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Research Update:

Icelandic Power Company Landsvirkjun Upgraded To 'BBB-' Following Sovereign Upgrade; Outlook Stable

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Research Update:

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Overview

- On Jan. 15, 2016, we raised our sovereign ratings on the Republic of Iceland to 'BBB+' from 'BBB'. The outlook is stable.
- We consider that the sovereign's ability to support government-owned power company Landsvirkjun has strengthened.
- We are therefore raising our long- and short-term ratings on Landsvirkjun to 'BBB-/A-3' from 'BB+/B'.
- The stable outlook primarily reflects that on Iceland.

Rating Action

On Jan. 19, 2016, Standard & Poor's Ratings Services raised its long- and short-term issuer credit ratings on Icelandic electricity generation and transmission company Landsvirkjun to 'BBB-/A-3' from 'BB+/B'. The outlook is stable.

Rationale

The upgrade follows our upgrade of the Republic of Iceland (see "Iceland Ratings Raised To 'BBB+' On Further Progress Toward Capital Account Liberalization And Declining Debt Levels," published Jan. 15, 2016, on RatingsDirect). It reflects our view that the ability of the sovereign to support Landsvirkjun in case of financial stress has increased. We continue to assess Landsvirkjun as a government-related entity that benefits from a very high likelihood of timely and sufficient extraordinary government support if needed. 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, its strategic importance to the Icelandic economy, and its central role in the promotion of power-intensive industries; and
- Very strong link with the Icelandic government, given the state's 100% ownership, our expectation that the company will not be privatized over the next few years at least, and the risk to the sovereign's reputation if Landsvirkjun were to default.

We see the potential for Landsvirkjun to demonstrate stronger credit measures over the next couple of years if it maintains modest spending levels. This could lead us to revise upward its stand-alone credit profile (SACP), which is

currently 'b+'.

Landsvirkjun continues to benefit from its position as the dominant power producer in Iceland, low-cost renewable-generation assets, and long-term take-or-pay contracts. Its business risk profile remains constrained, however, by high customer and geographic concentration and exposure to the aluminum sector for revenue and cash flow generation (around 50% of power supply contracts are linked to aluminum prices via contracts with aluminum smelters). We note, however, that aluminum price risk has reduced in the recent years following renegotiations of existing contracts and new contracts linked to the consumer price index. We assess Landsvirkjun's business risk profile as fair.

The company's debt remains high, owing to material debt-funded capital investments in the past that resulted in weak cash-flow coverage ratios. Although we forecast a gradual improvement, we believe that credit measures will remain commensurate with a highly leveraged financial risk profile in the near term--albeit at the stronger end of the range for this category--with weighted-average funds from operations (FFO) to debt just below 12% and debt to EBITDA above 6x.

The SACP incorporates a one-notch upward adjustment under our positive comparable ratings analysis for the company. This is based on our view that Landsvirkjun's FFO-to-debt ratio and interest coverage are strong for our highly leveraged financial risk profile. It also incorporates the ongoing support from the Icelandic government (the owner), which has requested very modest dividends from Landsvirkjun over the past few years.

Under our base case, we assume:

- EBITDA margins of about 75%-80% in 2015 and 2016, slightly lower than the margin of 80% in 2014. Power prices will likely continue to bear the weight of low aluminum prices, mitigated by price hedges. Volumes in 2015-2016 are expected to recover slightly compared with 2014.
- FFO well in excess of capital expenditures (capex) and dividends, leading to further debt reduction, although only by a modest amount relative to the overall high level of debt.
- Capex in 2015 in line with 2014, followed by capex in 2016 of more than the \$96 million spent in 2014 as a result of an expansion project related to a new customer contract.

Based on these assumptions, we arrive at the following credit measures for 2015 and 2016:

- FFO to debt of about 11%-13%.
- Debt to EBITDA of about 6.0x-6.5x.
- FFO cash interest coverage of about 3.8x-4.6x.

Liquidity

We view Landsvirkjun's liquidity position as adequate. We believe that available liquidity sources, in terms of cash, committed credit facilities, and operating cash flow, should be significantly more than 1.2x of forecast near-term cash outflows such as debt repayments, capex, and dividends. 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 will retain adequate headroom.

We further believe that the company has a sound relationship with its banks, a satisfactory standing in the credit markets, and prudent risk management.

We calculate the following principal liquidity sources, as of the second quarter of 2015:

- \$182 million in cash.
- Access to a \$200 million unused committed RCF expiring in December 2018, following its recent refinancing, and a committed credit facility amounting to 12 billion Icelandic krona (about \$90 million), expiring in September 2022.
- Annual FFO of about \$250 million.

As of the same date, we calculate the following principal liquidity uses:

- About \$250 million in debt maturing in the 12 months from second-quarter 2015.
- 2015 capex in line with 2014 at about \$96 million, and then slightly higher in the subsequent 12 months.
- Dividend payments of less than \$14 million annually in 2015 and 2016.

Outlook

The stable outlook reflects that on Iceland, and our assumption that Landsvirkjun will continue to benefit from a very high likelihood of support from the Icelandic government. We anticipate that Landsvirkjun will retain relatively stable EBITDA and generate free cash flow, which could improve credit measures and potentially lead to an upward revision of the SACP over the next couple of years.

Downside scenario

We could lower the ratings if we were to downgrade Iceland, as this would indicate that the government's ability to provide extraordinary support to Landsvirkjun had reduced; or if we believe that the government is less likely to provide timely and sufficient extraordinary support to Landsvirkjun. We could also lower the ratings on Landsvirkjun if its credit metrics or business position weaken significantly, leading us to revise down its SACP.

Upside scenario

The likelihood of an upgrade is currently limited in our view, but we could consider raising the ratings if we both raise the sovereign rating on Iceland and revise upward Landsvirkjun's SACP. The latter could occur if the company sustains by FFO to debt above 12%.

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: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

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: Positive (+1 notch)

Stand-alone credit profile: b+

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

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Group Rating Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Methodology For Standard & Poor's Metals And Mining Price Assumptions, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013
- Country Risk Assessments Update: December 2015, Dec. 21, 2015
- Iceland Ratings Raised To 'BBB+' On Further Progress Toward Capital Account Liberalization And Declining Debt Levels, Jan. 15, 2016

Ratings List

Upgraded; CreditWatch/Outlook Action

	To	From
Landsvirkjun		
Corporate Credit Rating	BBB-/Stable/A-3	BB+/Positive/B
Senior Unsecured	BBB-	BB+

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