



RATING ACTION COMMENTARY

Fitch Upgrades Orkuveita Reykjavikur to 'BBB-'; Outlook Stable

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Fitch Ratings - London - 15 Apr 2021: Fitch Ratings has upgraded Orkuveita Reykjavikur's (OR's) Long-Term Issuer Default Rating (IDR) to 'BBB-' from 'BB+', with a Stable Outlook.

The upgrade reflects our expectation of an improvement in credit metrics over 2021-2025 and OR's stable performance in 2020 despite the pandemic, leading to an upward revision of the company's Standalone Credit Profile (SCP) to 'bb' from 'bb-'. Our assessment of OR's linkages with its majority shareholder, the City of Reykjavik, under Fitch's Government-Related Entities (GRE) Criteria, are unchanged and result in a two-notch uplift of the IDR from the SCP.

Feedback

The rating continues to reflect the company's business profile, supported by a significant proportion of regulated activities with good visibility in the medium term, the contracted nature of the non-regulated generation and limited historical cash flow volatility, despite foreign exchange and commodity price exposure.

KEY RATING DRIVERS

Improving SCP: We forecast OR's leverage to gradually reduce driven by a consistent operational performance and positive free cash flow (FCF) generation. OR's funds from operations (FFO) net leverage at end-2021 is forecast to be 5.2x compared with 5.1x at end-2020, due to increased investments in 2021. We expect they will then gradually decline and remain significantly below the negative rating sensitivity of 5.2x.

OR's FFO interest cover is strong and Fitch expects it to average 5.8x during 2021-2025. OR's SCP also benefits from consistent profitability, with stable EBITDA margins at just over 60% and low to mid-single digit revenue growth.

Limited Impact from Pandemic: The full impact of the Covid-19 pandemic and global economic crisis on Iceland and consequently OR proved to be limited for 2020. There was a significant decline in tourism, on which Iceland's economy is heavily reliant, but the company increased earnings, with revenues up 4.4% and the EBITDA margin stable at 60.6%, in line with our pre-pandemic expectations. Increases in bad debts were limited and working capital was broadly stable. OR's 2020 performance was in contrast to some of its peers that experienced a larger impact from the pandemic.

FX Exposure Adequately Managed: OR'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. However, foreign currency debt, which acts as a natural hedge given some of OR's US dollar-denominated operations, helps mitigate the risk from FX exposure. In addition, OR maintains a hedging policy for FX as well as aluminium prices (60% hedged for 2021 and 48% for 2022), which further limit the risk.

At 31 December 2020, the company's total debt was ISK171.0 billion, of which approximately 41% was denominated in foreign currencies. OR generates about 23% of its EBITDA from businesses (ON Power) linked to FX and aluminium prices. OR currently has 60%-80% of its foreign currency cash flow exposure hedged for each year to 2025. In our view, although this exposure is mitigated through hedging, it could affect the pace at which OR will deleverage if currency fluctuations are substantial.

Positive Cash Flow Expectations: We expect FCF to be positive throughout the forecast horizon, except in 2021 due to higher investment. This will support deleveraging commensurate with the rating sensitivities at the 'bb' level for the SCP. This takes into account increased dividend payments, averaging ISK3.8 billion, and capex averaging slightly more than ISD18 billion during the forecast horizon. Substantial changes in planned capex or dividend payments would impact the FCF profile and reduce deleveraging capacity.

Regulated Earnings Support Rating: OR's rating is supported by a significant proportion (about 54%) of EBITDA being derived from regulated businesses, which we expect to remain stable over the medium term. However, this could decline due to a reduction in regulated tariffs, the 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.

Shareholder Links Supportive: OR's rating reflects a bottom-up approach under the GRE criteria, which maps to scores between 15 and 17.5, resulting in a two notch uplift of the IDR above OR'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 OR's business plan annually. We view the "support track record" factor as moderate as a result of the conditional nature of the guarantees provided by the parent. The conditional parent guarantees decreased to 40% of outstanding debt in 2020 from 81% in 2016 and are expected to further decrease as guaranteed debt amortises.

Fitch assesses the "socio-political impact of default" factor as moderate as OR plays an important role in Iceland's strategic energy sector. We also view the "financial implications of GRE default" as moderate as OR's default could cause some contagion risk to the municipalities and other GREs and could result in a moderate impact on the availability and costs of domestic financing options for the City of Reykjavik.

DERIVATION SUMMARY

OR is an integrated regional publicly owned utility with around 54% of its earnings derived from its regulated businesses, improving its business risk versus pure generation companies such as Energia Group Limited (BB-/Stable). OR's forecast FFO net leverage close to 4.6x for 2021-2025 is above Energia's of about 4.4x, while Energia's 'BB-' rating is lower than OR's SCP of 'bb'. This is because OR has higher exposure to regulated earnings as well as higher profitability.

In contrast to its peers, OR is more exposed to market risk, including foreign exchange risk, and aluminium price. However, this is managed through natural hedges with US dollar-denominated debt as well as a clear FX and aluminium price hedging policy. 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

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Assumptions for inflation in line with forecasts by Statistics of Iceland, with a lower increase in 2021 to reflect the impact of the Covid-19 crisis (CPI; 2.4% for 2021, 3.2% in 2022);
- Aluminium prices for 2021 and 2022 as per Fitch's commodity price assumptions of USD1,850;
- Around 5% appreciation of the Icelandic krona against the US dollar for 2021;
- Weighted average cost of debt of 3.2%.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

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

- Continued tariff increases, operational outperformance and continued net repayments of debt leading to FFO net leverage below 4.2x and FFO interest coverage over 5.5x on a sustained basis.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Weakening of City of Reykjavik's credit profile;
- Restrictions on tariff increases and higher investments, leading to FFO net leverage above 5.2x and FFO interest coverage 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

Strong Liquidity: At 30 December 2020 OR had around ISK30.7 billion in cash and cash equivalents and ISK6.5 billion of undrawn committed credit facilities as well as two undrawn loan facilities (ISK1.1 billion and USD48 million) against approximately ISK34 billion of debt maturities in the next 24 months. We assess the company's current liquidity as sufficient to cover operational requirements and debt repayments over the next 24 months after including our expectation of moderately negative FCF in 2021 but neutral to positive FCF in 2022.

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.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Orkuveita Reykjavikur	LT	BBB-	Rating Outlook Stable	BB+ Rating Outlook Stable
	IDR			

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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)

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Orkuveita Reykjavikur

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