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Research Update:

Icelandic Power Company Landsvirkjun Outlook To Positive After Similar Action On Iceland; 'BB/B' Ratings Affirmed

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Overview

- On July 18, 2014, we revised our outlook on Iceland to positive from stable and affirmed our 'BBB-/A-3' sovereign ratings.
- Icelandic electricity generation and transmission company Landsvirkjun is a government-related entity with a "very high" likelihood of extraordinary government support in the event of financial distress.
- We are therefore revising our outlook on Landsvirkjun to positive from stable and affirming our 'BB/B' ratings on the company.
- The positive outlook reflects that on Iceland, as well as our view that the Icelandic government's ability to provide support to Landsvirkjun in a financial stress scenario could potentially strengthen, and that an upgrade of Iceland would likely result in an upgrade of Landsvirkjun.

Rating Action

On July 24, 2014, Standard & Poor's Ratings Services revised its outlook on Iceland-based electricity generation and transmission company Landsvirkjun to positive from stable. At the same time, we affirmed our 'BB' long-term and 'B' short-term corporate credit ratings on Landsvirkjun.

Rationale

The outlook revision follows our similar action on the Republic of Iceland (see "Iceland Outlook Revised To Positive On Strong Growth And Improving Public Finances; 'BBB-/A-3' Ratings Affirmed," published July 18, 2014, on RatingsDirect).

We base our ratings on Landsvirkjun on the company's stand-alone credit profile (SACP), which we assess at 'b+', reflecting its "fair" business risk profile, "highly leveraged" financial risk profile, and a one-notch upward adjustment for our "positive" comparable ratings analysis, according to our criteria. The long-term rating further includes two notches of uplift based on our opinion that there is a "very high" likelihood that the government of the Republic of Iceland would provide timely and sufficient extraordinary support to Landsvirkjun in the event of financial distress.

We consider Landsvirkjun to be a government-related entity (GRE). In accordance with our criteria for GREs, our view that there is a "very high" likelihood of extraordinary government support is based on our assessment of 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;

strategic importance to the Icelandic economy; and central role in the promotion of power-intensive industries.

- "Very strong" link with the Icelandic state, given the state's 100% ownership and our expectation that the company will not be privatized in the medium term; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Our assessment of Landsvirkjun's financial risk profile as "highly leveraged" reflects the company's high debt due to significant debt-funded capital investments in recent years, resulting in weak cash-flow coverage ratios. Although we assume that Landsvirkjun will post positive free cash flow in the near term, we believe that credit measures will remain weak, with funds from operations (FFO) at about 10%, from about 9% in 2013, and debt to EBITDA at about 7.0x, from about 7.7x in 2013.

Landsvirkjun's "fair" business risk profile reflects Iceland's "moderately high" country risk, the "moderately high" industry risk of unregulated power and gas companies, and the company's "fair" competitive position. Landsvirkjun's competitive position is restricted by high customer and geographic concentration and the company's exposure to the aluminum sector for revenue and cash flow generation. Landsvirkjun's earnings and cash flow are exposed to volatile commodity prices, as about 50% of power sales are linked to aluminum prices through power supply contracts with aluminum smelters. These constraints are, however, mitigated by Landsvirkjun's position as the dominant power producer in Iceland, and its low-cost renewable generation asset base. Its long-term pay-or-take contracts with customers provide some predictability of earnings, which mitigates the concentration risk and exposure to aluminum prices.

We apply an upward adjustment of one notch, reflecting our "positive" comparable ratings analysis for the company. This is based on our view that Landsvirkjun's FFO-to-debt ratio is at the upper end of our "highly leveraged" category; that interest coverage is strong for the financial risk profile; and that there is ongoing support from the owner, the Icelandic government, which has requested very modest dividends from Landsvirkjun over the past few years.

Under our base case, we assume:

- EBITDA margins of about 75%-80% in 2014 and 2015, which is broadly unchanged from 79% in 2013. Power prices will likely face pressure due to low aluminum prices, mitigated by price hedges and modest volume growth.
- FFO well in excess of capital expenditures (capex) and dividends, leading to debt reduction, although only by a modest amount relative to the overall high level of debt.

Based on these assumptions, we arrive at the following credit measures for 2014 and 2015:

- FFO to debt of about 9%-11%.
- Debt to EBITDA of about 6.5x-7.5x.
- FFO cash interest coverage of about 3.2x-3.7x.

Liquidity

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 flow should be well in excess--more than 1.2x--of forecast near-term cash outflows such as debt repayments, capex, and dividends. We also expect that sources will exceed uses even if EBITDA declines by 15%. We understand that Landsvirkjun's \$200 million revolving credit facility contains financial covenants, under which we expect Landsvirkjun will retain adequate headroom.

We further believe that the company has a sound relationship with its banks, a satisfactory standing in the credit markets, and prudent risk management.

We calculate the following principal liquidity sources, as of Dec. 31, 2013:

- \$288 million in cash.
- Access to a \$200 million unused committed revolving credit facility that expires in December 2016, and an unused committed credit facility amounting to Icelandic krona 10.5 billion (about \$90 million), expiring in December 2016.
- FFO in excess of \$200 million annually.

At the same date, we calculate the following principal liquidity uses:

- About \$175 million in debt maturing in 2014 and about \$190 million in 2015.
- Annual capex that we estimate should be well below the about \$150 million in 2013, in both 2014 and 2015.
- Dividend payments of about \$15 million annually in 2014 and 2015.

Outlook

The positive outlook reflects that on Iceland, and our view that the Icelandic government's ability to provide support to Landsvirkjun in a financial stress scenario could potentially strengthen, and that an upgrade of Iceland would likely result in an upgrade of Landsvirkjun.

Upside Scenario

In line with our methodology for GREs, we could raise the rating on Landsvirkjun if we raised local currency rating on Iceland.

We could also upgrade Landsvirkjun if we were to revise our assessment of its SACP upward by one notch. This could result from a strengthening of the company's credit measures, for example if the company continues to generate positive free cash flow and pay down debt, leading to FFO to debt of at least 12% on a sustainable basis.

Downside scenario

All else remaining equal, an outlook revision on Iceland to stable would lead to a similar rating action on Landsvirkjun.

We could also revise the outlook to stable if Landsvirkjun's SACP were to be lowered by two notches to 'b-', something we currently see as unlikely.

Ratings Score Snapshot

Corporate Credit Rating: BB/Positive/B

Business risk: Fair

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

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

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: Positive (+1 notch)

Stand-alone credit profile: b+

- Sovereign rating: BBB-
- Likelihood of government support: Very high (+2 notches)

Related Criteria And Research

Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry - March 28, 2014
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - January 02, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 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 - November 13, 2012

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - December 09, 2010
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008

Related Research

- Research Update: Iceland Outlook Revised To Positive On Strong Growth And Improving Public Finances; 'BBB-/A-3' Ratings Affirmed, July 18, 2014
- Country Risk Assessments Update: May 2014, May 14, 2014
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

Ratings List

	Ratings	
	To	From
Landsvirkjun		
Corporate credit rating		
Foreign and Local Currency	BB/Positive/B	BB/Stable/B
Senior Unsecured		
Foreign and Local Currency	BB	BB
Foreign and Local Currency[1]	BB	BB
Short-Term Debt		
Foreign and Local Currency	B	B
Foreign and Local Currency[1]	B	B

[1] Dependent Participant(s): Iceland (Republic of)

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