MOODY'S
PUBLIC SECTOR EUROPE

Rating Action: Moody's affirms Faroe Islands' rating at Aa3 with a stable outlook notwithstanding a major infrastructure project

Global Credit Research - 07 Feb 2017

Note: On February 8, 2017, the press release was corrected as follows: In the fourth sentence of the first paragraph of the press release, the expected cost was changed to DKK 2.64 billion; at the end of the press release, the title of the first contact was changed to AVP - Analyst. Revised release follows.

London, 07 February 2017 -- Moody's Public Sector Europe (MPSE) has today affirmed the Aa3 long-term issuer rating of the Government of Faroe Islands. The outlook is stable. Today's rating action outlines our view that the Faroe Islands' current rating and credit strengths are sufficient to withstand the challenges associated with the provision of a minimum traffic guarantee on two major subsea tunnels (Eysturoy and Sundoy tunnel). The tunnels represent the biggest infrastructure deal in the history of the Faroe Islands, with an expected cost of approximately DKK 2.64 billion. Moody's views that despite potential exposure to construction risk, we expect the Faroe Islands to deliver strong financing surpluses in 2016 and onwards to mitigate any unforeseen construction cost overruns.

The financing of the project includes DKK 400 million which has been appropriated by the Faroese Government over a ten year horizon, while DKK 2.7 billion was raised as senior secured notes under a special purpose entity. The Faroese national government owns 100% of the Project Company and is the ultimate sponsor of the project. Taking into accounts the risk of this project during the construction phase our debt projections remain flat over the next five years, a trend Moody's had elsewise expected to reverse over the coming years. While the existing rating can support the planned increase in debt, any substantial overrun in costs or additional infrastructure projects with similar guarantees could lead to downward rating pressure. Once operational, we view that the project will predominantly be self-sufficient. Moody's notes the difference in financial viability between the tunnels, with the future earnings from the Eysturoy tunnel expected to cover the majority of the debt service requirements. The Sandoy tunnel remains financially non-viable on a standalone basis and once operational will only contribute approximately 10% of total combined income over the next 40 years.

RATINGS RATIONALE

RATIONALE FOR THE RATING AFFIRMATION

The Faroe Islands' rating affirmation at Aa3 stable reflects its fiscal autonomy resulting in a high level of revenue and expense flexibility combined with a track record of prudent budgeting. Moody's expects the government to deliver a financing surplus in 2016 and throughout the construction phase of the Eysturoy tunnel. In addition, the stable and historical relationship with the Government of Denmark (Aaa,Stable), with joint matters clearly defined under the 1948 Home Rule Act is credit positive. The rating also takes into account the construction and operational exposure that the Faroe Islands has underwritten by providing a minimum traffic revenue guarantee. The Faroe Islands' dependence on the fishing industry, which represents nearly 20% of GDP is also factored in the rating. This high dependence is somewhat offset by regular fish stock control to restrict the threat of stock depletion and a push to diversify the islands' trade partners. The Faroe Islands continue to rely on short-term borrowing and are susceptible to funding cost rises. In 2016, the government's liquidity reserve was recorded at DKK2.8 billion, which exceeds the necessary borrowing requirements in any single year and mitigates the refinancing risk associated with the government's reliance on short term borrowing.

WHAT COULD CHANGE THE RATINGS UP

A combination of the following could have positive rating implications: (1) a return to long term structurally balanced budgets; (2) a steady debt reduction to pre-recession levels; (3) a reduced reliance on short term borrowing.

WHAT COULD CHANGE THE RATINGS DOWN

One or a combination of the following could have negative rating implications: (1) construction risk resulting in significant project cost overruns; (2) materially increased debt levels above current levels; (3) Increased contingent liabilities via additional government guarantees; (4) a weakening of the Faroe Islands' relationship with Denmark; (5) an adverse shock impacting the Faroese fishing sector.

The impact of the sub-sea tunnels on the Faroe Islands required the publication of this credit rating action on a date that deviates from the previously scheduled release date in the sovereign release calendar, published on www.moodys.com.

The specific economic indicators, as required by EU regulation, are not available for this entity. The following national economic indicators are relevant to the sovereign rating, which was used as an input to this credit rating action.

Sovereign Issuer: Denmark, Government of

GDP per capita (PPP basis, US$): 45,723 (2015 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 1.6% (2015 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 0.3% (2015 Actual)

Gen. Gov. Financial Balance/GDP: -1.3% (2015 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 9.2% (2015 Actual) (also known as External Balance)

External debt/GDP: [not available]

Level of economic development: Very High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

SUMMARY OF MINUTES FROM RATING COMMITTEE

On 03 February 2017, a rating committee was called to discuss the rating of the Faroe Islands, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially increased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer has become increasingly susceptible to event risks.

The principal methodology used in this rating was Regional and Local Governments published in January 2013. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this credit rating action, and whose ratings may change as a result of this credit rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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Amir Girgis
AVP - Analyst
Sub-Sovereign Group
Moody's Investors Service EMEA Ltd.
One Canada Square
Canary Wharf
London E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

David Rubinoff
MD - Sub Sovereigns
Sub-Sovereign Group
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

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

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