

Rating Action: Moody's upgrades Orkuveita Reykjavíkur's rating to Ba2; stable outlook

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London, 05 September 2016 -- Moody's Investors Service, (Moody's) has today upgraded to Ba2 from Ba3 the long-term issuer rating of Orkuveita Reykjavíkur (OR). Concurrently, a stable outlook has been assigned.

Today's rating action concludes the rating review initiated on 13th June 2016 and it is driven by the speed and extent of Iceland's progress in recovering from its 2008 crisis, as captured by Moody's upgrade of Iceland's government bond rating to A3 stable from Baa2 under review for upgrade on 1st September 2016. For details, please refer to: http://www.moodys.com/viewresearchdoc.aspx?docid=PR_351195.

RATINGS RATIONALE

The upgrade of OR's issuer rating to Ba2 reflects the progress the company has made with regard to strengthening its financial profile and improving its liquidity position in the context of a continuing improvement in the macroeconomic environment and market conditions in Iceland. It also takes account of Moody's expectation that OR should be able to maintain its improved financial performance and good liquidity position.

OR's financial profile has improved as a result of the company's successful execution of a five-year plan approved by the board of directors in March 2011. The company has outperformed against almost all targets, including those related to increasing revenues, reducing costs, and postponing certain investments.

The rating upgrade takes into account Iceland's improved macroeconomic dynamics and the positive impact this will likely have on OR's business. The Icelandic economy has continued to grow at a strong pace since 2011 and Moody's forecasts GDP growth of 5% in 2016 and 3.9% in 2017. 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.

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. Since the beginning of 2015, the Icelandic krona has appreciated by more than 12% in trade-weighted terms. The strengthening of the local currency reflects both the solid fundamentals of the economy and market expectations that the interest rate differential between Iceland and other major countries will remain high. This has helped OR to alleviate its foreign currency debt servicing burden, and we expect OR's 2016 credit metrics to be positively impacted. Such benefits could disappear if the Icelandic krona reverses direction and weakens. Whilst we do not expect material movement in the exchange rate in 2016 and 2017, OR remains exposed to developments in the exchange rate, albeit against a background of lower exchange rate volatility.

Overall, OR's 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 more than 70% of Iceland's population; (2) the low business risk profile associated with regulated activities, which account for more than 60% of the company's EBITDA and provide a good degree of cash flow predictability; (3) the positive macroeconomic dynamics in Iceland that should be supportive of sustained demand growth for utility services; and (4) OR's asset base that has predictable and low levels of capital expenditure requirements. However, the rating also takes account of (1) OR's significant financial leverage; (2) its foreign currency exposure; and (3) its exposure to long-term power purchase agreements with aluminium smelters, which exposes revenues to 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 more than 95% of the total outstanding debt. The company'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 its ability to do so in potential stress case scenarios may be constrained, given OR's very 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, covering more than 70% of the Icelandic population, Moody's would expect the central government to try and coordinate with the local governments to arrange timely intervention, if necessary. We note that instances of default by municipalities in Iceland during the 2008 crisis indicate a low probability of extraordinary support could be forthcoming directly from the central government in the event that OR were to face financial distress.

RATIONALE FOR STABLE OUTLOOK

The stable outlook reflects Moody's expectation that OR will continue to prudently manage its liquidity and improve its financial position, such that credit metrics will be comfortably positioned within the ratio guidance for a ba3 bca, namely the maintenance of an FFO/ Net debt ratio in the low to mid-teens in percentage terms.

WHAT COULD CHANGE THE RATING UP/ DOWN

Moody's could consider an upgrade if the company's credit metrics were to improve such that 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.

Conversely, 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.

The methodologies used in these ratings were Regulated Electric and Gas Utilities published in December 2013, and Government-Related Issuers published in October 2014. Please see the Ratings 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 more than 70% of the Icelandic population.

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