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## Research Update:

# Icelandic Power Company Landsvirkjun Upgraded To 'BB+' Following Sovereign Upgrade; Outlook Stable

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## Table Of Contents

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Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria And Research

Ratings List

## Research Update:

# Icelandic Power Company Landsvirkjun Upgraded To 'BB+' Following Sovereign Upgrade; Outlook Stable

## Overview

- On July 17, 2015, we raised our sovereign ratings on Iceland to 'BBB/A-2' from 'BBB-/A-3'. The outlook is stable.
- Icelandic electricity generation and transmission company Landsvirkjun is a government-related entity with a "very high" likelihood of extraordinary government support in the event of financial distress.
- We are therefore raising our long-term ratings on Landsvirkjun to 'BB+' from 'BB'. At the same time, we are affirming our 'B' short-term ratings on the company.
- The stable outlook reflects that on Iceland and our assumption of an unchanged stand-alone credit profile (SACP) for Landsvirkjun over the outlook horizon.

## Rating Action

On July 23, 2015, Standard & Poor's Ratings Services raised its long-term issuer credit ratings on Iceland-based electricity generation and transmission company Landsvirkjun to 'BB+' from 'BB'. At the same time, we affirmed our short-term 'B' ratings on the company. The outlook is stable.

## Rationale

The upgrade follows our upgrade of Iceland (see "Iceland Ratings Raised To 'BBB/A-2' On Proposals Toward Lifting Capital Controls; Outlook Stable," published July 17, 2015, on RatingsDirect). In our view, this means that the Icelandic government's ability to support Landsvirkjun in a financial stress scenario has strengthened. The gradual removal of capital controls in Iceland would have a minimal direct effect on Landsvirkjun, which already has access to foreign capital markets.

We base our ratings on Landsvirkjun on the company's stand-alone credit profile (SACP), which we assess at 'b+', reflecting its "fair" business risk profile, "highly leveraged" financial risk profile, and a one-notch upward adjustment for our "positive" comparable ratings analysis, according to our criteria. The long-term rating also includes two notches of uplift, based on our opinion 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.

Landsvirkjun's "fair" business risk profile is constrained by Iceland's "moderately high" country risk, and the "moderately high" industry risk of unregulated power and gas companies. Landsvirkjun's business risk profile is constrained by its high customer and geographic concentration, and exposure to the aluminum sector for revenue and cash flow generation. Landsvirkjun's earnings and cash flow are exposed to volatile commodity prices because about 50% of power sales are linked to aluminum prices through power supply contracts with aluminum smelters.

These constraints are, however, mitigated by Landsvirkjun's position as the dominant power producer in Iceland and its low-cost renewable-generation asset base. Its long-term pay-or-take contracts with customers provide some earnings predictability, which mitigates concentration risk and exposure to aluminum prices.

Our assessment of Landsvirkjun's financial risk profile as "highly leveraged" reflects the company's high debt levels. This comes from its significant debt-funded capital investments in recent years, resulting in weak cash flow coverage ratios. Although we forecast a gradual improvement, we believe that credit measures will remain weak in the near term with funds from operations (FFO) to debt at about 11%, and debt to EBITDA at about 6.5x.

We apply an upward adjustment of one notch, reflecting our "positive" comparable ratings analysis for the company. This reflects our view that Landsvirkjun's FFO-to-debt ratio is at the upper end of our "highly leveraged" category; that interest coverage is strong for the financial risk profile; and that there is ongoing support from the Icelandic government (the owner), which has requested very modest dividends from Landsvirkjun over the past few years.

Our base case assumes:

- EBITDA margins of about 75% in 2015 and 2016, slightly lower than the 80% in 2014. Power prices will likely continue to face pressure due to low aluminum prices, mitigated by price hedges. Volumes in 2015 are expected to recover slightly compared to 2014, although pressured by low water reservoirs during the first half of the year.
- FFO well in excess of capital expenditure (capex) and dividends leading to further debt reduction, although only by a modest amount relative to the overall high level of debt.
- Capex for 2015 in line with 2014 followed by increasing capex in 2016 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 10%-12%.
- Debt to EBITDA of about 6.0x-7.0x.
- FFO cash interest coverage of about 3.4x-3.9x.

## **Liquidity**

We view Landsvirkjun's liquidity position as "adequate" under our criteria. We believe that available liquidity sources in terms of cash, committed credit facilities, and operating cash flow should far exceed--more than 1.2x--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 Dec. 31, 2014:

- \$207 million in cash and cash equivalents.
- Access to a \$200 million unused committed RCF that expires in December 2016.
- FFO in excess of \$200 million annually.

At the same date, we calculate the following principal liquidity uses:

- About \$272 million in debt maturing in 2015 and about \$245 million during 2016.
- Annual capex of below \$100 million in 2015, but increasing in 2016.
- Dividend payments of less than \$15 million annually in 2015 and 2016.

## **Outlook**

The stable outlook reflects that on Iceland and our assumption of an unchanged SACP for Landsvirkjun in the near term. Despite pressure from low aluminum prices, we assume that Landsvirkjun's FFO will far exceed its committed investments in the short term and that dividend payments will be modest. Although we anticipate this to result in positive free cash flow, we believe that any improvement in credit measures would be minor in the next year, including FFO to debt of about 11%.

## **Upside scenario**

We could raise the ratings on Landsvirkjun if we were to revise our assessment of its SACP upward by one notch. This could result from a strengthening of the company's credit measures, for example if the company continues to generate positive free cash flow and pay down debt, leading to FFO to debt of at least 12% on a sustainable basis. We could also raise the ratings on Landsvirkjun if we raised the local currency rating on Iceland, provided our assessment of the "very high" likelihood of support remained unchanged.

## **Downside scenario**

We would likely lower the ratings on Landsvirkjun if we lowered the local currency rating on Iceland, as this would indicate the government's reduced

ability to provide extraordinary support to Landsvirkjun. We could also lower the ratings on Landsvirkjun if we revised our assessment of the company's SACP downward by two notches to 'b-', although we currently see such a scenario as unlikely.

## **Ratings Score Snapshot**

Corporate Credit Rating: BB+/Stable/B

### **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 (+3 notches)

## **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
- Methodology For Standard & Poor's Metals And Mining Price Assumptions, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Industry Risk, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013

- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- 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**

- Iceland Ratings Raised To 'BBB/A-2' On Proposals Toward Lifting Capital Controls; Outlook Stable, July 17, 2015
- Country Risk Assessments Update: July 2015, July 8, 2015
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

## **Ratings List**

Upgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Landsvirkjun		
Corporate Credit Rating	BB+/Stable/B	BB/Positive/B
Senior Unsecured*	BB+	BB

\*Guaranteed by Republic of Iceland.

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