

**Research Update:**

**Icelandic Utility Landsvirkjun  
Outlook Revised To Stable After  
Similar Action On Iceland; 'BB/B-1'  
Ratings Affirmed**

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## Research Update:

# Icelandic Utility Landsvirkjun Outlook Revised To Stable After Similar Action On Iceland; 'BB/B-1' Ratings Affirmed

## Overview

- We have revised our outlook on Iceland to stable from negative.
- In line with our criteria for government-related entities, we are revising our outlook on Icelandic electricity generation and transmission company Landsvirkjun to stable from negative and affirming our 'BB/B-1' ratings on Landsvirkjun.
- The stable outlook reflects that on Iceland as well as our expectations that Landsvirkjun's stand-alone credit profile will not materially change in the near term.

## Rating Action

On Nov 24, 2011, Standard & Poor's Ratings Services revised its outlook on Iceland-based electricity generation and transmission company Landsvirkjun to stable from negative. At the same time, we affirmed our 'BB' long-term and 'B-1' short-term corporate credit ratings on Landsvirkjun.

## Rationale

The outlook revision follows our similar action on the Republic of Iceland (BBB-/Stable/A-3) on Nov. 23, 2011; see "Outlook On Iceland Revised To Stable From Negative On Return To Growth; 'BBB-/A-3' Ratings Affirmed", published Nov. 23, 2011, on RatingsDirect on the Global Credit Portal.

We base our 'BB' rating on Landsvirkjun on the company's stand-alone credit profile (SACP), which we assess at 'b+', as well as on our opinion that there is a "very high" likelihood that the government of Iceland would provide timely and sufficient extraordinary support to Landsvirkjun 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 all of Landsvirkjun's debt; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Landsvirkjun's SACP of 'b+' continues to largely reflect our view of the company's high financial leverage and weak cash flow coverage ratios. The SACP also reflects Landsvirkjun's fair business risk profile, which 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.

Although Landsvirkjun renegotiated a major contract in 2010, linking it to inflation rather than aluminum prices as previously, we believe that the company's earnings will continue to fluctuate in line with aluminum price movements, given that about 50% of its power production is sold through contracts with an aluminum price link.

Landsvirkjun's high debt leverage results in weak credit measures, with adjusted funds from operations (FFO) to debt of about 8.7% and adjusted debt to EBITDA of about 8.8x for the 12 months ended June 2011, although this was an improvement from the 7.6% and 10.0x achieved in 2010. We forecast positive free cash flows in the near term, but, reflecting the company's high debt burden and uncertainty about aluminum prices, we 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.

### **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 flows should be well in excess (more than 1.2x) of forecast near-term cash outflows, such as debt repayments and capital expenditures, and any potential dividend payments. We further believe that the company has a sound relationship with its banks, satisfactory standing in the credit markets, and prudent risk management.

On Sept. 30, 2011, Landsvirkjun had \$198 million in cash, about \$51 million in short-term deposits, \$358 million available under a committed revolving credit facility that expires in December 2012, and access to committed credit facilities amounting to Icelandic krona (ISK) 5.0 billion (\$42 million), expiring in March 2014. We understand that these facilities are free from financial or other restrictive covenants. We believe that Landsvirkjun plans to refinance its revolving credit facility expiring in December 2012 well in advance of its maturity.

In addition, during the first half of 2010, Landsvirkjun signed a €70 million (\$100 million) loan facility with the European Investment Bank (EIB; AAA/Stable/A-1+) maturing in 2031 and a \$70 million loan facility with the

Nordic Investment Bank (AAA/Stable/A-1+) maturing in 2027. On June 30, 2011, both these facilities were undrawn. We note that the EIB loan facility includes a provision requiring a minimum credit rating on Iceland, which could limit future access to this facility. In the third quarter of 2011, Landsvirkjun issued bonds of about \$133 million under a euro medium-term note program and signed a \$45 million export credit agency-based loan.

Landsvirkjun generated FFO of \$252 million in the 12 months ended June 2011, and we believe that its FFO will remain well in excess of \$200 million a year in the near term.

We project that capital spending will be in excess of \$100 million annually over the next few years, but that any dividends from 2012 and thereafter will be modest. On Sept. 30, 2011, Landsvirkjun had about \$208 million of short-term debt maturing within the coming 12 months, with an additional \$146 million of debt due in the following 12 months.

## 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 funds from operations should be well in excess of committed investments in the near term, and any future dividends 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 by up to two notches lower. 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

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Outlook On Iceland Revised To Stable From Negative On Return To Growth; 'BBB-/A-3' Ratings Affirmed, Nov. 23, 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
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008

## Ratings List

CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Landsvirkjun		
Corporate Credit Rating	BB/Stable/B-1	BB/Negative/B-1
Senior Unsecured (18 issues)	BB	BB

### Additional Contact:

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Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at [www.globalcreditportal.com](http://www.globalcreditportal.com). All ratings affected by this rating action can be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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