

### Summary:

## Landsvirkjun

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**Credit Rating:** BB/Stable/B-1

## Rationale

The 'BB' ratings on Iceland-based 100% state-owned utility Landsvirkjun reflect Standard & Poor's Ratings Services' opinion that there is a "very high" likelihood that the Republic of Iceland (foreign currency BBB-/Negative/A-3; local currency BBB-/Negative/A-2) would provide timely and sufficient extraordinary support to Landsvirkjun in the event of financial distress. We assess Landsvirkjun's stand-alone credit profile (SACP) at 'B-'.

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

- "Very important" role, given Landsvirkjun's dominant position as the incumbent power company and 64.7% owner and monopoly system operator 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 Landsvirkjun's 100% ownership by the state and our expectation that Landsvirkjun will not be privatized in the medium term; the provision of ultimate state guarantees for the collection of all of Landsvirkjun's debt; a two-year \$300 million contingent credit facility extended to Landsvirkjun by the Central Bank of Iceland; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Landsvirkjun's weak SACP largely reflects our view of the company's weak liquidity position, high financial gearing, and weak cash flow coverage ratios. It also reflects Landsvirkjun's weak business risk profile due to the risks of customer concentration and the company's exposure to inherently volatile aluminum prices and foreign exchange fluctuations. The company is, however, the dominant power producer in Iceland and has a modern and low-cost renewable generation asset base.

### Key business and profitability developments

Sales to power-intensive industries account for more than 80% of Landsvirkjun's total power sales. The price of aluminum drives the price of electricity in Landsvirkjun's power sale agreements with the aluminum plants. This business structure results in a lack of diversification and exposes the company to commodity risks. Aluminum prices gradually increased throughout 2009, with the result that Landsvirkjun posted stronger revenues and EBITDA than we had anticipated. That said, revenues and EBITDA fell by 33% and 35%, respectively, compared with 2008.

### Key cash flow and capital-structure developments

Landsvirkjun's financial risk profile is highly leveraged, in our view, due to debt-funded capital investments made in the \$1.1 billion Kárahnjúkar hydropower plant over recent years. The project is now complete and we understand that the company's capital expenditures (capex) will fall sharply in 2010 and mainly cover maintenance costs over the near to medium term.

The company's free operating cash flow was positive in 2009 and no dividends were paid. As a consequence, Landsvirkjun's adjusted debt was largely unchanged at \$3.1 billion on Dec. 31, 2009. Due to the sharp fall in

revenues and EBITDA, however, the company's debt-to-EBITDA ratio increased to about 13x in 2009 from about 9x in 2008. However, Landsvirkjun's ratio of adjusted funds from operations (FFO) to debt was largely unchanged at 6.8% (6.9%), while its FFO interest coverage ratio rose to 3.3x (from 1.8x). The latter largely reflects much lower interest costs in 2009 compared with 2008.

### Liquidity

Landsvirkjun's liquidity position remains weak, in our opinion, which weighs on the company's SACP. This is due to limited financial flexibility, significant upcoming debt maturities that remain largely unfunded, and Landsvirkjun's dependency on solidly improving operating cash flows and minimum capex to cover its debt service requirements.

On March 31, 2010, Landsvirkjun had \$98 million in freely available cash. The company also had \$282 million available under a committed revolving credit facility that expires in December 2012, which is free of covenants and other restrictions. This compares with about \$315 million of short-term debt and an additional \$335 million of debt due through 2012. We believe that the \$300 million contingent credit facility with the Central Bank of Iceland supports Landsvirkjun's liquidity position in the near term. However, we understand that the facility expires on July 1, 2011, so use of this contingency funding would only provide short-term relief.

### Outlook

The stable outlook reflects our opinion that Landsvirkjun's SACP is unlikely to improve materially in the near to medium term. While we believe that Landsvirkjun's credit metrics will strengthen, the improvement starts from a very weak position and is likely to be gradual. At the same time, Landsvirkjun's liquidity position remains weak due to low (albeit gradually improving) cash flow generation and significant short-term debt service requirements.

The stable outlook also reflects our view that--given Landsvirkjun's 'B-' SACP--a lower or higher local currency rating on the Republic of Iceland would not necessarily lead to a change in the rating on Landsvirkjun.

A negative rating action is likely to be triggered by an erosion of Landsvirkjun's already weak liquidity position. Successful refinancing of upcoming debt maturities will, we believe, be critical to the ratings over the near to medium term. There is no upside to the ratings as long as these immediate liquidity concerns remain.

### Related Criteria And Research

- "General Criteria: Enhanced Methodology And Assumptions For Rating Government-Related Entities," June 29, 2009
- "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," May 27, 2009
- "Principles Of Corporate And Government Ratings," June 26, 2007

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