S&P Global Ratings

Research

Research Update:

Icelandic Power Company Landsvirkjun Upgraded To 'BBB/A-2' Following Sovereign Upgrade; Outlook Stable

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Overview

- On Jan. 13, 2017, we raised our sovereign ratings on Iceland to 'A-' with a stable outlook.
- We consider that the sovereign's ability to support government-owned power company Landsvirkjun has strengthened.
- We are therefore raising our long- and short-term ratings on Landsvirkjun to 'BBB/A-2' from 'BBB-/A-3'.
- The stable outlook reflects that on Iceland, and our continued anticipation of a very high likelihood of support to Landsvirkjun from the government if needed.

Rating Action

On Jan. 18, 2017, S&P Global Ratings raised its long- and short-term issuer credit ratings on Icelandic electricity generation and transmission company Landsvirkjun to 'BBB/A-2' from 'BBB-/A-3'. The outlook is stable.

We also raised our rating on Landsvirkjun's senior unsecured debt to 'BBB' from 'BBB-'.

Rationale

The upgrade follows our rating action on Iceland (see "Iceland Long-Term Ratings Raised To 'A-' On Stronger External Position; Outlook Stable," published Jan. 13, 2017, on RatingsDirect). It reflects our view that the ability of the sovereign to support Landsvirkjun in case of financial stress has increased. We continue to assess Landsvirkjun as a government-related entity that benefits from a very high likelihood of timely and sufficient extraordinary government support if needed. We base this assessment on Landsvirkjun's:

- Very important role for the Icelandic government, given its dominant position as the incumbent power company and 64.7% owner of the national transmission grid, its strategic importance to the Icelandic economy, and its central role in the promotion of power-intensive industries; and
- Very strong link with the Icelandic government, given the state's 100% ownership, our expectation that the company will not be privatized over the next few years at least, and the risk to the sovereign's reputation if Landsvirkjun were to default.

In our view, Landsvirkjun's stand-alone credit profile is currently unchanged, at 'bb-'. Landsvirkjun's fair business risk profile reflects its position as the dominant power producer in Iceland, with a market share of generation of about 70%, despite the country's relatively small size. The generation is allocated mostly to power-intensive aluminum production.

Landsvirkjun also benefits from a very low-cost hydro and geothermal renewable generation asset base, which continues to support its above average EBITDA margins of about 77%-80%. Moreover, its long-term take-or-pay contracts with customers provide earnings predictability and EBITDA stability.

However, in our opinion, Landsvirkjun's earnings and profitability continue to be tempered by its high customer concentration. The top-three customers purchase about 70% of energy production, and the customer base is mostly composed of aluminum producers. This makes Landsvirkjun vulnerable to unexpected failures under single contracts. We also see this exposure as heightened because one-third of Landsvirkjun's revenues are directly linked to the aluminum price. However, we expect this portion to continue to decline over time as the company renegotiates existing contracts and adds new consumers.

Landsvirkjun's credit metrics have continued to improve as the company continues to pay down debt that accumulated throughout the completion of its largest hydro plant. We expect that management and the government will remain supportive of the deleveraging path. In our base case, we forecast that the company's metrics will continue to improve toward 15% funds from operations (FFO) to debt over the next few years, from about 11%-12% in 2016, which will be supported by low capital expenditure (capex) and dividends.

Assumptions:

- Revenues recovering in 2017 after decline in 2016 due to the low aluminum price.
- Aluminum prices at about $1,650/ton in 2017 and $1,650/ton in 2018.
- EBITDA margins of about 74%-77%.
- Capex of about $200 million in 2016, declining to about $180 million in 2017, and below $100 million in 2018.

Based on these assumptions, we arrive at the following credit measures for 2016-2018:

- FFO to debt of about 11-12% in 2016, 12%-13% in 2017, and about 15% in 2018.
- Discretionary cash flow to debt of 1%-10%.

Liquidity

The short-term rating is 'A-2'. We view Landsvirkjun's liquidity as adequate. We project that available liquidity sources in terms of cash, committed credit facilities, and operating cash flow should exceed our forecast of near-term cash outflows--such as debt repayments, capex, and dividends--by more than 1.2x. We also expect that sources will exceed uses even if EBITDA declines by 15%. We understand that Landsvirkjun's $200 million revolving credit facility (RCF) contains financial covenants, under which we expect Landsvirkjun to retain adequate headroom. Furthermore, we assume that Landsvirkjun will refinance or renew its RCF well ahead of its expiration. In addition, we consider that the company enjoys sound relationships with its banks, a satisfactory standing in credit markets, and prudent risk management, and we therefore assess liquidity as adequate rather than strong.

We calculate the following principal liquidity sources, as of the third quarter of 2016:

- Cash of $107.2 million.
- Committed facilities comprising a revolving credit facility of around $200 million expiring in 2019, about $116 million under loan agreements with NIB and JBIC/NEXI which should be drawn in 2018, and Icelandic krona (ISK) 12 billion (about $105 million) expiring in September 2022.
- FFO in the next 12 months of about $235 million-$240 million.

At the same date, we estimate the following principal liquidity uses for the next 12 months:

- Debt of about $280 million.
- Capex of about $180 million-$190 million.
- Dividends of about $11 million.

Outlook

The stable outlook reflects that on Iceland and our continued anticipation of a very high likelihood of extraordinary support to Landsvirkjun from the Icelandic government, if needed. It also reflects our assumption that Landsvirkjun will continue to benefit from low cost generation, relatively stable EBITDA, and gradually improving debt leverage, with FFO to debt of 12%-15% over the next two years.

Upside scenario

In our view, the rating upside is currently limited, as we believe it would require a strengthening of both Landsvirkjun's stand-alone credit profile and the government's ability to support Landsvirkun. However, we could raise the ratings if Landsvirkjun continues to deleverage and has financial policies that support an FFO-to-debt ratio of around 20% and if, at the same time, we raise the sovereign rating on Iceland, indicating that the government's ability to provide extraordinary support has increased.

Downside scenario

We could lower the rating if we revised down our stand-alone credit profile on Landsvirkun by one notch, for example because of an unexpected loss of contract revenues, which also could lead to weakened credit measures, with FFO to debt below 12%. We could also lower the rating if we saw a reduced likelihood of support from the government to Landsvirkjun or if we lowered our sovereign rating on Iceland.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/A-2

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb-

- Sovereign rating: A-
- Likelihood of government support: Very high (+4 notches)

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 Unregulated Power And Gas Industry, March 28, 2014
- Criteria - Corporates - Industrials: Methodology For Standard & Poor's Metals And Mining Price Assumptions, 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 07, 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. 01, 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

- Iceland Long-Term Ratings Raised To 'A-' On Stronger External Position; Outlook Stable

Ratings List

Upgraded

	To	From
Landsvirkjun		
Corporate Credit Rating	BBB/Stable/A-2	BBB-/Stable/A-3
Senior Unsecured	BBB	BBB-

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