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Summary:

Landsvirkjun

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Summary:

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Credit Rating: BB/Stable/B

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+', based on its "fair" business risk profile and "highly leveraged" financial risk profile. It includes two notches of uplift based on our opinion that there is a "very high" likelihood that the government of the Republic of Iceland (BBB-/Stable/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 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; its 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 and our expectation that the company will not be privatized in the medium term; the provision of ultimate state guarantees for Landsvirkjun's debt; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Landsvirkjun's "highly leveraged" financial risk profile is constrained by our view of the company's high financial leverage and weak cash flow coverage ratios, due to significant debt-funded capital investments in recent years. Landsvirkjun's "fair" business risk profile is restricted by high customer concentration, the company's exposure to the aluminum sector for revenue and cash flow generation, and weak profitability. The company is, however, the dominant power producer in Iceland and has a modern and low-cost renewable generation asset base.

S&P base-case operating scenario

In our base-case scenario, we assume that Landsvirkjun'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. As aluminum prices have decreased during 2012, we expect this to negatively impact Landsvirkjun's sales and EBITDA for the year. This was apparent in the first six months of 2012, when EBITDA decreased by about 9% compared with the corresponding period in 2011. We believe, however, that the negative impact of lower aluminum prices 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. We therefore assume that the decrease in EBITDA in 2012 will be relatively modest from the \$345 million recorded in 2011. We believe that there is scope for recovery in 2013 based on modest volume growth, and a possible recovery in aluminum prices. We assume that EBITDA margins will remain high at 75%-80%, and that return on capital will remain weak (5% in 2011).

S&P base-case cash flow and capital-structure scenario

In our base-case assessment, we assume that any change in Landsvirkjun's funds from operations (FFO) will follow EBITDA development. Accordingly, we assume that FFO in 2012 is likely to decrease modestly from the \$260 million achieved in 2011 as a result of lower aluminum prices, with a slight recovery in 2013.

We assume that construction of a power plant at Budarhals, with completion scheduled for the end of 2013, will lead to increased capital expenditures in 2012 and 2013 compared with 2011. This project is, however, smaller than a past significant project, and we believe that FFO will be well in excess of committed investments in the near term. Landsvirkjun paid a modest dividend of about \$14 million for 2011, and we assume future dividends will remain 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 Landsvirkjun's adjusted FFO to debt and adjusted debt to EBITDA will remain at 8%-10% and 8.0x-8.5x, respectively, over the near term. For the 12 months ended June 30, 2012, these figures were 9.0% and 8.3x respectively. We adjust Landsvirkjun's debt for minor post-retirement obligations, and accrued interest, which in 2011 amounted to about \$44 million in total. We note that Landsvirkjun's current FFO benefits from an absence of tax payments as the company has a deferred tax asset calculated on all carry forward losses, which can be utilized against taxable profits. As this asset gradually reduces, Landsvirkjun's FFO will eventually be impacted by tax payments, although we currently believe this will not significantly impact the company's financial risk profile.

Potential investments in new power stations in north east Iceland could put pressure on Landsvirkjun's credit measures over the medium term, although we expect that such investments would not start before the company secures contracts for the output.

Liquidity

The short-term rating is 'B'. 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, capital expenditure, and dividend payments. We further believe that the company has a sound relationship with its banks, a satisfactory standing in the credit markets, and prudent risk management.

Landsvirkjun's main liquidity sources consist of:

- \$245 million in unrestricted cash as of June 30, 2012.
- Access to a \$200 million unused committed revolving credit facility that expires in December 2014 with a possible extension of up to two years, and an unused committed credit facility amounting to Icelandic krona 10.5 billion (\$81 million), expiring in December 2014, also with two years of possible extension. We understand that the \$200 million facility contains financial covenants, under which we expect Landsvirkjun to retain adequate headroom.
- FFO, which stood at about \$250 million in the 12 months ended June 30, 2012, and which we assume will be modestly lower in the 12 months ending June 30, 2013.

Expected cash outflows consist of:

- About \$172 million in debt maturing in the next 12 months, and about \$107 million in the following 12 months as of June 30, 2012.

- Capital expenditures that we estimate in excess of \$100 million in the 12 months ending June 30, 2013.
- Dividend payments, which totaled \$14 million in 2012, and which we assume will not change materially in 2013.

Outlook

The stable outlook reflects the stable outlook on Iceland, and our assumption that Landsvirkjun's SACP will remain unchanged over the near term. In our base case, we assume that despite possible pressure on earnings from negative aluminum price developments, Landsvirkjun's FFO will be well in excess of committed investments over the near term, and dividend payments will be modest. Accordingly, we forecast near-term positive free cash flows. We further anticipate that the company's adjusted FFO to debt will remain at 8%-10% and adjusted debt to EBITDA at 8.0x-8.5x over the near term, which is in line with our expectations for the 'b+' SACP.

If we were to revise our assessment of Landsvirkjun's SACP upward 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 over 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%.

In accordance with our criteria for GREs, we would also likely raise the ratings on Landsvirkjun by one notch if we raised the sovereign local currency rating on Iceland by one notch, provided our assessment of the "very high" likelihood of extraordinary government support remained unchanged.

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

Related Criteria And Research

- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Methodology: Short-Term/Long-Term Ratings Linkage Criteria For Corporate And Sovereign Issuers, May 15, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Principles Of Credit Ratings, Feb. 16, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

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