FITCH UPGRADES ORKUVEITA REYKJAVIKUR TO 'BB'; OUTLOOK STABLE

Fitch Ratings-London-10 February 2017: Fitch Ratings has upgraded Orkuveita Reykjavikur's (RE) Long-Term Issuer Default Rating (IDR) to 'BB' from 'BB-'. The Outlook is Stable.

The upgrade reflects the company's progress on deleveraging, aided by improved macroeconomic conditions in Iceland (BBB+/Positive) and the significant appreciation of the Icelandic Krona (ISK), the company's track record in outperforming targets on the 2011-2016 business plan and expected continued shareholder support, including parent guarantees on debt.
The Stable Outlook takes into account the steady regulatory environment and the company's remaining high exposure to market risks and high financial leverage.

KEY RATING DRIVERS
Progress on Deleveraging: We forecast funds from operations (FFO) adjusted net leverage at 5.4x and interest cover at 5.6x for 2016, down from 6.4x and 6.3x, respectively, in 2015. The decrease in leverage in 2016 is driven by debt reduction, helped by the continuing appreciation of the Icelandic Krona. Proceeds from the aluminium-linked bond in 2016, increasing prices of aluminium on forward markets, increases in tariffs, and no dividends payments are also drivers of the deleveraging.

We forecast FFO-adjusted net leverage to average around 5.2x and interest cover to average 5.3x during 2016-2020. The company's ability to continue deleveraging beyond 2016 depends on shareholders' continued support to the company by means of maintaining similar measures to those agreed for the 2011-2016 business plan, especially keeping tariffs linked to inflation measures and zero or low dividend payments. Additional drivers include the price of aluminium and future movements of Icelandic Krona. Although not expected, a substantial depreciation of the Icelandic Krona could have a negative impact on RE's debt in local currency equivalent, mitigating debt reduction measures.

Shareholder Support Expected to Continue: Beyond 2016, we expect shareholders to continue to provide support through fully cost-reflective tariffs linked to inflation, returns on investments at similar levels to those agreed in the company's 2011-2016 five-year business plan, and moderate dividends.

IDR Uplift for Shareholder Links: The IDR incorporates a single-notch uplift over RE's standalone rating to reflect moderate-to-strong links between the company and its three municipality shareholders, the City of Reykjavik (approx. 93.5%), the Municipality of Akranes (approx. 5.5%) and the Municipality of Borgarbyggd (approx.1%). The shareholders' support includes the conditional parent guarantees of over 81% of outstanding debt (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.

Regulated and Supported Earnings: RE's rating is supported by a significant proportion of EBITDA over the next five years being derived from regulated businesses. For 2016 we expect the company's EBITDA from regulated networks to have reduced to 65% from 67% in 2015 as a result of a steep decrease in Building Cost Index (BCI) and a moderate decrease in Consumer Price Index (CPI) to which regulated tariffs are linked. Fitch expects the EBITDA share of the regulated networks to decrease to around 62% by 2020 as a result of lower expected tariff increases over the forecast period.

Market Risk Mitigated by Hedging: RE's cash flows are exposed to currency fluctuations (largest exposures being to USD and EUR), 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 30 September 2016, the company's total debt was ISK147.6 billion, of which 68.9% (ISK101.7 billion equivalent) was denominated in foreign currencies compared with around 14% (ISK5.7 billion equivalent of Fitch's revenue estimate for 2016) of the company's revenues in foreign currencies. Variable-rate debt was 69.6% and interest rate hedges along with fixed-rate loans covered on average 61% of the variable-rate debt for 2017-2020, before declining. The company has also hedged 50% of its exposure to aluminium prices a year ahead and some of its exposure up to 2019. RE has also hedged some of its foreign currency exposure up to 2021.

DERIVATION SUMMARY
RE has higher leverage than its peers. For comparison, we forecast average three-year FFO-adjusted net leverage of 5.5x for RE, 3.1x for UK's renewable electricity operator Melton Renewable Energy UK PLC (BB/Stable) and 4.2x for UK renewable power company Infinis Plc (BB-/Negative). In contrast to its peers the company is highly exposed to market risk, including foreign exchange risk, and aluminium and interest risk price. No country ceiling or operating aspects impacts the rating; however, parent/subsidiary linkage is applicable and the IDR incorporates a single-notch uplift to reflect this.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- Majority of wholesale electricity generation earnings are linked to aluminium forward prices. Retail earnings, including earnings from the regulated business, are inflation-linked throughout 2020. Assumptions for inflation from Statistics Iceland (CPI; 1.8% for 2016, peaking at 3.4% in 2018 and reducing to 2.6% in 2020); aluminium price per tonne at USD1,611 for 2016, USD1,700 for 2017 and 2018, USD1,750 for 2019 and USD1,800 for 2020 as per Fitch's commodity price assumptions, and more conservative cost of debt compared with management's;
- a 4% annual appreciation of ISK trade currency-weighted index (implying ISK depreciation against other currencies) from 2018 for FX- denominated debt;
- EBITDA on average of ISK26.6 billion for 2016-2020;
- Capex is to average around ISK14 billion a year for 2016-2020 following capex deferrals since 2012;
- Inflows from the bond to the amount of ISK4.3 billion in 2016 (received October 2016) and ISK4.3 billion in 2018;
- No dividends in 2016, dividend pay-out of 30% from 2017 onwards allowing positive free cash flow (FCF) on average ISK4.6 billion for 2016-2020.

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.
-Increased support from the parent, including unconditional 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, or lack of proceeds on the bond asset, leading to FFO-adjusted net leverage above 6x and FFO fixed charge coverage under 4.5x on a sustained basis;

-Weaker parent support, including de-linkage of tariffs to inflation or a significant reduction of the conditional parent guarantees for the company's debt.

LIQUIDITY
Adequate Liquidity: At 30 September 2016 RE had ISK10.5 billion in cash and cash equivalents and ISK8.5 billion of undrawn committed facilities against short-term debt maturities of ISK19.5 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 significantly FCF-positive over the next five years.

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Applicable Criteria
Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016)
https://www.fitchratings.com/site/re/885629
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)
https://www.fitchratings.com/site/re/886557

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