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Research Update:

Icelandic Power Company Landsvirkjun 'BBB-/A-3' Ratings Affirmed; Outlook Stable

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Research Update:

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Overview

- Iceland-based electricity generation and transmission company Landsvirkjun has continued to improve its credit metrics by using its positive free cash flows to reduce debt.
- We continue to view the likelihood that Landsvirkjun could receive extraordinary government support, if needed, as very high.
- We are affirming our 'BBB-/A-3' long- and short-term corporate credit ratings on the company.
- The stable outlook reflects our assumption that Landsvirkjun will continue to benefit from low cost generation, relatively stable EBITDA, and an unchanged likelihood of support from the Icelandic government.

Rating Action

On Aug. 4, 2016, S&P Global Ratings affirmed its 'BBB-/A-3' long- and short-term corporate credit ratings on Icelandic electricity generation and transmission company Landsvirkjun. The outlook is stable.

Rationale

The affirmation largely reflects our view that the likelihood that Landsvirkjun will receive government support, if needed, continues to be very high. It further reflects Landsvirkjun's solid position in the Icelandic power market, supported by high market share, low production costs, and long-term contracts. However, we see that it continues to be exposed to high customer concentration and the aluminum sector. We also see a continued gradual strengthening of Landsvirkjun's credit measures and have therefore revised our assessment of the company's financial risk profile to aggressive from highly leveraged. We also raised Landsvirkjun's stand-alone credit profile (SACP) to 'bb-' from 'b+'.

We consider that there is a very high likelihood that the Icelandic government would provide timely and sufficient extraordinary support to Landsvirkjun in the event of financial distress. We base this assessment on 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

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the medium term; and the risk to the sovereign's reputation if Landsvirkjun were to default.

Landsvirkjun's fair business risk profile reflects its position as the dominant power producer in Iceland, with a market share of generation of about 70% despite the country's relatively small size. The generation is allocated mostly to the power intensive aluminum production.

We see that Landsvirkjun also benefits from a very low-cost hydro and geothermal renewable generation asset base, which continues to support its above average EBITDA margins of 75%-80%. Moreover, its long-term take-or-pay contracts with customers provide earnings predictability and EBITDA stability.

However, in our opinion, Landsvirkjun's earnings and profitability continue to be tempered by its high customer concentration, where the top three customers purchase about 70% of energy production, and given that its customer base is mostly composed of aluminum producers. This makes Landsvirkjun vulnerable to unexpected failures under single contracts. We also see this exposure as heightened because one-third of Landsvirkjun's revenues are directly linked to the aluminum price. However, we expect this portion to continue to decline over time as the company renegotiates existing contracts and adds new consumers.

Landsvirkjun's credit metrics have continued to improve as the company continues to pay down debt that accumulated throughout the completion of its largest hydro plant. In our revision of the financial risk profile to aggressive from highly leveraged, we factor in our view that management and the shareholders are supportive of the deleveraging path. We expect that the company's metrics will continue to improve toward 15% funds from operations (FFO) to debt over the next few years, from about 11.7% in 2015, which will be supported by low capital expenditure (capex) and dividends.

Under our base case, we assume:
- Revenues declining slightly in 2016 due to the low aluminium price.
- Aluminum prices at about $1,500/ton in 2016, $1,550/ton in 2017, and $1,650/ton in 2018.
- EBITDA margins of about 75%.
- Capex of about $200 million in 2016 and declining thereafter.

Based on these assumptions, we arrive at the following credit measures for 2016-2018:
- FFO to debt of about 11% in 2016, 12.5% in 2017, and about 15.5% in 2018.
- Discretionary cash flow to debt of 1%-10%.

Liquidity

The short-term rating is 'A-3'. We view Landsvirkjun's liquidity as adequate. We project that available liquidity sources in terms of cash, committed credit facilities, and operating cash flow should exceed our forecast of near-term cash outflows--such as debt repayments, capex, and dividends--by more than

1.2x. We also expect that sources will exceed uses even if EBITDA declines by 15%. We understand that Landsvirkjun's $200 million revolving credit facility (RCF) contains financial covenants, under which we expect Landsvirkjun to retain adequate headroom. Furthermore, we assume that Landsvirkjun will refinance or renew its RCF well ahead of its expiration.

In addition, we consider that the company enjoys sound relationships with its banks, a satisfactory standing in credit markets, and prudent risk management.

We calculate the following principal liquidity sources, as of the first quarter of 2016:

- Cash of $126 million.
- Committed facilities of around $270 million expiring in 2018 and Icelandic krona (ISK) 12 billion (about $100 million) expiring in December 2022.
- FFO of about $240 million.

At the same date, we estimate the following principal liquidity uses for the next 12 months:

- Debt of about $180 million.
- Capex of about $200 million.
- Dividends of about $11 million.

Outlook

The stable outlook reflects our assumption that Landsvirkjun will continue to benefit from a very high likelihood of support from the Icelandic government, improving credit metrics, low cost generation, and relatively stable EBITDA.

Upside scenario

We could raise the ratings if Landsvirkjun continues to deleverage to and it has financial policies that support its FFO to debt around 20% and its competitive position remains stable. We could also consider an upgrade if we raise the sovereign rating on Iceland as this would indicate that the government's ability to provide extraordinary support has increased.

Downside scenario

We currently see a downgrade as unlikely, but it could occur if we see a reduced likelihood of support from the government to Landsvirkjun or if the company's SACP deteriorated significantly to 'b', which we view as unlikely in the next two years.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/A-3

Business risk: Fair

- Country risk: Moderately high
- 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)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb-
- Sovereign rating: BBB+
- Likelihood of government support: Very high (+3 notches)

Related Criteria And Research

Related Criteria
- General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Industrials: Key Credit Factors For The Unregulated Power And Gas Industry - March 28, 2014
- General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Industrials: Methodology For Standard & Poor's Metals And Mining Price Assumptions - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010

Related Research
- Country Risk Assessments Update: July 2016, July 1, 2016
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial

Corporate Industries, Nov. 20, 2013

Ratings List

Ratings Affirmed

Landsvirkjun	
Corporate Credit Rating	BBB-/Stable/A-3
Senior Unsecured	BBB-

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