

Research Update:

Iceland-Based Electricity Producer Landsvirkjun Upgraded To 'BBB+' On Strengthening Credit Metrics; Outlook Stable

June 3, 2021

Rating Action Overview

- Landsvirkjun's operations have proved resilient to the COVID-19 pandemic, and we forecast improved credit metrics in 2021.
- Following the resolution of a dispute about the ISAL smelter in February 2021, we think Landsvirkjun will benefit from its long-term take-or-pay contracts and rising prices, which will generate growth in the coming years.
- We expect funds from operations (FFO) to debt will gradually increase to about 25%-27% by 2023 thanks to organic growth, favorable commodity prices, and debt reduction of \$350 million-\$400 million by end-2023.
- We raised our issuer credit ratings on Landsvirkjun to 'BBB+/A-2' from 'BBB/A-2'. We also raised our issue rating on its senior unsecured debt to 'BBB+' from 'BBB', in line with the long-term issuer credit rating.
- The stable outlook indicates our expectations that the company will maintain FFO to debt close to 20% in 2021, increasing to 22%-25% in 2022.

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Rating Action Rationale

Improving market conditions and management's focus on debt reduction will lead to improved credit metrics. Landsvirkjun has significantly reduced its debt to about \$1.6 billion at end-2020 from about \$2.1 billion in 2017 by using surplus cash flows. We expect the company will continue reducing its leverage. This will help it to continue improving its credit metrics, since the current market conditions are very favorable and the company's long-term take-and-pay contracts are stabilizing cash flows to some extent. Landsvirkjun will be able to deliver positive cash flows, after dividends, of \$100 million-\$160 million over 2021-2023. This takes into consideration:

- An increase in dividends to \$140 million-\$160 million per year in 2022 and 2023 from \$50

million in 2021; and

- Low investment requirements, since the company currently has limited growth plans. About 70% of capex relates to grid investments (Landsnet) and the remaining investments relate to maintenance on existing plants.

This will allow Landsvirkjun to reduce S&P Global Ratings-adjusted debt by more than \$150 million in 2021, and we expect it to reduce debt by \$350-million-\$400 million by end-2023. As a result, we forecast FFO to debt will rise to close to 20% by end-2021 and improve year on year to about 25%-27% by 2023, up from 13.3% in 2020 and 16.4% in 2019.

Landsvirkjun's high concentration to aluminum smelters, which represent about 70 % of power sales in terms of megawatt hours, will continue to constrain the company's business risk profile.

High customer concentration entails certain event risks. Landsvirkjun's customer base mainly comprises aluminum producers. Its top three customers, Alcoa Corp. (BB+/Negative), Rio Tinto PLC (A/Stable), and Century Aluminum Co. (B-/Stable) purchase about 70% of the electricity it produces. This leaves Landsvirkjun vulnerable to unexpected failures relating to single contracts.

Landsvirkjun and Rio Tinto have resolved their dispute regarding the ISAL smelter. Rio Tinto lodged a formal complaint with the Icelandic Competition Authority in July 2020, claiming that Landsvirkjun's pricing terms for the smelter's power agreement amounted to anti-competitive behavior. The contract between Landsvirkjun and Rio Tinto goes back more than 50 years. In 2010, Rio Tinto and Landsvirkjun extended the contract to 2036, and both companies committed to increased capacity on both ends, which led to large investments. In February 2021, Rio Tinto and Landsvirkjun agreed terms with an addendum to the long-term take-and-pay contract maturing in 2036. We understand this only included minor adjustments and will not significantly affect Landsvirkjun's EBITDA.

Landsvirkjun's electricity contracts with aluminum smelters have historically been pegged to aluminum prices, but the company has decreased its exposure over the past few years. It has achieved this by renegotiating its power contracts to decrease the link with aluminum, instead linking contracted prices with Nord Pool system prices and different consumer price indices. During 2020, about 36% of electricity sales had a direct to link and about 18% of Landsvirkjun's revenue, including hedges, was linked to aluminum prices, versus about 65% (excluding hedges) in 2009. This risk is partly offset by the long-term take-or-pay nature of its contracts: The contract for the largest off-taker, Alcoa, matures in 2048; the Rio Tinto contract matures in 2036; and the Century Aluminum contract matures in 2023. Landsvirkjun also has a hedge strategy that will reduce the exposure over the next two years. Aluminum-linked cash flows are 70% hedged for 2021 and 50% for 2022. Landsvirkjun's 100% concentration in Iceland is also a constraint compared to other peers in the sector. That said, Landsvirkjun plays a key role for Iceland as the country's major energy producer, accounting for 75% of its total power needs. We view positively that 100% of its generation comes from low-cost renewable sources: Hydro accounts for 92%, while geothermal accounts for the remaining 8%. This allows Landsvirkjun to support and maintain above-average EBITDA margins of 70%-75%, well above the average for peers.

Landsvirkjun posted weak but resilient results in 2020, and it is well placed to benefit from improving market conditions. Reported revenue stood at \$454 million in 2020, down 11% from the \$510 million reported in 2019. Consequently, the company experienced a 20% reduction in reported cash flow from operations and net profit, while net debt remained stable. This resulted in

adjusted funds from operations (FFO) to debt of 13.3% in 2020, down from 16.4% in 2019, while adjusted debt to EBITDA increased to 5.3x from 4.6x. Nonetheless, operations remained resilient amid the pandemic and related restriction measures, with availability from its generation plants at 98%, in line with previous years. The volatility stemmed from the pandemic and a historically low Nord Pool power price of €12 per megawatt hour (/MWh), the price for 11% of the company's generated volumes. Aluminum prices deteriorated to a low point of \$1,500/ton during 2020, to which roughly 35% of volumes are directly linked and another 21% are partly linked. That said, we think recovery is underway and revenue will surpass pre-2020 levels by 2022. This is partly thanks to the recovery in aluminum prices, currently at about \$2,500/ton and Nord Pool system price at about €40/MWh. This is relevant because some of Landsvirkjun's long-term take-and-pay contracts are pegged to aluminum prices and Nord Pool system prices. Additionally, we expect Landsvirkjun to meaningfully increase its generation by at least 5% during 2021, almost reaching 14.0 terawatt hours (TWh) in 2021 and about 14.5TWh in 2022.

We do not think the potential sale of Landsnet, Iceland's power transmission system operator (TSO), would affect the very high likelihood of government support. In February 2020, Landsvirkjun's chief executive officer signed a memorandum of understanding that launched negotiations for the sale of the company's 64.7% stake in Landsnet to the government. We do not expect it will happen in the short to medium term, so we do not include it in our financial base-case assumptions. We also view positively the commitment of all parties involved in the memorandum to preserve Landsvirkjun's financial strength. According to our preliminary estimates, the sale would not harm the company's credit metrics, since we assume debt would be split on a proportional basis. Furthermore, it would be unlikely to change our view of Landsvirkjun's business risk profile, since Landsnet's proportionate contribution to Landsvirkjun's EBITDA is less than 20% on a pro forma basis. We also give little weight to the company's TSO operations in our assessment of Landsvirkjun, since the discussion of disposals has been ongoing for more than a year, and on two earlier occasions a sale did not materialize. Our long-term rating on Landsvirkjun continues to factor in four notches of uplift for extraordinary government support. If the Icelandic sovereign rating changed one notch in any direction, the uplift would not change, all else remaining equal. Even in the unlikely event that Landsvirkjun were to sell Landsnet, we would not review our assessment of potential government support to the company, considering that it is fully owned by the Icelandic government and will remain an essential part of the national economy as the main energy producer.

Outlook

The stable outlook reflects our expectation that Landsvirkjun will maintain credit metrics commensurate with the current rating level, with FFO to debt increasing to almost 20% by end-2021 and improving year on year to about 25%-27% by 2023. This stems from favorable market conditions such as aluminum prices above \$2,200/ton and Nord Pool system spot prices above €30/MWh, resulting in EBITDA margins at about 75%.

Downside scenario

We could downgrade Landsvirkjun if it fails to deliver on its plans to reduce leverage, for example, due to an unexpected loss or unfavorable contract renegotiations resulting in FFO to debt sustainably below 15%.

We could also lower the ratings if we saw a reduced likelihood of support from the government, which we currently view as unlikely.

Upside scenario

Rating upside is limited over the next two years because we would not raise the issuer credit rating on Landsvirkjun even if we revised upward its stand-alone credit profile (SACP) to 'bb+'. This is because, given the 'A' sovereign rating on Iceland, a very high level of support is not material enough to strengthen Landsvirkjun's credit quality beyond the 'BBB+' level.

We could revise upward Landsvirkjun's SACP if we thought the company's FFO to debt would improve close to 30%, supported by the company's financial policy.

We could also revise upward our assessment of Landsvirkjun's business risk profile if the company lowered its concentration risk to aluminum producers.

Company Description

Landsvirkjun is fully owned by Iceland's government and has a fully renewable generation portfolio. It meets 70% 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, is the national power TSO.

Our Base-Case Scenario

Assumptions

- 14% revenue growth in 2021, spurred by the recovery in aluminum and power prices, followed by steady growth of 5% on average in 2022 and 2023.
- Aluminum prices of \$2,191/ton in 2021, \$2,200/ton in 2022 and 2023.
- Nord Pool spot prices of €36/MWh in 2021, €40-€41/MWh in 2022 and 2023.
- Average capex of about \$90 million per year in the coming three years.
- Debt reductions of roughly \$100 million-\$150 million per year through 2023.
- No change in dividend policy.
- Landsnet remains Landsvirkjun's subsidiary.

Key metrics

Landsvirkjun -- Key Metrics

Mil. \$	2019	2020	2021	2022	2023
EBITDA	373	324	370-400	410-440	420-450

Landsvirkjun -- Key Metrics (cont.)

Mil. \$	2019	2020	2021	2022	2023
Debt	1,728	1,716	1,500-1,600	1,400-1,500	1,300-1,400
FFO to debt (%)	16.4	13.3	18-22	22-26	24-28
Debt to EBITDA (x)	4.6	5.3	3.5-4.5	3.0-4.0	2.5-3.5

All figures adjusted by S&P Global Ratings. FFO--Funds from operations.

Liquidity

We view Landsvirkjun's liquidity as strong. We forecast that available liquidity sources should exceed short-term cash outflows by more than 1.7x over the 12 months from March 31, 2021 and by 1.0x over the following 12 months. We also expect 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.

We expect principal liquidity sources over the 12 months from March 31, 2021 will include:

- Cash of about \$152 million;
- Committed facilities of \$200 million, of which \$150 million expires in July 2023 and \$50 million in March 2023; and
- FFO of about \$310 million.

We expect principal liquidity uses over the same period will include:

- Debt maturities of about \$226 million;
- Capex of \$100 million-\$110 million; and
- Annual dividend pay-out of about \$50 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

Landsvirkjun's reported debt was \$1.7 billion as of December 2020. Landsvirkjun issues about 77% of the debt, while its fully consolidated subsidiary, Landsnet, issues the remaining 23%.

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+/Stable/A-2

Business risk: Fair

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

Financial risk: Significant

- Cash flow/Leverage: Significant

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

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

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate

Entities, Nov. 13, 2012

- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Landsvirkjun, Aug. 21, 2020
- Landsvirkjun 'BBB/A-2' Ratings Affirmed; Outlook Positive, Feb 28, 2020

Ratings List

Upgraded; Outlook Action; Ratings Affirmed

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

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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