

Research Update:

Iceland-Based Utility Landsvirkjun Rating Raised To 'BB+' On Improved Stand-Alone Credit Profile; Outlook Negative

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Overview

- Iceland-based utility Landsvirkjun's business risk profile has strengthened. At the same time, liquidity has improved and is no longer weighing on the rating.
- As a consequence, we are revising Landsvirkjun's stand-alone credit profile to 'b+' from 'b-'.
- We are raising our long-term corporate credit rating on Landsvirkjun to 'BB+' from 'BB'.
- The negative outlook reflects that on the Republic of Iceland.

Rating Action

On Oct. 20, 2010, Standard & Poor's Ratings Services raised its long-term corporate credit rating (CCR) on Iceland-based utility Landsvirkjun to 'BB+' from 'BB'. At the same time, we affirmed the 'B-1' short-term CCR. The outlook is negative. In addition, we revised Landsvirkjun's stand-alone credit profile (SACP) to 'b+' from 'b-'.

Rationale

The upgrade reflects our view of Landsvirkjun's improved SACP. This is partly due to a gradual improvement in the stability and predictability of the company's earnings, and partly to a stronger liquidity position.

In our view, Landsvirkjun's reduced exposure to inherently volatile aluminum prices--following the renegotiation of a contract with one of the smelters that buy power from Landsvirkjun--should result in less volatile swings in the company's earnings and cash flows.

In addition, we take a positive view of Landsvirkjun's focus on improving its profitability, which we believe is poor. We consider profitability to be poor due to the company's strategically important role as a provider of relatively low-cost energy to power-intensive industries.

We also consider that Landsvirkjun's financial risk profile is likely to improve, as was evident in the first half of 2010. This is based on our assumption that profitability and cash flow generation will continue to improve gradually in the near to medium term, and that investment levels will remain low. Moreover, Landsvirkjun's liquidity position has strengthened and

is no longer weighing on the SACP, which we now assess at 'b+'.

The 'BB+' rating on Landsvirkjun is based on the company's SACP, as well as on our opinion that there is a "very high" likelihood that the government of the Republic of Iceland (foreign currency BBB-/Negative/A-3; local currency BBB/Negative/A-3) 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 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 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; a two-year \$300 million contingent credit facility extended to Landsvirkjun by the Central Bank of Iceland in June 2009; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Landsvirkjun's SACP largely reflects our view of the company's high financial gearing and weak cash flow coverage ratios. We anticipate that the company's ratio of adjusted funds from operations (FFO) to debt will remain at just less than 10% through 2011, but will likely continue to improve gradually thereafter. 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. We also note that Landsvirkjun operates in line with the strategic goals for the Republic of Iceland, providing relatively low-cost energy to power-intensive industries.

Liquidity

Landsvirkjun's liquidity position has strengthened in the past few months and is adequate, in our opinion. This is due to Landsvirkjun's improved access to funding sources, as evidenced by successful debt issuance to redeem expiring debt obligations. Most recently, a \$100 million five-year bond was increased to \$150 million due to good demand from the investor base. We continue to believe, however, that Landsvirkjun is reliant on positive discretionary cash flow to support its debt service requirements in the medium term.

On June 30, 2010, Landsvirkjun had \$130 million in freely available cash and \$282 million available under a committed revolving credit facility that expires in December 2012, and which is free of covenants and other

restrictions. Landsvirkjun also had access to a committed Icelandic krona (ISK) 3.0 billion (\$24 million) bank line until April 2013. This compares with about \$290 million of short-term debt, of which we understand \$105 million had already been repaid by the end of September 2010, with an additional \$202 million of debt due in the following 12 months. 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, the facility expires on July 1, 2011, so use of this contingency funding would only provide short-term relief.

In our assessment of Landsvirkjun's adequate liquidity position, we assume that the company will address the \$358 million back-up facility expiring in December 2012 in a timely manner. A failure to extend the facility in due course or a negative deviation in FFO from our base-case assumptions could put pressure on the company's liquidity profile.

Outlook

The negative outlook reflects our opinion that a downgrade of the local currency rating on the sovereign--which currently has a negative outlook--would likely result in us lowering the CCR on Landsvirkjun. This is in line with our criteria on GREs and assumes an unchanged SACP.

In addition to what we view as a stronger business risk profile, our base-case assessment assumes that Landsvirkjun's credit metrics should gradually improve, albeit from a weak position.

We could consider taking a positive rating action if Landsvirkjun's cash flow coverage of debt and financial risk profile improve further--that is, by the company maintaining an adjusted FFO-to-debt ratio of 10% on a sustainable basis.

However, we are likely to take a negative rating action on Landsvirkjun if we downgrade the Republic of Iceland, and, at the same time, maintain Landsvirkjun's SACP at 'b+'.

Related Criteria And Research

- Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010
- 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

Ratings List

Upgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Landsvirkjun		
Corporate Credit Rating	BB+/Negative/B-1	BB/Stable/B-1
Senior Unsecured Debt*	BB+	BB
Short-Term Debt*	B-1	B-1

*Guaranteed by the Republic of Iceland.

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