FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Fortum's Outlook to Stable; Affirms IDR at 'BBB'

Tue 21 Mar, 2023 - 11:00 ET

Fitch Ratings - Madrid - 21 Mar 2023: Fitch Ratings has revised the Rating Outlook on Fortum Oyj's (Fortum) Long-Term Issuer Default Rating (IDR) to Stable from Negative. Fitch has also affirmed Fortum's Long-Term IDR and senior unsecured debt at 'BBB' and its Short-Term IDR at 'F3'. The Outlook revision mainly reflects the positive impact of the Uniper exit for Fortum's credit profile. Significant deleveraging resulted from the transaction in 2022, especially from the recovery of the EUR 4.0 billion shareholder loan.

Fortum confirmed its focus on maintaining a prudent capital structure with a long-term guidance on its financial net debt-to-comparable EBITDA of up to 2.0x-2.5x, which is consistent with our negative sensitivity for the rating of funds from operations (FFO) net leverage of 3.5x. As a clean electricity generation company, Fortum benefits from a supportive power price environment.

Over the rating horizon we expect Fortum to apply high capex scrutiny, see positive pre-dividend free cash flows (FCF) and remain within our rating sensitivities with substantial leverage headroom.

KEY RATING DRIVERS

Rating Scope: In 2022 Fitch deconsolidated Fortum's Uniper segment and Russian activities for rating purposes. While the Uniper divestment concluded in December 2022, the Russian business has not been sold yet. The divestment process is likely to take further time and is subject to uncertainties including regulatory approvals. Fortum remains committed to exiting Russia, and the group's Russian business operations are disconnected in practice from the core group.

Favourable Price Environment: Following the 2022 Uniper divestment and considering the planned exit from Russia, Fortum's business reflects the profile of a clean genco that is focused on hydro and nuclear. Additional activities represent around 15% of the EBITDA in our rating case. The company is now well placed to benefit from the strong fundamentals for clean generation. Fortum's higher hedged prices will support revenues in 2023-2024, while Nordic electricity forward prices remain well above the historical average.

Financial Headroom: Fortum FFO Net Leverage stood at 1.7x at year-end 2022. The deleverage was driven by the Uniper exit (in particular by the recovery of the EUR 4 billion shareholder loan) as well as by Fortum's strong performance in 2022. In our rating case we expect FFO net leverage to gradually increase up to 2.7x by 2025 but remain well below the negative sensitivity of 3.5x for the current rating, also due to a strong EBITDA higher than EUR1.5 billion and the gradual cash-in of outstanding margin calls at end-2022. Fitch is not considering any material disposal proceeds in its rating case.

The key factor for the stabilization of the Outlook is Fortum's commitment to maintain an adequate capital structure with credit metrics consistent with the 'BBB' rating. Following the Uniper exit (and the related losses), we now expect the company to apply a high scrutiny in its capex allocation and prioritize profitability over growth. We do not expect Fortum to entirely exhaust its financial headroom over the next few years and assume that FFO Net Leverage will remain comfortably within guidelines.

Prudent Financial Policy: In its March 2023 strategic presentation, Fortum reviewed its financial targets with the aim to adequately balance between financial strength, growth investments and dividend distributions. The company is now guiding to a slightly higher net leverage of up to 2.0x-2.5x versus below 2x previously.

The additional leverage flexibility is not meant to accommodate growth in the short term but rather to account for more volatile market conditions given the company's higher exposure to Nordic power prices as a pure genco. Fortum has returned to an explicit dividend policy and is setting a dividend payout ratio in the 60% to 90% range of comparable earnings per share.

Rating Neutral Investment Plan: Fortum has budgeted total cumulated capex of EUR 2.4 billion for 2023-2025, of which EUR 0.9 billion relates to maintenance capex and up to EUR 1.5 billion to growth capex. The growth capex includes EUR 0.8billion of committed projects. In our rating case we assume growth capex to be allocated to (i) renewable projects (EUR 0.35billion; mainly Pjelax wind power plant project), (ii) investments in hydro and nuclear (EUR 0.35 billion; including the lifetime extension of Loviisa nuclear power plant) and (iii) decarbonization projects (EUR 0.1 billion).

For new build projects, Fortum seeks to close PPAs with industrial clients since it does not target new merchant renewable projects. The company has also established investment hurdles (project WACC in a range of 150 bps to 400bps) that are dependent on specific project characteristics.

Finnish Windfall Tax: The Finnish Parliament approved in February 2023 a law establishing a temporary windfall tax in the electricity sector. The tax applies to Finnish companies generating electricity or participating in wholesale or partly in retail sales. Pursuant to the law, the tax is 30% of the companies' net profits generated from Finnish operations exceeding a 10% return on equity in 2023, while the tax becomes payable in 2024.

Manageable Refinancing Exercise: As of December 2022, Fortum had short-term maturities of EUR 4.1 billion which can be comfortably covered with cash on balance and undrawn committed credit facilities. Fortum expects to tap the bond markets in order to extend the average life of its debt and reinforce its financial flexibility. We view the refinancing as manageable based on Fortum's adequate liquidity position, low leverage at year-end 2022 and solid business profile.

DERIVATION SUMMARY

Fortum's closest peers are RWE AG (BBB+/Stable) and Statkraft AS (A-/Stable). Statkraft's rating includes a single-notch uplift that reflect government links, which we view as stronger compared with that of Fortum and the Finnish government. Fortum's debt capacity at 'BBB' is similar to Statkraft's, given their clean asset base, which is mostly focused on the Nordics. Statkraft has a higher prominence of low-cost, flexible hydro-asset base (versus hydro and nuclear for Fortum), while we see Fortum better integrated with its city solutions and customer solutions businesses, resulting in the same negative sensitivity at 'BBB' (based on Statkraft's SCP).

RWE has a higher share of quasi-regulated business (50%-60%), but unlike Fortum it remains significantly exposed to thermal generation, and its implied debt capacity at 'BBB' would probably be broadly in line with Fortum's.

ERG S.p.A. (BBB-/Stable) benefits from much higher revenue visibility (generally through auctions or power purchase agreements), but it is smaller and lacks hydro generation and integration into supply. ERG has a slightly higher debt capacity than Fortum (positive sensitivity 3.6x).

KEY ASSUMPTIONS

- EBITDA averaging EUR 1.7 billion in 2023-2025, excluding the Russian business.

- Finnish windfall tax payable in 2024 is factored in. Fitch would expect regulatory intervention to persist if electricity prices remain substantially above historical levels.

- Capex of around EUR 0.8billion per year, excluding the Russian business.

- Cash-in related to the settlement of margining receivables of EUR 1 billion on a cumulative basis.

- Dividends at around EUR 0.9 billion per year (90% payout ratio assumed for 2024-2025).

- No new M&A and no material disposal proceeds assumed.

RATING SENSITIVITIES

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

- FFO net leverage falling below 1.5x on a sustained basis

- Significant improvement of the company's business profile (for instance coming from materially higher quasi-regulated earnings)

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

- FFO net leverage above 3.5x and FFO interest coverage cover below 5.0x, both on a sustained basis

- Deterioration in the regulatory and operating environment, for instance with windfall taxes, energy price caps or similar measures considerably weakening credit metrics.

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

Sufficient Liquidity: Like many other utilities in Europe, Fortum faced significant margin payments during 2022 due to the rapidly increasing and historically-high power prices. Fortum received liquidity support from the Finnish state, in the form of a one-year bridge loan facility of EUR2.35 billion signed in September 2022 (of which only EUR 350million were drawn at year-end). However, the repayment of the EUR4 billion shareholder loan and the EUR 0.5 billion proceeds from the disposal of Uniper have significantly reinforced Fortum's liquidity position. As per company indication, the bridge loan will be repaid and cancelled by end-March 2023.

As of December 2022, Fortum had a cash balance of around EUR 3.5 billion and EUR 4.5billion of undrawn committed credit lines due after 2023 to comfortably cover its short-term maturities of EUR 4.1 billion. In addition, the company states that it has the right to extend EUR 1.6 billion of current maturities to 2024.

ISSUER PROFILE

Fortum is an energy company that is 51% owned by the Finnish state and is engaged in the generation and sale of electricity, heat, cooling, and power products and services. Fortum is one of the largest power generators and one of the largest electricity retailers in the Nordics.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch deconsolidates the Russian activities of Fortum for rating purposes.

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.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Fortum Oyj	LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Negative
	ST IDR	F3	Affirmed	F3
senior unsecured	LT	BBB	Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 28 Oct 2022)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Fortum Oyj	EU Issued, UK Endorsed

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