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Research Update:

Icelandic Power Company Landsvirkjun 'BBB/A-2' Ratings Affirmed; Outlook Remains Stable

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Overview

- We anticipate that Iceland-based electricity generation and transmission company Landsvirkjun will gradually improve its credit metrics by using its positive free cash flow to reduce debt.
- We assume that Landsvirkjun should maintain its very important role to the Icelandic government as by far the largest power company in Iceland.
- We are affirming our 'BBB/A-2' 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 and relatively stable EBITDA, and that there is a very high likelihood of support from the Icelandic government.

Rating Action

On Aug. 23, 2017, S&P Global Ratings affirmed its 'BBB/A-2' 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 is also based on Landsvirkjun's solid position in the Icelandic power market, supported by high market share, low production costs, and long-term contracts. However, the company continues to be exposed to high customer concentration and the aluminum sector. We also see a continued gradual strengthening of Landsvirkjun's credit measures in line with our previous forecasts, as the company should benefit from volume increases due to capacity expansions and improving free operating cash flows (FOCF) once the investment peak is over.

We continue to 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 Landsnet, transmission system operator; 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 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 about 72% despite the country's relatively small size. The generation is allocated mostly to the power intensive aluminum production.

We see that Landsvirkjun benefits from a very low-cost hydro and geothermal renewable generation asset base, which continues to support its above average EBITDA margins of about 70%-75%. 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, given that its customer base is mostly composed of aluminum producers and its top-three customers purchase about 70% of energy generation. This makes Landsvirkjun vulnerable to unexpected failures under single contracts. Landsvirkjun has, however, continued to lessen its exposure to aluminum prices. With the hedges currently in place, only 15% of operating revenues are linked to aluminum prices.

Despite a slight dip in EBITDA in 2016--mainly due to interruptions for some customers which led to lower volume off-take--we anticipate that Landsvirkjun's credit metrics will improve further as the company continues to pay down debt that accumulated throughout the construction of its largest hydro plant. We assume that management and the shareholders will remain supportive of the deleveraging path, and we expect that the company's metrics will continue to improve toward 12%-15% funds from operations (FFO) to debt over the next few years from about 10.8% in 2016.

Under our base case, we assume:
- Revenues growth of about 7%-9% in 2017 and 2018, with new capacity coming online during these years;
- EBITDA margins of about 70%-75%; and
- Capital expenditure (capex) of about $220 million in 2017 and steadily declining thereafter to about $50 million by 2019.

Based on these assumptions, we arrive at the following credit measures for 2016-2018:
- FFO to debt of 10.8x, 11.5x-12.5x, and 14.5x-15.5x, respectively; and
- FOCF to debt of 2.7x, 0.0x-2.0x, and 9.0x-11.0x, respectively.

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%. We understand that Landsvirkjun's $200 million revolving credit facility (RCF) contains financial covenants, under which we expect Landsvirkjun will 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 solid relationships with its banks, a generally high standing in the credit markets, and prudent risk management.

We calculate the following principal liquidity sources over the 12 months from March 31, 2017:

- Cash of about $240 million;
- Committed facilities of about $365 million expiring in December 2019 and Icelandic krona (ISK) 12 billion (about $105 million) expiring in September 2022; and
- FFO of about $270 million.

We anticipate the following principal liquidity uses over the same period:

- Debt maturities of about $300 million;
- Capex of about $170 million-$180 million; and
- Dividends of about $12 million.

Outlook

The stable outlook reflects our continued anticipation of a very high likelihood of support to Landsvirkjun from the Icelandic government if needed. It also reflects our assumption that Landsvirkjun will continue to benefit from low cost generation, relatively stable EBITDA, and gradually improving credit measures, with FFO to debt of 12%-15% over the next two years.

Upside scenario

In our view, the potential for an upgrade is currently limited. We could, however, raise the ratings if Landsvirkjun continues to deleverage and has financial policies that support an FFO to debt ratio sustainably above 15%, as well as a substantially increasing FOCF generation once its new capacity investments slow down.

Downside scenario

We could lower the ratings if Landsvirkjun's stand-alone credit profile weakens by one notch, for example, due to the unexpected loss of contract revenues, which also could lead to weakened credit measures, including FFO to debt below 12%. We could also lower the ratings if we see a reduced likelihood of support from the government to Landsvirkjun, for example, through reduced ownership, although we view this as unlikely at present.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/A-2

Business risk: Fair
- Country risk: Intermediate
- 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: Strong (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: A
- Likelihood of government support: Very high (+4 notches)

Related Criteria

- 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: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Methodology For Standard & Poor's Metals And Mining Price Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

Landsvirkjun	
Corporate Credit Rating	BBB/Stable/A-2
Senior Unsecured	BBB

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