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Ratings

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Landsvirkjun

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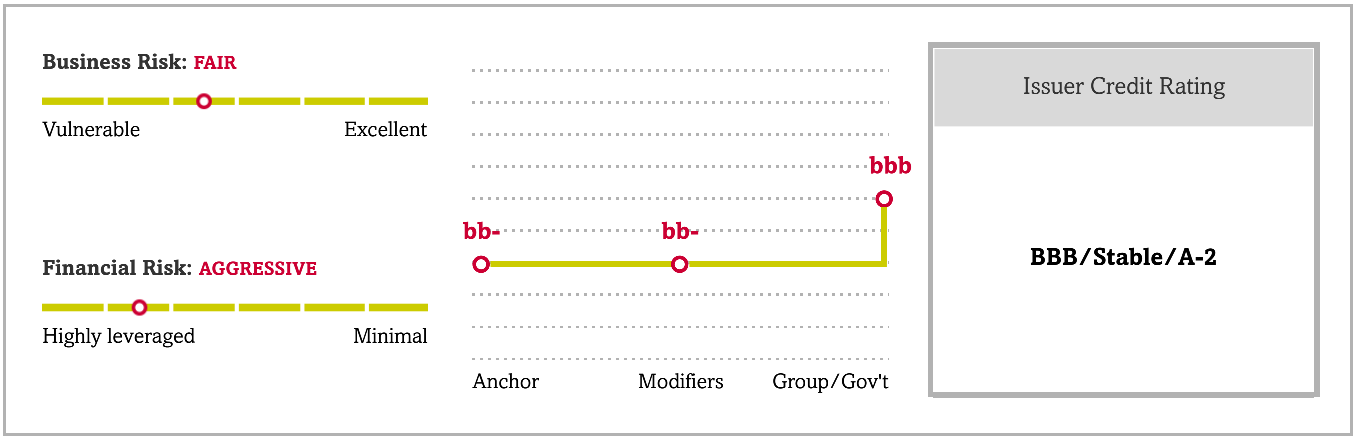
Landsvirkjun



Credit Highlights

Overview

Key Strengths	Key Risks
The largest electricity generator in Iceland, meeting roughly 75% of the country's electricity needs.	Large customer concentration, with about 70% of sales coming from the three largest customers.
A low-cost and 100% renewable generation portfolio.	High debt due to large recent investments.
Roughly 80% of sales on long-term take-or-pay contracts.	Exposure to relatively volatile aluminum prices.
Very high likelihood of support from the government of Iceland (A/Stable/A-1).	

S&P Global Ratings expects Landsvirkjun's cash flow to remain stable from its 100% renewable generation business. We expect Landsvirkjun to maintain stable margins over the coming years, due to the company's large proportion of long-term take-or-pay contracts.

Landsvirkjun plans to decrease its capital expenditure (capex) over the coming years. With no large projects in the pipeline, we expect capex to decrease over the coming years, to allow for further deleveraging

The company's customer base focuses on aluminum smelters. In our view, Landsvirkjun's large exposure to the aluminum smelter industry raises its concentration risk, despite providing an attractive electricity pricing environment for smelter operators and other power-intensive users.

We expect increasing shareholder distributions. Although the company's dividends have been relatively small in the past, we expect a dividend increase of Icelandic krona (ISK) 10 billion-ISK20 billion ($80 million-$160 million) in the coming years, from ISK1.5 billion in 2017.

In our view, Landsvirkjun plays a very important role for Iceland. Landsvirkjun has a 64.7% stake in the national transmission network (Landsnet) and provides 75% of Iceland's electricity needs. The company is fully owned by the government and an essential part of the national economy.

Outlook: Stable

The stable outlook on Landsvirkjun reflects our expectation that the company will continue to benefit from low-cost generation, relatively stable EBITDA, and gradually improving credit measures, with funds from operations (FFO) to debt at 13%-16% through 2019. The stable outlook also reflects the very high likelihood of Landsvirkjun receiving support from Iceland in the event of financial distress.

Upside scenario

We could raise our ratings if Landsvirkjun continues to deleverage and has financial policies that support an FFO-to-debt ratio sustainably above 15%, and substantially increases free operating cash flow (FOCF) generation once its new capacity investments slow down.

Downside scenario

We could lower our ratings if Landsvirkjun's stand-alone credit profile weakens by one notch, for example, due to unexpected loss of contract revenues, which could lead to weakened credit measures such as FFO to debt below 12%. We could also lower the ratings if we see a reduced likelihood of support from the government, although we view this as unlikely at present.

Our Base-Case Scenario

Assumptions

- Revenue growth of about 10% in 2018 with new capacity coming online, followed by steady growth of 4% on average in 2019 and 2020;
- Debt declining by roughly $150 million per year through 2020;
- Aluminum prices of $2,100/ton through 2020; and
- Capex of about $150 million in 2018, steadily declining thereafter to about $70 million by 2020.

Key Metrics

	2017A	2018E	2019F	2020F
EBITDA margin (%)	71.5	72-74	72-74	72-74
FFO/Debt (%)	11.9	13-15	14.5-16.5	16-18
FOCF/Debt (%)	0.9	6-8	10-12	14-16

FFO--Funds from operations. FOCF--Free operating cash flow (after capex). A--Actual. E--Estimate. F--Forecast.

Recent Developments

Landsvirkjun's results for the first nine months of 2018 are in line with our previous forecast, with an EBITDA margin of about 74% resulting in FFO to debt of approximately 14%. We acknowledge that Landsvirkjun's capex has decreased as projected, leading to deleveraging and improved credit metrics. We also recognize the company's statement that its main focus is now on reducing debt.

Base-Case Projections

New capacity will generate significant revenue growth from 2019. We project revenue growth of 2%-6% in 2019 and 2020 as well as EBITDA margins of 72%-74%.

FFO-to-debt ratios are set to improve. We expect to see increasing FFO to debt over the coming years, mainly thanks to lower capex, leading to debt reductions and improved credit metrics.

Company Description

Landsvirkjun is fully owned by Iceland's government and has a fully renewable generation portfolio. It meets 75% of Iceland's power needs using hydro (92%) and geothermal (8%) generation, at a low marginal cost. The company operates 18 power stations and two wind turbines across Iceland in five areas of operation. It sells the majority of power generated to power-intensive corporations, primarily aluminum smelters. Landsvirkjun's 64.7% subsidiary, Landsnet, operates the national power transmission system.

Business Risk: Fair

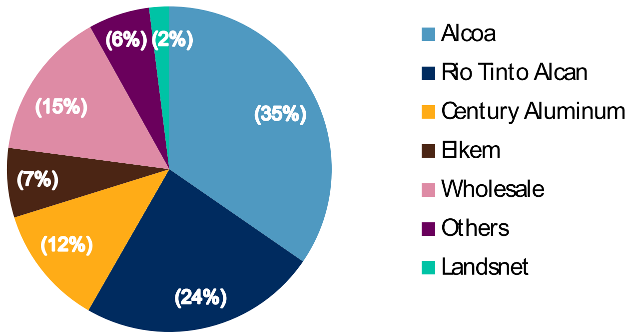
Landsvirkjun's business risk profile reflects its reliance on specific customer types and geographies, in particular the aluminum sector, for revenue and cash flows. Landsvirkjun's earnings and cash flows are exposed to relatively volatile commodity prices. These constraints are partly mitigated by Landsvirkjun's position as the dominant power producer in Iceland and its low-cost renewable generation, which continues to support above-average EBITDA margins of 72%-74%. Moreover, its long-term take-or-pay contracts with customers provide earnings predictability and stable EBITDA.

However, the high customer concentration entails certain event risks, since Landsvirkjun's customer base mainly comprises aluminum producers, and its top-three customers (Alcoa, Rio Tinto Alcan Inc., and Century Aluminum Co.) purchase about 70% of the electricity it produces. This makes Landsvirkjun vulnerable to unexpected failures relating to single contracts. On a more positive note, Landsvirkjun has lessened its exposure to aluminum prices, with the hedges currently in place, only about 10% of the company's operating revenues are linked to aluminum prices.

Chart 1

Landsvirkjun's Largest Customers Are Aluminum Smelters

Distribution of electricity sales (MWh)



Source: S&P Global Ratings.

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Peer comparison

We view Statkraft and Orsted as Landsvirkjun's closest peers due to their sizeable renewable generation portfolios, although they are both significantly larger than the latter. Other Nordic peers include Fortum and Vattenfall, but they have a more diverse portfolio and are not fully focused on renewable generation. We view Landsvirkjun's business as weaker than its peers' due to its isolated market, limited scale, and customer concentration.

Landsvirkjun is among the lowest cost producers in the peer group, with one of the highest EBITDA margins. However, comparing FFO to debt, Landsvirkjun has a weaker financial profile than its peers, mainly due to a higher debt burden.

Table 1

Landsvirkjun--Peer Comparison

Industry Sector: Energy

	Landsvirkjun	**Fortum Oyj**	**Orsted A/S**	**Vattenfall AB**	**Statkraft AS**
Rating as of Jan. 23, 2019	BBB/Stable/A-2	BBB/Negative/A-2	BBB+/Stable/A-2	BBB+/Stable/A-2	A-/Stable/A-2
(Mil. $)	**--Fiscal year ended Dec. 31, 2017--**				
Revenues	483	5,428	9,597	16,534	8,441
EBITDA	346	1,630	2,008	4,631	1,862
FFO	251	1,172	1,201	3,364	1,213
Net income from cont. oper.	98	1,040	2,150	1,029	1,446
Cash flow from operations	264	1,183	(35)	3,516	1,027
Capital expenditures	245	789	2,716	2,392	432
Free operating cash flow	19	394	(2,751)	1,124	595
Discretionary cash flow	5	(779)	(3,267)	979	217
Cash and short-term investments	127	4,680	4,635	3,287	1,842
Debt	2,108	3,065	2,960	14,978	3,455
Equity	2,063	15,956	10,456	12,661	11,284

Table 1

Landsvirkjun--Peer Comparison (cont.)					
Adjusted ratios					
EBITDA margin (%)	71.5	30.0	20.9	28.0	22.1
Return on capital (%)	5.5	6.6	8.0	10.3	9.0
EBITDA interest coverage (x)	4.4	5.8	4.0	5.4	10.7
FFO cash interest coverage (x)	4.4	6.5	2.3	7.2	149.3
Debt/EBITDA (x)	6.1	1.9	1.5	3.2	1.9
FFO/debt (%)	11.9	38.3	40.6	22.5	35.1
Cash flow from operations/debt (%)	12.5	38.6	(1.2)	23.5	29.7
Free operating cash flow/debt (%)	0.9	12.9	(93.0)	7.5	17.2
Discretionary cash flow/debt (%)	0.2	(25.4)	(110.4)	6.5	6.3
Total debt/debt plus equity (%)	50.5	16.1	22.1	54.2	23.4

FFO--Funds from operations.

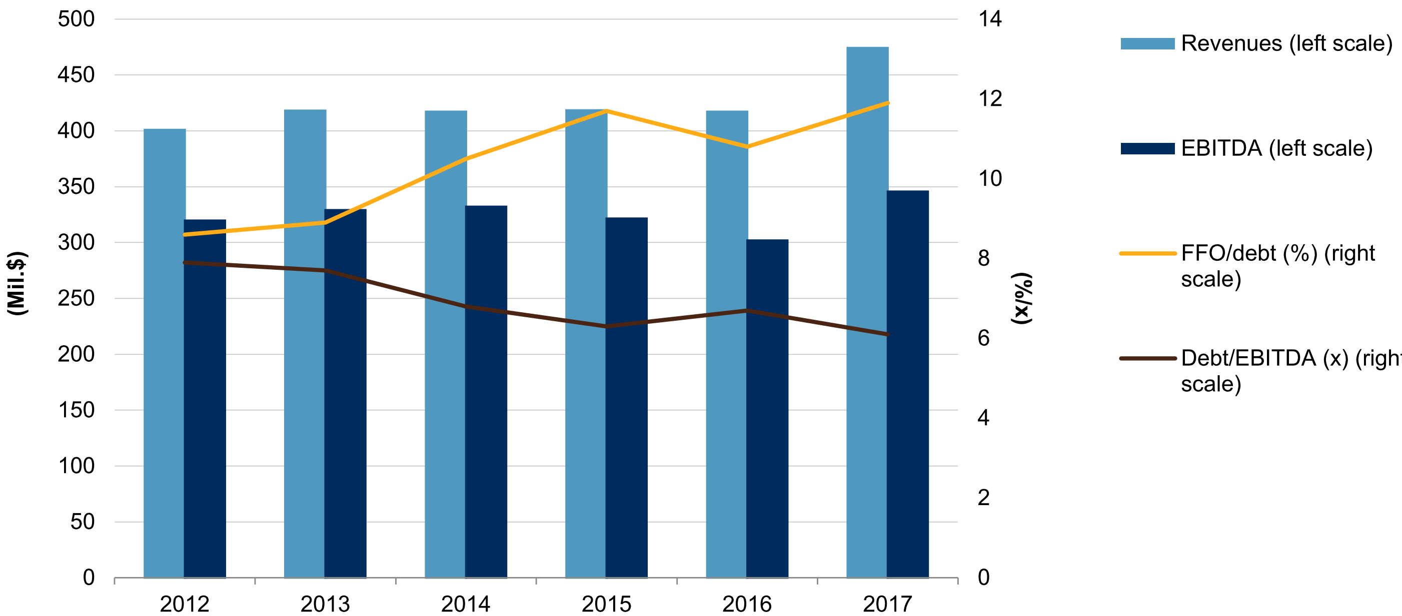
Financial Risk : Aggressive

Landsvirkjun's financial risk profile reflects its relatively high leverage following many years of historical debt-funded investments. However, in recent years, capex programs have been covered by operating cash flow.

We believe that Landsvirkjun's credit metrics will improve as the company starts to pay down debt that accumulated during the construction of its largest hydro plant. We assume that management and shareholders will continue to support this deleveraging path and expect that the company's metrics will improve. We forecast Landsvirkjun's FFO to debt will increase to 16%-18% by 2020 from about 12% in 2017, thanks to the repayment of loans, a large decrease in capex, and strong EBITDA margins.

Chart 2

Landvirkjun's Performance History



Source: S&P Global Ratings adjusted numbers

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Financial summary

Table 2

Landsvirkjun--Financial Summary					
Industry Sector: Energy					
	--Fiscal year ended Dec. 31--				
(Mil. $)	**2017**	**2016**	**2015**	**2014**	**2013**
Revenues	483	420	421	417	418
EBITDA	346	302	322	332	329
FFO	251	219	238	237	227
Net income from continuing operations	98	71	73	67	(45)
Cash flow from operations	264	220	244	232	250
Capital expenditures	245	165	76	94	149
Free operating cash flow	19	54	168	138	102
Dividends paid	14	13	11	13	13
Discretionary cash flow	5	41	157	125	89
Debt	2,108	2,019	2,036	2,246	2,543
Preferred stock	0	0	0	0	0
Equity	2,063	1,969	1,917	1,705	1,658

Table 2

Landsvirkjun--Financial Summary (cont.)					
Industry Sector: Energy					
	--Fiscal year ended Dec. 31--				
(Mil. $)	**2017**	**2016**	**2015**	**2014**	**2013**
Debt and equity	4,171	3,988	3,953	3,951	4,201
Adjusted ratios					
EBITDA margin (%)	72	72	76	80	79
EBITDA interest coverage (x)	4.4	4.2	4.1	3.5	3.1
FFO cash interest coverage (x)	4.4	4.2	3.6	4.0	4.0
Debt/EBITDA (x)	6.1	6.7	6.3	6.8	7.7
FFO/debt (%)	11.9	10.8	11.7	10.5	8.9
Cash flow from operations/debt (%)	12.5	10.9	12.0	10.3	9.8
Free operating cash flow/debt (%)	0.9	2.7	8.2	6.1	4.0
Discretionary cash flow/debt (%)	0.2	2.0	7.7	5.5	3.5
Net cash flow/capex (%)	96.9	124.3	298.8	237.9	144.1
Return on capital (%)	5.5	4.5	5.2	5.4	5.0
Return on common equity (%)	4.4	3.4	3.9	4.0	(3.2)
Common dividend payout ratio (un-adj.) (%)	14.3	17.0	15.0	20.0	(28.6)

Liquidity: Strong

We project that available liquidity sources (cash, committed credit facilities, and operating cash flow) should exceed our forecast of near-term cash outflows (debt repayments, capex, and dividends) by more than 1.5x over the next 12 months and by 1.0x over the next 24 months. We also expect that sources will exceed uses even if EBITDA declines by 30%. In addition, we consider that the company enjoys solid relationships with its banks, a generally high standing in the credit markets, and prudent risk management.

Principal Liquidity Sources (as of Sept. 30, 2018):	Principal Liquidity Uses (as of Sept. 30, 2018):
• Cash of about $90 million; • Committed facilities of about $200 million expiring in December 2020 and ISK12 billion (about $97 million) expiring in September 2022; and • FFO of about $290 million.	• Debt maturities of about $200 million; • Capex of about $80 million-$100 million; and • Dividends of about $20 million.

Covenant Analysis

Landsvirkjun's $200 million revolving credit facility contains financial covenants, under which we expect the company will retain adequate headroom.

Government Influence

The ratings on Landsvirkjun include four notches of uplift owing to our view of a very high likelihood that Iceland would provide timely and sufficient extraordinary support to the company in the event of financial distress. We base this assessment on 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 system operator, Landsnet. Landsvirkjun also has strategic importance to Iceland's economy, and plays a central role in the promotion of power-intensive industries; and
- Very strong link with the government, given the state's 100% ownership of the company and risk to its reputation if Landsvirkjun were to default. We don't expect the company will be privatized.

Environmental, Social, And Governance (ESG) Factors

Because Landsvirkjun is a power generation company, environmental factors are the most significant ESG considerations in our credit assessment. Landsvirkjun's carbon footprint is low due to its 100% green generation portfolio, and the company is making significant investments to reduce the carbon impact of corporate activities, including employee transportation. The company's low-cost renewable portfolio supports a high EBITDA margin of about 72% and improved FFO-to-debt ratios in the future. This also helps insulate Landsvirkjun from competition that could arise from changes in international power prices. In addition, all current and future investments in the company's generation profile consist of 100% renewable energy.

Landsvirkjun also prioritizes social and governance factors and has established an ambitious strategy on corporate social responsibility. This states that it is the company's role to create, value, respect and protect natural resources and the environment, and share its expertise to effectively contribute to society. Landsvirkjun is a member of the U.N. Global Compact, which commits the company to following the 10 principles issued by the U.N. on human rights, labor rights, environmental issues, and anti-corruption.

Issue Ratings--Subordination Risk Analysis

Capital structure

Landsvirkjun's reported debt was $2.2 billion as of December 2017. Roughly 90% of the debt is issued by the parent company, with the remainder issued by Landsnet, a fully consolidated subsidiary.

Analytical conclusions

The issue rating on Landsvirkjun's senior unsecured debt is 'BBB', in line with the issuer credit rating, since no significant elements of subordination risk are present in the capital structure.

Reconciliation

Table 3

Reconciliation Of Landsvirkjun Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. $)

	--Fiscal year ended Dec. 31, 2017--						
Landsvirkjun reported amounts							
	Debt	**Shareholders' equity**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Capital expenditures**
Reported	2,169	1,944	218	65	346	278	259
S&P Global Ratings' adjustments							
Interest expense (reported)	--	--	--	--	(65)	--	--
Interest income (reported)	--	--	--	--	3	--	--
Current tax expense (reported)	--	--	--	--	(18)	--	--
Postretirement benefit obligations/deferred compensation	26	--	--	--	--	--	--
Surplus cash	(114)	--	--	--	--	--	--
Capitalized interest	--	--	--	14	(14)	(14)	(14)
Asset retirement obligations	5	--	--	--	--	--	--
Non-operating income (expense)	--	--	2	--	--	--	--
Non-controlling interest/Minority interest	--	119	--	--	--	--	--
Debt - Accrued interest not included in reported debt	21	--	--	--	--	--	--
D&A - Impairment charges/(reversals)	--	--	9	--	--	--	--
Total adjustments	(62)	119	12	14	(95)	(14)	(14)
S&P Global Ratings' adjusted amounts							
	Debt	**Equity**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Capital expenditures**
Adjusted	2,108	2,063	230	79	251	264	245

Ratings Score Snapshot

Issuer Credit Rating

BBB/Stable/A-2

Business risk: Fair

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

Financial risk: Aggressive

- **Cash flow/Leverage:** Aggressive

Anchor: bb-

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : bb-

- **Related government rating:** A
- **Likelihood of government support:** Very high (+4 notches from SACP)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Methodology For Standard & Poor's Metals And Mining Price Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Iceland 'A/A-1' Ratings Affirmed; Outlook Stable, Dec. 7, 2018
- Aluminum Maker Alcoa Corp. Upgraded To 'BB+' On Improved Profitability And Stronger Balance Sheet; Outlook Stable, May 14, 2018
- Rio Tinto Upgraded To 'A' On Strong Financial Results; Outlook Stable, Feb. 12, 2018
- Century Aluminum Co. Outlook Revised To Positive From Stable On Improving Credit Measures; Ratings Affirmed, Sept. 14, 2017

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	Significant	**Aggressive**	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	**bb-**	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of January 23, 2019)

Landsvirkjun	
Issuer Credit Rating	BBB/Stable/A-2
Senior Unsecured	BBB
Short-Term Debt	A-2
Issuer Credit Ratings History	
18-Jan-2017	BBB/Stable/A-2
19-Jan-2016	BBB-/Stable/A-3
01-Dec-2015	BB+/Positive/B
23-Jul-2015	BB+/Stable/B
24-Jul-2014	BB/Positive/B
30-Jan-2014	BB/Stable/B

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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