FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Orkuveita Reykjavikur at 'BB+'; Outlook Stable

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Fitch Ratings - London - 17 Apr 2020: Fitch Ratings has affirmed Orkuveita Reykjavikur's (RE) Long-Term Issuer Default Rating (IDR) at 'BB+' with a Stable Outlook.

The affirmation reflects RE's business profile, supported by a significant proportion of quasi-regulated activities with modest visibility in the medium term, as well as higher exposure to market risks, including aluminium price and foreign exchange, than rated peers. RE's credit metrics for 2019 and our forecast for 2020-2024 show levels strong for the rating. However, the impact from the COVID-19 pandemic and global economic crisis represent a key near-term risk. RE's ratings benefit from a two-notch uplift for support from its majority shareholder, the City of Reykjavik, under Fitch's government-related entities (GRE) rating criteria. We assess the company's Standalone Credit Profile (SCP) at 'bb-'.

KEY RATING DRIVERS

Impact from COVID-19 Pandemic: The full impact of the COVID-19 pandemic and global economic crisis on Iceland and consequently on RE are yet to be realised and are uncertain. An estimated 50% decline in tourism, on which Iceland's economy is heavily reliant, may have material implications on RE's revenues. However, the company provides essential services to approximately 70% of the population of Iceland and we note that during the peak of the global financial crisis (2008-2010), RE experienced less than 1% in terms of lost customer claims.

RE currently has sufficient liquidity (enough to service 18 months of debt obligations), and is looking at additional funding options to reinforce liquidity. RE also has flexibility in its capex plan for its largest projects.

FX Important Credit Driver: RE's cash flows are exposed to currency fluctuations (largest exposures being to US dollars and euros), interest rates, and aluminium prices, to which some of the company's generation contracts are linked. Depreciation of the krona against US dollar will likely benefit krona-denominated group profits due to ON Power's US dollar-linked revenues. Foreign currency debt, which acts as a natural hedge given some of RE's US dollar denominated operations, will partially limit the benefit of the krona depreciation. At 31 December 2019, the company's total debt was ISK154.0 billion, of which approximately 45% was denominated in foreign currencies compared with around 13% of the company's revenues in foreign currencies (total revenues stood at ISK46.6 billion for 2019).

The decline in aluminium prices will have a limited impact on RE in the short term due to its hedging policy. However, as hedges roll off, the impact would be visible if aluminium prices remain at lower levels as contracted electricity price with key aluminium smelters are linked to aluminium prices. We note that such contracts reduce the counterparty risk for RE by supporting the viability of smelting operations.

Positive Cash Flow Expectations: We expect free cash flow (FCF) to remain positive throughout the forecast horizon supporting deleveraging and with metrics strong for the rating. An increase in cash interest paid (reflecting weakening of the krona), a stronger than expected hit from global economic crisis, substantial changes in planned capex or dividend payments would impact the FCF profile and offset the positive momentum.

Quasi-Regulated Earnings Support Rating: RE's rating is supported by a significant proportion of EBITDA being derived from quasi-regulated businesses, albeit having recently declined slightly to about 53% where we expect it to remain over the medium term. However, this could decline further depending upon factors such as any reduction in regulated tariffs, Building Cost Index (BCI) or CPI, which in turn could be driven by the impact of the economic shock. Increases in EBITDA from ON

Power due to, for example, continued weakness in the krona versus the US dollar could also reduce the proportion of EBIDTA from regulated businesses.

Tariffs Expectations: The tariffs for the cold water and electricity distribution businesses were lowered in 2018 by 5.9% and 6.3%, respectively, while sewerage grew by 3.5%. The tariff reductions were implemented as a result of the company achieving a greater return on investment than stipulated by the shareholders mainly due to operating cost efficiencies achieved by RE in those regulated businesses, while the increase is linked to the BCI index. For cold water and sewerage we forecast an annual tariff growth of approximately 3% while electricity distribution tariff was increased by 2.4% from beginning of 2020, and we expect it to grow on average 1.5% per year thereafter.

Shareholder Links Supportive: RE's rating reflects a bottom-up approach under the GRE criteria, which results in two notches above RE's SCP of 'bb-'. We view the status ownership and control factor as strong, given that the City of Reykjavik has a clear influence on the company's strategy and ultimately approves RE's business plan annually; and support track record and expectations factor as moderate as a result of the conditional nature of the guarantees provided by the parent.

The socio-political impact of default factor is assessed as moderate as RE plays an important role in Iceland's strategic energy sector. We also view the financial implications of GRE default as moderate as we see some contagion risk to the municipalities and other GREs coming from a default by RE but we believe this would result in a moderate impact on availability and costs of domestic financing options for the City of Reykjavik.

DERIVATION SUMMARY

RE is an integrated regional publicly owned utility with around 53% of its earnings deriving from its quasi-regulated businesses, which compares well with peers. The company is more leveraged than its peers, with forecast funds from operations (FFO) net leverage close to 5x for 2020-2024, compared with Energia Group Limited (B+/Stable) with forecast net leverage averaging 4.3x for 2019-2022 but with higher business risk.

In addition, in contrast to its peers the company is more exposed to market risk, including foreign exchange risk, and aluminium price. The rating incorporates a two-notch uplift from the SCP (bb-) as a result of our assessment of the links between the company and its main shareholder, the City of Reykjavik.

KEY ASSUMPTIONS

- Assumptions for inflation from Statistics Iceland, with a reduction in 2020 and 2021 to reflect the impact of the COVID-19 crisis (CPI; 3.4% for 2019, 2.2% in 2021 and then averaging 2.6% until 2024);

- Aluminium prices for 2020: 50% of aluminium price per tonne at RE's forecasts (at hedged forward prices) and 50% as per Fitch's commodity price assumptions (as of 6 April 2020) of USD1,560. For 2021: 26% of aluminium price per tonne at hedged forward prices and 74% as per Fitch's commodity price assumptions of USD1,600 for 2021 and then USD1800 for 2022 and then USD1900 until 2024;

- 18.5% annual appreciation of krona trade currency-weighted index (implying krona depreciation against other currencies) from 2020 for FX-denominated debt and then an average of 2.8% from 2021 onwards;

- Weighted average cost of debt of 4.0%

- Average EBITDA of ISK31.7 billion for 2020-2024;

- Total capital expenditure of around ISK86 billion for 2020-2024;

- Dividend pay-out ratio of 15% in 2020 and 30% from 2021 onward

RATING SENSITIVITIES

Factors That May, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Strengthening of the City of Reykjavik's credit profile together with continued support from the parent, including unconditional guarantees or prolonged restrictions on dividends.

- Continued tariff increases and operational outperformance and continued net repayments of debt leading to FFO net leverage below 5.0x and FFO interest cover over 5.0x on a sustained basis.

Factors That May, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- A weakening of the City of Reykjavik's credit profile.

- Restrictions on tariff increases and higher investments leading to FFO net leverage above 6x and FFO interest cover under 4.5x on a sustained basis.

- A reassessment of the likelihood of support in case of financial difficulties of the GRE including de-linkage of tariffs to inflation or a significant reduction of the conditional parent guarantees for the company's debt.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At 30 December 2019 RE had about ISK18.5 billion in cash and cash equivalents and about ISK7 billion of undrawn committed facilities against ISK14.8 billion of short-term debt. We assess the company's current liquidity as adequate to cover operational requirements over the next 24 months due to our expectation that it will remain FCF positive over the medium term.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR

ENTITY/DEBT	RATING			PRIOR
Orkuveita Reykjavikur	LT IDR	BB+	Affirmed	BB+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 13 Nov 2019)

Corporate Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

Sector Navigators-Addendum to the Corporate Rating Criteria (pub. 27 Mar 2020)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Orkuveita Reykjavikur	EU Issued

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