Icelandic Economic Update

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Icesave and the ISK

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Icelandair floats – more to come?

- Share offering of Icelandair Group, the parent company of Icelandair and several related companies, was concluded recently and represented the final stage in the restructuring of the company. Icelandair's stock offering might be the first step towards the regeneration of the Icelandic stock market, a market currently suffering from having been made up of a small number of large financial companies that eventually ended up collapsing. According to the CEO of Nasdaq OMX Iceland, 10 companies have announced their entry into the Icelandic stock market this year.

Calendar

Date	Title	Period
2 February 2011	CBI's Interest Rate Decision	
4 February 2011	Auction Treasury Bonds	
11 February 2011	Auction Treasury Bills	
11 February 2011	Unemployment Figures	January 2011

Icesave and the ISK

The Icelandic parliament is set to discuss a bill on paying off the Icesave debt of Landsbanki Íslands. It represents a better agreement for Iceland than the previous one, although the main difference lies in a brighter outlook for recovery and payments from Landsbanki's bankruptcy estate and the appreciation of the ISK. Interest-rate terms are also far better and repayments will be made more quickly, which also reduces the costs to the Icelandic government substantially. However, there remain numerous uncertain factors.

In order to get a clear view of the overall picture, it is vital to examine two main points (we'll concentrate on the loan principal in this discussion): i.e. the relationship between the assets and liabilities in the bankruptcy estate of Landsbanki; and the Icelandic Depositors' and Investors' Guarantee Fund (TIF):

Assets of the bankruptcy estate	Liabilities of the bankruptcy estate
Based on a recovery rate of 86%, the value of assets is currently ISK 1,138 billion (91% denominated in foreign currency, 9% in ISK).	Priority claims against the Landsbanki estate total IS 1,319 billion (fixed in ISK).

Assets of TIF	Liabilities of TIF
51.4% of priority claims against the bankruptcy estate og to TIF. Based on an 86% recovery rate of the estate's assets TIF's assets totalled ISK 584 billion on the valuation date (ISK 600 billion today).	TIF guarantee is 1.3 billion EUR and 2.35 billion GBP.

1. *Landsbanki bankruptcy estate:*

Liabilities:

Priority claims against the Landsbanki estate total ISK 1,319 billion and do *not* change even if the exchange rates of foreign currencies change as priority claims in Landsbanki are fixed in ISK at the exchange rate of 22 April 2009. Therefore, the Icelandic state stands to suffer the blow if the ISK depreciates substantially, as claims against Landsbanki remain fixed while foreign liabilities rise in line with the depreciation of the ISK.

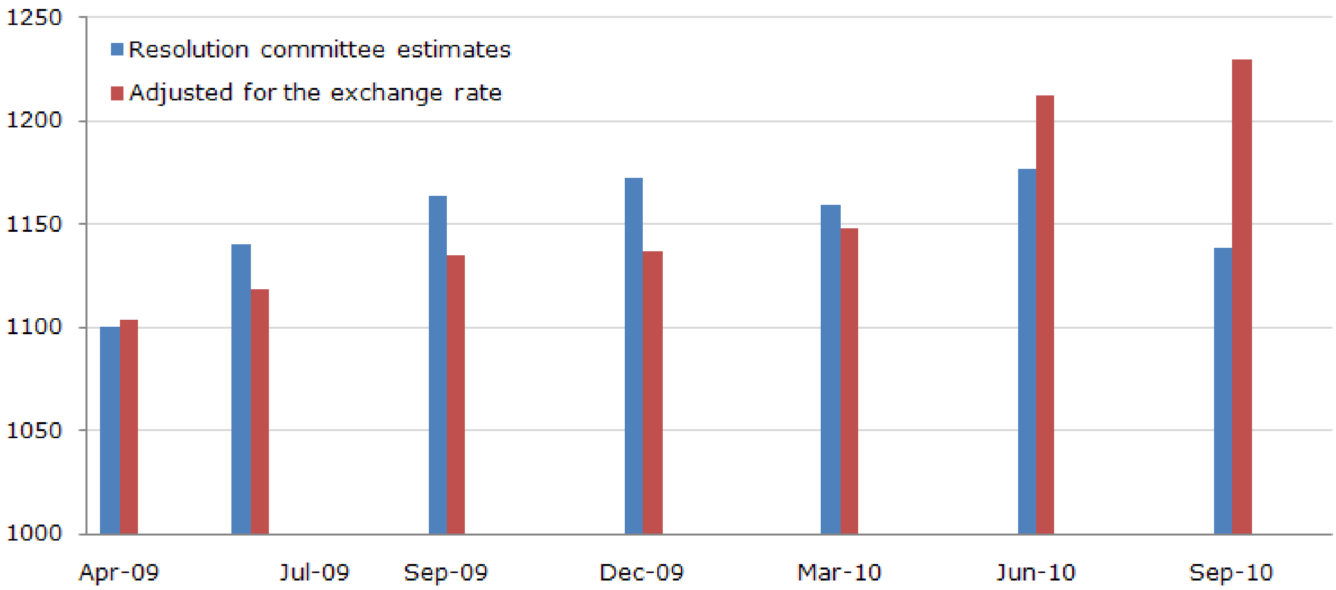
Assets:

The assets of the Landsbanki bankruptcy estate are mostly denominated in foreign currencies, i.e. about 91% (9% is in ISK). According to the latest estimate of the Landsbanki bankruptcy estate, about 86% (ISK 1,138 billion) are expected to be recovered of this ISK 1,319 billion.

The figure below shows changes in the expected recovery rate since April 2009. If adjusted for the exchange rate of the ISK (the red column below), recovery has increased by ISK 125 billion since priority claims were fixed in April 2009. The blue columns show recovery based on the estimates of the Resolution Committee of the bankruptcy estate's assets. Recovery has increased less by this measure, or less than ISK 40 billion, taking development of the ISK exchange rate into account.

The best possible development for the Icelandic state would, of course, be if the recovery rate increased independent of the exchange rate of the ISK (see details below). That is, that Iceland receives more of the bankruptcy estate's assets while the TIF liability remains unchanged (or decreases).

Landsbanki bankruptcy recovery - in ISK billion



Source: Resolution Committee of Landsbanki

2. The Icelandic Depositors' and Investors' Guarantee Fund (TIF):

Liabilities:

According to the agreement on the table, TIF will guarantee payments to the Netherlands worth €1.3 billion and to the United Kingdom worth £2.35 billion, i.e. those general deposits in Icesave accounts that were below €20,887.

When the claims were fixed on 22 April 2009, this amount was ISK 675 billion. This liability is in foreign currency and therefore follows the ISK exchange rate against the euro and the pound. Due to favourable exchange-rate development, the liability of TIF has fallen by ISK 25 billion and currently stands at around ISK 650 billion (excluding accrued interest).

Assets:

TIF guarantees all deposits up to a maximum of €20,887 – this means that 51.4% (around = 675/1319) of the estate's priority claims go to TIF - based on the Landsbanki Resolution Committee's estimate of 86% recovery of the estate's assets, around ISK 584 billion will be recovered (given the depreciation of the ISK in recent days the figure is probably around ISK 600 billion).

TIF liability - in ISK billion

Source: Central bank of Iceland & Arion Research estimates

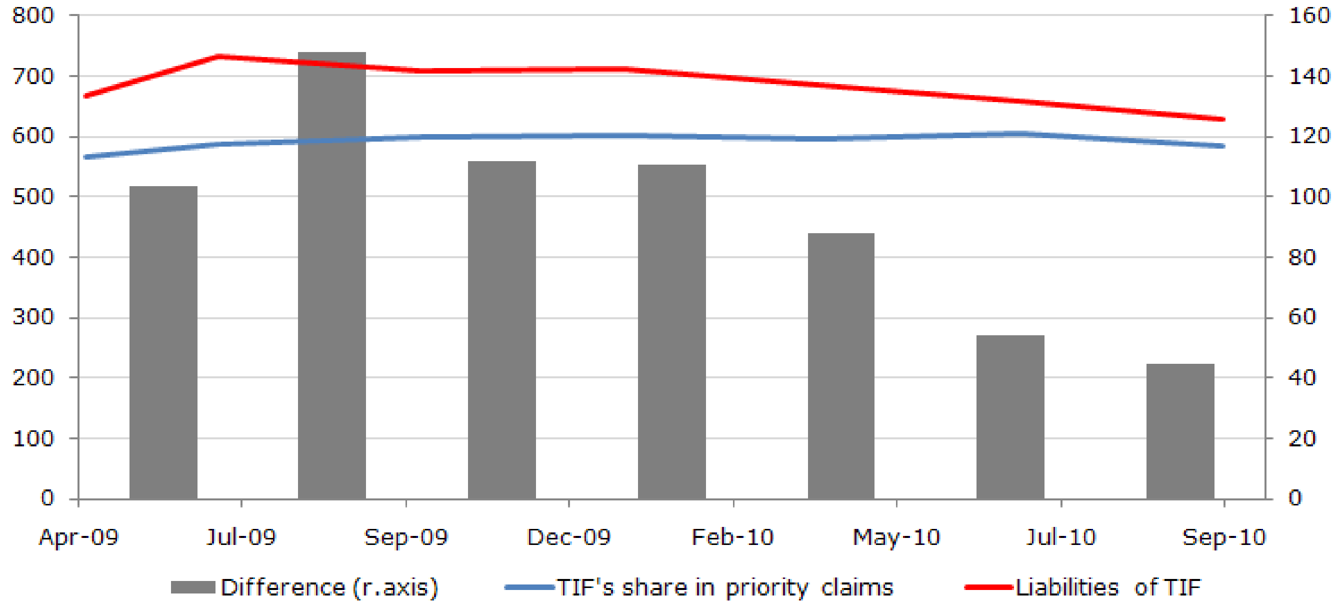
Is the value of the bankruptcy estate's assets likely to rise or fall?

As indicated by the blue line below, the asset portfolio of Landsbanki (since the claims were fixed) retained its value (measured in ISK) despite the appreciation of the ISK (about 91% of the assets being foreign-currency denominated). Similarly, TIF's liability has fallen as a result of the appreciation of the ISK. The position has in fact changed for the better for Iceland on most fronts.

The recovery estimate can indeed be considered "cautious" as the Resolution Committee in fact publishes a snapshot of its assets, without accounting for interest income from the assets which are likely to prove substantial (but of course the price of the assets can rise and fall depending on developments on foreign markets). As an example, the bankruptcy estate is known to receive ISK 23 billion in interest income from a bond in New Landsbanki (NBI) (and no doubt more assets) which in time will increase the recovery rate, all else equal.

As indicated by news reports, one of the estate's largest assets, i.e. in the British retailer Iceland, is most likely worth more than estimated in the accounts of the bankruptcy estate. The difference is tens of billions of króna for the Landsbanki bankruptcy estate, according to news reports. The picture will most likely become clearer in the coming months. However, if such a sale were to go ahead it would have a considerable impact on the recovery rate of the estate's assets and so lower the Icesave bill dramatically.

Convergence of assets and liabilities - without accrued interest, in ISK billion



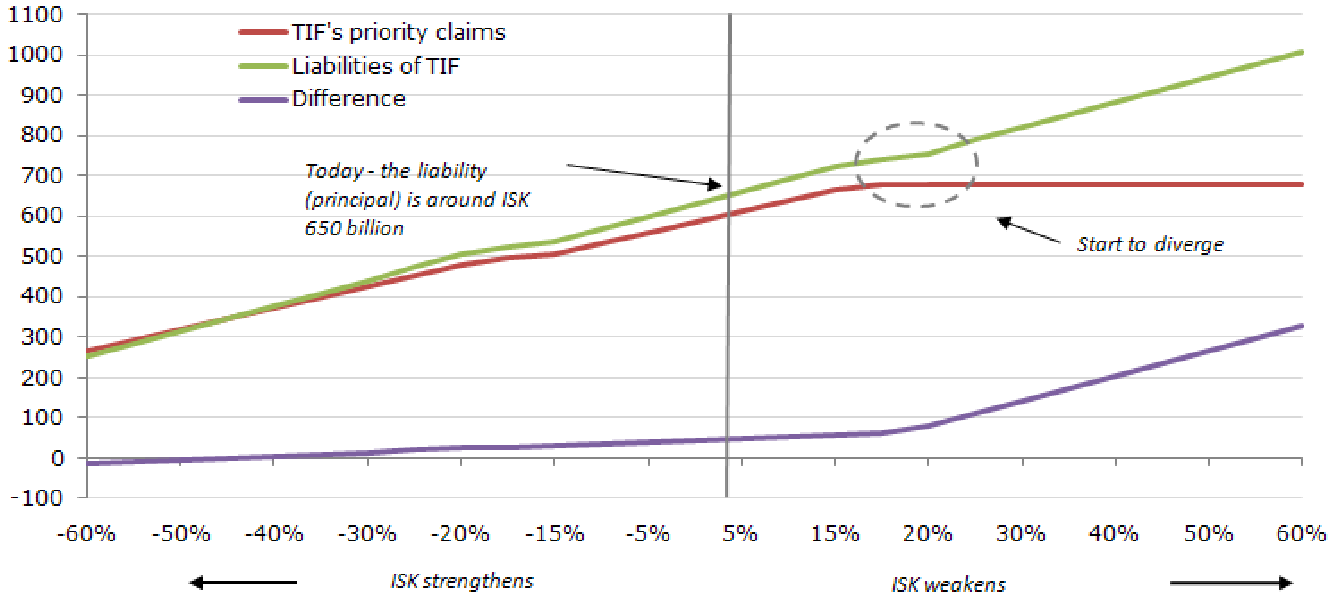
Source: Resolution Committee of Landsbanki & Arion Research estimates

The ISK is the big question

As is evident below, the debts and assets of Icelandic savers (TIF) start to diverge if the ISK depreciates by 17% or more (based on the Resolution Committee's last estimate of assets and the ISK exchange rate at that time – the debt/assets have in fact risen by more than 3% since the estimate was made due to the depreciation of the ISK). Until that point, recovery from the Landsbanki estate increases at the same rate as Icelandic' assets.

However, if the ISK depreciates by more than 17%, Icelandic assets stop rising at a similar rate, there being a limit of around ISK 675 billion on TIF's priority claim in the bankruptcy estate (i.e. 51.4% of an ISK 1,319 billion priority claim, based on 100% recovery). At the same time, there is no maximum limit on the debt side which can therefore rise infinitely if the ISK falls through the floor (TIF would however have a general claim for the rest of the debt along with other claimants – this is however a relatively low amount based on the current price of bonds in the old Landsbanki which assumes 10% recovery in excess of priority claims).

The ISK effect on recovery and liability principal - in ISK billion



Source: Resolution Committee of Landsbanki & Arion Research estimates

Does Icesave delay the lifting of capital controls?

If the capital controls remain in place and no major external blows occur, it is quite likely that the impact of the ISK exchange rate on the Icesave debt will remain within reasonable limits (i.e. that the ISK does not depreciate much more than 15-20%), since there are strong indications that foreign trade will continue to yield a surplus and that the banking system will stand strong, shielded by capital controls. However, if the government decides to take serious steps towards lifting the controls in the coming months or years, the likelihood of a sharp depreciation of the exchange-rate will inevitably increase (resulting in a higher Icesave bill). We therefore find it unlikely that the capital controls will be changed significantly until the principal of the debt has been significantly reduced, which will probably not be for one to two years at the earliest. In this context it does not matter how much is borrowed to boost the currency reserves.

The IMF seems to be of the same opinion as a report published in relation to the fourth review indicates that a careful and slow lifting of the capital controls is necessary to maintain stability in the economy. The report stresses that even though goals to achieve economic stability have been met (including stability in public finances) and the build-up of the currency reserves is going well, the financial system is still too fragile. Már Gudmundsson, governor of the Central Bank of Iceland, agreed with this view at his meeting at Akureyri University on 14 January. However, the governor seems optimistic regarding the steps ahead, deeming it likely that the banking system will receive the clean bill of health needed to finance itself beyond the capital controls in the coming months. It is clear that all speculation about when and how the controls are lifted will not be answered until the end of February when the government, in conjunction with the IMF, presents a new plan for the lifting of the controls.

Icelandair floats – more to come?

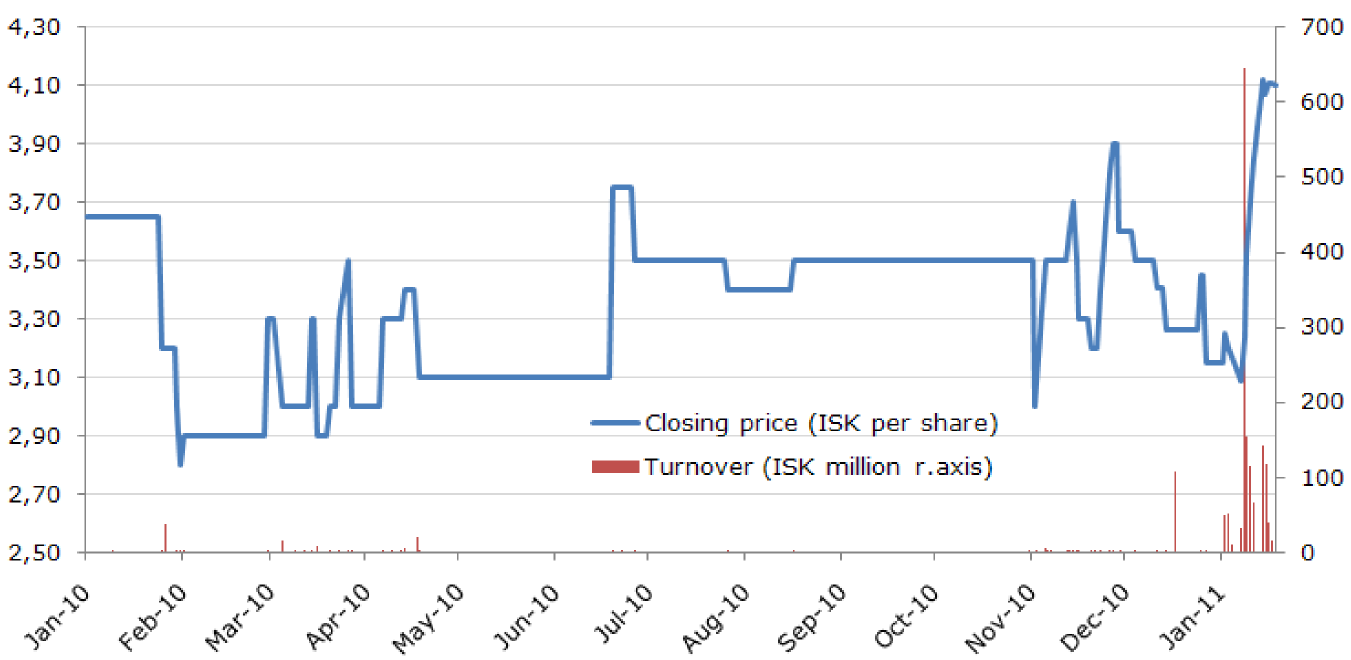
Share offering of Icelandair Group, the parent company of Icelandair and several related companies, was concluded recently and represented the final stage in the restructuring of the company. While there are some loose ends to be tied up regarding the sale of assets outside the core business, the company expects everything to be completed by the end of January. Icelandair Group began to experience difficulties in its business soon after it was listed on the Iceland Stock Exchange in 2006 (re-listed). Initially high oil prices hampered the company but later the high level of debt and a fall in demand further undermined the company. The company's prospects are brighter after financial restructuring as its debts have been reduced substantially.

Excess demand. The Icelandair Group share offering concluded on 23 December 2010 and attracted interest among investors. More than 1 billion shares were on offer but investors subscribed for three times that amount. Current shareholders exercised all their pre-emptive rights while the company's employees subscribed for less than half the shares available to them. Retail investors showed great interest in the company. Originally only 100 million shares were going to be offered to them but in light of the great demand (and the low demand from employees) the number of shares was raised to 180 million.

Liquidity. The company's shareholder base is rather uniform and there is likely to be limited float on the company's shares to begin with. Pension funds own about 45% of issued share capital after the offering; Íslandsbanki owns approximately 21%; and the resolution committees of the old banks have about 9%. These investors therefore hold around 75% of the issued share capital.

It should be noted that Icelandair Group has entered into market making agreements with Landsbanki Íslands and Saga Investment Bank which will improve the liquidity of the shares. Active price formation with the company's shares will only occur when the shareholder base becomes more diversified. The turnover in the first day of trading was approximately ISK 647 million in 37 transactions, compared with ISK 250 million in 82 transactions in 2010.

Icelandair Group closing price and turnover



Source: Mentis

Restructuring. Icelandair Group's business was restructured in several stages since radical changes were deemed necessary. The company's debts were reduced in two ways: creditors converted debt into equity and the company launched a share offering. The company's net interest-bearing debts have been cut from more than ISK 30 billion to around ISK 9 billion after the offering (based on Q3 2010 pro forma balance sheet). The company's cost of capital will therefore drop considerably.

Icelandair's capital ratio is approximately 35% after the offering (Q3 2010), similar to that of other European airlines. The company's business was also redefined; previously the company was classed as a holding company for companies in the airline and tourism service industries. Now the company is defined as an operational company in the airline and tourism industries. Furthermore, assets which were not considered to be part of the core activities are to be sold, i.e. Bluebird Cargo, Travel Service and SmartLynx.

Increased business. Icelandair Group recently announced that Icelandair had performed strongly last year. The company transported 1.5 million passengers, almost 15% more than the previous year. The load factor was the best in the company's history at 78.4%. Icelandair expects to increase its capacity by 17% this year, bringing the number of passengers up to 1.7 million. The company announced that bookings for the first quarter had increased 10% over the previous year and the company will decide on whether to increase its capacity at the end of January based on the number of bookings and expected increases in fares and taxes.

The company reported net earnings of ISK 2,364 million for the first nine months of 2010. The management of Icelandair Group expects the company's EBITDA for Q4 to be virtually zero.

More to come? Icelandair's stock offering might be the first step towards the regeneration of the Icelandic stock market, a market currently suffering from having been made up of a small number of large financial companies that eventually ended up collapsing. Today, the OMXI6 stock index comprises three Icelandic operating companies (including Icelandair), which are however largely dependent on international markets, and three Faroese companies. Four of the six companies are listed on two markets, i.e. in Iceland and on the Danish stock exchange. One of the Icelandic companies, Össur, is in fact leaving the Icelandic stock exchange and will therefore only be listed in Denmark. Following the financial collapse, there has been some speculation as to which companies, including those currently undergoing financial restructuring by the banks, will be listed on the Icelandic stock market.

According to the CEO of Nasdaq OMX Iceland, 10 companies have announced their entry into the Icelandic stock market this year. Although the listing of so many companies is difficult to envisage, the list below contains some likely candidates.

- **Hagar.** Hagar is the largest retailer in the country with a market share of over 50%. The company is in the process of being sold and five consortiums of investors remain. It is not clear whether the company will be sold in its entirety or whether a core holding will be sold separately and the company then listed on the market.

- **Eimskip.** Eimskip is the largest shipping company in Iceland. It has long been dubbed the nation's favourite and bathed in a certain glory as it was the first company to offer its shares to the Icelandic public in 1914. Nothing has been stated about the sale of the company, which has been undergoing restructuring. However, it would not be listed again until 2013 due to the stock exchange's condition on having a three-year record of operations. (Eimskip became insolvent in 2009).

- **TM and VÍS.** Those two companies are insurance companies and were previously listed on the market.

- **Icelandic Group.** Icelandic Group is owned by The Enterprise Investment Fund, which is involved in discussions with investors about the sale of the company or part of its operations. Icelandic Group processes and sells fish products in Iceland and mainland Europe. Shares in the company may possibly enter the public market. The Enterprise Investment Fund also owns other companies, including Vodafone Iceland, which might be listed in the market within 1–2 years.

- **Real estate companies.** There has been some discussion about the listing of real estate companies on the stock exchange. One has already announced its arrival and preparations are under way.

The economic environment should to some extent be favourable to the stock market; interest rates are low, inflation historically low and the exchange rate of the ISK is low. Although investments to support future economic growth are clearly substantially lacking, conditions for new listings should emerge soon and the number of listed companies in Iceland will rise.

Contacts

Ásdís Kristjánsdóttir
Head of Research
Capital Markets & Corporate Banking
Tel: +354 444 6968
asdis.kristjansdottir@arionbanki.is

Davíd Stefánsson
Analyst
Capital Markets & Corporate Banking
Tel: +354 444 6965
david.stefansson@arionbanki.is

Fannar Jónsson
Analyst
Capital Markets & Corporate Banking
Tel: +354 444 6962
Fannar.jonsson@arionbanki.is

Thorbjörn Sveinsson
Senior Analyst
Capital Markets & Corporate Banking
Tel: +354 444 6973
thorbjörn.sveinsson@arionbanki.is