



## Fitch Affirms Orkuveita Reykjavikur at 'BB+'; Outlook Stable

Fitch Ratings-London-18 April 2019: Fitch Ratings has affirmed Orkuveita Reykjavikur's (RE) Long-Term Issuer Default Rating (IDR) at 'BB+' with a Stable Outlook.

The affirmation reflects RE's outperformance of our financial forecast for 2018 and expected relatively stable credit metrics over 2019-2023 with marginal improvement in leverage. The rating is also underpinned by the company's business profile, supported by a significant proportion of quasi-regulated activities with modest visibility in the medium term, but cash flow volatility higher than peers due to foreign exchange and commodity price exposure. RE's ratings benefit from a two-notch uplift for support from its majority shareholder, the City of Reykjavik, under Fitch's government-related entities (GRE) rating criteria. We assess the company's standalone credit profile at 'bb-'.

### KEY RATING DRIVERS

**FX Expectations Affect Deleveraging:** RE has gradually reduced debt through positive free cash flow generation, but its credit metrics are exposed to currency fluctuations (largest exposures to the US dollar and euro), interest rates and to aluminium prices, to which some of the company's generation contracts are linked. In our view, this exposure, although mitigated through hedging, may affect the pace at which RE will deleverage if currency fluctuations are substantial. At 31 December 2018, the company's total debt was ISK151.3 billion, of which about 57.6% was denominated in foreign currencies, compared to around 14% of the company's revenues in foreign currencies.

**Positive Cash Flow Expectations:** We expect free cash flow (FCF) to remain mostly positive through the forecast horizon. However, we expect it to experience a significant fall in 2019 due to a combination of increased capex and cash interest expense. The increase in cash interest expense is driven by the forecast general weakening of the Icelandic krone, resulting in higher debt. The impact on credit metrics is partially offset by an increase in profitability from ON Power, which benefits from a weakening krone due to its dollar revenue exposure. We forecast funds from operations (FFO) net adjusted leverage to average at 5.5x for 2019-2023 (5.1x in 2018).

**Quasi-Regulated Earnings Support Rating:** RE's rating is supported by a significant proportion of EBITDA being derived from quasi-regulated businesses, although we expect the share of EBITDA from quasi-regulated business to decrease to around 50% by 2023 from 55% in 2018. This is due to a combination of the reduction of regulated tariffs and lower assumptions for the Building Cost Index (BCI) and the Consumer Price Index (CPI), and an increase in EBITDA from the generation segment, reflecting the improved economic outlook in Iceland.

**Tariff Expectations:** Tariffs for the cold water and electricity distribution businesses were lowered in 2018 by 4.9% and 6.3%, respectively, while sewerage grew by 3.5%. 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, while the increase for sewerage is linked to the BCI index. For cold water and sewerage we forecast annual tariff growth of about 3.8%, while

electricity distribution tariffs are likely to remain flat in 2019 and 2020, and to grow at 1.5% a year thereafter.

Shareholder Support: RE's 'BB+' rating benefits from a two-notch uplift from its standalone credit profile of 'bb-' based on our assessment of the moderate-to-strong links between the company and the City of Reykjavik under the GRE criteria. We view the "status ownership and control" factor as strong because the City of Reykjavik, as majority owner, has a clear influence on the company's strategy and ultimately approves RE's business plan annually. We assess "support track record and expectation" as moderate because of the conditional nature of the guarantees provided by the parent.

We consider "socio-political impact of default" moderate as 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. In addition, we assess "financial implications of GRE default" as moderate as we see some contagion risk to the municipalities and other GREs coming from the hypothetical default by RE, but we believe this would result in a moderate impact on availability and the costs of domestic financing options for the City of Reykjavik and other GREs.

## DERIVATION SUMMARY

RE is an integrated regional publicly owned utility with around 55% of its earnings deriving from its quasi-regulated businesses, which compares well to peers. The company is more leveraged than its peers, with forecast FFO net adjusted leverage averaging 5.5x for 2019-2023, compared with Viridian Group Investments Limited (B+/Negative) with forecast net leverage averaging 4.3x for 2019-2022 but with higher business risk.

In addition, in contrast to its peers the company is more exposed to market risk, including foreign exchange risk, and aluminium price. 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.

## KEY ASSUMPTIONS

- Assumptions for inflation from Statistics Iceland (CPI; 2.7% for 2018, peaking at 3.6% in 2019 and reducing to 2.6% in 2023)
- 50% of aluminium price per tonne based on RE's forecasts for 2018-2020 (at hedged forward prices) and 50% in line with Fitch's most recent commodity price assumptions of USD2,161 for 2018, USD2,000 for 2019, USD2,050 for 2020 and then USD2,100 until 2023
- An 8.9% annual appreciation of krone trade currency-weighted index (implying krone depreciation against other currencies) from 2019 for FX-denominated debt and then an average of 4.6% from 2020
- Weighted average cost of debt of 4.2%
- Average EBITDA of ISK30.5 billion for 2019-2023
- Total capital expenditure of around ISK87 billion for 2019-2023
- Dividend pay-out ratio of 15% in 2019 and 30% from 2020

## RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action

- Strengthening of the links with the City of Reykjavik, including unconditional guarantees and prolonged restrictions on dividends
- 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

Developments that May, Individually or Collectively, Lead to Negative Rating Action

- A weakening of the links with the City of Reykjavik

- 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

## LIQUIDITY

Adequate Liquidity: At 30 December 2018 RE had ISK18.2 billion in cash and cash equivalents and ISK8.5 billion of undrawn committed facilities against ISK14.9 billion of short-term debt. 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 mostly FCF positive over the next five years.

### Contact:

Principal Analyst  
Steve Jun  
Analyst  
+44 20 3530 2625

Supervisory Analyst  
Ana Gaspar  
Director  
+44 20 35301601  
Fitch Ratings Limited  
30 North Colonnade  
London E14 5GN

Committee Chairperson  
Angelina Valavina  
Senior Director  
+44 20 3530 1314

Media Relations: Adrian Simpson, London, Tel: +44 20 3530 1010, Email: [adrian.simpson@thefitchgroup.com](mailto:adrian.simpson@thefitchgroup.com)

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### Applicable Criteria

Corporate Rating Criteria (pub. 19 Feb 2019)  
Government-Related Entities Rating Criteria (pub. 29 Mar 2019)  
Sector Navigators (pub. 23 Mar 2018)

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