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Research Update:

Icelandic Power Company Landsvirkjun Outlook To Positive On Improving Trend; 'BB+/B' Ratings Affirmed

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Overview

- Iceland-based electricity generation and transmission company Landsvirkjun has generated positive free cash flows over the past few years, resulting in improving credit measures.
- We think there is potential for further debt reduction and a strengthening financial position over the coming two years if Landsvirkjun's spending levels remain modest.
- We are therefore revising our outlook on Landsvirkjun to positive from stable, and affirming our 'BB+/B' ratings.
- The positive outlook reflects the possibility of an upgrade within the next one to two years if Landsvirkjun's credit measures continue to strengthen sustainably.

Rating Action

On Dec. 1, 2015, Standard & Poor's Ratings Services revised its outlook on Iceland-based electricity generation and transmission company Landsvirkjun to positive from stable. At the same time, we affirmed our 'BB+' long-term and 'B' short-term corporate credit ratings on the company.

Rationale

The outlook revision stems from an improving trend in Landsvirkjun's credit measures over the past few years. This is due to a combination of relatively stable EBITDA generation, reduced capital spending, and low dividend pay-outs, which have gradually reduced debt. Subsequently, the company's funds from operations (FFO)-to-debt ratio has strengthened, rising to about 10.5% in 2014 from about 9.0% in 2013. We see potential for continued improvements in credit measures over the next couple of years if Landsvirkjun retains modest spending levels.

Still, we note that these improvements are from weak levels, with Landsvirkjun carrying high debt following past investments in new power plants. We continue to assess Landsvirkjun's stand-alone credit profile (SACP) at 'b+', reflecting our view of its fair business risk profile and highly leveraged financial risk profile, as well as a one-notch upward adjustment for our positive comparable ratings analysis.

The long-term rating also includes three notches of uplift, based on our opinion that there is a very high likelihood that the Icelandic government would provide timely and sufficient extraordinary support to Landsvirkjun 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 grid, strategic importance to the Icelandic economy, and central role in the promotion of power-intensive industries; and
- Very strong link with the Icelandic government, given the state's 100% ownership and our expectation that the company will not be privatized in the medium term, and the risk to the sovereign's reputation if Landsvirkjun were to default.

In our opinion, Landsvirkjun's fair business risk profile continues to be constrained by Iceland's moderately high country risk, and the moderately high industry risk of unregulated power and gas companies. In addition, the company continues to be exposed to high customer and geographic concentration, and exposure to the aluminum sector for revenue and cash flow generation, although the company has actively reduced market risks in recent years. Landsvirkjun's earnings and cash flow are exposed to aluminum, as 50% of power supply contracts are linked to aluminum prices via contracts with aluminum smelters. However, aluminum price risk has been reduced over the recent years following renegotiations of existing contracts and new consumer price index-based contracts.

Landsvirkjun's position as the dominant power producer in Iceland and its low-cost renewable-generation asset base partially mitigate these constraints, providing an above-average EBITDA margin of 75%-80%. Moreover, its long-term take-or-pay contracts with customers provide earnings predictability and EBITDA stability, further mitigating concentration risk and exposure to aluminum prices.

Our assessment of Landsvirkjun's financial risk profile as highly leveraged reflects the company's continued high debt. This comes from its material debt-funded capital investments in the past that resulted in weak cash-flow coverage ratios. Although we forecast a gradual improvement, we believe that credit measures will remain at the upper end of our highly leveraged financial risk profile in the near term, with weighted average FFO to debt just below 12% and debt to EBITDA above 6x.

We apply a one-notch upward adjustment to reflect our positive comparable ratings analysis for the company. This is based on our view that Landsvirkjun's FFO-to-debt ratio is at the upper end of the range for our highly leveraged financial risk profile; its interest coverage is strong for this financial risk category; and the ongoing support from the Icelandic government (the owner), which has requested very modest dividends from Landsvirkjun over the past few years.

Under our base case, we assume:

- EBITDA margins of about 75%-80% in 2015 and 2016, slightly lower than the 80% in 2014. Power prices will likely continue to bear the weight of low aluminum prices, mitigated by price hedges. Volumes in 2015-2016 are expected to recover slightly compared with 2014, although strained by low water reservoirs during the first half of 2015.
- FFO well in excess of capital expenditures (capex) and dividends, leading to further debt reduction, although only by a modest amount relative to the overall high level of debt.
- Capex in 2015 in line with 2014, followed by capex in 2016 of more than the \$96 million spent in 2014 as a result of an expansion project related to a new customer contract.

Based on these assumptions, we arrive at the following credit measures for 2015 and 2016:

- FFO to debt of about 11%-13%.
- Debt to EBITDA of about 6.0x-6.5x.
- FFO cash interest coverage of about 3.8x-4.6x.

Liquidity

The short-term rating is 'B'. We view Landsvirkjun's liquidity as adequate. We project that available liquidity sources in terms of cash, committed credit facilities, and operating cash flow should exceed by more than 1.2x our forecast of near-term cash outflows, such as debt repayments, capex, and dividends. We also expect that sources will exceed uses even if EBITDA declines by 15%. We understand that Landsvirkjun's \$200 million revolving credit facility (RCF) contains financial covenants, under which we expect Landsvirkjun will retain adequate headroom. Furthermore, we assume that Landsvirkjun will refinance or renew its RCF well ahead of its expiration.

In addition, we consider that the company enjoys sound relationships with its banks, a satisfactory standing in the credit markets, and prudent risk management.

We calculate the following principal liquidity sources, as of the second quarter of 2015:

- \$182 million in cash.
- Access to a \$200 million unused committed RCF that expires in December 2016 and an unused committed credit facility amounting to Icelandic krona (ISK) 10.5 billion (about \$80 million), expiring in December 2016. However, we note that this facility has since been renewed to ISK12 billion (about \$90 million, expiring in September 2022, of which ISK9 billion was unused in third-quarter 2015).
- FFO of about \$250 million annually.

As of the same date, we estimate the following principal liquidity uses:

- About \$250 million in debt maturing in the next 12 months.
- Slightly higher annual capex in the next 12 months compared with the \$96 million spent in 2014 and slightly lower in the subsequent 12 months.
- Annual dividends of less than \$14 million in 2015 and 2016.

Outlook

The positive outlook reflects the possibility of an upgrade within the next one to two years if Landsvirkjun retains relatively stable EBITDA and positive free cash flow generation. The outlook also incorporates our assumption that credit measures will strengthen sustainably.

Upside scenario

We would see FFO to debt sustainably above 12% as commensurate with an aggressive financial risk profile, which could lead to an SACP assessment that is one notch higher and, subsequently, an upgrade of the company.

Downside scenario

We could revise the outlook to stable if we believe it is unlikely that Landsvirkjun's credit measures would strengthen on a sustainable basis, for example due to increased capital expenditure or significantly higher dividend payouts.

Ratings Score Snapshot

Corporate Credit Rating: BB+/Positive/B

Business risk: Fair

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

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: b+

- Sovereign rating: BBB
- Likelihood of government support: Very high (+3 notches)

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Methodology For Standard & Poor's Metals And Mining Price Assumptions, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Country Risk Assessments Update: October 2015, Oct. 8, 2015
- Iceland Ratings Raised To 'BBB/A-2' On Proposals Toward Lifting Capital Controls; Outlook Stable, July 17, 2015
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Landsvirkjun		
Corporate Credit Rating	BB+/Positive/B	BB+/Stable/B
Senior Unsecured	BB+	BB+

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