

Research Update:

# Landsvirkjun 'BBB/A-2' Ratings Affirmed; Outlook Positive

February 28, 2020

## Rating Action Overview

- Rio Tinto, one of Landsvirkjun's largest customers, is putting its Icelandic aluminum smelter up for strategic review, but we believe it is unlikely to breach its binding take-or-pay contract, which represented about 20% of Landsvirkjun's gigawatt hour sales in 2019, because it would incur significant costs.
- We forecast funds from operation (FFO) to debt for Landsvirkjun of about 17% in 2019 and about 19%-22% in 2020-2021, thanks to annual deleveraging of about \$200 million through 2021.
- We are therefore affirming our 'BBB/A-2' rating on Landsvirkjun.
- The positive outlook reflects the possibility of an upgrade within the next two years if Landsvirkjun sustains its improved financial position and uncertainty surrounding Rio Tinto's Icelandic smelter is addressed.

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## Rating Action Rationale

**We believe the decision of Rio Tinto, Landsvirkjun's second largest client, to review its Icelandic aluminum smelter, is unlikely to lead to a sudden plant shutdown.** According to Landsvirkjun's management, the take-or-pay contract with The Icelandic Aluminum Company (ISAL) is binding until 2036, and covered by Rio Tinto via a parental guarantee. We therefore expect Landsvirkjun will be compensated if Rio Tinto decides to close the plant before 2036. Rio Tinto has already adjusted down utilization capacity at the smelter to 85%, which is the lowest level at which it can operate without the company being penalized, according to the contract. In our base case, we now expect capacity will be maintained at 85%, and we do not anticipate a smelter shutdown, or significantly lower renegotiated prices in Landsvirkjun's contract with Rio Tinto. Based on the above, we expect it would be very costly for Rio Tinto to close the plant.

**We expect stronger credit metrics for Landsvirkjun in 2020-2021 because the company's capital expenditure (capex) program has ended and deleveraging is on track.** We expect funds from operations (FFO) to debt of about 18%-20% in 2020-2021, and that Landsvirkjun will be able to

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reduce debt thanks to strong cash flow and lower investments. Consequently, we expect debt to EBITDA will decrease toward 4.0x by end-2020 and 3.5x by end-2021, mainly because the company has no large project in its pipeline and capex is therefore mainly related to maintenance. Landsvirkjun repaid about \$200 million debt during 2019, and we expect an annual reduction of \$200 million will continue through 2021.

**We believe Landsvirkjun's high concentration in aluminum smelters, which represent about 70 % of power sales in terms of gigawatt hour, continues to constrain the company's business risk profile.** High customer concentration entails certain event risks. 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. Over the past few years, however, Landsvirkjun has decreased its exposure to aluminum prices by renegotiating its power contracts to remove the link with aluminum, diversifying its customer base, and hedging. Now, only about 10%, including hedges, of Landsvirkjun's revenue is linked to aluminum prices, versus about 65% in 2009.

**Landsvirkjun plays a key role for Iceland as the major energy producer.** Our long-term rating on Landsvirkjun factors in four notches of uplift for extraordinary government support. The company is fully owned by the Icelandic government and an essential part of the national economy.

## Outlook

The positive outlook indicates the possibility of an upgrade over the next 12-24 months if Landsvirkjun's financial metrics continue to strengthen, resulting in FFO to debt sustainably above 15%, and uncertainty surrounding the ISAL smelter is resolved.

## Downside scenario

We could revise the outlook to stable if Landsvirkjun fails to achieve its targeted FFO to debt of 15%, for example, due to an unexpected loss or unfavorable contract negotiations. We could also lower the ratings if we see a reduced likelihood of support from the government. We view this as unlikely at this time.

## 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.

## Our Base-Case Scenario

- Modest annual revenue growth of 3%-4% in 2020 and in 2021, because of contract renegotiations coming into effect.

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- Annual capex of about \$65 million over the coming three years.
- Expected dividend payouts of \$45 million in 2020 and about \$65 million in 2021.
- Debt reductions of roughly \$200 million per year through 2021.
- The Rio Tinto smelter will remain at 85% utilization capacity, equivalent to about 2.9 terawatt hours annually.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures over 2018-2021:

### Landsvirkjun--Selected Indicators

(Mil. \$)	2018a	2019p	2020f	2021f
EBITDA	390	375	380-400	390-410
FFO	290	290	290-300	285-300
Capital expenditure	144.0	66.0	60-65	60-65
Debt	1,914	1,691	1500-1550	1300-1400
Dividend	14.0	25.0	40.0-50.0	60.0-70.0
FFO/debt (%)	15.2	17.0	19.0-19.5	20.0-23.0
Debt/EBITDA (x)	4.9	4.5	4.0	3.5
DCF/debt (%)	6.9	11.4	12.0-13.0	12.0-13.0

DCF--Discretionary cash flow. FFO--Funds from operations. FOCF--Free operating cash flow. p--projected. f--forecast.

## Liquidity

We view Landsvirkjun's liquidity as strong. We project that available liquidity sources should exceed our forecast of near-term cash outflows 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.

Our estimate of Landsvirkjun's principal liquidity sources as of Sept. 30, 2019, are:

- Cash of about \$79 million;
- Committed facility of \$150 million expiring in July 2022; and
- FFO of about \$300 million.

Our estimate of the company's principal liquidity uses at the same date are:

- Debt maturities of about \$260 million;
- Capex of \$60 million-\$65 million; and
- Dividend pay-out expected of about \$45 million in 2020 and \$65 million in 2021.

## **Environmental, Social, And Governance**

Because Landsvirkjun is a power generation company, environmental factors are the most significant environmental, social, and governance considerations in our credit assessment. Landsvirkjun's carbon footprint is low due to its 100% green renewable 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. It also helps insulate Landsvirkjun from competition that could arise from changes in international power prices. In addition, all investments to increase electricity generation are into renewable generation such as hydro power or geothermal plants. It is our understanding that Landsvirkjun's renewable energy profile is positive for attracting large power-using companies, such as aluminum smelters and data centers.

Landsvirkjun also prioritizes social and governance factors and has established an ambitious strategy on corporate social responsibility. It outlines its role in creating, valuing, respecting and protecting natural resources and the environment, and sharing 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 \$1.8 billion as of December 2019. About 85% of the debt is issued by the parent company, with the remainder issued by fully consolidated subsidiary Landsnet.

### **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.

### **Ratings Score Snapshot**

Issuer Credit Rating: BBB/Positive/A-2

Business risk: Fair

- Country risk: Low
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Aggressive

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- 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

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, 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

## Ratings List

### Ratings Affirmed

#### Landsvirkjun

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Issuer Credit Rating	BBB/Positive/A-2
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Senior Unsecured	BBB
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceId/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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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