

Research Update:

# Landsvirkjun 'BBB+' Rating Affirmed; Outlook Revised To Positive

June 28, 2023

## Rating Action Overview

- The stand-alone credit profile (SACP) of Iceland-based electricity generator Landsvirkjun has improved well above our previous base case, with funds from operations (FFO) to debt of 41% in 2022, up from 21% in 2021.
- We, therefore, revised upward the company's SACP to 'bb+' from 'bb'.
- Due to the recent revision of our outlook on Iceland to positive and the strengthening of Landsvirkjun's SACP, we revised our outlook on the company to positive from stable. We are affirming our 'BBB+' issuer credit rating and our 'BBB+' issue rating on the company's notes.
- The positive outlook indicates that we could upgrade Landsvirkjun if we took a similar action on Iceland (A/Positive) and if Landsvirkjun continued to sustainably post FFO to debt above 30%.

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## Rating Action Rationale

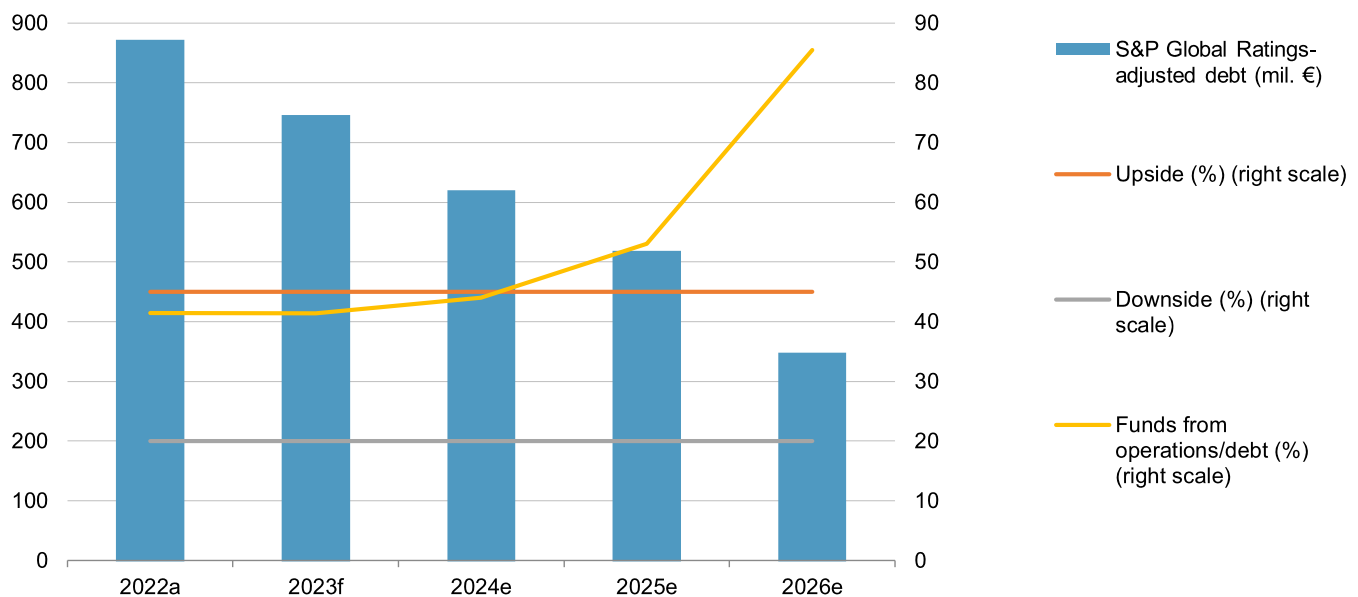
**Landsvirkjun's financial performance continues to be very strong thanks to continuous favourable market conditions and the management's focus on deleveraging, which enables the company to quickly build substantial rating headroom that is well above our previous base case.** After the Icelandic state acquired Landsvirkjun's share in Landsnet, Landsvirkjun has significantly reduced its S&P Global Ratings-adjusted net debt to about \$870 million at the end of 2022, from \$1.5 billion in 2021. This compares favorably with historical levels of \$2.1 billion in 2017-2018. The debt reduction was possible largely thanks to internally generated cash flows. In line with the management's focus on deleveraging, we expect the company will continue reducing its leverage, which will support its credit metrics further. Despite high dividend payments in 2022, the company has generated very high discretionary cash flow (DCF) of around 30%. This was due to high prices on the Nord Pool power exchange and the global aluminum market, which have allowed a quicker debt reduction than we previously had assumed. We now expect Landsvirkjun will post adjusted net debt of around \$740 million-\$750 million in 2023, which will decrease to about \$610 million-\$620 million in 2024, compared with \$870 million in 2022. At the same time, we forecast EBITDA of around \$420 million-\$430 million in 2023, decreasing to around \$360

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million-\$370 million in 2024. This is due to a change in price links in one of the contracts with Nord Pool, from Nord Pool prices to USD prices that are linked to the aluminum price. Landsvirkjun's deleveraging efforts should result in continued strong credit metrics, even after record-high dividends of \$140 million, which the board approved for 2023. We expect investments will remain very low for the next two years, with maintenance capital expenditure (capex) at around \$20 million-\$30 million. We now forecast FFO to debt of 40%-45% in 2023 and 2024, up from a forecast 25%-30% previously. This new forecast prompted us to revise Landsvirkjun's SACP to 'bb+' from 'bb'.

Chart 1

**Continuous deleveraging will result in strong ratios over 2023-2026, absent any development capital expenditure**



a--Actual. e--Estimated. f--Forecast.

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**The positive outlook reflects Landsvirkjun's stronger SACP and the Icelandic government's increasing capacity to support the company if needed.** The outlook revision on Landsvirkjun follows a similar action on Iceland on May 12, 2023, coupled with an upward revision of Landsvirkjun's SACP to 'bb+' from 'bb'. Strong ongoing economic recovery from the pandemic fallout, alongside continued fiscal consolidation over the next few years, will improve Iceland's public finances beyond our previous expectation and lead to an increased capacity to support Landsvirkjun if needed. The company is fully owned by the Icelandic government. Landsvirkjun represents an essential part of the national economy because its 100% renewable energy generation assets cover more than 70% of Iceland's total electricity demand. We think it is very likely that Iceland would provide timely and sufficient extraordinary support to the company in the

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event of financial distress, given its very important role for the Icelandic government, its dominant position as the incumbent power company, and its central role in the promotion of power-intensive industries. Landsvirkjun's sale of the transmission system operator Landsnet to the Icelandic government at year-end 2022 did not change our view. Our long-term rating on Landsvirkjun factors in three notches of uplift for extraordinary government support. If we upgrade the sovereign credit rating on Iceland, we could raise the rating on Landsvirkjun, all else being equal.

**We forecast very low capex for at least for the next two to three years, leading to a strong positive DCF, despite high dividends.** We acknowledge the company's ambition to build new projects but forecast minimal capex in the range of \$20 million-\$30 million, which will consist of maintenance capex only, in 2023-2024. Absent any development capex, we expect dividends will increase to \$140 million in 2023 and to around \$170 million in 2024. Dividends will be in line with Landsvirkjun's financial policy, according to which the maximum amount of dividends depends on cash from operations, investments, and leverage. This will lead to strong DCF of around \$170 million in 2024 and 2025, after a decrease to around \$100 million in 2023, due to increased dividends. We understand that Landsvirkjun has four potential new investment opportunities, with an estimated scale of about \$1 billion in total. Timing and cost, however, remain very uncertain and there is no final investment decision on any of the projects. Moreover, on June 15, 2023, the appeals committee of Iceland's Environmental and Natural Resources Board revoked the permit of the Hvammur hydropower plant, which was one of Landsvirkjun's most advanced projects, with an estimated cost of around \$550 million-\$600 million. We understand Landsvirkjun will re-apply for the permit, but the outcome is uncertain. If Landsvirkjun receives the permit, the bulk of investments would likely occur after 2026, which exceeds our current base-case horizon. The other three projects Landsvirkjun is considering require estimated total investments of around \$400 million-\$500 million and aim to increase generation capacity, which could increase growth capex materially. As with Hvammur, final investment decisions have not been made yet. We, therefore, are not including these projects in our base case at this stage. Landsvirkjun will likely try to launch one or two of these projects post 2025, but we also believe that the company will continue to deleverage during 2023 and 2024 and create sufficient headroom for such growth investments. We also understand the management aims to provide a large share of the power these project will generate under long-term industrial contracts.

**Landsvirkjun posted very strong results in 2022 and the first quarter of 2023 and shows a strong start to 2024.** The company posted very strong results in 2022, with reported EBITDA increasing to \$609 million, an increase of \$125 million versus 2021. This is the most significant increase in Landsvirkjun's history and mainly results from higher global prices on aluminum and the Nord Pool power market. Investments were very low and stood at \$10 million, but Landsvirkjun paid a record \$128 million in dividends to the state. Net reported debt decreased significantly by \$657 million to \$844 million, thanks to healthy cash flow generation and the management's continuous deleveraging efforts. Due to these strong results, adjusted FFO to debt was at 41.5% in 2022, compared with 21.7% in 2021. The company reported a 19% increase in reported revenues in the first quarter of 2023, compared with the first quarter of 2022, since it was able to secure favorable hedging prices that offset the substantial decrease in prices on international commodity and energy markets.

**Landsvirkjun's high concentration in aluminum smelters, which represent about 60 % of power sales in terms of megawatt hours, will continue to constrain the company's business risk profile.** About 67% of the company's power sales are concentrated on three players, including

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Alcoa Corporation (BB+/Positive/--), Rio Tinto (A/Stable/A-1), and Century Aluminum Company (B-/Stable/--). This implies very high concentration risk. That said, Landsvirkjun's concentration risk decreased from about 70% in 2021, since the company set up more diverse sources of income and signed power purchase agreements with new customers. The concentration risk is offset by long-term contractual agreements for 2034-2048, which have take-and-pay features, bring longer-term visibility, and have supportive features with pre-agreed volumes and a floor price feature that supports stable cash flow and ties power prices to aluminum. We also view positively that 100% of Landsvirkjun's power generation comes from low-cost renewable energy sources. Hydroelectricity accounts for 91%, while geothermal energy accounts for the remaining 9%. This enables Landsvirkjun to support and maintain an above-average EBITDA margin of 68%-73%, well above the peer average.

## Outlook

The positive outlook reflects our expectation that Landsvirkjun will maintain credit metrics commensurate with the current rating level and an SACP of 'bb+' and with FFO to debt well above 30% in the next two years, supported by the company's financial policy. The positive outlook on Landsvirkjun also reflects the positive outlook on Iceland.

## Downside scenario

We could revise the outlook back to stable if we take the same action on Iceland. We could also revise the outlook back to stable if Landsvirkjun fails to achieve its targeted FFO to debt of 30% in the next two years, for example due to unexpected losses, unfavorable negotiations of contract revenue, or a significant drop in aluminum prices below our base case of \$2400 per metric ton. We could also revise our outlook back to stable if we see a reduced likelihood of support from the government. We view this as unlikely at this stage.

## Upside scenario

We could upgrade Landsvirkjun if we take the same action on the sovereign, assuming we continue to expect that Landsvirkjun's FFO to debt will remain well above 30%.

The possibility of revising upward the company's SACP is currently remote due to the company's high concentration on aluminum producers.

## Company Description

Landsvirkjun is fully owned by the Icelandic government and has a 100% renewable energy generation portfolio. It meets 70% of Iceland's power needs at a low marginal cost, with hydroelectricity contributing 91% and geothermal energy accounting for 9%. The company operates 18 power stations (15 hydroelectric and three geothermal power plants) and two wind turbines across Iceland, with an installed capacity of around 2,150 megawatts and an annual electricity generation of about 14.0 terawatt hours. Electricity generation was 14.6 terawatt hours in 2022. Landsvirkjun sells the majority of the power it generates to power-intensive corporations, primarily aluminum smelters. Approximately 86% of the energy is sold to large end-users in the industrial market and 14% on the wholesale market. Landsvirkjun sold its 64.7% subsidiary Landsnet, the national power transmission system, to the Icelandic government at year-end 2022.

## Our Base-Case Scenario

### Assumptions

- Real GDP growth in Iceland of 1.9% in 2023 and 2.5% in 2024. Consumer price inflation close to 6.3% in 2023 and around 3.4% in 2024.
- Revenue decrease of 2.7% in 2023 and 9.2% in 2024 as power and aluminum prices stabilize and income from transmission system operations is deconsolidated as Landsnet was sold in 2022.
- Stable EBITDA margin in the range of 68%-72% in 2023-2025.
- Maintenance capex of about \$25 million-\$30 million annually. No planned growth capex currently.
- Aluminum prices average \$2,400 per metric ton for the remainder of 2023 and for 2024 and 2025, based on S&P Global Ratings' metals price assumptions. Our assumptions are similar to Landsvirkjun's assumptions.
- Dividends will increase to \$140 million in 2023, \$175 million in 2024, and \$200 million in 2025, based on the revised dividend policy in 2023.

### Key metrics

#### Landsvirkjun--Key metrics\*

(Mil. \$)	2021a	2022a	2023f	2024f	2025f
EBITDA	421.2	451.682	380-480	315-415	315-415
Funds from operations (FFO)	335.1	361.419	285-335	245-295	250-300
Capital expenditure	103.8	10.105	25-35	20-30	20-30
Dividends	209.3	128.49	130-150	165-185	190-210
Discretionary cash flow (DCF)	154.4	293.235	160-180	90-110	50-70
Debt	1541.5	870.949448	730-760	600-630	500-530
Debt to EBITDA (x)	3.7	1.9	1.5-2.0	1.5-2.0	1.3-1.7
FFO to debt (%)	21.7	41.5	39-43	42-46	51-55

\*All figures adjusted by S&P Global Ratings. §Landsnet deconsolidated from 2023. a--Actual. 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 about 2x over the next 12 months and by more than 1.4x 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 benefits from a generally high standing in the credit markets and prudent risk management. Furthermore, as critical infrastructure operator and government-owned entity, Landsvirkjun has a strong relationship with

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local banks.

Landsvirkjun's principal liquidity sources as of March 31, 2023, are:

- Cash of about \$115 million;
- Committed facility of \$125 million, expiring in July 2028;
- Working capital inflow of about \$20 million; and
- FFO of about \$315 million.

Our estimate of the company's principal liquidity uses as of March 31, 2023, are:

- Debt maturities of about \$60 million in the next 12 months and \$90 million in the subsequent 12 months;
- Capex of \$35 million in the next 12 months; and
- Annual dividends of about \$150 million in the next 12 months.

## Issue Ratings - Subordination Risk Analysis

### Capital structure

Landsvirkjun's reported debt was around \$1 billion as of year-end 2022. 100% of the debt is issued by Iceland's government. We, therefore, do not see any significant risk of subordination and we align our rating on Landsvirkjun's senior unsecured debt with the issuer credit rating.

### 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 risk
Industry risk	Moderately high risk
Competitive position	Fair
Financial risk	Intermediate
Cash flow/leverage	Intermediate
Anchor	bb+
Modifiers:	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral

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Issuer credit rating	BBB+/Positive/A-2
Liquidity	Strong
Management and governance	Satisfactory
Comparable rating analysis	Neutral
Stand-alone credit profile	bb+
Likelihood of government support	Very high likelihood of support (+3 notches)

**ESG credit indicators: E-2, S-2, G-2**

### Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: 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

- Iceland Outlook Revised To Positive From Stable On Improving Public Finances And Strong Growth; 'A/A-1' Ratings Affirmed, May 12, 2023

## Ratings List

### Outlook Action; Ratings Affirmed

	To	From
<b>Landsvirkjun</b>		
Issuer Credit Rating	BBB+/Positive/A-2	BBB+/Stable/A-2
Senior Unsecured	BBB+	

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