

**Credit Opinion: Landsvirkjun**

Global Credit Research - 05 May 2015

Reykjavik, Iceland

**Ratings**

<b>Category</b>	<b>Moody's Rating</b>
Outlook	Positive
Senior Unsecured	Ba2
Other Short Term	(P)NP

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**Key Indicators**

<b>[1]Landsvirkjun</b>	<b>12/31/2014</b>	<b>12/31/2013</b>	<b>12/31/2012</b>	<b>12/31/2011</b>	<b>12/31/2010</b>
(FFO + Interest) / Interest	3.3x	2.9x	2.8x	2.7x	3.2x
FFO / Debt	8.8%	7.5%	7.2%	7.5%	6.4%
RCF / Debt	8.3%	7.1%	6.7%	7.5%	6.4%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

**Opinion**

**Rating Drivers**

- Dominant power generation company in the Icelandic energy market
- Minimal capital expenditure requirements
- Long term take-or-pay contracts provide some predictability of earnings but bring some exposure to aluminium price and counterparty risk
- High debt burden and the ability to deleverage is dependent on external variables
- Support from the owner provides an uplift to the standalone rating

**Corporate Profile**

Landsvirkjun is the dominant power producer in Iceland, responsible for around 72% of the country's total electricity production of 18.1 TWh in 2014. The company currently operates 14 hydropower plants, 2 geothermal

plants and 2 wind turbines with total installed capacity of 1,960 MW. It provides 100% renewable energy for domestic users via electricity sales to public utilities, although the majority of sales are to power intensive industries (PII), mostly for aluminium smelting, under long-term take-or-pay contracts.

Additionally, Landsvirkjun is the majority owner (64.7%) of Landsnet, the country's electricity transmission system operator. Landsnet is a fully regulated company. Transmission revenues for 2014 account for about 14% of total revenues.

Landsvirkjun is a partnership, 99.9% is owned directly by the Government of Iceland and the rest is owned by Eignarhlutir hf, which is a special purpose vehicle owned by the state.

## **SUMMARY RATING RATIONALE**

Landsvirkjun's rating factors in positively (1) the company's dominant position in the Icelandic energy market; (2) its low-cost renewable generation asset base and minimal levels of capital expenditure; and (3) its ability to generate relatively stable cash flows. However, the company's assessment is constrained by (1) Landsvirkjun's still high financial leverage; (2) its concentrated exposure to a comparatively small number of counterparties, mainly in the aluminium industry; (3) its degree of exposure to aluminium prices in a weak commodity market; (4) its foreign exchange risk; and (5) a considerable proportion of outstanding debt linked to floating interest rates.

The (P)Ba2/(P)NP unguaranteed ratings assigned to Landsvirkjun's USD1 billion EMTN programme incorporate two notches of uplift from the company's BCA of b1 to reflect the likelihood of extraordinary support being provided by the Government of Iceland (Baa3 stable) in the event this was needed to avoid a payment default. This uplift reflects the high level of commitment that Iceland has shown in the past to support Landsvirkjun's debt and the strategic importance of the company to the Icelandic economy.

The (P)Baa3/(P)Prime-3 guaranteed ratings assigned to Landsvirkjun's USD2.5 billion EMTN backed programme are at par with the sovereign rating and reflect the additional credit support provided by the guarantee of collection from the Icelandic government.

## **DETAILED RATING CONSIDERATIONS**

### **DOMINANT POWER GENERATION COMPANY IN THE ICELANDIC ENERGY MARKET**

Landsvirkjun is Iceland's largest power producer with total installed generation capacity of 1,960 MW, which represents more than 70% of the total country's electricity capacity.

The company currently operates 14 hydropower plants, 2 geothermal plants and 2 wind turbines. Landsvirkjun's total energy generation for 2014 was 13,082 GWh, of which 96% was from hydropower plants and 4% from geothermal resources. Landsvirkjun's portfolio of generation assets compares relatively well with Iceland generation mix of 71% based on hydro and 29% based on geothermal sources.

Given the very low marginal costs of production associated with its hydro sources, Landsvirkjun has a very attractive generation portfolio. In addition, competition from regional players, primarily Reykjavik Energy and Hitaveita Sudurnesja, is fairly limited. These strengths are, however, to some extent offset by the fact that the power market in Iceland is small, geographically isolated and highly dependent on the demand from power intensive industries, which consume around 80% of all electricity produced in Iceland.

### **MINIMAL LEVELS OF CAPITAL EXPENDITURE REQUIREMENTS**

Landsvirkjun operates a modern, well maintained and developed asset base. The company's larger assets are relatively new, with about 995 MW developed within the last 15 years. Scheduled investments are relatively modest and mainly related to maintenance, with some investments in the transmission grid, which has already reached its capacity and will require improvements in the infrastructure in order to maintain uninterrupted operations.

In terms of new generation projects, the company has recently started the first phase construction of the Theistareykir Geothermal Power Station (45 MW), which is expected to be operational by 2017. Since major investments for the construction of new power plants are only undertaken when new supply contracts are signed, additional expansionary capex is not expected over the next few years, as the existing capacity is sufficient to cope with current demand and may accommodate small increases. Nevertheless, Landsvirkjun has already identified a number of new opportunities which could be developed if needed. We highlight that any increase in currently planned capex will have a direct impact on the speed of the company's deleveraging.

## LONG TERM CONTRACTS WITH INDUSTRIAL CUSTOMERS PROVIDE SOME PREDICTABILITY OF EARNINGS BUT BRING SOME EXPOSURE TO ALUMINIUM PRICE AND COUNTERPARTY RISK

Landsvirkjun is predominantly a wholesale electricity producer, with about 86% of revenues coming from power sales. The remaining 14% is mostly derived from regulated transmission revenues of Landsnet.

The majority of Landsvirkjun's energy generation is sold to power intensive industry (PII) customers under long-term take-or-pay US dollar-denominated contracts, which provide valuable foreign currency earnings and good visibility over the long term power demand.

However, Landsvirkjun has a significant concentration in terms of small number of counterparties, as its three largest customers (Alcoa, Rio Tinto Alcan and Century Aluminium) are aluminium companies that purchase approximately 75% of the company's production. We note that so far the aluminium smelters have had a track record of timely payments.

In addition, about half of Landsvirkjun's energy generation is sold under contracts directly linked to aluminium prices and the remaining half is mostly CPI linked. The share in revenue mix would fluctuate depending on aluminium prices. During 2014, about 30% of revenues were linked to aluminium price. As such, Landsvirkjun has assumed a commodity risk not seen for other utilities in Europe outside of Iceland.

As of end-April 2015, spot aluminium was around USD1,909. We believe that aluminium prices will remain under pressure with no catalyst seen for a material price improvement through 2015. Prices are expected to remain range bound within current trading levels and regional premiums are declining in the face of slowing demand and increasing supply. Although various end markets such as automotive and aerospace remain favourable, weak global growth expectations and slowing fundamentals in China will continue to pressure sentiment. Moreover, inventories, while evidencing downward movement, remain high with metal off market in financing transactions. In addition, lower fuel prices could result in aluminium smelters that are currently idled coming back on line, which would be negative for the industry.

We note that exposure to aluminium prices has significantly decreased over the recent past. In particular, after the renegotiation of the long term contract with Rio Tinto in 2010, the implementation of a prudential pricing strategy for new signed contracts and consistent hedging activities, revenue from power sales has started to decouple from aluminium prices and cash flow generation has been stable.

## HIGH DEBT BURDEN AND THE ABILITY TO DELEVERAGE IS DEPENDENT ON EXTERNAL VARIABLES

Landsvirkjun's financial profile has improved as a result of the company's solid operating performance and management efforts to reduce exposure to commodity and financial market risks. The company managed to reduce its debt burden to USD2.4 billion as at end-2014 from USD2.7 billion at end-2013, but debt leverage still remains high.

In addition, Landsvirkjun is exposed to a considerable foreign exchange mismatch between foreign currency income and its debt servicing obligations. In particular, the company is exposed to adverse movements in the US dollar against the euro, as the majority of Landsvirkjun's revenues are in US dollars while around 27% of outstanding debt as at end-2014 was euro denominated. Landsvirkjun has also debt denominated in Icelandic krona (c.15%), but exposure is limited since revenues from power sales to local utilities are also in local currency.

We note that Landsvirkjun has made important progress in reducing its interest rate risk, nevertheless a significant proportion of outstanding debt (c.57%) as at end-2014 is still linked to floating rates and exposes the company to potential increases in funding costs.

The pace of improvement in Landsvirkjun's financial leverage and credit metrics will be dependent on the level of aluminium prices, foreign exchange rates and funding costs, but also whether the company undertakes any further investment projects funded by additional debt or pays significant dividends.

## SUPPORT FROM THE OWNER PROVIDES AN UPLIFT TO LANDSVIRKJUN'S STANDALONE RATING

Given its 100% state-ownership Landsvirkjun is considered a government-related issuer (GRI) under Moody's methodology. The company's ratings incorporate an uplift for potential government support to its standalone credit quality (BCA) of b1.

We believe that extraordinary financial support to Landsvirkjun from the Icelandic government would be

forthcoming if needed. Our assumption reflects the high level of commitment that the government has shown in the past by the provision of guarantees of collection to support company's debt and the strategic importance of Landsvirkjun to Iceland, given the company's position as the country's dominant power producer and the role it plays in the provision of electricity to the aluminium smelting industry, which directly contributes to about 40% of Icelandic exports.

We note that guarantees of collection do not offer bondholders the same degree of protection as a timely payment guarantee. There is a potential risk of non-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. However, given Landsvirkjun's strategic role for Iceland and other incentives for the shareholders (such as its liability for penalty interest), we expect that the state would intervene in a timely fashion and provide financial or other assistance to ensure timely payments.

The USD2.5 billion EMTN programme allows for issuance of notes only with the benefit of a guarantee of collection provided by the Republic of Iceland and Eignarhlutir ehf.

The USD1 billion EMTN programme allows for issuance of notes without a guarantee from the Government of Iceland. Consequently, and notwithstanding the very high support for the company, we differentiate between the ratings of the two programmes.

Our assessment of high default dependence balances Landsvirkjun's position as the country's dominant electric utility with the company's high level of US dollar-denominated revenues from contracts with exporting aluminium smelters with international parent companies.

### **Liquidity Profile**

Landsvirkjun's liquidity position is strong. As of end-December 2014, Landsvirkjun had USD207 million of cash and cash equivalents, as well as access to USD200 million under committed long-term revolving credit facilities (RCFs) with international and domestic commercial banks, maturing in December 2016. The company also has a ISK10.5 billion RCF facility with Icelandic banks, which was fully drawn at the end of 2014 but totally repaid in March 2015, also maturing in December 2016.

Landsvirkjun has a relatively well-spread maturity profile, which mitigates refinancing risk, albeit we caution that the amount of debt is still sizeable. Based on the available cash and credit lines coupled with forecast positive free cash flow generation, we expect the company to have enough liquidity to carry it through 2016.

We understand that the bank facilities in USD contains financial covenants but Landsvirkjun shows adequate headroom against the breach levels.

### **Rating Outlook**

The positive rating outlook reflects Moody's expectation that Landsvirkjun will continue to improve its financial profile, reduce leverage and exposure to market risks and prudently manage its liquidity position and capex program.

### **What Could Change the Rating - Up**

Moody's would consider an upgrade of the unguaranteed debt ratings if (1) Landsvirkjun continues to demonstrate the ability to withstand significant volatility in commodity and financial markets and maintain its strong operational performance; and (2) the company demonstrates a funds from operation (FFO)/ total debt ratio greater than 10% on a consistent and sustainable basis, while continuing to make progress in reducing its debt burden. Additionally, an improvement in the Government of Iceland rating would be required before Moody's would consider an upgrade of Landsvirkjun's backed senior unsecured ratings that benefit from a guarantee of collection from the state.

### **What Could Change the Rating - Down**

Given the positive outlook, downward rating pressure on the unguaranteed ratings is not anticipated in the near term but could develop as a result of (1) a substantial deterioration in Landsvirkjun's operating performance, which would cause financial metrics to materially deviate from Moody's expectation or considerably increase funding requirements; and/or (2) if it appears likely that the company's available liquidity was not sufficient to insulate it from market risks, particularly in relation to sudden movements in exchange rates, aluminium prices or interest rates. The unguaranteed ratings would also come under downward pressure if Moody's were to revise the current assumption of a very high probability of timely support from the government. Equally, the guaranteed ratings would

be downgraded if the rating of the Government of Iceland is downgraded.

## Other Considerations

In our assessment of Landsvirkjun's credit profile, we apply our global Rating Methodology for Unregulated Utilities and Power Companies, published in October 2014. Under this methodology, Landsvirkjun is considered an unregulated power company and the grid output maps to ba2. In assigning the BCA of b1, we give additional considerations to Landsvirkjun's high debt leverage in conjunction with the company's concentration exposure to small number of counterparties in a single commodity sector, the degree of exposure to aluminium prices in a weak market environment, the degree of currency mismatch between revenues and debt service costs, as well as the vulnerability to increased funding costs in the event of high interest rates.

Other methodologies used include the Government-Related Issuers, published in October 2014. Please see the Credit Policy page on [www.moodys.com](http://www.moodys.com) for a copy of these methodologies.

## Rating Factors

### Landsvirkjun

Unregulated Utilities and Unregulated Power Companies Industry Grid [1][2]	Current FY 12/31/2014		[3]Moody's 12-18 Month Forward View as of 4/30/2015	
Factor 1 : Scale (10%)	Measure	Score	Measure	Score
a) Scale (USD Billion)		Ba	Ba	Ba
<b>Factor 2 : Business Profile (40%)</b>				
a) Market Diversification		Ba	Ba	Ba
b) Hedging and Integration Impact on Cash Flow Predictability		Baa	Baa	Baa
c) Market Framework & Positioning		Ba	Ba	Ba
d) Capital Requirements and Operational Performance		Aa	Aa	Aa
e) Business Mix Impact on Cash Flow Predictability		NA		
<b>Factor 3 : Financial Policy (10%)</b>				
a) Financial Policy		Ba	Ba	Ba
<b>Factor 4 : Leverage and Coverage (40%)</b>				
a) (CFO Pre-W/C + Interest) / Interest (3 Year Avg)	3.0x	Ba	3.3x - 3.7x	Ba
b) (CFO Pre-W/C) / Debt (3 Year Avg)	7.8%	B	8.5% - 10.5%	B
c) RCF / Debt (3 Year Avg)	7.3%	B	8% - 9.5%	Ba
<b>Rating:</b>				
a) Indicated Rating from Grid		Ba2		Ba2
b) Actual BCA Assigned		b1		

Government-Related Issuer	Factor
a) Baseline Credit Assessment	b1
b) Government Local Currency Rating	Baa3 / Stable
c) Default Dependence	High
d) Support	Very High
e) Final Rating Outcome	Baa3 / Ba2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2014; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

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