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Research Update:

Transport Group Norges Statsbaner AS 'A-/A-2' Ratings Affirmed Despite Loss Of Concession Contract; Outlook Negative

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Table Of Contents

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Overview

- Norwegian transportation group Norges Statsbaner AS (NSB) has lost the first tender under Norway's rail liberalization program to operate the Southern package, which represents about 5% of NSB's total EBITDA.
- We believe that the loss of the tender has somewhat weakened NSB's competitive position, as it will be seeking to replace the earnings with bus operations in the very competitive Nordic market.
- We are affirming the long- and short-term issuer credit ratings on NSB at 'A-/A-2', reflecting our expectation that it will maintain stronger cash flow ratios mostly as a result of the transfer of the operating leases related to the first tender package.
- The negative outlook reflects the risk of a one-notch downgrade if NSB does not compensate for its loss of passenger rail market share by strengthening its financial metrics, in particular adjusted funds from operations to debt above 25%.

Rating Action

On Oct. 24, 2018, S&P Global Ratings affirmed its long- and short-term issuer credit ratings on Norwegian transportation group Norges Statsbaner AS (NSB) at 'A-/A-2'. The outlook remains negative.

Rationale

The affirmation follows the recent announcement that Norwegian authorities have awarded the tender for an eight-year concession contract (including two one-year extension options) for the Southern package, currently operated by NSB, to the Go-Ahead Group. The change in operator comes on the back of efforts by the authorities to reform and unbundle Norway's rail market over the last two years to allow competition. From December 2019, NSB will no longer provide passenger rail services in a relatively densely populated area of Norway, the south west of Oslo, although the impact on NSB's earnings will be limited to 5% of the group's EBITDA annually. This includes the impact of receiving, under the Public Purchase Contract, about 8% less subsidy from the government. We believe that the loss of the first tender has somewhat weakened NSB's competitive position, as it will seek to replace the earnings with bus operations in the very competitive Nordic market. We expect NSB's profitability to decrease as NSB increases participation in the bus market segment, which due to higher staff and fuel costs has a somewhat lower EBITDA margin compared to about 15%-20% in the more stable infrastructure rail sector. NSB's size and negotiating power will also weaken as it will no longer be a monopoly operating one big contract.

The weakening of NSB's competitive position is partly offset by the improvement in cash flow ratios as the contract will transfer, alongside trains and personnel, about 6% of the existing operating leases. We now expect over the long-term about 45% of NSB's EBITDA to originate from the potentially more volatile and less profitable bus, freight, and tourism businesses, compared with about 30% before the loss of the contract. As NSB is currently increasing its exposure to more volatile cash flows, we expect NSB to maintain stronger financial metrics at the same rating level, in particular funds from operations (FFO) to debt above 25% after 2019. We expect that NSB could achieve these metrics with increased earnings from other segments.

We also have more clarity on how NSB will use the significant cash balances it maintained after the rail reform and the related unbundling of the Norwegian rail sector. In 2017, NSB completed a demerger of its real estate company, and the maintenance, ticketing, and sales operations were all transferred to the Ministry of Transport and Communication. NSB's rolling stock and most of its debt has been transferred to Norske Tog AS, a newly created rolling stock company also owned by the Ministry of Transport and Communication. The company plans to ramp up the investment in bus activities as well as settling down its pension deficit in 2019.

We also believe we need to rebalance our guidance for metrics commensurate with the rating to account for the changes in ratios following NSB's early adoption of the IFRS16 accounting standard on operating leases. This is because the company will recognize a lower interest expense than our adjustment for operating leases, while there is no change in the underlying stock of lease liabilities (see "What Do New Lease Accounting Changes Mean For Corporate Credit Ratings?" published April 16, 2018, on RatingsDirect).

The second tender is for the Northern package, which contributes about 8% of NSB's EBITDA. The results of this tender are expected in June 2019, with operations under the new contract starting from June 2020. We see NSB as well-positioned to compete for the Northern package due to its experience of operating rail services in the harsher northern climates. Even if NSB loses the Northern tender, it will continue operating passenger trains in at least six out of the eight geographical service areas in Norway until its public purchase contact finishes for NSB in December 2022 and for NSB Gjøvikbanen in 2023. NSB will also maintain its function as a passenger rail "operator of last resort" (meaning that it would need to take over from any other operator if it underperforms operationally or defaults).

We believe opening of the Norwegian rail market to competition may motivate NSB to improve the efficiency of its operations and to expand, both geographically and in new products. In response to losing market share in the passenger train segment, we expect NSB to grow its passenger train operations in Sweden, where its market share is currently only 3%, and expand in the bus segment from currently about 30% of the market in Norway and 7% in Sweden, both organically and by acquisitions. We also expect NSB to intensify its operations in freight in both Norway and Sweden, and to grow the tourism business in Norway. We expect NSB could also enter into new segments of operation.

In order to become more attractive and competitive, NSB will have to improve efficiency, including with regards to personnel. It may reduce maintenance costs by leasing newer trains, which have lower maintenance requirements. NSB will also have to undertake initiatives to improve punctuality and service quality that will involve investments in, among other areas, digitalization and offering door-to-door solutions to bring more customers to the trains. NSB has recently bought and made available 250 small electric cars in Oslo.

In our base case for the financial years 2018-2020 (ending Dec. 31), we assume:

- NSB will continue operating all passenger train services until December 2019, with passenger volumes rising in line with economic growth and ticket prices growing in line with the consumer price index.
- Ticket revenue to drop in 2020 as a result of loss of the Southern package contract, and related public purchase revenue (the government subsidy). We assume NSB will win the Northern package contract.
- S&P Global Ratings-adjusted EBITDA margin declining to about 15% in 2020 from about 17% in 2017 due to increasing participation of bus services. NSB plans to compensate the decline with the implementation of cost efficiencies, which we have not factored into our forecasts.
- Investments of about Norwegian krone (NOK) 1.4 billion annually, mainly via leasing, to support new contracts, mainly in the bus segment.
- No additional financial debt. We expect NSB to close the defined benefit pension scheme in FY2019 and repay outstanding pension liabilities of about NOK2 billion. NSB's obligations will consist only of operating leases for the rolling stock from Norske Tog and some financial leases for the bus operations. We assume an average contract length of eight years. NSB to adopt the IFRS16 leasing standard in 2018, resulting in the transfer of all financial leases on its balance sheet as of this year.

Based on our assumptions, we arrive at the following weighted-average credit measures in 2018-2020:

- Adjusted FFO to debt of 27%-30%; and
- Adjusted debt to EBITDA of 2.5x-3.0x.

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.

The 'A-' rating on NSB incorporates three notches of uplift from its stand-alone credit profile of 'bbb-'. This is based on our view of a high likelihood that the government of Norway will provide sufficient and timely extraordinary support to NSB if needed. This reflects our assessment of the group's:

- Important role for the Norwegian government as the country's incumbent provider of passenger rail services and main railway freight operator. Although NSB's influence will diminish with increased competition, it will still play an important role.
- Very strong link with its sole owner, the Norwegian government. We base this view on the existing mechanisms and capacity of the government to provide support to NSB, and the government's ownership classification of NSB in Category 3 (a company delivering commercial objectives and other specific goals). The assessment is also supported by our understanding that the state is not contemplating the privatization of NSB in the medium to long term.

The imminent liberalization of the rail market in Europe, and the opening of previously national markets to competition, could result in a diminished role for NSB in Norway but increased presence and revenue generation internationally. Should market liberalization be more rapid or detrimental to NSB, we could reconsider our assessment of the likelihood of extraordinary state support.

Liquidity

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

We assess NSB's liquidity as strong, with sources exceeding uses by more than 1.5x over the 12 months to June 30, 2019, and by more than 1.0x in the following 12 months. The cash balance includes proceeds received in the first quarter of 2017 from a real estate subsidiary, ROM Eiendom AS, which was spun off against the intercompany loan provided by NSB to the subsidiary. The company plans to use the significant cash balances partly to settle down its pension deficit in 2019.

Our liquidity assessment is supported by NSB's sound relationship with banks and generally prudent risk management. The company repaid its last financial debt, Swiss franc (CHF) 325 million in Nov. 15, 2017, and has no more outstanding debt and no refinancing risk. Therefore, we believe the company will maintain strong liquidity.

In the 12 months to June 30, 2019, we expect the following sources of cash:

- Cash and cash equivalents totalling about NOK4.78 billion;
- Undrawn committed overdraft facility of NOK50 million available until October 2020. In March 2018, NSB cancelled NOK2 billion RCF available until April; and

- FFO that we forecast at approximately NOK1.6 billion.

Over the same period, we expect the following principal liquidity uses:
- Capital investments of about NOK2.5 billion, mainly via operating leases; and
- Dividends of about NOK180 million.

Outlook

The negative outlook reflects that we could lower the rating by one notch if NSB continues losing its market to competition and increases its reliance on riskier activities to supplement the lost earnings, without being adequately compensated by stronger credit ratios. We are monitoring the outcome of the second tender for the Northern package in 2019. We could lower the ratings by one notch even if NSB retains the Northern package but sees a weakening of credit metrics, in particular adjusted FFO to debt falling below 25%.

We could also lower the ratings if we assessed that the likelihood of extraordinary government support had weakened. This is currently unlikely, in our view, but could happen if the government were to dispose of a substantial stake in NSB, for example through an IPO.

We could revise the outlook back to stable if NSB maintained its markets share in passenger rail, including operation of the Northern contact, or its expansion in other segments, for example in buses, results in sufficient earnings growth to compensate for the losses in the rail segment, with its credit metrics stabilizing.

Ratings Score Snapshot

Corporate Credit Rating: A-/Negative/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: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- 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: Group Rating Methodology, Nov. 19, 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

Related Research

- Norway-Based Norges Statsbaner Downgraded To 'A-/A-2' On Weaker Credit Ratios After Rail Reform; Outlook Negative, May 5, 2017

- 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

Ratings Affirmed

Norges Statsbaner AS	
Issuer Credit Rating	A-/Negative/A-2

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