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Summary:
Landsvirkjun

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Corporate Credit Rating	BB/Stable/B

Profile Assessments

BUSINESS RISK	FAIR	Vulnerable — Excellent
FINANCIAL RISK	HIGHLY LEVERAGED	Highly leveraged — Minimal

Likelihood Of Extraordinary Government Support

The ratings on Iceland-based electricity generation and transmission company Landsvirkjun are based on the company's stand-alone credit profile (SACP), which we assess as 'b+', based on its "fair" business risk profile and "highly leveraged" financial risk profile. The long-term rating includes 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 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; the provision of ultimate state guarantees for Landsvirkjun's debt; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Rationale

Business Risk: Fair	Financial Risk: Highly leveraged
• High customer concentration. • Exposure to the aluminum sector for revenue and cash flow generation. • Weak profitability, although it has high EBITDA margins. • Dominant power producer in Iceland. • Low-cost renewable generation asset base. • Long-term take-or-pay power supply contracts.	• High debt leverage owing to past significant investments. • Weak cash flow coverage ratios. • Foreign currency exposure through significant share of euro-denominated debt. • Positive free cash flow owing to modest future capital expenditure (capex) needs and low dividend payments.

Outlook: Stable

The stable outlook reflects the stable outlook on Iceland, and our assumption that Landsvirkjun's SACP will remain unchanged in the near term. Under our base-case scenario, we assume that despite possible pressure on earnings from falling aluminium prices, Landsvirkjun's funds from operations (FFO) will be well in excess of committed investments over the near term, and dividend payments will be modest. Accordingly, we forecast near-term positive free cash flows. We also expect the company's adjusted FFO to debt to 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.

Downside scenario

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.

Upside scenario

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 over 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 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.

Standard & Poor's Base-Case Scenario

Our base-case for 2013-2014 results in broadly unchanged credit measures.

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Assumptions	Key Metrics
• Broadly unchanged EBITDA and margins compared with 2012 ($320 million; 79.7%) as pressure on power prices from low aluminum prices will be mitigated by price hedges and modest volume growth. • FFO well in excess of capex and dividends. • Continued debt reduction, albeit modest in relation to the overall high level of debt.	(see table below)

	2012A	2013E	2014E
EBITDA margin	79.7%	75%-80%	75-80%
FFO/debt	8.8%	8%-10%	8%-10%
Debt/EBITDA	8.3x	8.0x-8.5x	8.0x-8.5x

*Fully Standard & Poor's-adjusted. A--Actual. E--Estimated.

We adjust Landsvirkjun's debt for minor post-retirement obligations, and accrued interest, which in 2012 amounted to about $41 million in total.

Business Risk: Fair

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 weak profitability. Landsvirkjun operates only in the small and isolated Icelandic market, and over 80% of the power it produces is sold to power-intensive industries, mostly a small number of aluminum smelters. In addition, Landsvirkjun's earnings and cash flows are exposed to volatile commodity prices, as about 50% of power sales are linked to aluminum prices through power supply contracts with aluminum smelters. The company's return on capital is weak, at about 3%-5% in recent years, as a result of significant investments in new capacity.

These constraints are, however, mitigated by Landsvirkjun being the dominant power producer in Iceland, and its low-cost renewable generation asset base, resulting in high EBITDA margins. Its long-term pay-or-take contracts with customers provide some predictability of earnings, which mitigates the concentration risk and exposure to aluminum prices.

Under our base-case scenario, we assume that Landsvirkjun's earnings will continue to fluctuate in line with the aluminum price. We believe, however, that the negative impact of lower aluminum prices is likely to be offset by the fact that the company hedges part of its aluminum price exposure, and by some modest volume growth primarily related to a new power plant--Budarhals--scheduled to start producing electricity at the beginning of 2014. We therefore assume that EBITDA and EBITDA margins should stay broadly unchanged during 2013 and 2014 compared with 2012.

Financial Risk: Highly leveraged

Landsvirkjun's "highly leveraged" financial risk profile is constrained by our view of the company's high debt leverage and weak cash flow coverage ratios, due to significant debt-funded capital investments in recent years. In addition, Landsvirkjun has foreign-currency exposure through a significant share of debt denominated in euros, while most cash flows are generated in U.S. dollars. Landsvirkjun hedges part of this exposure, however.

The financial risk assessment benefits from Landsvirkjun generating positive free cash flows following completion of past significant plant investments, as the company has modest capex needs and pays low dividends. Although this results in gradual debt reduction, it is from a high level, which limits the positive impact on credit measures.

In our base-case assessment for 2013-2014, we assume that any change in Landsvirkjun's FFO will broadly follow EBITDA development, and not change significantly from 2012's €234 million. We further assume that FFO will be well in excess of committed investments in the near term, especially when the investment in Budarhals is completed in 2013. We anticipate that future dividends will remain modest, and 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 Landsvirkjun's adjusted FFO to debt and adjusted debt to EBITDA will remain at 8%-10% and 8.0x-8.5x, respectively, during 2013 and 2014.

Potential investments in new power stations in north east Iceland could put pressure on Landsvirkjun's credit measures over the medium term, although we expect that such investments will not start before the company secures contracts for the output.

Liquidity: Adequate

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, capex, 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.

Principal Liquidity Sources	Principal Liquidity Uses
• $245 million in cash as of Dec. 31, 2012. • Access to a $200 million unused committed revolving credit facility that expires in December 2015 with a possible extension of one year, and an unused committed credit facility amounting to Icelandic krona 10.5 billion ($81 million), expiring in December 2015, also with a one year possible extension. We understand that the $200 million facility contains financial covenants, under which we expect Landsvirkjun to retain adequate headroom. • FFO in excess of $200 million annually.	• About $208 million in debt maturing in 2013, and about $169 million in 2014. • Capex that we estimate in excess of $100 million in 2013, and potentially slightly lower in 2014. • Dividend payments, which totaled about $13 million in 2013, and which we assume will not change significantly in 2014.

Related Criteria And Research

- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Methodology: Short-Term/Long-Term Ratings Linkage Criteria For Corporate And Sovereign Issuers, May 15, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Principles Of Credit Ratings, Feb. 16, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Business And Financial Risk Matrix

	Financial Risk					
Business Risk	Minimal	Modest	Intermediate	Significant	Aggressive	Highly Leveraged
Excellent	AAA/AA+	AA	A	A-	BBB	--
Strong	AA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair	--	BBB-	BB+	BB	BB-	B
Weak	--	--	BB	BB-	B+	B-
Vulnerable	--	--	--	B+	B	B- or below

Note: These rating outcomes are shown for guidance purposes only. The ratings indicated in each cell of the matrix are the midpoints of the likely rating possibilities. There can be small positives and negatives that would lead to an outcome of one notch higher or lower than the typical matrix outcome. Moreover, there will be exceptions that go beyond a one-notch divergence. For example, the matrix does not address the lowest rungs of the credit spectrum (i.e., the 'CCC' category and lower). Other rating outcomes that are more than one notch off the matrix may occur for companies that have liquidity that we judge as "less than adequate" or "weak" under our criteria, or companies with "satisfactory" or better business risk profiles that have extreme debt burdens due to leveraged buyouts or other reasons. For government-related entities (GREs), the indicated rating would apply to the standalone credit profile, before giving any credit for potential government support.

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