MOODY'S
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# Rating Action: Moody's upgrades Landsvirkjun's unguaranteed debt ratings to Baa2; stable outlook

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London, 23 March 2018 -- Moody's Investors Service, ("Moody's") has today upgraded Landsvirkjun's unguaranteed senior unsecured debt ratings to Baa2 from Baa3, and the ratings of the $1 billion EMTN programme to (P)Baa2 from (P)Baa3. Concurrently, Moody's has affirmed Landsvirkjun's Baa1 debt ratings that are supported by a guarantee of collection issued by the Government of Iceland (A3 stable), and the (P)Baa1 guaranteed senior unsecured rating of the $2.5 billion EMTN programme. The (P)P-3 short term rating of the unguaranteed EMTN programme and the (P)P-2 short term rating of the guaranteed EMTN programme were also affirmed. All ratings have a stable outlook.

RATINGS RATIONALE

The upgrade of the unguaranteed debt rating reflects (1) Landsvirkjun's track record of stable operating performance and ability to withstand significant volatility in the commodity markets without increasing its financial risk profile; (2) the progress the company has made in reducing its exposure to foreign exchange, interest rate and aluminium price risk; and (3) the expectation that after the completion of two major projects in 2018, Landsvirkjun's cash flow will substantially reduce its financial leverage.

Over the last two years, Landsvirkjun has renegotiated two power contracts that expire in 2019 and signed a few new contracts with power intensive industries in the silicon and data center sectors. These long-term power contracts will increase the amount of volume sold by around 5%, but most importantly will reduce Landsvirkjun's exposure to aluminium price fluctuations, as the percentage of total revenues linked to aluminium prices is expected to decrease to around 20% by 2020. Moody's also expects Landsvirkjun to maintain its prudent financial policy and continue to implement hedging agreements that provide greater visibility of cash flow and help the company to further reduce its aluminium price exposure and decrease its foreign currency and interest rate risks over the medium term.

Landsvirkjun's recent investments in the construction of Theistareykir geothermal plant and the expansion of Burfell Hydropower station had restricted the ability of the company to deleverage. Following the completion of both projects in the first half of 2018, Moody's expects Landsvirkjun´s capital expenditure levels to reduce considerably with annual spend averaging less than 3% of total assets over the next three to five years. Moody's expects Landsvirkjun to reduce its financial leverage, such that the Funds from operations (FFO) / Net debt ratio will be comfortably positioned in the mid-teens in percentage terms.

Overall, the standalone credit strength of Landsvirkjun, which is represented by a ba2 baseline credit assessment (BCA), upgraded from ba3, factors in positively (1) the company's dominant position in the Icelandic energy market; (2) its low-cost renewable generation asset base with minimal levels of capital expenditure needed for maintenance; and (3) its ability to generate relatively stable cash flows through long-term power contracts. At the same time, the BCA also incorporates (1) Landsvirkjun's concentrated exposure to a small number of counterparties, mainly in the aluminium industry; and (2) some degree of exposure to aluminium price volatility that will remain in the business over the long-term.

Given Landsvirkjun's ownership by the Government of Iceland (A3 stable), the company's Baa2 unguaranteed debt rating incorporates three notches of uplift for potential extraordinary support to Landsvirkjun's ba2 BCA. 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, which directly contributes to about 34% of Icelandic exports. 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.

The Baa1 and (P)Baa1/(P)P-2 guaranteed ratings of Landsvirkjun's USD2.5 billion 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. Albeit small, there is a potential 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 Baa1 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 STABLE OUTLOOK

The stable outlook reflects Moody's expectation that Landsvirkjun will continue to prudently manage its exposure to market risks and improve its financial position, such that credit metrics will be comfortably positioned within the ratio guidance for a Baa2 unguaranteed debt rating / ba2 BCA, namely the maintenance of a FFO/ Net debt ratio in the mid-teens in percentage terms.

WHAT COULD CHANGE THE RATING UP/ DOWN

Moody's could consider an upgrade of Landsvirkjun's unguaranteed debt ratings if its financial profile were to materially improve resulting in FFO / Net debt in the high-teens to low-twenties per cent on a sustainable basis, provided that the company continues to demonstrate the ability to withstand significant volatility in the commodity markets and maintains a strong liquidity position. This would also assume no change to the assumption of support from the owner incorporated into Landsvirkjun's rating. In addition, Landsvirkjun's guaranteed debt ratings could be upgraded following an upgrade of the Icelandic sovereign rating.

Conversely, downward pressure on Landsvirkjun's ratings could develop as a consequence of a substantial deterioration in the company's business risk profile or weakening of its financial position, such that FFO/Net debt in percentage terms was expected to remain consistently in the low teens. The guaranteed debt ratings would come under downward pressure if Moody's were to downgrade the Icelandic government's ratings.

CORPORATE PROFILE

Headquartered in Reykjavik, Landsvirkjun is Iceland's dominant power producer. It is responsible for about 70% of Iceland's total electricity production of 18 terawatt hours 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 August 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

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