

# RatingsDirect®

---

**Research Update:**

## Icelandic Power Company Landsvirkjun 'BBB-/A-3' Ratings Affirmed; Outlook Stable

**Primary Credit Analyst:**

Sarah Harkins, CFA, London +44 (20) 7176 3716; sarah.harkins@spglobal.com

**Secondary Contact:**

Alf Stenqvist, Stockholm (46) 8-440-5925; alf.stenqvist@spglobal.com

### Table Of Contents

---

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria And Research

Ratings List

## Research Update:

# Icelandic Power Company Landsvirkjun 'BBB-/A-3' Ratings Affirmed; Outlook Stable

## Overview

- Iceland-based electricity generation and transmission company Landsvirkjun has continued to improve its credit metrics by using its positive free cash flows to reduce debt.
- We continue to view the likelihood that Landsvirkjun could receive extraordinary government support, if needed, as very high.
- We are affirming our 'BBB-/A-3' long- and short-term corporate credit ratings on the company.
- The stable outlook reflects our assumption that Landsvirkjun will continue to benefit from low cost generation, relatively stable EBITDA, and an unchanged likelihood of support from the Icelandic government.

## Rating Action

On Aug. 4, 2016, S&P Global Ratings affirmed its 'BBB-/A-3' long- and short-term corporate credit ratings on Icelandic electricity generation and transmission company Landsvirkjun. The outlook is stable.

## Rationale

The affirmation largely reflects our view that the likelihood that Landsvirkjun will receive government support, if needed, continues to be very high. It further reflects Landsvirkjun's solid position in the Icelandic power market, supported by high market share, low production costs, and long-term contracts. However, we see that it continues to be exposed to high customer concentration and the aluminum sector. We also see a continued gradual strengthening of Landsvirkjun's credit measures and have therefore revised our assessment of the company's financial risk profile to aggressive from highly leveraged. We also raised Landsvirkjun's stand-alone credit profile (SACP) to 'bb-' from 'b+'.

We consider 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.
- Very strong link with the Icelandic state, 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.

Landsvirkjun's fair business risk profile reflects its position as the dominant power producer in Iceland, with a market share of generation of about 70% despite the country's relatively small size. The generation is allocated mostly to the power intensive aluminum production.

We see that Landsvirkjun also benefits from a very low-cost hydro and geothermal renewable generation asset base, which continues to support its above average EBITDA margins of 75%-80%. Moreover, its long-term take-or-pay contracts with customers provide earnings predictability and EBITDA stability.

However, in our opinion, Landsvirkjun's earnings and profitability continue to be tempered by its high customer concentration, where the top three customers purchase about 70% of energy production, and given that its customer base is mostly composed of aluminum producers. This makes Landsvirkjun vulnerable to unexpected failures under single contracts. We also see this exposure as heightened because one-third of Landsvirkjun's revenues are directly linked to the aluminum price. However, we expect this portion to continue to decline over time as the company renegotiates existing contracts and adds new consumers.

Landsvirkjun's credit metrics have continued to improve as the company continues to pay down debt that accumulated throughout the completion of its largest hydro plant. In our revision of the financial risk profile to aggressive from highly leveraged, we factor in our view that management and the shareholders are supportive of the deleveraging path. We expect that the company's metrics will continue to improve toward 15% funds from operations (FFO) to debt over the next few years, from about 11.7% in 2015, which will be supported by low capital expenditure (capex) and dividends.

Under our base case, we assume:

- Revenues declining slightly in 2016 due to the low aluminium price.
- Aluminum prices at about \$1,500/ton in 2016, \$1,550/ton in 2017, and \$1,650/ton in 2018.
- EBITDA margins of about 75%.
- Capex of about \$200 million in 2016 and declining thereafter.

Based on these assumptions, we arrive at the following credit measures for 2016-2018:

- FFO to debt of about 11% in 2016, 12.5% in 2017, and about 15.5% in 2018.
- Discretionary cash flow to debt of 1%-10%.

### **Liquidity**

The short-term rating is 'A-3'. 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 our forecast of near-term cash outflows--such as debt repayments, capex, and dividends--by more than

1.2x. 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 to 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 credit markets, and prudent risk management.

We calculate the following principal liquidity sources, as of the first quarter of 2016:

- Cash of \$126 million.
- Committed facilities of around \$270 million expiring in 2018 and Icelandic krona (ISK) 12 billion (about \$100 million) expiring in December 2022.
- FFO of about \$240 million.

At the same date, we estimate the following principal liquidity uses for the next 12 months:

- Debt of about \$180 million.
- Capex of about \$200 million.
- Dividends of about \$11 million.

## Outlook

The stable outlook reflects our assumption that Landsvirkjun will continue to benefit from a very high likelihood of support from the Icelandic government, improving credit metrics, low cost generation, and relatively stable EBITDA.

### Upside scenario

We could raise the ratings if Landsvirkjun continues to deleverage to and it has financial policies that support its FFO to debt around 20% and its competitive position remains stable. We could also consider an upgrade if we raise the sovereign rating on Iceland as this would indicate that the government's ability to provide extraordinary support has increased.

### Downside scenario

We currently see a downgrade as unlikely, but it could occur if we see a reduced likelihood of support from the government to Landsvirkjun or if the company's SACP deteriorated significantly to 'b', which we view as unlikely in the next two years.

## Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/A-3

Business risk: Fair

- Country risk: Moderately high
- 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)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb-

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

## **Related Criteria And Research**

### **Related Criteria**

- General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Industrials: Key Credit Factors For The Unregulated Power And Gas Industry - March 28, 2014
- General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Industrials: Methodology For Standard & Poor's Metals And Mining Price Assumptions - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010

### **Related Research**

- Country Risk Assessments Update: July 2016, July 1, 2016
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial

Corporate Industries, Nov. 20, 2013

## **Ratings List**

Ratings Affirmed

Landsvirkjun

Corporate Credit Rating

BBB-/Stable/A-3

Senior Unsecured

BBB-

### **Additional Contact:**

Infrastructure Finance Ratings Europe; InfrastructureEurope@spglobal.com

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. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on the 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.

Copyright © 2016 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, [www.standardandpoors.com](http://www.standardandpoors.com) (free of charge), and [www.ratingsdirect.com](http://www.ratingsdirect.com) and [www.globalcreditportal.com](http://www.globalcreditportal.com) (subscription) and [www.spcapitaliq.com](http://www.spcapitaliq.com) (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.