S&P Global
Ratings

RatingsDirect®

Research Update:

Landsvirkjun Ratings Affirmed At 'A-'; Outlook Stable

September 23, 2024

PRIMARY CREDIT ANALYST

Renata Gottliebova
Dublin
+ 00353 (1) 5680608
renata.gottliebova@spglobal.com

SECONDARY CONTACT

Per Karlsson
Stockholm
+ 46 84 40 5927
per.karlsson@spglobal.com

Rating Action Overview

- Landsvirkjun is planning to increase investments to build new power stations, which could lead to capital expenditure (capex) increasing to around $1.2 billion during 2025-2028, up from about $20 million-$30 million in maintenance capex only over the past five years. This is to meet the increasing energy demand in Iceland.
- The company will finance the investment plan with a combination of cash flows and new debt, which will shrink existing headroom in its credit metrics. Despite the heavy increase in capex, we continue to expect that Landsvirkjun's funds from operations (FFO) to debt will remain above 30% for the next two years. This is because the company meaningfully lowered its debt from $1.5 billion in 2021 to about $730 million in 2024. Furthermore, under our base case, we assume the group will honor its dividend policy and lower its dividend to about $150 million annually in 2025-2026 from $220 million in 2024.
- We therefore affirmed our 'A-/A-2' long- and short-term issuer credit ratings on Landsvirkjun and our 'A-' issue rating on the company's notes.
- The stable outlook mirrors that on the sovereign and reflects our expectation that Landsvirkjun's FFO to debt will remain above 30%.

Rating Action Rationale

Depleted reservoirs in Iceland could lead to Landsvirkjun's EBITA being in the lower end of our expected range for 2024. The company reported EBITDA of $199 million in the second quarter of 2024, a year-on-year decrease of about $55 million. This is in the lower end of our expected range of S&P Global Ratings-adjusted EBITDA of about $380 million-$480 million by year-end 2024. The decrease is mainly due to lower realized power prices and smaller volumes caused by curtailments. Less than average rainfall, notably in second quarter 2024 has led to lower reservoir levels compared with historical averages . While rainfall is hard to predict, this makes curtailments in second half of 2024 likely, which could lead to lower revenue and EBITDA than we currently assume. We will continue to monitor the situation and assess whether this could weaken Landsvirkjun's credit metrics; however given current headroom under the rating, we expect adjusted FFO to debt will remain above 30%, which is our threshold for 'bb+' stand-alone credit profile (SACP), even if curtailment were to increase.

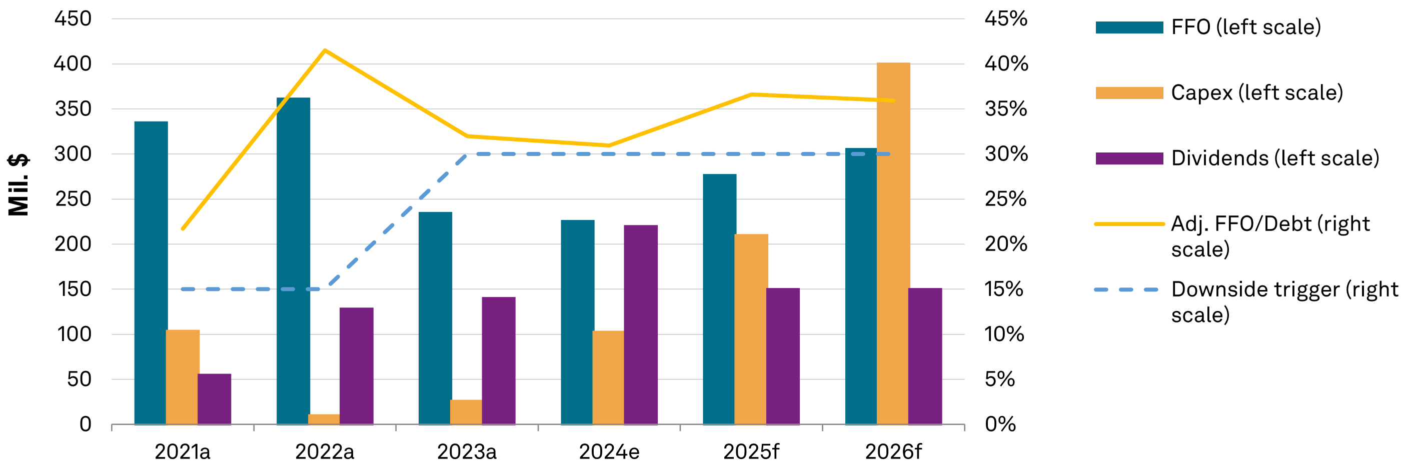
Landsvirkjun's net reported debt remained almost flat year-on-year and stood at $635 million in June 2024, while we forecast net debt to be around $720 million-$730 million by the end of 2024, which however assumes a step up in capex spending in the second half of the year to about $100 million; only $14.8 million was invested during the first half of the year. We note that debt has decreased substantially over the past few years, having more than halved from $1.5 billion at year-end 2021. As a result, we forecast adjusted FFO to debt of about 30%-35% at the end of 2024.

Increased investments in the next two-to-three years will lead to negative discretionary cash flow (DCF). We understand that Landsvirkjun has four potential new investment opportunities to increase generation capacity, which could lead to a heavy increase in capex to about $1.2 billion in total, if all the projects materialize. This is in stark contrast to the company's fairly low maintenance capex over the past years. However, we note that management has tried to ramp up capex for several years and has also prepared the company by meaningfully decreasing debt since 2021. We note that the Icelandic electricity system is fully utilized with high demand. The licensing process is cumbersome, however, and has led to delays in receiving permits. That said, in August 2024, Landsvirkjun obtained a license to build and operate the onshore windfarm Burfellslundur with installed capacity of 120 megawatts (MW); total estimate cost around $250 mill with commissioning in 2026. Moreover, On Sept. 13, 2024 Landsvirkun's biggest project, Hvammur Hydro power plant with installed capacity of 95 MW, was granted a power station license and is now awaiting a construction permit from the local municipalities. Management aims to start the project in 2025 and plans to complete it by the end of 2028. The estimated cost is around $550 million-$600 million. We now include these two projects in our credit metrics and forecast that capex will increase to around $100 million in 2024 then further to $205 million-$215 million in 2025 with a peak in 2026 when we expect capex of around $400 million.

The timing and cost of the other two projects remain more uncertain, therefore we have not included them in our forecast. At the same time, and as Landsvirkjun's dividend policy is dynamic, we expect dividend payout will decrease as it depends on cash flow levels and leverage. We therefore cautiously expect dividends to come down to about $150 million in both 2025 and 2026, from the high $220 million paid for the financial year 2023 ending Dec. 31. Still, this will lead to negative DCF for the next two-to-three years at negative $45 million-$65 million in 2024-2025 and then peaking at around negative $240 million-$260 million in 2026.

Chart 1

Credit ratios are expected to remain above the rating thresholds



Source: S&P Global Ratings. FFO--Funds from operations.

We expect Landsvirkjun's credit metrics to remain consistent with the current 'bb+' SACP and 'A-' issuer credit rating. We forecast adjusted FFO to debt to remain between 30% and 35% for the next two to three years, however the large investment pipeline could lead to limited headroom in case of cost overruns or delays. Post completion, we expect healthy EBITDA growth to keep FFO to debt above 30% over the next few years.

Our rating continues to be supported by Landsvirkjun's 100% ownership by the Icelandic government. Landsvirkjun represents an essential part of the national economy because its 100% renewable energy generation assets cover more than 70% of Iceland's total electricity demand. We think it is very likely that Iceland would provide timely and sufficient extraordinary support to the company in the event of financial distress, given its very important role for the Icelandic government, its dominant position as the incumbent power company, and its central role in the promotion of power-intensive industries. Our long-term rating on Landsvirkjun factors in four notches of uplift for extraordinary government support.

Outlook

The stable outlook mirrors that on the sovereign. It also reflects our expectation that Landsvirkjun will maintain credit metrics commensurate with the current rating level and the SACP of 'bb+', with FFO to debt above 30% in the next two years coupled with moderately negative DCF due to increased investments.

Downside scenario

We could downgrade Landsvirkjun following a similar rating action on the sovereign or if we were to revise downward the SACP to 'bb'. A revision of the SACP could come from increased challenges with reservoirs levels, leading to materially lower cash flow, as well as construction delays or cost overruns when the heavier construction period is entered. FFO to debt staying below 30% could therefore lead rating pressure, notably if dividends were not lowered in line with the group's financial policy. We could also lower the rating if we thought the likelihood of extraordinary sovereign support had diminished.

Upside scenario

We are unlikely to upgrade Landsvirkjun as this action would hinge on an upward revision of the SACP to 'bbb', which is two notches above the current SACP of 'bb+'. A further upgrade of Iceland may lead us to raise the rating on Landsvirkjun.

Company Description

Landsvirkjun is fully owned by the Icelandic government and has a 100% renewable energy generation portfolio. It meets 70% of Iceland's power needs at a low marginal cost, with hydroelectricity contributing 91% and geothermal energy accounting for 9%. The company operates 18 power stations (15 hydroelectric and three geothermal power plants) and two wind turbines across Iceland, with an installed capacity of about 2,150 megawatts and annual electricity generation of about 15.0 terawatt hours. Electricity generation was 14.7 terawatt hours in 2023. Landsvirkjun sells most of the power it generates to power-intensive corporations, primarily aluminum smelters. It sells approximately 86% of the energy to large end-users in the industrial market and 14% on the wholesale market. Landsvirkjun sold its 64.7% subsidiary Landsnet, the national power transmission system, to the Icelandic government at year-end 2022.

Our Base-Case Scenario

Assumptions

- Real GDP growth in Iceland of 2.3% in 2024 and 2.5% in 2025. Consumer price inflation close to 4.8% in 2024 and around 3.5% in 2025.
- Revenue shrinking by about 16% in 2024, then increasing by about 4%-5% in 2025 and 2026.
- Stable EBITDA margin of approximately 70% in 2024-2026.
- Development capex of around $100 million in 2024 then increasing to around $200 million in 2025 and peaking at about $400 million in 2026. We include the wind farm and hydro power plans in our forecast.
- Aluminum prices average $2,400 per metric ton for the remainder of 2024, $2,500 for 2025, then increasing to around $2,600 in 2026, based on S&P Global Ratings' metals price assumptions. Our assumptions are similar to Landsvirkjun's assumptions.
- Dividends of $220 million in 2024, decreasing to about $150 million in 2025 and 2026.
- No acquisition

Key metrics

Landsvirkjun--Key metrics*

(Mil. $)	2022a	2023a	2024f	2025f	2026f
EBITDA	451.682	474.869	350-450	380-480	400-450
Funds from operations (FFO)	361.419	234.595	200-250	250-300	280-330
Capital expenditure	10.105	26.076	100-110	205-215	395-405
Dividends	128.49	140	220	140-160	140-160
Discretionary cash flow (DCF)	293.235	225.716	(35)-(55)	(60)-(80)	(230)-(250)
Debt	870.949448	733.68494	720-750	740-770	840-870
Debt to EBITDA (x)	1.9	1.5	1.7-2.2	1.7-2.2	1.8-2.3
FFO to debt (%)	41.5	32	30-35	33-38	33-38

*All figures adjusted by S&P Global Ratings. §Landsnet deconsolidated from 2023. a--Actual. f--Forecast.

Liquidity

We now view Landsvirkjun's liquidity as adequate. We project that available liquidity sources will exceed our forecast of near-term cash outflows by about 1.3x over the next 12 months. We also expect that liquidity sources will exceed liquidity uses even if EBITDA declines by 15%. In addition, we consider that the company benefits from a generally high standing in the credit markets and prudent risk management. Furthermore, as critical infrastructure operator and government-owned entity, Landsvirkjun has a strong relationship with local and international banks. Near-term debt maturities amount to less than $100 million, which the company will likely be able to meet.

Landsvirkjun's principal liquidity sources over the 12 months from June 30, 2024, include:

- Cash of about $128 million;
- Committed facility of $125 million, expiring in July 2026;
- $40 million principal payment from the Icelandic government from the sale of Landsnet; and
- FFO of about $270 million-$280 million.

Principal liquidity uses over the 12 months from June 30, 2024, include:

- Debt maturities of about $90 million;
- Capex of about $150 million; and
- Annual dividends of about $184 million.

Issue Ratings--Subordination Risk Analysis

Capital structure

100% of the debt is issued by Landsvirkjun. We therefore do not see any significant risk of subordination and align our rating on Landsvirkjun's senior unsecured debt with the long-term issuer credit rating.

Analytical conclusions

The issue rating on Landsvirkjun's senior unsecured debt is 'A-', in line with the long-term issuer credit rating, since no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating	A-/Stable/A-2
Business risk:	Fair
Country risk	Low Risk
Industry risk	Moderately High Risk
Competitive position	Fair
Financial risk:	Intermediate (standard volatility)
Cash flow/leverage	Intermediate
Anchor	bb+
Modifiers:	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Neutral
Comparable rating analysis	Neutral
Stand-alone credit profile:	bb+
Related government rating	A+
Likelihood of government support	Very High (+4 notches)

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Ratings Affirmed	
Landsvirkjun	
Issuer Credit Rating	A-/Stable/A-2
Senior Unsecured	A-