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## Research Update:

# Icelandic Utility Landsvirkjun Outlook Revised To Stable After Similar Action On Iceland; 'BB/B' Ratings Affirmed

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## Research Update:

# Icelandic Utility Landsvirkjun Outlook Revised To Stable After Similar Action On Iceland; 'BB/B' Ratings Affirmed

## Overview

- On Jan. 24, 2014, we revised our outlook on Iceland to stable from negative and affirmed our 'BBB-/A-3' sovereign ratings.
- Icelandic electricity generation and transmission company Landsvirkjun is a government-related entity with a "very high" likelihood of extraordinary government support.
- We are therefore revising our outlook on Landsvirkjun to stable from negative and affirming our 'BB/B' ratings on the company.
- The stable outlook on Landsvirkjun reflects that on Iceland and our expectation that Landsvirkjun's stand-alone credit profile will not materially change in the near term.

## Rating Action

On Jan. 30, 2014, Standard & Poor's Ratings Services revised its outlook on Iceland-based electricity generation and transmission company Landsvirkjun to stable from negative. At the same time, we affirmed our 'BB' long-term and 'B' short-term corporate credit ratings on Landsvirkjun.

## Rationale

The outlook revision follows our similar action on the Republic of Iceland (see "Republic of Iceland Outlook Revised To Stable From Negative On Receding Fiscal Risk; 'BBB-/A-3' Ratings Affirmed," published Jan. 24, 2014, on RatingsDirect).

We base our ratings on Landsvirkjun on the company's stand-alone credit profile (SACP), which we assess at 'b+', reflecting its "fair" business risk profile, "highly leveraged" financial risk profile, and a one-notch upward adjustment for our "positive" comparable rating analysis, according to our criteria. The long-term rating further includes two notches of uplift based on our opinion that there is a "very high" likelihood that the government of the Republic of Iceland would provide timely and sufficient extraordinary support to Landsvirkjun in the event of financial distress.

In accordance with our criteria for government-related entities (GREs), our view that there is a "very high" likelihood of extraordinary government support 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.
- "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.

Our assessment of Landsvirkjun's financial risk profile as "highly leveraged" reflects the company's high debt due to significant debt-funded capital investments in recent years, resulting in weak cash-flow coverage ratios. Although we assume that Landsvirkjun will post positive free cash flow in the near term, we believe that credit measures will remain weak, with funds from operations (FFO) at about 9%-10%, from about 9% in 2012, and debt to EBITDA at about 7.0x-8.0x, from about 7.9x in 2012.

Landsvirkjun's "fair" business risk profile reflects the "moderately high" country risk of Iceland, "moderately high" industry risk of unregulated power and gas companies, and the company's "fair" competitive position. Landsvirkjun's competitive position is restricted by high customer and geographic concentration, and the company's exposure to the aluminum sector for revenue and cash flow generation. Landsvirkjun's earnings and cash flow are exposed to volatile commodity prices, as about 50% of power sales are linked to aluminum prices through power supply contracts with aluminum smelters. These constraints are, however, mitigated by Landsvirkjun's position as the dominant power producer in Iceland, and its low-cost renewable generation asset base. Its long-term pay-or-take contracts with customers provide some predictability of earnings, which mitigates the concentration risk and exposure to aluminum prices.

We apply an upward adjustment of one notch, reflecting our "positive" comparable rating analysis for the company. This is based on our view that Landsvirkjun's FFO-to-debt ratio is at the upper end of our "highly leveraged" category; that interest coverage is strong for the financial risk profile; and that there is ongoing support from the owner, the Icelandic government, which for example has requested very modest dividends from Landsvirkjun over the past few years.

Our base case assumes:

- EBITDA margins of about 75%-80% in 2013 and 2014, broadly unchanged compared with 80% in 2012. Power prices will likely face pressure due to low aluminum prices, mitigated by price hedges and modest volume growth.
- FFO well in excess of capital expenditures (capex) and dividends, leading to debt reduction, although only by a modest amount relative to the overall high level of debt.

Based on these assumptions, we arrive at the following credit measures for 2013 and 2014:

- FFO to debt of about 9%-10%.
- Debt to EBITDA of about 7.0-8.0x.
- FFO cash interest coverage of about 3.0x-3.5x.

## **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 flow should be well in excess--more than 1.2x--of forecast near-term cash outflows such as debt repayments, capex, and dividend payments. We also expect that sources will exceed uses even if EBITDA declines by 15%. We understand that Landsvirkjun's \$200 million revolving credit facility contains financial covenants, under which we expect Landsvirkjun will retain adequate headroom.

We further believe that the company has a sound relationship with its banks, a satisfactory standing in the credit markets, and prudent risk management.

## **Principal liquidity sources**

- \$159 million in cash as of June 30, 2013.
- Access to a \$200 million unused committed revolving credit facility that expires in December 2016, and an unused committed credit facility amounting to Icelandic krona 10.5 billion (about \$91 million), expiring in December 2016.
- Proceeds from \$30 million bond issue in August 2013.
- FFO in excess of \$200 million annually.

## **Principal liquidity uses**

- As of June 30, 2013, about \$175 million in debt maturing between July 2013 and June 2014, and about \$118 million in the second half of 2014. In December 2013, Landsvirkjun, however, extended about \$68 million of short-term maturities to 2020.
- Capex that we estimate in excess of \$100 million in 2013, and potentially slightly lower in 2014.
- Dividend payments of about \$13 million in 2013, which we assume will not change significantly in 2014.

## **Outlook**

The stable outlook reflects that on Iceland, and our assumption of an unchanged SACP for Landsvirkjun in the near term. Despite pressure from low aluminum prices, we assume that Landsvirkjun's FFO will be well in excess of its committed investments in the near term, and that dividend payments will be modest. Although we anticipate this to result in positive free cash flow, we believe that any improvement in credit measures would be minor in the next year, including FFO to debt of about 9%-10%.

## **Downside scenario**

In line with our criteria for GREs, we would likely lower the ratings on

Landsvirkjun if we lowered the local currency rating on Iceland. However, we would likely not lower the ratings on Landsvirkjun even if we revised our assessment of the company's SACP downward by up to two notches.

### **Upside scenario**

We could raise the ratings on Landsvirkjun if we were to revise our assessment of its SCAP upward by one notch. This could result from a strengthening of the company's credit measures, for example if the company continues to generate positive free cash flow and pay down debt, leading to FFO to debt of at least 12% on a sustainable basis. We could also raise the ratings on Landsvirkjun if we raised the local currency rating on Iceland, provided our assessment of the "very high" likelihood of support remained unchanged.

## **Ratings Score Snapshot**

Corporate Credit Rating: BB/Stable/B

Business risk: Fair

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

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

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: Positive (+1 notch)

Stand-alone credit profile: b+

- Sovereign rating: BBB-
- Likelihood of government support: Very high (+2 notches)

## **Related Criteria And Research**

- Republic of Iceland Outlook Revised To Stable From Negative On Receding Fiscal Risk; 'BBB-/A-3' Ratings Affirmed, Jan 24, 2014
- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014

- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- Standard & Poor's Publishes Finalized Country Risk Assessments For 103 Countries, Nov. 19, 2013
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

## Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Landsvirkjun		
Corporate Credit Rating	BB/Stable/B	BB/Negative/B
Senior Unsecured	BB	

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