

Global Credit Research - 03 Jul 2014

Reykjavik, Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	Ba2
Other Short Term	(P)NP

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Key Indicators

[1]Landsvirkjun	12/31/2013	12/31/2012	12/31/2011
FFO + Interest Expenses / Interest Expenses	2.9x	2.8x	2.7x
FFO / Net Debt	8.4%	7.8%	8.2%
RCF / Net Debt	7.9%	7.2%	8.2%
FCF / Net Debt	3.6%	3.7%	6.7%

[1] All ratios are calculated using Moody's standard accounting adjustments. Source: Moody's Financial MetricsTM

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Rating Drivers

- Iceland's dominant power producer with a unique and low-cost generation asset base
- Power sales to aluminium smelters bring exposure to aluminium price risk and volatility in cash flows
- Foreign currency risk is fairly material, albeit decreasing
- Investment plans are modest but financial leverage remains high
- Support from the owner provides uplift to the standalone rating

Corporate Profile

Landsvirkjun is Iceland's largest electric utility, responsible for around 73% of Iceland's total electricity production of 18.1 TWh in 2013. It provides green energy for domestic users via electricity sales to public utilities, although

the bulk of sales are to power intensive industries (PII), mostly for aluminium smelting, an important source of Iceland's foreign currency earnings. The company's installed capacity, totalling 1,955 MW, is mainly based on hydro sources, which account for approximately 96% of the total owned capacity, with geothermal plants accounting for the remainder. Landsvirkjun is a majority owner (64.7%) of Landsnet, the country's electricity transmission grid.

Landsvirkjun is 100% owned by the Government of Iceland. In order to meet the requirements of the partnership agreement, 99.9% of the company is directly owned by the state and 0.1% by Eignarhlutir hf, a special purpose vehicle owned by the Republic of Iceland.

SUMMARY RATING RATIONALE

Landsvirkjun's rating factors in positively the company's dominant position in the Icelandic energy market and its low-cost renewable generation asset base, albeit in a small and isolated market. The company's assessment is constrained by (1) exposure to aluminium prices in a weak commodity market; (2) concentrated exposure to a comparatively small number of counterparties in the aluminium industry; (3) currency risk; and (4) the company's high financial leverage.

The (P)Ba2/(P)NP ratings assigned to Landsvirkjun's USD1 billion EMTN programme reflect the standalone credit quality of Landsvirkjun, expressed as a baseline credit assessment (BCA) of b1 together with two notches of uplift to reflect the likelihood of extraordinary support being provided by the Government of Iceland (Baa3 stable) in the event this was needed to avoid a payment default. This uplift reflects the high level of commitment that Iceland has shown in the past by the provision of guarantees of collection to support Landsvirkjun's debt and the strategic importance of Landsvirkjun to Iceland, given the company's position as the country's dominant electric utility, and the significant role it plays in the provision of electricity to the aluminium smelting industry.

The (P)Baa3/(P)Prime-3 ratings assigned to Landsvirkjun's USD2.5 billion backed EMTN programme are on par with the sovereign rating and reflect the additional credit support provided by the guarantee of collection from the Icelandic government.

DETAILED RATING CONSIDERATIONS

ICELAND'S DOMINANT POWER PRODUCER WITH A UNIQUE AND LOW-COST GENERATION ASSET BASE

Landsvirkjun is Iceland's largest power producer with total installed generation capacity of 1,955 MW and a 73% share in the country's electricity generation.

The company currently operates 14 hydropower plants, two geothermal plants and two windmills. Landsvirkjun's electricity generation in 2013 amounted to 12.8 TWh, of which 96% was from hydrological resources and 4% from geothermal resources. This presents a very unique portfolio of generation assets and compares with Iceland's mix of 71% based on hydro and 29% based on geothermal sources.

Given the very low marginal costs of production associated with its hydro sources, Landsvirkjun has a very attractive generation portfolio. In addition, competition from regional players, primarily Reykjavik Energy and Hitaveita Sudurnesja, is fairly limited. These strengths are, however, somewhat offset by the fact that Landsvirkjun operates in a small and isolated market.

POWER SALES TO ALUMINIUM SMELTERS BRING EXPOSURE TO ALUMINIUM PRICE AND VOLATILITY IN CASH FLOWS, ALTHOUGH SHORT-TERM RISK MITIGATED BY HEDGING

Landsvirkjun is predominantly a wholesale producer, with about 85% of revenues coming from power sales. The remaining 15% is mostly derived from transmission activities, spread between local utilities and PIIs.

Some 85% of Landsvirkjun's energy generation is to PIIs under long-term take-or-pay contracts. The company's major customers are aluminium smelters which include: Alcoa Fjardeel, Rio Tinto Alcan Iceland, Nordural, Elkem Iceland and Becromal. Concentration in terms of a small number of counterparties is a negative, although we note that so far the aluminium smelters have had a track record of timely payments.

About half of Landsvirkjun's energy generation is sold through contracts directly linked to aluminium prices and remaining half is CPI indexed. These contracts provide valuable foreign currency earnings but also expose the company to volatility in the price of aluminium. As such, Landsvirkjun has assumed a commodity risk not seen for other utilities in Europe and outside of Iceland.

Aluminium price underwent a major correction in 2008, when it dropped from over USD3,000 per tonne in July 2008 to around USD1,300 per tonne in February 2009. As of end-June 2014, spot aluminium was around USD1,870. We believe that aluminium prices will remain under pressure in the short to medium term with no catalyst for a material price improvement through early-to-mid 2015. Aluminium's end market (excluding China) is weak, there is still high inventory on the London Metal Exchange and new capacity is expected to be built in the Middle-East offsetting the relatively increased demand coming from the automotive and aerospace industries in North America.

We note that in order to reduce cash flow volatility, the company has adopted a hedging strategy, wherein they hedge a certain percentage of their future energy sales. The actual amount hedged is dependent on market conditions. Landsvirkjun has been also implementing a pricing strategy which aims to reduce its exposure to aluminium power prices and an amendment of one of the power contracts in 2010 is one example of this.

FOREIGN CURRENCY RISK IS FAIRLY MATERIAL, ALBEIT DECREASING

Landsvirkjun's reporting currency is US dollar, the currency in which most of its revenues are derived. The company also has revenues in Icelandic krona that balance against its operating expenses, Norwegian krona and a relatively small amount in euros.

A substantial proportion of its debt is US dollar denominated and the company has limited exposure to the Icelandic krona. It has, however, some sensitivity to adverse movements in the US dollar against the euro given the weighting towards the latter currency in its funding base (around 29% of debt as of end-2013 was euro denominated).

We note that earlier this year Landsvirkjun finalised agreements on amendments of its three outstanding bonds. The euro-denominated bonds were amended and converted into US dollar bonds. The total amount was EUR75 million but after the conversion the amount is USD103 million. These agreements result in a small reduction in the company's foreign exchange risk. Following conversion of debt, the share of euro-denominated debt reduced to 25% and the proportion of US dollar-denominated increased to 58% from 54% as of end-December 2013.

INVESTMENT PLANS ARE MODEST BUT FINANCIAL LEVERAGE REMAINS HIGH

Landsvirkjun's current investment plans are relatively modest compared with historical highs reported in 2005-08, when the company undertook a major expansion of its production capacity. The latest addition to the company's generation portfolio was the construction of Budarhals hydro power plant with 95 MW of capacity (to produce 585 GWh), which became fully operational in March this year.

Scheduled investments are mainly related to maintenance, with some investment in the transmission grid. In terms of new generation projects, Landsvirkjun is currently preparing an investment into a 45-90MW geothermal power plant at Theistareykir region. There could be other projects in the future in southern and north-eastern Iceland, but the company has not committed to any further investments as of today.

Landsvirkjun has also engaged in a feasibility study on a sub-marine cable between Iceland and Europe. This would be a very significant and strategic project for Iceland. However, no decisions have been made with regard to its construction and Landsvirkjun's possible involvement.

With the completion of major investment projects, we expect that the company's debt coverage metrics such as funds from operations (FFO)/ net debt and retained cash flow (RCF)/ net debt will improve gradually over time, although will likely remain in the high-single digits into the medium term. The pace of improvement in Landsvirkjun's credit metrics will be primarily dependent on the level of aluminium prices and funding costs, but also whether the company undertakes any further investment projects or pays dividends.

SUPPORT FROM THE OWNER PROVIDES AN UPLIFT TO LANDSVIRKJUN'S STANDALONE RATING

Landsvirkjun is considered a government-related issuer (GRI) because of its ownership by the Government of Iceland. The company's ratings incorporate an uplift for potential government support to its standalone credit quality of b1.

Our assumption of a very high support reflects the high level of commitment that Iceland has shown in the past by the provision of guarantees of collection to support Landsvirkjun's debt and the strategic importance of Landsvirkjun to Iceland, given the company's position as the country's dominant electric utility, and the significant role it plays in the provision of electricity to the aluminium smelting industry.

Guarantees of collection do not offer bondholders the same degree of protection as a timely payment guarantee. There is a potential risk of non-timely repayment should the company fail to meet its obligations, as exhaustive administrative and legal procedures must be followed before the shareholders are obliged to pay. However, given Landsvirkjun's vital strategic importance to Iceland and other incentives for the shareholders (such as its liability for penalty interest), we expect that the state would intervene in a timely fashion and provide financial or other assistance.

The USD2.5 billion EMTN programme allows for issuance of notes only with the benefit of a guarantee of collection provided by the Republic of Iceland and Eignarhlutir ehf.

The USD1 billion EMTN programme allows for issuance of notes without a guarantee from the Government of Iceland. Consequently, and notwithstanding the very high support for the company, we differentiate between the ratings of the two programmes.

Our assessment of high default dependence balances Landsvirkjun's position as the country's dominant electric utility with the company's high level of US dollar-denominated revenues from contracts with exporting aluminium smelters with international parent companies.

Liquidity Profile

As of end-December 2013, Landsvirkjun had USD288 million of cash and cash equivalents, as well as access to USD291 million under committed long-term revolving credit facilities (RCFs). Of this amount, USD200 million relates to a committed revolving facility with international and domestic commercial banks, maturing in December 2016 and the remaining USD91 million (ISK10.5 billion equivalent) relates to an RCF facility with Icelandic banks, also maturing in December 2016. In addition, Landsvirkjun had an undrawn ECA facility amounting to USD10.7 million.

Landsvirkjun has a relatively well-spread maturity profile, which mitigates refinancing risk, albeit we caution that the amounts of debt are still sizeable. Based on the available cash and credit lines coupled with forecast positive free cash flow generation, we expect the company to have enough liquidity to carry it through 2015.

We understand that the bank facility in USD (undrawn) contains financial covenants but Landsvirkjun shows adequate headroom against the default levels.

Rating Outlook

Given the support assumption embedded within our ratings, the stable outlook reflects the stable outlook on the Icelandic government's ratings. It further reflects the strong liquidity of the company and our view that Landsvirkjun's capital structure is reasonably able to withstand downside sensitivities.

What Could Change the Rating - Up

An improvement in the sovereign rating would be required before we would consider an upgrade of Landsvirkjun's ratings under an assumption of a continued very high support from the government.

What Could Change the Rating - Down

We would expect to downgrade Landsvirkjun's ratings (1) following any downgrade of the sovereign rating; or (2) if we were to perceive that there were a reduced likelihood of the government providing timely support to Landsvirkjun. In addition, a deterioration in the standalone credit quality of Landsvirkjun due to, for example, a significant fall in aluminium prices, could exert downward rating pressure.

Other Considerations

In our assessment of Landsvirkjun's credit profile, we apply our global Rating Methodology for Unregulated Utilities and Power Companies, published in August 2009. Under this methodology, Landsvirkjun is considered an unregulated power company and the grid output maps to ba2. In assigning the BCA of b1, we give additional weight to the company's exposure to aluminium prices in a weak commodity market, a degree of currency mismatch between revenues and debt service costs, as well as vulnerability to increased funding costs in the event of higher interest rates.

Rating Factors

Landsvirkjun

Power Companies	Current	
Factor 1: Market Assessment, Scale and Competitive Position (20%)	Measure	Score
a) Market and Competitive Position		A
b) Geographic Diversity		Ba
Factor 2: Cash Flow Predictability of Business Model (20%)		
a) Effectiveness of Hedging Strategy		B
b) Fuel Strategy and Mix		B
c) Capital Requirements & Operational Performance		A
Factor 3: Financial Policy (10%)		
a) Financial Policy		B
Factor 4: Key Credit Metrics (50%) [2][3]		
a) FFO + Interest expenses / Interest expenses	2.9x	Ba
b) FFO / Net Debt	8.4%	B
c) RCF / Net Debt	7.9%	B
d) FCF / Net Debt	3.6%	Ba
Rating:		
a) Indicated Rating from Grid		ba2
b) Actual BCA assigned		b1

[1]Moody's 12-18 months forward viewAs of 7/03/2014	
Measure	Score
	A
	Ba
	B
	B
	A
	B
3.3-3.5x	Ba
9-10%	B
8-9%	Ba
6-8.5%	Ba
	ba2
	b1

Government-Related Issuer	Factor
a) Baseline Credit Assessment	b1
b) Government Local Currency Rating	Baa3
c) Default Dependence	High
d) Support	Very High

[1] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures [2] As of 12/31/2013 [3] All ratios are calculated using Moody's Standard Adjustments; Source: Moody's Financial Metrics



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