

RatingsDirect®

Summary:

Landsvirkjun

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Summary:

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**Credit
Rating:**

BB/Stable/B

Rationale

The rating on Iceland-based electricity generation and transmission company Landsvirkjun is based on the company's stand-alone credit profile (SACP), which we assess as 'b+', based on the group's "fair" business risk profile and "highly leveraged" financial risk profile. They further include two notches of uplift based on our opinion that there is a "very high" likelihood that the government of the Republic of Iceland (BBB-/Stable/A-3) would provide timely and sufficient extraordinary support in the event of financial distress.

In accordance with our criteria for government-related entities (GREs), our view of a "very high" likelihood of extraordinary government support is based on our assessment of Landsvirkjun's:

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

Landsvirkjun's "highly leveraged" financial risk profile is constrained by our view of the company's high financial leverage and weak cash flow coverage ratios, due to significant debt-funded capital investments in recent years. Landsvirkjun's "fair" business risk profile is restricted by high customer concentration, the company's exposure to the aluminum sector for revenue and cash flow generation, and poor profitability. The company is, however, the dominant power producer in Iceland and has a modern and low-cost renewable generation asset base.

S&P base-case operating scenario

In our base-case scenario, we assume that Landsvirkjun's earnings will continue to fluctuate in line with aluminum price movements, as about 50% of its power production is sold through contracts with an aluminum price link. Higher aluminum prices were a supportive factor in an increase in Landsvirkjun's earnings and margins in 2011, when EBITDA increased by 16% compared with 2010, and the company's adjusted EBITDA margin remained high at 80%. We note, however, that aluminum prices have decreased during the first half of 2012, which could impact earnings negatively in 2012. We believe that this impact is likely to be mitigated by stability in volumes through take-or-pay contracts, and the fact that the company hedges part of its aluminum price exposure. We therefore assume that any potential decrease in EBITDA in 2012 would be modest.

S&P base-case cash flow and capital-structure scenario

In our base-case assessment, we believe that development in Landsvirkjun's funds from operations (FFO) will follow

EBITDA development. Thus, we assume that FFO in 2012 could decrease slightly from the \$260 million achieved in 2011 as a result of lower aluminum prices.

We assume that the construction of the new power plant Budarhals, with completion scheduled for 2013, could lead to increased capital expenditures in 2012 and 2013 than last year. This project is, however, smaller than a past significant project, and we believe that the FFO should be well in excess of committed investments in the near term. Landsvirkjun has not paid dividends in the past few years, but its Board of Directors proposed a modest dividend of about \$14 million to be paid for the year 2011. Accordingly, we forecast positive free cash flows in the near term. Reflecting the company's high debt burden and uncertainty about aluminum prices, we anticipate, however, that the company's adjusted FFO and adjusted debt to EBITDA will remain at 8%-10% and 8.0x-8.5x, respectively, in the near term. In 2011, these figures were 9.3% and 8.1x respectively.

Potential investments in new power stations in north east Iceland could put pressure on credit measures in the medium term, although we expect that such investments would not be started before Landsvirkjun secures contracts for the output.

Liquidity

The short-term rating is 'B'. We view Landsvirkjun's liquidity position as "adequate" under our criteria. We believe that available liquidity sources in terms of cash, committed credit facilities, and operating cash flows should be well in excess (more than 1.2x) of forecast near-term cash outflows such as debt repayments, capital expenditure, and dividend payments. We further believe that the company has a sound relationship with its banks, a satisfactory standing in the credit markets, and prudent risk management.

Landsvirkjun's main liquidity sources consist of:

- \$257 million in unrestricted cash as of March 31, 2012.
- Access to a \$200 million unused committed revolving credit facility that expires in December 2014 with a possible extension of up to two years, and an unused committed credit facility amounting to Icelandic krona (ISK) 10.5 billion (\$81 million), expiring in December 2014, also with two years of possible extension. We understand that the \$200 million facility contains financial covenants, under which we expect Landsvirkjun to retain adequate headroom.
- FFO of \$260 million in 2011, which we assume could be slightly lower in 2012.

Expected cash outflows consist of:

- About \$168 million in debt maturing in the next 12 months, and about \$89 million in the following 12 months as of March 31, 2012.
- Capital expenditures that we estimate in excess of \$100 million annually in 2012 and 2013.
- Dividend payments of \$14 million in 2012, and no material change in 2013.

Outlook

The stable outlook reflects the stable outlook on Iceland, and our assumption of an unchanged SACP for Landsvirkjun in the near term. In our base case, we assume that despite possible pressure on earnings from negative aluminum price

developments, Landsvirkjun's FFO should be well in excess of committed investments in the near term, and dividend payments would be modest. Accordingly, we forecast positive free cash flows in the near term. We further anticipate that the company's adjusted FFO will remain at 8%-10% and adjusted debt to EBITDA at 8.0x-8.5x in the near term, which is in line with our expectations for the 'b+' SACP.

If we were to revise our assessment of Landsvirkjun's SACP upward by one notch, we would also raise the ratings by one notch. This could result from a significant strengthening of the company's financial risk profile and credit measures in the medium term, for example if the company were to continue to generate positive free cash flows and pay down debt, leading to adjusted FFO to debt of sustainably above 10%.

In accordance with our criteria for GREs, we would also likely raise the ratings on Landsvirkjun by one notch if we raised the sovereign local currency rating on Iceland by one notch, provided our assessment of the "very high" likelihood of extraordinary government support remained unchanged.

We would not lower the ratings on Landsvirkjun even if we revised our assessment of the company's SACP downward by up to two notches. We would, however, likely lower the ratings by one notch if we lowered the local currency rating on Iceland by one notch.

Related Criteria And Research

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Principles Of Credit Ratings, Feb. 16, 2011
- Methodology: Short-Term/Long-Term Ratings Linkage Criteria For Corporate And Sovereign Issuers, May 15, 2012

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