A-2'.

We assess NSB's liquidity as strong, with sources exceeding uses by around 3.1x over the 12 months to March 31, 2018. Our liquidity assessment is supported by NSB's sound relationship with banks and generally prudent risk management. There are no covenants attached to the CHF325 million bond maturing in November 2017. The company will only decide in fall 2017 how to utilize the NOK5.7 billion cash received from the real estate subsidiary, ROM Eiendom. However, given that there is no "hard" debt (except for NOK12 million in CargoNet) after the repayment of the only outstanding issue--of CHF325 million due Nov. 15, 2017--we believe the company will maintain strong liquidity. In our view, NSB would be able to absorb high-impact, low-probability events with no need for a refinancing.

In the 12 months to March 31, 2018, we expect the following sources of cash:

- Cash and cash equivalents totaling about NOK5.7 billion;
- Undrawn committed bank lines of NOK2.05 billion including NOK2 billion until April 2019 and NOK50 million until October 2020.
- FFO that we forecast at approximately NOK1.1 billion.

Over the same period we expect the following principal liquidity uses:

- Debt amortization of about NOK2.0 billion;
- Working capital outflows of about NOK0.5 billion;
- Capital investments of about NOK0.2 billion; and
- Acquisitions of about NOK70 million.

## **Outlook**

The negative outlook reflects the risk that we could lower the ratings if a change in NSB's financial policies, following a strategy review due in fall

2017, led to weakening financial metrics.

In our base case we anticipate that NSB will maintain FFO to debt ratios of 22%-24% in 2018-2019 after it settles the last remaining maturity in November 2017. Furthermore, we assume that NSB will win tender one and two due to its favorable position as a current operator.

If the company fails to win the tenders, we will review the impact on its stand-alone credit profile. This would depend on the expected earnings under contracts for additional activities secured instead, as well as the degree of credit ratio improvement as NSB will no longer account for operating leases under the two contracts. Furthermore, we will review the impact on the business profile and financial metrics if NSB were to engage in additional rail operations and enter into further operating leases arrangements.

### **Downside scenario**

We could lower the ratings by a notch if we expected that the company's FFO to debt ratio could decrease sustainably below 20%. This could happen as a result of more aggressive dividend policies, or if the current cash balances were used for higher risk investments.

We could also lower the ratings if assessed that the likelihood of extraordinary government support had weakened. Although, in our view, at present this is unlikely, this could happen if the government were disposed of a substantial stake in NSB, for example through an IPO.

### **Upside scenario**

We could revise the outlook back to stable if we assessed that NSB's new strategy and financial policies would not result in a further deterioration of its credit metrics.

## **Ratings Score Snapshot**

Corporate Credit Rating: A-/Neg/A-2

Business risk: Satisfactory

- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

- Diversification/portfolio effect: Neutral/undiversified (no impact)

- Capital structure: Neutral (no impact)
- Financial Policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile (SACP): bbb-

- Group credit profile: bbb-
- Likelihood of government support: High (+3 notches from SACP)
- GRE Link: Very strong
- GRE Role: Important

## **Related Criteria**

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Transportation Cyclical Industry, Feb. 12, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Transportation Infrastructure 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating 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
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

## **Related Research**

- Norway-Based Norges Statsbaner 'A+' Rating On CreditWatch Negative On Details Of Rail Reform Implementation, Oct. 25, 2016
- Norwegian Railway Operator Norges Statsbaner ASA Downgraded To 'A+' On Rail Reform Implementation; Outlook Negative, Feb. 11, 2016

## Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Norges Statsbaner AS		
Corporate Credit Rating	A-/Negative/A-2	A+/Watch Neg/A-1
Senior Unsecured	A-	A+/Watch Neg

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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