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Research Update:

Icelandic Power Generator Landsvirkjun Outlook Revised To Positive On Improved Financial Position; Affirmed At 'BBB/A-2'

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Table Of Contents

Rating Action Overview

Rating Action Rationale

Outlook

Company Description

Our Base-Case Scenario

Liquidity

Issue Ratings - Subordination Risk Analysis

Ratings Score Snapshot

Related Criteria

Ratings List

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Rating Action Overview

- Landsvirkjun has reduced its exposure to relatively volatile aluminum prices over the past few years, and we expect existing and recently added generation capacity to support higher EBITDA.
- These supporting factors, alongside greater stability and predictability of revenues and the company's commitment to deleveraging, have spurred steady improvements in Landsvirkjun's credit ratios; we expect this trend to continue over the coming two years.
- We are therefore revising our outlook on Landsvirkjun to positive from stable and affirming our 'BBB/A-2' ratings.
- The positive outlook reflects the possibility of an upgrade within the next two years if Landsvirkjun sustains its improved financial position, namely with funds from operations (FFO)-to-debt ratio sustainably above 15%.

Rating Action Rationale

The outlook revision to positive indicates that we now expect Landsvirkjun to report FFO to debt of about 16% in 2019, compared with 14.6% in 2018 and 12.0% in 2017. The improvement stems from increased power sales, as well as greater stability and predictability of revenues and the company's commitment to deleveraging.

Historically, most of Landsvirkjun's contracts with customers were indexed to the price of aluminum. This resulted in earnings volatility due to the inherent variations in commodity prices. Over the past few years, however, Landsvirkjun has decreased its exposure to aluminum price through renegotiations of power contracts where the link to aluminum was removed, the diversification of the customer base, and hedging. Now, only about 10% of Landsvirkjun's revenues is linked to aluminum prices, versus about 65% in 2009. This is despite the still-high concentration of aluminum smelters in Landsvirkjun's customer base.

We also acknowledge the increased contribution from Landsvirkjun's regulated operation, 64.7% owned subsidiary Landsnet, of about \$87 million of revenue in 2018 (compared with \$65 million in 2016). Landsnet is Iceland's transmission system operator.

Landsvirkjun's investments in new generation capacity have resulted in a 10% increase of installed capacity, at 2,145 MW in 2018 versus 1,957 MW at end-2016. This, alongside the company's strong EBITDA margins sustained at about 72%-74%, should support an increase of EBITDA to about \$420 million in 2021 from about \$390 million in 2018 and \$345 million in 2017. We also expect capital expenditure (capex) to decrease to roughly \$70 million annually over the coming three years from \$145 million in 2018 and approximately \$245 million in 2017. This will likely enable Landsvirkjun to reduce debt in line with its stated target.

Although the projected metrics could translate to a higher rating, an upgrade would hinge on the sustainability of such improvements.

Our long-term rating on Landsvirkjun factors in four notches of uplift for extraordinary government support. The company is fully owned by the Icelandic government and an essential part of the national economy.

Outlook

The positive outlook indicates the possibility of an upgrade over the next 12-24 months if Landsvirkjun's strengthening financial metrics continue on their current trajectory, namely FFO to debt exceeding 15% on a sustainable basis. We expect this could happen if the company continues to benefit from its low-cost generation and stable EBITDA, while delivering on its plan to reduce debt.

Upside scenario

We could raise our ratings if Landsvirkjun continues to deleverage, has financial policies that support an FFO-to-debt ratio sustainably above 15%, and maintains positive discretionary cash flows on the back of lower capex.

Downside scenario

We could revise the outlook to stable if Landsvirkjun fails to achieve its targeted 15% FFO to debt, for example, due to an unexpected loss of contract revenues.

We could also lower the ratings if we see a reduced likelihood of support from the government. We view this as unlikely at this time.

Company Description

Landsvirkjun is fully owned by Iceland's government and has a fully renewable generation portfolio. It meets 75% of Iceland's power needs using hydro (92%) and geothermal (8%) generation, at a low marginal cost. The company operates 18 power stations and two wind turbines across Iceland in five areas of

operation. It sells the majority of power generated to power-intensive corporations, primarily aluminum smelters. Landsvirkjun's 64.7% subsidiary, Landsnet, operates the national power transmission system.

Our Base-Case Scenario

In our base case, we assume:

- Modest revenue growth in 2019, as there is limited new capacity added, followed by steady growth of 4% on average in 2020 and 2021;
- Aluminum prices of \$2,100 per ton through 2021;
- Annual capex of about \$70 million over the coming three years;
- Dividend payouts expected in the range of \$30 million to \$70 millions in 2019 until 2021; and
- Debt reductions by roughly \$190 million per year through 2021.

Based on these assumptions, we arrive at the following credit measures:

- FFO to debt of 15%-17% in 2019, and about 19%-21% in 2020.
- Debt to EBITDA of 4x-5x in 2019 and 2020.

Liquidity

We view Landsvirkjun's liquidity as strong. We project that available liquidity sources (cash, committed credit facilities, and operating cash flow) should exceed our forecast of near-term cash outflows (debt repayments, capex, and dividends) by more than 1.5x over the next 12 months and by 1.0x over the next 24 months. We also expect that sources will exceed uses even if EBITDA declines by 30%. In addition, we consider that the company enjoys solid relationships with its banks, a generally high standing in the credit markets, and prudent risk management.

Our estimate of Landsvirkjun's principal liquidity sources as of Dec. 31, 2018, are:

- Cash of about \$115 million;
- Committed facilities of about \$200 million expiring in December 2020 and ISK12 billion (about \$97 million) expiring in September 2022; and
- FFO of about \$290 million.

Our estimate of the company's principal liquidity uses at the same date are:

- Debt maturities of about \$200 million;
- Capex of about \$70 million; and
- Dividend pay-out expected at about \$30 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

Landsvirkjun's reported debt was \$2 billion as of December 2018. Roughly 85% of the debt is issued by the parent company, with the remainder issued by Landsnet, a fully consolidated subsidiary.

Analytical conclusions

The issue rating on Landsvirkjun's senior unsecured debt is 'BBB', in line with the issuer credit rating, since no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Positive/A-2

Business risk: Fair

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

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb-

- Related government rating: A
- Likelihood of government support: Very high (+4 notches from SACP)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Landsvirkjun		
Issuer Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2
Senior Unsecured	BBB	BBB

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