

Landsvirkjun

Primary Credit Analyst:

Alf Stenqvist, Stockholm (46) 8-440-5925; alf_stenqvist@standardandpoors.com

Secondary Contact:

Karin Erlander, London (44) 20-7176-3584; karin_erlander@standardandpoors.com

Table Of Contents

Major Rating Factors

Rationale

Outlook

Business Description

Government Support And GRE Methodology Impact

Business Risk Profile: Fair, Due To Lack Of Diversification In Small And Isolated Power Market

Financial Risk Profile: Highly Leveraged, Due To Sizable Debt-Financed Investments

Financial Statistics/Adjustments

Related Criteria And Research

Landsvirkjun

Major Rating Factors

Strengths:

- A "very high" likelihood of timely and sufficient extraordinary ownership support in an event of financial distress.
- Dominant position in the Icelandic electricity market.
- Low-cost renewable generation asset base and mainly take-or-pay contracts.

Corporate Credit Rating

BB/Negative/B-1

Weaknesses:

- Highly leveraged financial risk profile owing to sizable debt-financed expansion of power generation capacity.
- Customer concentration in a small and isolated market.
- Exposure to aluminum prices for revenues.

Rationale

The rating on Iceland-based electricity generation and transmission company Landsvirkjun is based on the company's stand-alone credit profile (SACP), which we assess as 'b+', as well as our opinion that there is a "very high" likelihood that the government of the Republic of Iceland (BBB-/Negative/A-3) would provide timely and sufficient extraordinary support in the event of financial distress.

In accordance with our criteria for government-related entities (GREs), our view of a "very high" likelihood of extraordinary government support is based on our assessment of Landsvirkjun's:

- "Very important" role for the Icelandic government, given Landsvirkjun's dominant position as the incumbent power company and 64.7% owner of the national transmission grid; Landsvirkjun's strategic importance to the Icelandic economy; and its central role in the promotion of power-intensive industries.
- "Very strong" link with the Icelandic state, given the state's 100% ownership of Landsvirkjun and our expectation that Landsvirkjun will not be privatized in the medium term; the provision of ultimate state guarantees for all of Landsvirkjun's debt; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Landsvirkjun's SACP largely reflects our view of the company's high financial leverage and weak cash flow coverage ratios. The SACP also reflects Landsvirkjun's fair business risk profile, which is restricted by high customer concentration, the company's exposure to the aluminum sector for revenue and cash flow generation, and poor profitability. The company is, however, the dominant power producer in Iceland and has a modern and low-cost renewable generation asset base.

Key business and profitability expectations

Although Landsvirkjun renegotiated a major contract in 2010, linking it to inflation rather than aluminum prices as previously, we believe that the company's earnings will continue to fluctuate in line with aluminum price movements, as about 50% of its power production is sold through contracts with an aluminum price link. Higher aluminum prices were a supportive factor in an increase in Landsvirkjun's earnings and margins in the first half of 2011, when EBITDA increased by 24% compared with the first half of 2010, and the company's EBITDA margin

increased to 83% from 80%. We note, however, that aluminum prices have decreased in the second half of 2011, which could impact earnings negatively in the near term. We believe that this impact is likely to be mitigated by stability in volumes through take-or-pay contracts, and the fact that the company hedges part of its aluminum price exposure.

Key cash flow and capital-structure expectations

Landsvirkjun's financial risk profile is highly leveraged, in our view, due to significant debt-funded capital investments in recent years. This results in weak credit measures, with adjusted funds from operations (FFO) to debt and adjusted debt to EBITDA of about 8.7% and 8.8x for the 12 months ended June 2011, although this was an improvement from the 7.6% and 10.0x achieved in 2010.

The company is constructing a new power plant, Budarhals, with completion scheduled for 2013, which will lead to increased capital expenditures in the next few years, compared with 2010. This project is, however, smaller than past significant project, and we believe that the FFO should be well in excess of committed investments in the near term. Landsvirkjun has not paid dividends in the past few years, and we would expect any future dividends to be modest. Accordingly, we forecast positive free cash flows in the near term. Reflecting the company's high debt burden and uncertainty about aluminum prices, we anticipate, however, that the company's adjusted FFO and adjusted debt to EBITDA will remain at 8%-10% and 8.0x-8.5x respectively in the near term.

Potential investments in new power stations in north east Iceland could pressure credit measures in the medium term, although we expect that such investments would not be started before Landsvirkjun secures contracts for the output.

Liquidity

We view Landsvirkjun's liquidity position as "adequate" under our criteria. We believe that available liquidity sources in terms of cash, committed credit facilities, and operating cash flows should be well in excess (more than 1.2x) of forecast near-term cash outflows such as debt repayments and capital expenditure, and any potential dividend payments. We further believe that the company has a sound relationship with its banks, satisfactory standing in the credit markets, and prudent risk management.

On June 30, 2011, Landsvirkjun had \$193 million in reported cash, \$308 million available under a committed revolving credit facility that expires in December 2012, and access to committed credit facilities amounting to Icelandic krona (ISK) 5.0 billion (\$44 million), expiring in March 2014. We understand that these facilities are free from financial or other restrictive covenants. We believe that Landsvirkjun plans to refinance its revolving credit facility expiring in December 2012 well in advance of its maturity.

In addition, during the first half of 2010, Landsvirkjun signed a €70 million (\$100 million) loan facility with the European Investment Bank (EIB; AAA/Stable/A-1+) maturing in 2031 and a \$70 million loan facility with the Nordic Investment Bank (AAA/Stable/A-1+) maturing in 2027. On June 30, 2011, both these facilities were undrawn. We note that the EIB loan facility includes a provision requiring a minimum credit rating on the Republic of Iceland, which could limit future access to this facility. In the third quarter of 2011, Landsvirkjun issued bonds of about \$133 million under a euro medium-term note program and signed a \$45 million export credit agency-based loan.

Landsvirkjun generated FFO of \$252 million in the 12 months ended June 2011, and we believe that its FFO will remain well in excess of \$200 million a year in the near term.

We project that capital spending will be in excess of \$100 million annually over the next few years, but that any dividends from 2012 and onwards will be modest. On June 30, 2011, Landsvirkjun had about \$197 million of short-term debt maturing within the coming 12 months, with an additional \$211 million of debt due in the following 12 months.

Outlook

The negative outlook reflects the negative outlook on the sovereign, and the likelihood that we would lower the ratings following a negative rating action on the sovereign rating, provided our assessments of the company's SACP and the "very high" likelihood of extraordinary government support remain unchanged.

An outlook revision to stable would depend on a similar outlook revision on the sovereign.

In accordance with our criteria for GREs, we would not lower the ratings on Landsvirkjun even if the company's SACP were lowered by up to two notches. If we were to raise the SACP on Landsvirkjun by one notch, we would also raise the ratings by one notch. This could result from a significant strengthening of the company's financial risk profile and credit measures in the medium term, for example if the company were to continue to generate positive free cash flows and pay down debt, leading to adjusted FFO to debt of sustainably above 10%.

Business Description

Landsvirkjun produces about 75% of the electricity in Iceland, using low marginal cost and environmentally friendly hydropower (96%) and geothermal power (4%), and is one of the largest corporations in the country.

Landsvirkjun's subsidiary Landsnet, in which it holds a 64.73% stake, owns and operates the Icelandic transmission system.

Landsvirkjun operates 13 hydroelectric power plants and two geothermal plants, backed up by one fossil-fuel reserve plant. In addition to its own production of 12,534 gigawatt hours (GWh) in 2010, Landsvirkjun purchased 392 GWh from Reykjavik Energy (not rated) and HS Orka (not rated). Landsvirkjun sold 83% of the produced and purchased energy to power-intensive industries, predominantly aluminum smelters, under long-term take-or-pay contracts. The remainder was sold to public utilities and distribution companies.

Landsvirkjun is a fully state-owned public partnership controlled by the Ministry of Finance. The State Treasury of Iceland directly owns 99.9% of the shares and indirectly owns the remaining 0.1% through a special-purpose vehicle, Eignarhlutir ehf.

Government Support And GRE Methodology Impact

The ratings on Landsvirkjun reflect our opinion that there is a "very high" likelihood that the Republic of Iceland would provide timely and sufficient extraordinary support to Landsvirkjun in the event of financial distress. We assess Landsvirkjun's SACP at 'b+'.

In accordance with our criteria for GREs, our view of a "very high" likelihood of extraordinary timely and sufficient government support is based on our assessment of Landsvirkjun's "very important" role and "very strong" link with the Icelandic state.

We view Landsvirkjun's role as very important to the Republic of Iceland. Not only is Landsvirkjun the dominant power company in the country, generating 75% of the power produced, and the majority owner of the national transmission grid, it is also one of the country's largest corporations. In our view, Landsvirkjun plays a very important role in the promotion of power-intensive industries in Iceland, evidenced by its cost-competitive long-term customer contracts, which have enabled the country to increase diversification of its private sector.

We assess Landsvirkjun's link to the sovereign as very strong. The state owns 100% of Landsvirkjun and we do not expect privatization in the medium term. The state provides a guarantee for the ultimate collection of Landsvirkjun's debt, together with two previous owners (the city of Reykjavik and the town of Akureyri for the debt issued before Jan. 1, 2007). However, we consider that the collection does not guarantee timely payment of Landsvirkjun's debt service obligations, and that Landsvirkjun would need to exhaust its own resources before the guarantee would apply.

We also factor into our assessment of Landsvirkjun's link to the sovereign the fact that the Central Bank of Iceland extended a two-year \$300 million contingent credit facility to Landsvirkjun in June 2009, which the company could draw on if all other funding sources were exhausted. The contingent credit facility, which has now expired, was established to ensure that Landsvirkjun met all of its debt obligations in a full and timely manner. At the same time, the government enhanced its surveillance of state-owned entities, including Landsvirkjun. We also consider that there is considerable reputational risk for the sovereign if Landsvirkjun were to default, as the company is inherently linked to the sovereign.

Business Risk Profile: Fair, Due To Lack Of Diversification In Small And Isolated Power Market

The major constraints for Landsvirkjun's fair business risk profile are:

- A lack of diversification and high customer concentration, given that Landsvirkjun operates only in the small and isolated Icelandic market, and that over 80% of the power produced is sold to power-intensive industries, mostly a small number of aluminum smelters. Although Landsvirkjun is seeking to diversify its customer base, we believe this will take time as it will largely depend on the establishment of new companies/operations in Iceland and construction of new power stations.
- Exposure to inherently volatile commodity prices, given that about 60% of the company's power supply contracts with aluminum smelters, corresponding to about 50% of its total electricity production, contain embedded derivatives linking the price of the power sold to the price of aluminum.
- Poor profitability, with return on capital of about 4% on average over the past few years, as a result of significant investments in a new power plant (Kárahnkjar Power Plant), albeit mitigated by low operating costs.

These constraints are mitigated by:

- Landsvirkjun's dominant position as the incumbent power producer in Iceland and majority owner of the transmission grid.
- A modern and efficient asset base comprising low-cost renewable generation assets. Landsvirkjun operates 13 hydroelectric power stations and two geothermal plants, backed up by a small fossil-fuel reserve plant.
- Long-term pay-or-take contracts with power-intensive industries. We consider that this should provide some predictability of earnings. We also consider that following the renegotiation of one major contract in 2010, the

company reduced risk exposure to aluminum prices, which should reduce earnings volatility.

Financial Risk Profile: Highly Leveraged, Due To Sizable Debt-Financed Investments

The main weaknesses of Landsvirkjun's highly leveraged financial risk profile are:

- A highly leveraged balance sheet due to heavy front-ended and debt-financed investments in power generation. Landsvirkjun's adjusted debt-to-capital ratio was 64% on June 30, 2011.
- Very weak cash flow protection of debt. Landsvirkjun's adjusted FFO to debt (on a rolling 12-month basis) was 8.7% on June 30, 2011, and adjusted debt to EBITDA 8.8x. However these levels represented improvements compared with 2009 and 2010. We believe that further improvement in the medium term is possible, but will depend on aluminum price developments and the level of investments. We currently believe that FFO to debt and debt to EBITDA will range between 8%-10% and 8.0x-8.5x respectively in the near term.
- Exposure to interest rates and foreign currency movements. About 70% of Landsvirkjun's loan portfolio carries floating interest rates. Although this has been beneficial for the company during the past few years of low interest rates, it exposes earnings and cash flows to any increases in interest rates. Foreign exchange risk is present because the group's income is mainly in U.S. dollars, but about 40% of its debt is euro-denominated. Landsvirkjun reduces this risk through hedging arrangements.

These weaknesses are mitigated by:

- Pre-financing of expansionary investments and strengthened liquidity sources. Landsvirkjun proactively signed new loan agreements and issued bonds under its euro medium-term note-program during the first three quarters of 2011 to pre-fund its upcoming investment in the Budarhals power station. This has also strengthened the group's liquidity sources, providing a cushion for any deterioration in free cash flows owing to for example lower aluminum prices.
- An extended maturity profile. Landsvirkjun's debt maturity profile is well spread, with a debt duration of about 7.5 years on average as of June 30, 2011 and a relatively low maturity concentration.

Financial Statistics/Adjustments

Landsvirkjun has been reporting under International Financial Reporting Standards (IFRS) since 2007, and has been using the U.S. dollar as its reporting currency since Jan. 1, 2008.

We make adjustments to Landsvirkjun's reported income, balance sheet, and cash flow statement (see table 1). We adjust reported debt to include \$27.7 million in accrued interest and post-tax postretirement benefit obligations of \$17.3 million. We also adjust Landsvirkjun's reported revenues for realized aluminum hedges related to electric power sale agreements. This adjustment reduced revenues by \$6 million in 2010, having added to them by \$42 million in 2009).

Table 1

Reconciliation Of Landsvirkjun Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. \$)										
--Fiscal year ended Dec. 31, 2010--										
Landsvirkjun reported amounts										
	Debt	Shareholders' equity	Revenues	EBITDA	Operating income	Interest expense	Cash flow from operations	Cash flow from operations	Dividends paid	Capital expenditures
Reported	2,939.5	1,608.5	379.2	304.4	197.2	84.8	229.6	229.6	--	44.5
Standard & Poor's adjustments										
Postretirement benefit obligations	17.3	--	--	--	--	--	--	--	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	2.3	--	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	(1.4)	--	--
Minority interests	--	35.8	--	--	--	--	--	--	--	--
Debt - Accrued interest not included in reported debt	27.7	--	--	--	--	--	--	--	--	--
Revenues - Realized aluminum hedges	--	--	(6.3)	(6.3)	(6.3)	--	--	--	--	--
Total adjustments	45.1	35.8	(6.3)	(6.3)	(4.0)	0.0	0.0	(1.4)	0.0	0.0
Standard & Poor's adjusted amounts										
	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Dividends paid	Capital expenditures
Adjusted	2,984.5	1,644.3	372.9	298.1	193.1	84.8	229.6	228.2	0.0	44.5

Table 2

Landsvirkjun -- Peer Comparison			
	Landsvirkjun	Fortum Oyj	Statkraft AS
Rating as of Oct. 27, 2011	BB/Negative/B-1	A/Stable/A-1	A-/Stable/A-2
--Average of past three fiscal years--			
(Mil. \$)			
Revenues	366.0	8,034.7	4,356.8
EBITDA	288.8	3,344.0	2,269.3
Interest Expense	120.8	443.7	345.5
Net income from cont. oper.	(14.0)	1,925.6	2,419.2
Funds from operations (FFO)	207.2	2,702.5	2,002.8
Capital expenditures	129.7	1,434.9	503.7

Table 2

Landsvirkjun -- Peer Comparison (cont.)			
Free operating cash flow	71.5	1,246.2	1,373.7
Cash and short-term investments	194.9	1,288.3	1,705.1
Debt	3,022.5	11,241.9	7,294.9
Equity	1,528.5	11,816.7	11,519.8
Debt and equity	4,551.0	23,058.6	18,814.7
Adjusted ratios			
EBITDA margin (%)	78.9	41.6	52.3
EBITDA interest coverage (x)	2.4	7.5	6.5
EBIT interest coverage (x)	1.5	6.5	6.4
Return on capital (%)	4.0	11.5	11.7
FFO/debt (%)	6.9	23.9	27.8
Free operating cash flow/debt (%)	2.4	10.9	19.0
Debt/EBITDA (x)	10.5	3.4	3.2
Total debt/debt plus equity (%)	66.4	48.8	38.7

Table 3

Landsvirkjun -- Financial Summary				
--Fiscal year ended Dec. 31--				
	2010	2009	2008	2007
Rating history	BB+/Negative/B-1	BB/Stable/B-1	BBB-/Negative/A-3	AA/Negative/A-1+
(Mil. \$)				
Revenues	372.9	338.3	386.9	302.6
EBITDA	298.1	271.7	296.8	203.6
Interest Expense	84.8	92.5	185.0	161.6
Net income from continuing operations	62.6	188.8	(293.4)	463.8
Funds from operations (FFO)	228.2	184.3	209.0	86.6
Capital expenditures	44.5	79.9	264.6	573.3
Free operating cash flow	185.1	117.1	(87.5)	(504.3)
Dividends paid	0.0	0.0	7.8	8.1
Cash and short-term investments	265.5	194.2	125.0	179.6
Debt	2,984.5	3,055.4	3,027.5	3,211.8
Equity	1,644.3	1,564.5	1,376.8	1,600.1
Debt and equity	4,628.9	4,619.9	4,404.3	4,812.0
Adjusted ratios				
EBITDA margin (%)	79.9	80.3	76.7	67.3
EBITDA interest coverage (x)	3.5	2.9	1.6	1.3
EBIT interest coverage (x)	2.3	1.6	1.1	0.8
FFO int. cov. (x)	3.6	3.0	1.8	1.4
FFO/debt (%)	7.6	6.0	6.9	2.7
Free operating cash flow/debt (%)	6.2	3.8	(2.9)	(15.7)
Discretionary cash flow/debt (%)	6.2	3.8	(3.2)	(16.0)
Net cash flow/capex (%)	512.4	230.7	76.0	13.7

Table 3

Landsvirkjun -- Financial Summary (cont.)				
Debt/EBITDA (x)	10.0	11.2	10.2	15.8
Debt/debt and equity (%)	64.5	66.1	68.7	66.7
Return on capital (%)	4.2	3.4	4.4	0.1

Related Criteria And Research

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Principles Of Credit Ratings, Feb. 16, 2011

Ratings Detail (As Of October 27, 2011)

Landsvirkjun		
Corporate Credit Rating		BB/Negative/B-1
Senior Unsecured (1 Issue)		BB
Short-Term Debt (1 Issue)		B-1
Corporate Credit Ratings History		
18-May-2011	<i>Foreign Currency</i>	BB/Negative/B-1
14-Apr-2011		BB+/Watch Neg/B-1
20-Oct-2010		BB+/Negative/B-1
30-Jun-2009		BB/Stable/B-1
08-May-2009		BBB-/Watch Neg/A-3
24-Nov-2008		BBB-/Negative/A-3
07-Oct-2008		BBB/Negative/A-3
30-Sep-2008		A-/Watch Neg/A-2
18-Apr-2008		A/Negative/A-1
01-Apr-2008		A+/Watch Neg/A-1
22-Dec-2006		A+/Negative/A-1
18-May-2011	<i>Local Currency</i>	BB/Negative/B-1
14-Apr-2011		BB+/Watch Neg/B-1
20-Oct-2010		BB+/Negative/B-1
30-Jun-2009		BB/Stable/B-1
08-May-2009		BBB-/Watch Neg/A-3
18-Dec-2008		BBB-/Negative/A-3
07-Oct-2008		BBB+/Negative/A-2
30-Sep-2008		A+/Watch Neg/A-1
18-Apr-2008		AA-/Negative/A-1+
01-Apr-2008		AA/Watch Neg/A-1+
22-Dec-2006		AA/Negative/A-1+
Business Risk Profile		Fair
Financial Risk Profile		Highly leveraged

Ratings Detail (As Of October 27, 2011) (cont.)

Debt Maturities

As of June 30, 2011:
July 1, 2011-June 30, 2012: \$197 mil.
July 1, 2012-Dec. 31, 2012 : \$117 mil.
2013: \$161 mil.
2014: \$159 mil.
2015: \$248 mil.
2016: \$266 mil.
Thereafter: \$1,730 mil.

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact:

Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com

Additional Contact:

Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com

Copyright © 2011 by Standard & Poors Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, 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 S&P. The Content shall not be used for any unlawful or unauthorized purposes. S&P, its affiliates, 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, 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) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions. 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's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. 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.

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 non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain credit-related 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 (free of charge), and www.ratingsdirect.com and www.globalcreditportal.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.