# FITCH UPGRADES ORKUVEITA REYKJAVIKUR TO 'BB+'; OUTLOOK STABLE

Fitch Ratings-London-06 March 2018: Fitch Ratings has upgraded Orkuveita Reykjavikur's (RE) Long-Term Issuer Default Rating (IDR) to 'BB+' from 'BB'. The Outlook is Stable.

The upgrade of RE's IDR reflects our assessment of the moderate-to-strong links between the company and its main shareholder, the City of Reykjavik under Fitch's Government-Related Entities (GRE) Criteria published on 7 February 2018.

The ratings also take into account the company's progress on deleveraging, and increased earnings as a result of RE's improved operational performance including cost efficiencies achieved by management and improved macroeconomic conditions in Iceland (A/Stable), with EBITDA expected to increase by 5.4% to ISK26.7 billion in 2017. Leverage and high exposure to market risks continue to constrain the rating. The Stable Outlook reflects the expected continued shareholder support including parent guarantees of RE's debt, and the steady regulatory environment.

KEY RATING DRIVERS

Standalone Credit Profile of 'BB-': RE was among the companies Fitch placed on Rating Watch in November 2017 when the exposure draft of its new GRE Rating Criteria was published. Under the new methodology, RE's rating is based on a bottom-up approach, and is two notches above RE's standalone credit profile, which we continue to assess as commensurate with a 'BB-' rating. The uplift is based on the moderate-to-strong links with the City of Reykjavik (main municipality shareholder), including tangible support.

Moderate-to-Strong Municipal Links: Fitch views the municipality's ownership and control of RE as strong. The municipality has an influence on the company's strategy and ultimately approves RE's business plan annually. We view the support track record and likelihood of municipality support as moderate, mainly as a result of the conditional nature of the guarantees provided by the parent which are expected to decrease as debt amortises.

We also assess the socio-political implications of a potential GRE default as moderate. In our view RE plays an important role in Iceland's strategic energy sector, but a financial default would not materially affect water and electricity supply as we would expect the municipality's intervention until a substitute is found to assure continuation of operations. We also assess the financial implications of a hypothetical GRE default as moderate as we see some contagion risk to the municipalities and other GREs coming from the hypothetical default of RE, but we believe this would result in a moderate impact on the availability and costs of domestic financing options for the municipality and other GREs owned by it.

Shareholder Support Expected to Continue: We expect RE's three municipality shareholders, the City of Reykjavik (around 93.5%), the Municipality of Akranes (around 5.5%) and the Municipality of Borgarbyggd (around 1%) to continue to provide support through fully cost-reflective tariffs linked to inflation, adequate returns on investments, and moderate dividends. The shareholders' support includes the conditional parent guarantees of over 67% of outstanding debt (81% in 2016 and expected to decrease in future as the guaranteed debt amortises) and subordinated shareholder loans from its municipality shareholders representing a further 9% of outstanding debt.

Deleveraging Anticipated: We forecast average funds from operations (FFO) adjusted net leverage at 5.1x and average FFO fixed charge cover at 4.9x over 2017-2021, indicating continued deleveraging, albeit at a slower pace than previously expected. In addition to management's efforts to reduce leverage and the expected increase in earnings and cash flow generation as a result of operational efficiencies the company's ability to continue deleveraging depends to some extent on movements of the Icelandic krona and the price of aluminium. Other factors include shareholders' continued support with similar measures to those agreed for the 2011-2016 business plan, and especially keeping tariffs linked to inflation, and moderate dividend payments.

For the year ending 31 December 2017 we expect FFO adjusted net leverage at 5.5x and FFO fixed charge cover at 5.5x. The increase in leverage compared to 5.2x in 2016 is as a result of a slight depreciation of the Icelandic krona in the last months of 2017, which has an impact on RE's debt in local-currency equivalent and lessens management's debt reduction measures, as well as reductions in some regulated tariffs, increased capital expenditure, the acquisition of the company's headquarters for ISK5.5 billion and first-time payments of income taxes and dividends. This is mitigated by the increased EBITDA as a result of the improvements in RE's operational performance and improving macroeconomic conditions in Iceland.

Regulated Earnings Support Rating: RE's rating is supported by a significant proportion of EBITDA over the next five years being derived from regulated businesses, although we expect the share of regulated business to decrease to around 56% by 2020. This is due to lower expected tariff increases over the forecast period driven by lower assumptions for the Building Cost Index (BCI) and the Consumer Price Index (CPI) to which regulated tariffs are linked, and the proportion of EBITDA derived from the non-regulated businesses (ON Power and Fibre Optics and Other) growing at a faster pace over the forecast period than previously anticipated due to the improvement in economic growth in Iceland ('A'/Stable).

For 2017 we expect the company's EBITDA from regulated networks to fall to around 60% of total EBITDA from 61.2% in 2016 as a result of the reduction of regulated tariffs as well as lower BCI and CPI. The tariffs for the cold water and electricity distribution businesses were lowered in some municipalities by the regulator in 2017 by 11.2% and 5.7% respectively. A further reduction of 7.5% was applied to the electricity distribution tariffs for 2018. 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.

Market Risk Mitigated by Hedging: RE's cash flows are exposed to currency fluctuations (with the largest exposures to the dollar and the euro), interest rates and to aluminium prices to which some of the company's generation contracts are linked. In our view, this exposure, though mitigated through hedging, may affect the pace at which RE will deleverage if currency fluctuations are substantial.

At 31 December 2017, the company's total debt was ISK144.5 billion, of which 56.1% (ISK81.0 billion equivalent) was denominated in foreign currencies compared with around 14% of the company's revenues in foreign currencies. Variable-rate debt was 61.4% and interest-rate hedges along with fixed-rate loans covered on average 69% of the variable-rate debt for 2018-2022. The company has also hedged 49% of its exposure to aluminium prices a year ahead and 30% for 2019. RE has also hedged some of its foreign-currency exposure up to 2021.

DERIVATION SUMMARY

Reykjavik Energy is an integrated regional publicly owned utility with around 60% of its earnings deriving from its regulated business which compares well to peers. The company is more highly leveraged than its peers with forecast FFO net adjusted leverage averaging 5.2x for 2017-20 compared with the UK's renewable electricity operator Melton Renewable Energy UK PLC's (BB/Stable) average forecast leverage of 2.9x for 2018-21 and Viridian Group Investments Limited (B+/Stable) with forecast net leverage averaging 4.4x for 2018-20. In addition, in contrast to its peers the company is highly exposed to market risk, including foreign-exchange risk, and aluminium-price and interest-rate risk. No Country Ceiling or operating aspects impact the rating. The rating incorporates a two-notch uplift from the standalone credit profile (BB-) as a result of our assessment of the links between the company and its main shareholder, the City of Reykjavik under the Government-Related Entities Criteria.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- inflation from Statistics Iceland (CPI; 1.8% for 2017, peaking at 2.9% in 2018-2019 and falling to 2.6% in 2021);
- the majority of wholesale electricity generation earnings are linked to aluminium forward prices;
- retail earnings, including earnings from the regulated business, are inflation-linked throughout 2021;
- aluminium price per tonne at USD2,061 for 2017 and USD1,900 for 2018-2021 as per Fitch's current commodity price assumptions;
- a 4% annual appreciation of the krona trade currency-weighted index (implying krona depreciation against other currencies) from 2019 for FX- denominated debt;
- weighted average cost of debt of 3.5%;
- average EBITDA of ISK27.7 billion for 2017-2021;
- total capital expenditure of around ISK80 billion for 2017-2021;
- inflows from the bond of around ISK4 billion received in full in February 2018;
- dividends in line with management assumptions in 2017, a payout ratio of 15% in 2018 and 30% from 2019 onwards, resulting in generally positive free cash flow (FCF) of on average ISK2.0 billion for 2017-2021.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Continued tariff increases and operational outperformance and continued net repayments of debt leading to FFO adjusted net leverage below 5.0x and FFO fixed charge coverage over 5.0x on a sustained basis
-Stronger support from the parent, for example unconditional debt guarantees or prolonged restrictions on dividends
Future Developments That May, Individually or Collectively, Lead to Negative Rating Action
-Restrictions on tariff increases and higher investments leading to FFO adjusted net leverage above 6x and FFO fixed charge coverage under 4.5x on a sustained basis
-A significant weakening of the City of Reykjavik's credit profile or a reassessment of the likelihood of support in case of financial difficulties of the GRE, for example a significant reduction of the conditional parent guarantees for the company's debt

LIQUIDITY

Adequate Liquidity: At 30 September 2017 RE had ISK12.8 billion in cash and cash equivalents and ISK8.5 billion of undrawn committed facilities against short-term debt maturities of ISK4.8 billion. 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 on average FCF-positive over the next five years.

Contact:

Primary Analyst
Siddharth Singh
Analyst
+44 20 3530 1601

Supervisory Analyst
Victoria Munarriz
Associate Director
+44 20 3530 1419
Fitch Ratings Limited.
30 North Colonnade
London E14 5GN]

Committee Chairperson
Arkadiusz Wicik
Senior Director
+48 22 338 62 86

Media Relations: Adrian Simpson, London, Tel: +44 203 530 1010, Email: adrian.simpson@fitchratings.com.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017)
https://www.fitchratings.com/site/re/901296
Exposure Draft: Corporate Rating Criteria (pub. 14 Dec 2017)
https://www.fitchratings.com/site/re/907387
Government-Related Entities Rating Criteria (pub. 07 Feb 2018)
https://www.fitchratings.com/site/re/10019302

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