

Rating Action: Moody's upgrades Landsvirkjun's ratings; outlook stable

12 Nov 2019

London, 12 November 2019 -- Moody's Investors Service ("Moody's") has today upgraded Landsvirkjun's unguaranteed senior unsecured debt rating to Baa1 from Baa2 and the short-term rating of its unguaranteed EMTN programme to (P)Prime-2 from (P)Prime-3. Moody's has also upgraded to A3 from Baa1 the backed senior unsecured rating of the company's debts supported by a guarantee of collection from the Government of Iceland (A2 stable) and affirmed the (P)Prime-2 short term rating of its backed EMTN programme. Concurrently, Moody's has upgraded Landsvirkjun's senior unsecured EMTN programme rating to (P)Baa1 from (P)Baa2 and the backed senior unsecured EMTN programme rating to (P)A3 from (P)Baa1. The outlook on all ratings remains stable.

The upgrade of the unguaranteed ratings reflects continued improvement in Landsvirkjun's standalone credit profile, as represented by a ba1 baseline credit assessment (BCA), upgraded from ba2, which in turn reflects ongoing deleveraging following a period of high investment. The upgrade of the guaranteed ratings follows Moody's upgrade of the long-term rating of the Government of Iceland to A2 from A3 on 8 November 2019.

RATINGS RATIONALE

The upgrades to Landsvirkjun's BCA and unguaranteed ratings reflect improvements in financial performance and prudent financial policy, which Moody's expects will allow the company to achieve a ratio of funds from operations (FFO) to net debt close to 17% in 2019, compared to 14.7% in 2018. The upgrades also reflect the company's reduced exposure to aluminium prices, which are now the basis for around a third of power sales by volume, excluding hedges, compared to around half in 2018.

Landsvirkjun's unguaranteed rating benefit from a highly-contracted revenue base, with the majority of power sales derived from long-term contracts providing predictable revenue. The low cost and reliability of the company's fully-renewable power generation portfolio underpins Iceland's strong position in the global aluminium industry.

Following completion of the Theistareykir geothermal plant and the expansion of Burfell hydroelectric power station in 2018, Moody's expects Landsvirkjun's capital expenditure to average less than 3% of total assets for several years. Moody's expects that the company will use the resulting financial flexibility to reduce debt further.

However, strong free cash flow will also allow the company to substantially increase distributions to its shareholder. Dividends will rise by 125% in 2019 compared to the previous year, and are likely to increase further. Uncertainty over the future profile of dividends is a constraint on the unguaranteed ratings. The unguaranteed ratings are also constrained by uncertainty over the timing and terms of the expected divestiture of the company's controlling interest in Landsnet, Iceland's transmission system owner. A government working group was appointed in March 2019 to lead discussions on the purchase of Landsnet that were expected to conclude by the end of 2019.

Given Landsvirkjun's ownership by the Government of Iceland, the company's Baa1 unguaranteed debt rating incorporates three notches of uplift for potential extraordinary support from the BCA of ba1 based on Moody's assumptions of high support and very high dependence. The high level of Government support incorporated in Landsvirkjun's unguaranteed debt ratings reflects the strategic importance of the company as the national power producer and the role it plays in the provision of electricity to the aluminium smelting industry. Moreover, it also considers the high level of commitment that the Government has shown in the past by the provision of guarantees of collection to support Landsvirkjun's debt.

RATIONALE FOR THE GUARANTEED DEBT RATINGS

The A3 and (P)A3/(P)P-2 ratings of Landsvirkjun's backed EMTN programme and notes issued thereunder reflect the value of the guarantee of collection issued by the Government of Iceland. Moody's notes that guarantees of collection do not offer bondholders the same contractual protection as a timely payment guarantee. There is a risk that the Government would not step in with timely repayment should the company

fail to meet its obligations, as exhaustive administrative and legal procedures must be followed before the shareholders are obliged to pay. The A3 rating reflects a very high likelihood that the Government would pay on a timely basis, but the positioning of the guaranteed debt ratings at one notch below that of the Government of Iceland reflects this residual uncertainty of payment from a single A rated sovereign.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects Moody's expectation that Landsvirkjun will achieve further reductions in net debt and continue to prudently manage its exposure to market risks. The outlook also reflects Moody's expectation that any disposal of Landsnet will be completed on terms that do not result in a deterioration of Landsvirkjun's credit quality.

WHAT COULD CHANGE THE RATING UP

An upgrade to the BCA is unlikely before terms of the Landsnet disposal are known. Following completion or termination of such a transaction, the BCA could be upgraded if Landsvirkjun achieved a ratio of FFO to net debt consistently above the mid-20s and a ratio of retained cash flow (RCF) to net debt consistently above the mid-teens, both in percentage terms. Any potential upgrade to the unguaranteed rating would take account of the BCA, the level of the rating of the Government of Iceland and Moody's view of the likelihood of extraordinary support.

The guaranteed ratings could be upgraded if the rating of the Government of Iceland was upgraded.

WHAT COULD CHANGE THE RATING DOWN

The BCA and unguaranteed ratings could be downgraded if Landsvirkjun's FFO/net debt appeared likely to fall below the high teens or its RCF/net debt below the low double digits, both in percentage terms. The rating could also be downgraded if the rating of the Government of Iceland was downgraded, or if Moody's assessment of high support for the company was to be revised downwards.

The guaranteed ratings could be downgraded if the rating of the Government of Iceland was downgraded.

CORPORATE PROFILE

Headquartered in Reykjavik, Landsvirkjun is Iceland's dominant power producer. It is responsible for around 70% of Iceland's total electricity production and owns the majority of the transmission grid. It provides 100% renewable energy for domestic users via electricity sales to public utilities, although the majority of sales are to power intensive industries, mostly for aluminium smelting, under long-term take-or-pay contracts.

PRINCIPAL METHODOLOGY

The methodologies used in these ratings were Unregulated Utilities and Unregulated Power Companies published in May 2017, and Government-Related Issuers published in June 2018. Please see the Rating Methodologies page on www.moody.com for a copy of these methodologies.

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