

Rating Action: Moody's changes outlook to positive on Orkuveita Reykjavikur's Ba2 rating

Global Credit Research - 15 Jun 2017

London, 15 June 2017 -- Moody's Investors Service, ("Moody's") has today changed the outlook on Orkuveita Reykjavikur (OR) to positive from stable. Concurrently, Moody's has converted the Ba2 issuer rating into a Ba2 corporate family rating (CFR) in line with the rating agency's practice for corporates with non-investment-grade ratings.

RATINGS RATIONALE

The change of outlook to positive recognises the progress OR has made with regard to improving its operational performance, reducing its financial leverage and strengthening its liquidity profile over recent years, and the increased likelihood that the company will meet Moody's ratio guidance for a rating upgrade in the near future.

OR's financial profile has improved as a result of the company's strict implementation of a five-year plan approved by the board of directors in March 2011. Owing to a very strong commitment from management, the company outperformed the targets well in advance of the completion date in December 2016. Moody's expects that the company will continue to maintain a prudent cash management and hedging policy, which provides greater visibility over funding and helps the company to partially reduce its interest rate, exchange rate and commodity risks. The positive outlook recognises that the company may continue to reduce its financial leverage and will maintain a conservative financial policy in the context of a continuing improvement in the macroeconomic environment and market conditions in Iceland.

The positive macroeconomic dynamics in Iceland will likely have a positive impact on OR's business. The Icelandic economy has continued to grow at a strong pace and Moody's forecasts GDP growth of 5.5% in 2017 and 3.5% in 2018. These improvements are underpinned by increasingly robust domestic demand from private consumption and business investments, including the expansion of the fast-growing tourist infrastructure, which should be supportive of sustained demand growth for utility services.

Albeit materially improved from the past, OR's foreign currency exposure remains substantial owing to a significant mismatch between the majority of its revenues being generated in Icelandic krona and the majority of its debt being denominated in foreign currency, and this continues to weigh on the rating. During 2016 the Icelandic krona has appreciated by almost 15% in trade-weighted terms and by almost another 12% since the beginning of this year. This has helped OR to alleviate its foreign currency debt servicing burden in 2016, and we expect OR's 2017 credit metrics to be positively impacted. Such benefits could disappear if the Icelandic krona reverses direction and weakens. Whilst we do not expect a material depreciation of the Icelandic krona in 2017 and 2018, OR remains exposed to developments in the exchange rate, albeit against a background of lower exchange rate volatility.

OR's Ba2 rating factors in positively (1) the company's strong market position and strategic importance to Reykjavik, and Iceland more broadly, as the provider of essential utility services to almost 70% of Iceland's population; (2) the low business risk profile associated with regulated activities, which accounts for almost 65% of the company's EBITDA and provide a good degree of cash flow predictability; and (3) its asset base with predictable and low levels of capital expenditure requirements. However, the rating also takes account of (1) OR's still significant financial leverage; (2) the foreign currency risk; and (3) the company's exposure to unregulated business and long-term power purchase agreements with aluminium smelters, which exposes revenue to some volatility in the price of aluminium.

OR is considered a government-related issuer under Moody's methodology because of its ownership by municipal authorities, which include the City of Reykjavik (93.5%), the Town of Akranes (5.5%) and the Municipality of Borgarbyggð (1%). The owners provide a guarantee of collection in support of OR, which currently covers around 95% of the total outstanding debt. OR's Ba2 rating incorporates one notch of uplift for potential extraordinary support to the company's baseline credit assessment (BCA, a measure of standalone credit strength) of ba3. This recognises that despite the very strong incentives of the owners to provide timely

financial support to OR their ability to do so in potential stress case scenarios may be constrained, given OR's significant debt burden relative to the financial resources of its shareholders. Therefore, considering the critical nature of utility services that OR provides to the City of Reykjavik and the surrounding communities, Moody's would expect the central government to try and coordinate with the local governments to arrange timely intervention, if necessary.

RATIONALE FOR POSITIVE OUTLOOK

The positive rating outlook reflects the progress OR has made with regard to improving its operational performance, reducing its financial leverage and strengthening its liquidity profile over recent years and the increased likelihood that the company will meet Moody's ratio guidance for a rating upgrade in the near future.

WHAT COULD CHANGE THE RATING UP/ DOWN

We would consider an upgrade if the company's credit metrics were to improve such that funds from operations (FFO)/Net debt was greater than 15% on a sustainable basis without increasing its financial risk profile. This would also assume no change to the assumption of support from the owner incorporated into OR's rating.

Although not currently expected, downward pressure on OR's rating could develop (1) as consequence of a weakening in the company's financial profile, such that FFO/ Net debt in percentage terms was expected to remain consistently below 10%; or (2) it would appear likely that the company's liquidity was not sufficient to insulate it from market risks, particularly in relation to exchange rates, aluminium prices or interest rates, and OR were unable to raise debt in the domestic or international markets.

PRINCIPAL METHODOLOGY

The methodologies used in this rating were Regulated Electric and Gas Utilities published in December 2013, and Government-Related Issuers published in October 2014. Please see the Rating Methodologies page on www.moody.com for a copy of these methodologies.

Headquartered in Reykjavik, Orkuveita Reykjavikur is the largest multi-utility in Iceland. The company operates its own power plants, electricity distribution system, geothermal district heating system and provides cold water and waste services in 20 communities in the southwest of the country, covering almost 70% of the Icelandic population. As at fiscal year ending 2016, the company had revenues of ISK41.4 billion (c.USD370 million) and EBITDA of ISK25.3 billion (c.USD230 million).

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Erica Gauto Flesch
Asst Vice President - Analyst
Infrastructure Finance Group
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Andrew Blease
Associate Managing Director
Infrastructure Finance Group
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Releasing Office:
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454



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