S&P Global Ratings

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Landsvirkjun

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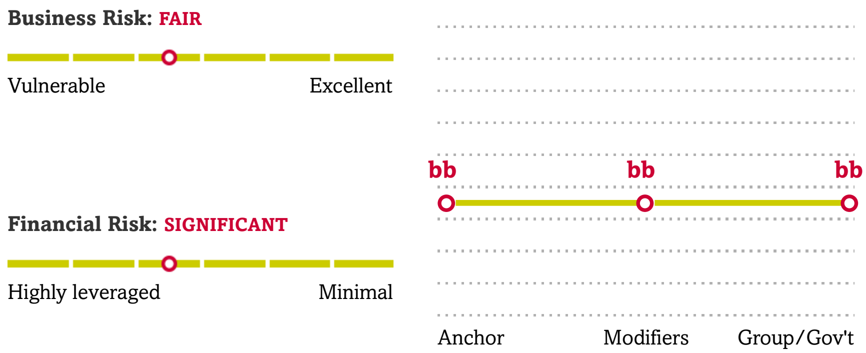
Landsvirkjun



Issuer Credit Rating

BBB+/Stable/A-2

Credit Highlights

Overview

Key strengths	Key risks
The dominating electricity generator in Iceland, producing about 70% of the country's power needs.	High concentration in aluminum smelters, which represent about 60% of power offtake in terms of megawatt hours (MWh).
Superior cost advantages, as the 100% renewable generation portfolio, the vast majority (92%) of which is hydro production, has a very low operating costs.	Price risk to aluminum, given about 70% of operating revenue is linked to aluminum prices under its long-term take-or-pay contracts.
Stability provided from long-term contracts, about 80% of volumes have take-or-pay contracts which reduces volume risks.	Investments in additional generation capacity could ramp up in coming years and leverage could increase during the construction phase. No final decision has been taken though, and project details such as the amount and construction time remains unclear.
Ample credit rating headroom with expected funds from operations (FFO) to debt at about 25%-30%, well above the 15% downside threshold.	Final terms remain unclear on the pending carve-out of its subsidiary Landsnet will likely result in de-consolidation from 2023. Our expectation is that the transaction should have a financially neutral effect for Landsvirkjun.
Support from the government of Iceland (A/Stable/A-1) which fully owns the company.	

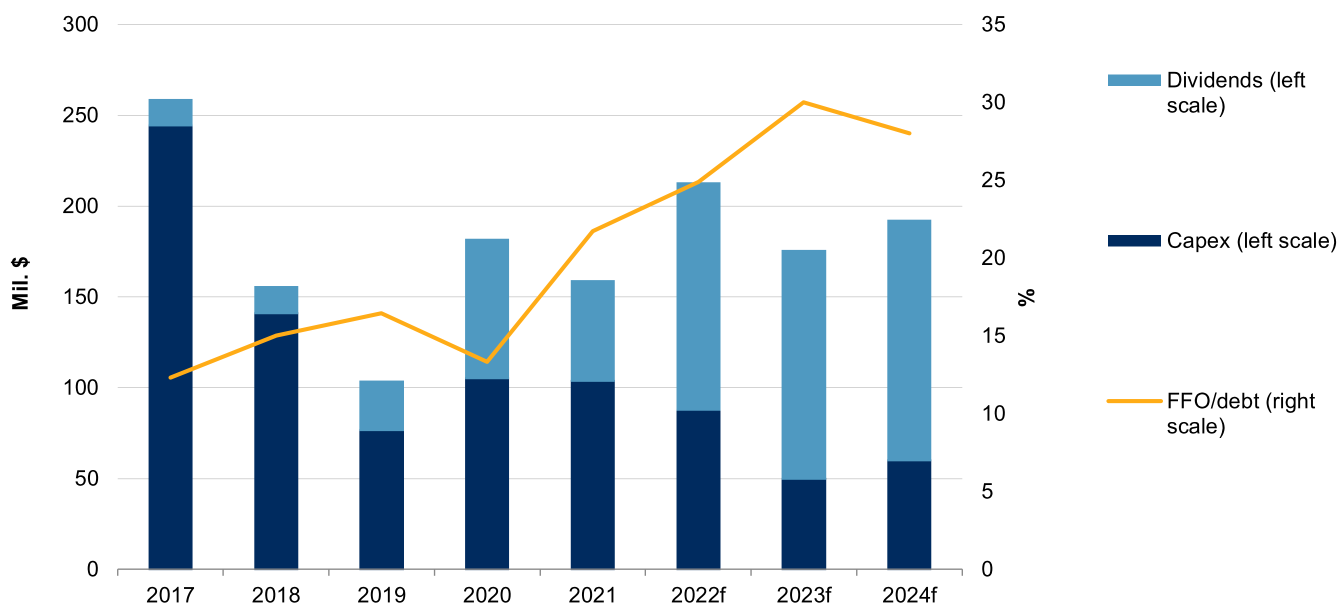
Landsvirkjun plays a key role for Iceland as the major energy producer and has a dominant position in the country. Landsvirkjun provides Iceland with more than 70% of its total electricity demand with its 100% renewable generation assets. Its low-cost renewable generation should continue to support above-average EBITDA margins of 70%-75% on average, which is well above the average for peers. Due to Landsvirkjun's dominant position and Iceland's remote location, we believe competitive pressure will remain low. The company is fully owned by the Icelandic government and is essential part of the national economy; Therefore, our long-term rating on Landsvirkjun factors in four notches of uplift for extraordinary government support. If our sovereign rating on Iceland changed one notch up or down, the uplift would not change, all else remaining the same.

Comfortable credit headroom and expected further improvement on strong cash flow generation thanks to favorable market conditions, on a stand-alone basis. We foresee that Landsvirkjun, excluding Landsnet (which will be deconsolidated from year-end 2022) will continue to enjoy favorable market conditions resulting in credit ratios, namely FFO to debt at 25%-30%, which is well above our downside threshold at 15%. Landsvirkjun's revenue is derived mainly from aluminum smelters (70% of electricity sales remaining from smaller corporates and private consumption with less than 15% of electricity volumes sold) with take-and-pay contracts which are linked to aluminum price movements. This has resulted in increased margins and cash flows, which have allowed Landsvirkjun to reduce debt.

Landsvirkjun has managed to materially lower adjusted debt, to $1.5 billion in 2021 and $1.4 billion on June 30, 2022, from $2.1 billion by 2017, which supported a healthy improvement in credit ratios and created headroom under the rating. S&P Global Ratings-adjusted debt decreased to 3.7x by the end of 2021 from 5.3x in 2020, and we expect debt to EBITDA well below 3x in 2022 and through the end of 2024. Additionally, foresee FFO to debt at around 25% at year-end 2022, which is well above the 15% downside rating trigger for the rating. Landsvirkjun is considering embarking on up to three larger greenfield projects to increase generation capacity, which materially could increase growth capital expenditure (capex). Final investment decisions have not been taken yet, and so cost and timing remain unclear. The bulk of such investment would likely occur after 2025, i.e., after our current base case horizon. We therefore are not including them in our base case at this stage. We also believe that Landsvirkjun will continue to deleverage during 2022 and 2023, which likely would create sufficient headroom for the investments, if they were to be undertaken, assuming total investment of $500 million-$700 million according to our estimates.

Chart 1

FFO/Debt Covers Capex And Dividends



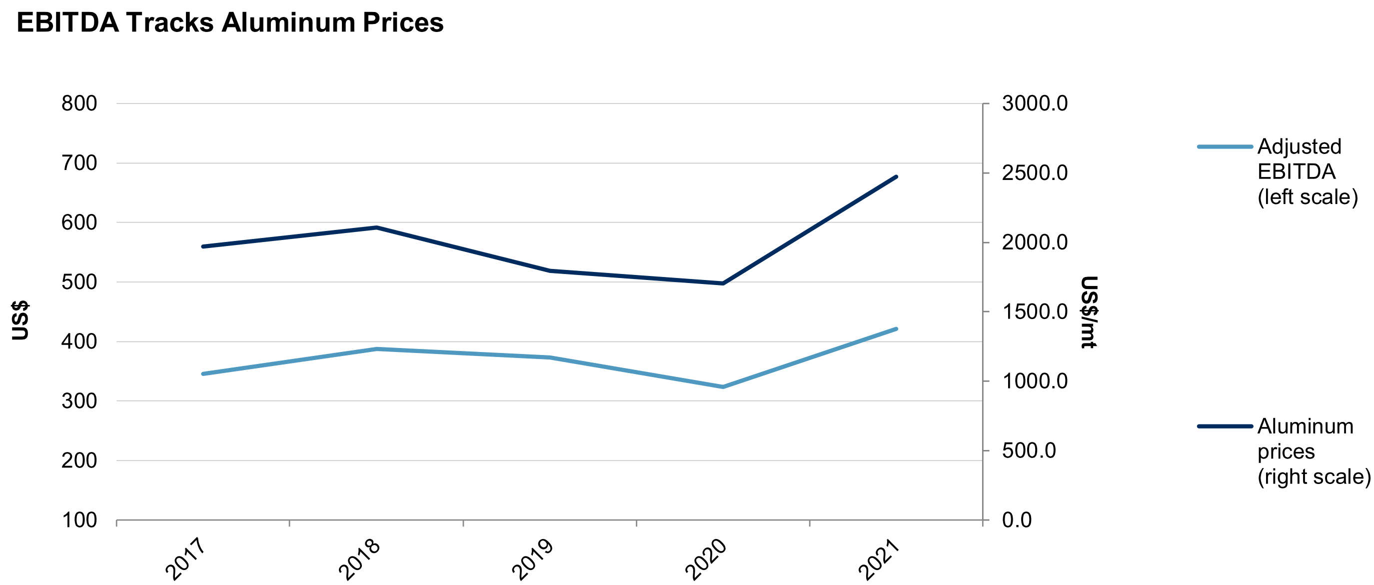
f--Forecast. FFO--Funds from operations. Capex--Capital expenditure. Source: S&P Global Ratings.

Landsvirkjun currently benefits from its long-term take-and-pay contracts with very limited volume risk alongside underlying favorable market conditions with high aluminum prices. Landsvirkjun's revenue is to a large extent correlated to the aluminum price and the aluminum market conditions. This is because the about 70% of its power sales in terms of MWh are concentrated in three players: Alcoa Corp. (BB+/Positive/--), Rio Tinto (A/Stable/A-1), and Century Aluminium (B-/Stable/--). The contractual agreements (2034-2048) have long-term take-and-pay features, bringing longer-term visibility, and have supportive features with locked on volumes and a floor price feature that supports stable cash flows but also ties to power prices to aluminum. The very high concentration risk, constrains our view of Landsvirkjun's business profile, because underlying revenue and prices for the customers are pending on aluminum price development.

Given that volume volatility is limited thanks to the underlying take-and-pay contracts, Landsvirkjun's earning is heavily dependent on aluminum prices. The aluminum price has been at a peak of close to $4,000 per metric ton (/mt) this year but has declined to about $2,312/mt in September 2022. S&P Global Ratings' metal assumption published on Aug 8, 2022, assumes aluminum prices on average of $2,500/mt for full-year 2022, then a gradual decline toward $2,200/mt by the end of 2024, which is well above the prices during 2019-2020 that saw the price decline below $1,500/mt. We believe that Landsvirkjun continues to benefit from aluminum prices above historical averages, and reported $264 EBITDA million in the first half of 2022, up from $196 million in the same period of 2021. We expect EBITDA at about $450 million for full-year 2022, up from $421 million in 2021, and continued strong EBITDA generation in 2023-2024 of about US$350 million-US$400 million.

The company uses derivative contracts to manage risk associated with fluctuations in aluminum prices and Nordic electricity prices (Nord Pool). About 60% of its electricity sales are exposed to aluminum and about 13% to Nord Pool prices of electricity sales are under its contracts. However, typically, hedges only limits the short-term exposure and reduce near-term volatility. Landsvirkjun hedges 50%-75% of is estimated sales on a 12-month rolling basis. As a result, Landsvirkjun's EBITDA has followed a similar trend but with lower volatility than the aluminum price. In addition, Landsvirkjun have no exposure to margin calls currently for its trading activities.

Chart 2



mt--Metric ton. Source: S&P Global Ratings..

As sale of Landsnet seems likely, but we expect it to have a neutral financial effect. Landsvirkjun owns 64.7% of Landsnet's shares, the transmission system operator (TSO) in Iceland. It is our understanding that the government has now asked Landsvirkjun and the other owners to sell their stakes, to a company directly controlled by the Iceland government according to a new law that took effect on July 1, 2021, stating that the TSO shall be directly owned by the Icelandic state or Icelandic municipalities because the government has stated that, in the long run, it would not optimal that Landsnet is owned by power generators and distributors.

The deconsolidation of Landsnet from the group should be completed before the end of 2022, as communicated and printed in Icelandic law. We therefore intend take the same analytical approach when analyzing Landsvirkjun, and will now deconsolidate Landsnet. It is also agreed in a letter of understanding that the transaction should have a financially neutral effect for Landsvirkjun. Landsnet already operates at an arms-length basis, with its own financial statements, and also issues its own debt without any cross default or other clauses related to Landsvirkjun.

Furthermore, we are unlikely to change our view of Landsvirkjun's business risk profile, since Landsnet's proportional contribution to Landsvirkjun's EBITDA has been in the past at around 20% of total EBITDA for Landsvirkjun. We have also given little weight to the company's TSO operations in our assessment of Landsvirkjun, since the discussion of disposals has been ongoing for more than a year, albeit on two earlier occasions a sale did not materialize. Our long-term rating on Landsvirkjun continues to factor in four notches of uplift for extraordinary government support, and the sale of the TSO operations would not change our view.

If the Icelandic sovereign rating changed one notch in any direction, the uplift would not change, all else remaining equal. Even in the unlikely event that Landsvirkjun did not sell Landsnet, we would not review our assessment of potential government support to the company, considering that it is fully owned by the Icelandic government and will remain an essential part of the national economy as the main energy producer.

Extraordinary support from the government of Iceland. The company is fully owned by the Icelandic government, and it remains an essential part of the national economy. We view a very high likelihood that Iceland would provide timely and sufficient extraordinary support to the company in the event of financial distress, given its very important role for the Icelandic government, dominant position as the incumbent power company, and its central role in the promotion of power-intensive industries.

Our long-term rating on Landsvirkjun factors in four notches of uplift for extraordinary government support, and, if the Icelandic sovereign rating changed one notch in any direction, the uplift would not change, all else remaining the same.

Outlook: Stable

The stable outlook reflects our expectation that Landsvirkjun will maintain credit metrics commensurate with the current rating level, with FFO to debt increasing to about 25%-30% in the coming two years. This includes our assumption that the asset rotation of Landsnet would have a neutral effect financially, aluminum prices would remain well above $2,000/mt, and EBITDA margins would remain above 70%.

Downside scenario

We could downgrade Landsvirkjun if it fails to achieve its targeted 15% FFO to debt, for example, due to an unexpected loss or unfavorable contract negotiations of contract revenue, or aluminum prices dropping significantly, or if the Landsnet transaction would result in a worse financial position for Landsvirkjun.

We could also lower the rating if we see a reduced likelihood of support from the government. We view this as unlikely at this time.

Upside scenario

Rating upside is limited over the next two years because we would not raise the issuer credit rating on Landsvirkjun even if we revised upward its stand-alone credit profile (SACP) to 'bb+'. This is because, given the 'A' sovereign rating on Iceland, a very high level of support is not material enough to strengthen Landsvirkjun's credit quality beyond the 'BBB+' level.

We could revise upward Landsvirkjun's SACP if we thought the company's FFO to debt would improve close to 30%, supported by the company's financial policy and after the finalization of Landsnet carve-out. We could also revise upward our assessment of Landsvirkjun's business risk profile if the company lowered its concentration risk to aluminum producers.

Our Base-Case Scenario

Assumptions

- Deconsolidation of Landsnet from Landsvirkjun as a result of government carve-out starting in 2023.
- Real GDP growth in Iceland of 4.5% in 2022 and 3.1% in 2023. Consumer price inflation (CPI) close to 7% in 2022 and around 4.7% in 2023.
- Revenue growth of about 7% in 2022 to then show a degrowth of about 5% in 2023 and bounce back to about 6.8% by 2024.
- Stable EBITDA margins at about 70%-75% during 2022-2024.
- Maintenance capex of about $25 million-$30 million annually.
- No planned growth capex currently, but we could see growth investments ramp up during 2024 toward $50 million-$70 million.
- Aluminum prices to average about $2,500/mt for the remainder of 2022, dropping to about $2,350/mt in 2023 and about $2,200/mt in 2024, based on S&P Global Ratings' metals price assumptions. S&P Global Ratings' assumptions are conservative compared with company's assumptions.
- Dividends expected at about $120 million-$140 million annually based on the dividend policy set in May 2020.

Key metrics

Landsvirkjun--Key Metrics*

(Mil. US$)	2020a	2021a	2022f	2023f§	2024f
EBITDA	323.6	421.2	395-495	350-450	300-400
Funds from operations (FFO)	228.3	335.1	320-370	300-350	200-300
Capital expenditure	105.1	103.8	80-120	30-60	50-70
Dividends	121.2	209.3	120-130	110-140	110-140
Discretionary cash flow (DCF)	45.0	154.4	170-190	100-150	0-50
Debt	1,716.3	1,541.5	1390-1440	850-950	800-900
Debt to EBITDA (x)	5.3	3.7	2.9-3.4	2.0-2.5	2.0-2.5
FFO to debt (%)	13.3	21.7	22-27	25-30	25-30

*All figures adjusted by S&P Global Ratings. §Landsnet deconsolidated from 2023. a--Actual. f--Forecast.

Company Description

Landsvirkjun is fully owned by Iceland's government and has a fully renewable generation portfolio. It meets 70% of Iceland's power needs at a low marginal cost. The company operates 18 power stations and two wind turbines across Iceland in five areas of operation and sells the majority of power generated to power-intensive corporations, primarily aluminum smelters. Landsvirkjun currently holds a 64.7% stake in Landsnet, which operates the national power transmission system.

Landsvirkjun was founded in 1965 and is headquartered in Reykjavik, Iceland.

Peer Comparison

Table 1

Landsvirkjun--Peer Comparison

Industry sector: Energy

	Landsvirkjun	Statkraft AS	Fortum Oyj	Orsted A/S	Vattenfall AB
Global scale rating as of Sept. 19, 2022	BBB+/Stable/A-2	A/Stable/A-1	BBB/Negative/A-2	BBB+/Stable/A-2	BBB+/Positive/A-2
National scale rating as of Sept. 19, 2022	--/--/--	--/--/--	--/--/--	twAA/Stable/twA-1+	--/--/K-1
(Mil. $)	**--Fiscal year ended Dec. 31, 2022--**				
Revenues	558.8	9,786.0	127,835.3	11,880.9	19,920.6
EBITDA	421.2	3,149.7	5,326.1	2,507.9	5,096.8
Funds from operations (FFO)	335.1	2,740.0	4,535.7	1,916.3	4,035.6
Cash flow from operations	313.1	2,930.9	5,652.5	1,710.1	11,086.3
Capital expenditures	103.8	847.2	1,339.8	5,168.1	2,754.9
Free operating cash flow	209.3	2,083.6	4,312.7	(3,458.0)	8,331.4
Discretionary cash flow	154.4	1,666.7	2,986.6	(4,283.1)	7,718.0
Cash (reported)	97.6	4,218.3	8,581.1	1,520.9	7,540.1
Debt	1,541.5	688.0	12,478.7	6,921.6	1,605.5
Equity	2,368.8	12,233.6	15,540.4	11,647.2	22,937.0
Adjusted ratio					
EBITDA margin (%)	75.4	32.2	4.2	21.1	25.6
Return on capital (%)	7.4	20.8	14.2	7.4	12.7
EBITDA interest coverage (x)	6.5	87.3	16.0	4.8	43.4
FFO cash interest coverage ratio (x)	6.5	43.6	20.7	6.0	13.7
FFO/debt (%)	21.7	398.3	36.3	27.7	251.4
Debt/EBITDA (x)	3.7	0.2	2.3	2.8	0.3
CFO/debt (%)	20.3	426.0	45.3	24.7	690.5
FOCF/debt (%)	13.6	302.9	34.6	(50.0)	518.9
DCF/debt (%)	10.0	242.3	23.9	(61.9)	480.7

FOCF--Free operating cash flow. DCF--Discretionary cash flow. CFO--Collateralized fund obligation.

Overall, Landsvirkjun's business risk profile is weaker than that of its Nordic peers due to its small size, the isolated market in which the company operates, as well as its dependence on and exposure to aluminum smelters. The company's financial risk profile is also weaker than most of its Nordic peers, reflecting the high, but decreasing, debt levels owing to past investments compared with those of peers.

However, Landsvirkjun is also the entity that receives the most notches of uplift from its related government, given that we view a generator like Landsvirkjun as very hard to replace in a small and isolated country such as Iceland. Landsvirkjun also has superior cost competitiveness compared with peers, thanks to the efficiency of its modern fleet following a 10-year cycle of investments. Its 100% renewable production is reflected in low costs and efficiency, which supports its high EBITDA margins of around 70%-75%.

Business Risk: Fair

Landsvirkjun's business risk profile reflects its 100% renewable generation, mainly hydropower. Together with favorable conditions for hydrological production on Iceland, with supportive water levels, production is advantageous and highly competitive, as it has a very low cost of production. Landsvirkjun's position as the dominant power producer in Iceland supports the rating, and we expect limited, if any, changes in competition. We therefore expect the market share to remain high and sustainable and the earnings base and margin levels to remain predictable.

The company also has a sustainable leading cost position due to economies of scale and high and stable load factors through the cycle in Iceland. There is also greater than 95% availability due to steady base load from heavy industries operating in Iceland. We assume profitability will remain in the range of 70%-75%, which is well above peers such as Statkraft with similar operations at 32% EBITDA margin in 2021, or the Danish wind developer Orsted at 21% during 2021.

The rating is instead constrained by its reliance on the aluminum sector and limited geographic location, as 100% of revenue stems from Iceland. The high customer concentration entails certain event risks and contract risk since Landsvirkjun's customer base mainly comprises aluminum producers, and its top-three customers (Alcoa Corp., Rio Tinto, and Century Aluminum Co.) purchase about 70% of the electricity it produces. It is our understanding that it is a comparative advantage for aluminum smelters to be located on the territory of Iceland, as electricity on average is at very low cost, but also generated from renewable sources with very low carbon emissions on its production.

Its concentration risk makes Landsvirkjun vulnerable to unexpected failures relating to single contracts. We note positively that Landsvirkjun has lessened its exposure to aluminum prices over recent years. With the hedges currently in place, only about 10% of the company's operating revenue is linked to aluminum prices. Without hedges, a change in aluminum prices of about $200 would result in about $19 million in revenue. This is however offset by long tenures and generally satisfactory contract terms, and the company has lowered its risk toward aluminum prices with about 10% exposure versus about 65% in 2009. To mitigate for its concentration risk, Landsvirkjun has long-term take-or-pay contracts with customers, and these provide earnings predictability and stable EBITDA. These contracts are pegged against different commodities, power exchanges, and consumer price indexes to diversify from volatility in a specific market.

Financial Risk: Significant

Market conditions have been favorable, and we expect the conditions to remain favorable for Landsvirkjun operations with strong cash flow generation and consequently debt reduction. Aluminum prices are trending downward, but from very high levels compared with historical levels. It is our understanding that the underlying take-and-pay contracts are not like-for-like linked to aluminum market price movements, but a function of price movements. We foresee strengthening FFO to debt at 25%-30% and debt to EBITDA toward 2x in the two coming years (not including

Landsnet).

Its subsidiary Landsnet, which is under pending carve-out, is Iceland's TSO and has operated at an arms-lengths basis issuing its own debt. The deconsolidation of Landsnet from the Landsvirkjun group has a financial neutral effect, as we expect Landsnet' related debt and cash flows to be excluded from 2023. We expect that all debt related to Landsnet would follow the transaction, which amounted to about $450 million as of June 30, 2022, which represents about 30% of Landsvirkjun's total debt. We are not including any cash proceeds from the transaction, because the terms for the transactions are not finalized yet. However, all related parties have agreed in a letter of understanding that the transaction should have a financially neutral effect.

Landsvirkjun's maintenance capex is expected to be $25 million-$30 million annually. It is our understanding that the company is considering a few large growth projects, which could increase its investments heavily. However, we do not expect any large increase in capex in 2022 or 2023, because neither license or final investment decisions are taken yet. Additionally, we also believe that the company will have some headroom for increasing capex as it continues to deleverage and improve credit ratios.

A dividend payment to the owners of Landsvirkjun amounting to US$120 million was approved for 2021, based on the new dividend policy approved in April 2020, which defines maximum dividends to be paid based on cash from operations, investments, and leverage. Landsvirkjun's dividend policy is dynamic, as payout will vary depending on cash flow levels and leverage, which we view as prudent. This will allow some influence of investments and key credit metrics. It visualizes maximum dividend amounts based on the financial performance of the company and profit carried forward from previous years. In our view, the policy adds transparency because it clearly demonstrates how maximum dividends will be calculated as a function of FFO to debt.

Landsvirkjun's maximum dividend formula is as follows: maximum dividend payment= (cash from operations previous financial year – investments previous financial year x k) x H, where k represents the "investment subtraction factor and H represents the "payout ratio".

Table 2

Landsvirkjun--Dividend Policy

FFO to net debt*	k	H
<10%	100%	10%
10-15%	80%	20%
15-20%	60%	30%
20-30%	40%	60%
>30%	20%	80%

*Landsvirkjun calculation. k--Investment subtraction factor. H--Payout ratio. FFO--Funds from operations.

Financial summary

Table 3

Landsvirkjun--Financial Summary

Industry sector: Energy					
	--Fiscal year ended Dec. 31--				
	2021	**2020**	**2019**	**2018**	**2017**
(Mil. $)					
Revenue	558.82	453.54	509.59	533.92	483.08
EBITDA	421.22	323.56	372.68	387.11	345.57
Funds from operations (FFO)	335.05	228.35	283.95	287.38	255.35
Interest expense	65.28	63.21	72.61	91.36	79.22
Cash interest paid	61.45	68.98	70.61	82.27	75.25
Cash flow from operations	313.06	226.34	290.18	286.59	263.78
Capital expenditure	103.79	105.09	76.66	141.09	244.50
Free operating cash flow (FOCF)	209.27	121.25	213.52	145.50	19.28
Discretionary cash flow (DCF)	154.41	44.99	186.89	131.25	5.21
Cash and short-term investments	97.56	91.96	110.49	116.28	126.54
Gross available cash	97.56	91.96	110.49	116.28	126.54
Debt	1,541.54	1,716.26	1,728.34	1,913.95	2,074.10
Equity	2,368.77	2,235.14	2,235.40	2,163.06	2,063.11
Adjusted ratios					
EBITDA margin (%)	75.38	71.34	73.13	72.50	71.54
Return on capital (%)	7.43	4.95	6.16	6.45	5.67
EBITDA interest coverage (x)	6.45	5.12	5.13	4.24	4.36
FFO cash interest coverage (x)	6.45	4.31	5.02	4.49	4.39
Debt/EBITDA (x)	3.66	5.30	4.64	4.94	6.00
FFO/debt (%)	21.73	13.30	16.43	15.02	12.31
Cash flow from operations/debt (%)	20.31	13.19	16.79	14.97	12.72
FOCF/debt (%)	13.58	7.06	12.35	7.60	0.93
DCF/debt (%)	10.02	2.62	10.81	6.86	0.25

Reconciliation

Table 4

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

	--Fiscal year ended Dec. 31, 2021--							
Landsvirkjun reported amounts								
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Capital expenditure**
Reported	1,598.3	2,202.7	425.0	286.3	59.4	421.2	323.3	114.0
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	(24.7)	--	--
Cash interest paid	--	--	--	--	--	(55.7)	--	--
Reported lease liabilities	6.3	--	--	--	--	--	--	--

Table 4

Landsvirkjun--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. $) (cont.)								
Postretirement benefit obligations/deferred compensation	24.7	--	0.8	0.8	--	--	--	--
Accessible cash and liquid investments	(97.6)	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	5.7	(5.7)	(5.7)	(5.7)
Capitalized development costs	--	--	(4.5)	(4.5)	--	--	(4.5)	(4.5)
Asset-retirement obligations	9.8	--	--	--	0.1	--	--	--
Nonoperating income (expense)	--	--	--	0.4	--	--	--	--
Noncontrolling interest/minority interest	--	166.1	--	--	--	--	--	--
Depreciation and amortization: Impairment charges/(reversals)	--	--	--	9.3	--	--	--	--
Total adjustments	(56.8)	166.1	(3.8)	5.9	5.9	(86.2)	(10.2)	(10.2)
S&P Global Ratings' adjusted amounts								
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Capital expenditure**
Adjusted	1,541.5	2,368.8	421.2	292.2	65.3	335.1	313.1	103.8

Liquidity: Strong

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%. As Iceland's main state-owned utility company, we believe that the company will continue to enjoy solid relationships with banks, a generally high standing in the credit markets, and prudent risk management. This has repeatedly been demonstrated by early debt repayments and refinancing, which shows active debt management.

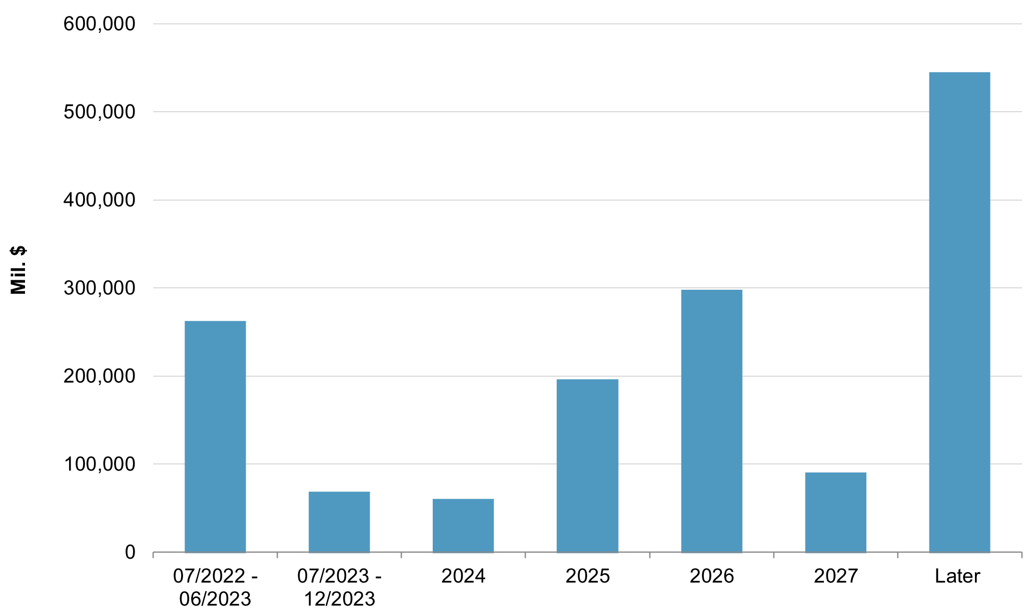
Principal liquidity sources	Principal liquidity uses
Our estimate of Landsvirkjun's principal liquidity sources as of June 30, 2022, are: • Cash of about $160 million; • Committed facility of $150 million expires in July 2024; • Working capital inflow of about $40 million;	Our estimate of the company's principal liquidity uses at the same date are: • Capex of about $30 million-$50 million; and • Annual dividend pay-out expected of about $125 million. • Debt maturities of about $260 million.

- and
- FFO of about $340.0 million.

Debt maturities

Chart 3

Debt Maturities As Of June 2022



Source: S&P Global Ratings.

Covenant Analysis

Requirements

Landsvirkjun has some covenants in place for some of its instruments. The strictest one has an equity ratio of 40% and interest coverage of 3.0. We note that the company has always operated well above these covenants, and we expect there will be significant headroom in the coming years.

Environmental, Social, And Governance

ESG Credit Indicators

E-1	**E-2**	E-3	E-4	E-5	S-1	**S-2**	S-3	S-4	S-5	G-1	**G-2**	G-3	G-4	G-5

ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumerical 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicators: Definition And Applications," published Oct. 13, 2021.

ESG factors have an overall neutral influence on our credit rating analysis of Landsvirkjun. Environmental factors are supported by the fact that Landsvirkjun's main source of generation is hydro, with zero CO2 emissions. Additionally, the company could possibly expand its hydro and wind generation if demand increases, or if hydrogen becomes cost efficient and transportable.

Landsvirkjun will be carbon neutral in 2025 and is currently well on the way to reaching that target, as the net carbon intensity from its operations has been reduced by 61% from 2008. The key factor is to significantly reduce emissions from geothermal electricity generation, given most of greenhouse gas emissions from the company's operations stem from its geothermal operations. The Koldís project means that from 2025 almost all carbon dioxide and hydrogen sulfide from the Þeistareykir Geothermal Station will be captured and reinjected to the underground.

The reduction in emissions from geothermal electricity generation directly contributes to Iceland's international climate commitments. The government's Climate Action Plan aims for emissions from geothermal power stations in Iceland to be reduced by 47% in 2030 compared with the year 2005. Landsvirkjun is determined to do even better and aims for reducing emissions from geothermal energy generation in Northeast Iceland by at least 60% by 2025 versus 2005.

Carbon footprint expresses as grams of carbon dioxide equivalent per kilowatt-hour of electricity generated (gCO2eq/kWh) was low during 2021 at 3.6 g/kWh versus the EU definition for Green Energy transmission of 100 g/kWh. It went down by about 3% from 2020.

Government Influence

Iceland is the sole owner of Landsvirkjun, through a partnership owned by State Treasury of Iceland (99.9%) and its wholly owned subsidiary Eignarhlutir ehf (0.1%). In accordance with our criteria for government-related entities (GREs), our view is that there is a very high likelihood of extraordinary government support this provides four notches of uplift to the long-term foreign currency rating to 'BBB+' from the 'bb' SACP. Currently a one-notch sovereign downgrade would not affect the final rating of Landsvirkjun.

Our view is based on our assessment of 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. Even in the foreseeable event of the disposal of the TSO (Landsnet), we believe that Landsvirkjun would still maintain its very important role given its high share of power generation in the country and its irreplaceability.

- 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. After the sovereign upgrade, the 'BBB+' local currency long-term rating on Landsvirkjun benefits from a four-notch uplift from its SACP of 'bb'

Issue Ratings - Subordination Risk Analysis

Capital structure

Landsvirkjun's reported debt was $1.5 billion as of June 2022. About 70% of the debt is issued by the parent company, with the remainder issued by subsidiary Landsnet. We assume that all issued debt at Landsnet will follow the carve-out transaction.

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+/Stable/A-2

Business risk: Fair

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

Financial risk: Significant

- **Cash flow/leverage:** Significant

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 Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- ESG Credit Indicator Report Card: Power Generators, Nov. 18, 2021
- Iceland-Based Electricity Producer Landsvirkjun Upgraded To 'BBB+' On Strengthening Credit Metrics; Outlook Stable, June 03, 2021
- Landsvirkjun, Aug. 21, 2020
- Landsvirkjun 'BBB/A-2' Ratings Affirmed; Outlook Positive, Feb. 28, 2020

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 September 26, 2022)*		
Landsvirkjun		
Issuer Credit Rating		BBB+/Stable/A-2
Senior Unsecured		BBB+
Issuer Credit Ratings History		
03-Jun-2021	*Foreign Currency*	BBB+/Stable/A-2
21-Mar-2019		BBB/Positive/A-2
18-Jan-2017		BBB/Stable/A-2
03-Jun-2021	*Local Currency*	BBB+/Stable/A-2
21-Mar-2019		BBB/Positive/A-2
18-Jan-2017		BBB/Stable/A-2

*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.