FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Fortum's Outlook to Negative; Downgrades Short-Term IDR to 'F3'

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Fitch Ratings - Milan - 23 Jun 2022: Fitch Ratings has revised Fortum Oyj's Outlook to Negative from Stable, while affirming the utilities group's Long-Term Issuer Default Rating (IDR) at 'BBB'. Fitch has also downgraded its Short-Term IDR to 'F3' from 'F2'.

The Outlook revision mainly reflects growing risks related to further gas market disruption across EU due to a potential stoppage of Russian gas flow, which would have a negative impact especially for German subsidiary Uniper's global commodities business, potentially triggering also liquidity tension for Fortum. The Short-Term IDR downgrade reflects our reassessment of Fortum's financial flexibility considering the significantly increased margin call requirements which may increase further.

The affirmation of the Long-Term IDR factors in the continuing business diversification of the group, with clean electricity generation benefitting from current high electricity prices, a conservative financial structure, record of successful divestments, and management's commitment to the current rating. Our rating case foresees an average funds from operations (FFO) net leverage that is still consistent with the rating for 2022-2024, albeit with increased material downside risk.

KEY RATING DRIVERS

EU Gas Disruption More Likely: The tension between EU and Russia continues to escalate, with several countries already cut off from Russian gas due to the refusal of incumbent utilities to put in place the rouble-payment mechanism required by the Russian government. The recent material reduction of gas flow through Nord Stream I is also part of this escalation trend. Our rating case does not foresee a complete halt to Russian gas, but rather continuing tension between the relevant parties and in the gas market, and with increasing downside risk.

Limited Results Visibility: The current tension in the gas market limits visibility for Fortum's results. Based on the Energy Security Law in Germany, we expect that in case of a complete cut-off of Russian gas, the German government would intervene in the market to protect importers, including Uniper, from incurring large losses. However, its supply margins would become immaterial while such state intervention would be unprecedented and untested. This is one of the key drivers for the Negative Outlook.

Strong Results Under Normal Circumstances: Fortum's generation business is mostly based on nuclear and hydro capacity in the Nordics, benefiting from current electricity prices to the extent not already hedged for 2022 and 2023 (20% and 45% at end-1Q22, respectively). Uniper is more exposed to thermal generation, but derives a significant part of its generation margins from contracted capacity. Our rating case, which considers much lower prices than the forwards for unhedged volumes, includes an EBITDA of around EUR2.4 billion for 2022-2023, excluding Russian activities.

Deconsolidation of Russian Activities: We are deconsolidating Russian activities for rating purposes, given the group's strategic target to exit the country. At group level, the Russian business represents around EUR0.6 billion-EUR0.7 billion EBITDA without meaningful debt towards third parties, therefore resulting in negative impact on leverage from deconsolidation. However, it is beneficial for the group's debt capacity, since we deem Russian assets as higher risk for the group. Conservatively, we are not assuming any cash-in from the expected sale of the Russian business, given the limited visibility on the process, but we view this as material upside to our rating case.

Solid Liquidity; Margin Call Risk: Fortum has been proactive in managing liquidity during the recent months of market turbulence. It has just signed new liquidity facilities worth EUR5.5 billion and shows a solid liquidity profile under normal circumstances. However, Uniper would face significant margin calls in its large trading business in case of its downgrade below investment grade. The risk of additional margin calls drives our downgrade of Fortum's Short-Term IDR to 'F3'.

Conservative Financial Structure: Fortum posted solid results in 2021 and executed a large disposal plan worth EUR5.2 billion in 2020-2021. As a result of this, and notwithstanding working-capital absorption of EUR5.7 billion in 2021 (mainly related to margin calls), Fortum's funds from operations (FFO) net leverage was a modest 2.6x in 2021. We assume cash inflows from working capital of around EUR4.5 billion related to margins posted in 2021, and expect an average FFO net leverage of 2.3x for 2022-2024, which is firmly positioned within the current rating.

Long-Term Challenges: Fortum has a large thermal generation fleet, which will see a material transition during this decade, mainly to develop a large renewables fleet, decarbonise thermal plants and develop hydrogen-related activities. This brings execution risk and requires material investments, which underlines the importance of low starting leverage.

Fortum has an ESG Relevance Score of '4' for energy management due to the large scale of thermal generation, which is subject to Emission Trading Scheme and commodities price fluctuations.

DERIVATION SUMMARY

Fortum's closest peers are Statkraft AS (BBB+/Stable, including a single-notch uplift reflecting government links, which we view as stronger compared with that of Fortum and the Finnish government) and RWE AG (BBB+/Stable). Fortum's debt capacity at 'BBB' is around 0.5x lower than both peers' (3.0x vs. 3.5x). Statkraft has a similar share of quasi-regulated business, but benefits from a substantially cleaner asset base dominated by low-cost hydro. RWE has a higher share of quasi-regulated business (50%-60%), but like Fortum remains significantly reliant on thermal generation.

Other generation companies mostly focused on renewables like ERG S.p.A. (BBB-/Stable) and Orsted A/S (BBB+/Stable) benefit from higher revenue visibility (generally through auctions or power purchase agreements) and have higher debt capacity than Fortum (negative sensitivity at 'BBB-' is 4.4x for ERG and 3.5x at 'BBB+' for Orsted).

KEY ASSUMPTIONS

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

- EBITDA of around EUR2.4 billion, excluding the Russian business, to 2025

- Tax rate as communicated by Fortum

- Working-capital inflow of cumulatively EUR4.5 billion to 2025

- Capex of around EUR1.2 billion per year, excluding Russian business, to 2025

- Dividends growing around 3% p.a.

- No new M&A (only proceeds of EUR1 billion in 2022 for the sale of the stake in Oslo Varme) to 2025

RATING SENSITIVITIES

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

An upgrade is unlikely under current market conditions. However, factors that could lead to an upgrade include:

- FFO net leverage under 1.5x on a sustained basis, assuming an unchanged business profile

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

- FFO net leverage above 3.0x on a sustained and FFO interest coverage cover below 5.0x, both on a sustained basis

- Near-complete cut to Russian gas supply to EU could lead to a downgrade, if it poses a serious risk to Fortum's earnings or liquidity profile

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

Large Margin Requirements, Proactive Approach: In 2021 surging commodity prices triggered very high margin requirements from Fortum's commodity hedging activities, creating a liquidity need of EUR7.4 billion. Fortum has proactively managed such margin payments, resorting to short-term financial debt (which increased by EUR5.4 billion in 2021) and using its own cash resources accumulated from robust operating cash flow.

At end-2021 Fortum held around EUR8 billion of readily available cash and in 1H22 secured total committed credit facilities amounting to around EUR7.5 billion. Moreover, we expect the settlement of margin receivables to contribute to positive free cash flow of EUR3.5 billion in 2022. These sources of liquidity are sufficient to cover Fortum's expected debt repayment of around EUR10 billion in 2022.

However, liquidity tensions could result from a sudden cut-off of Russian gas to Europe, especially if this would trigger a rating downgrade of Uniper to sub-investment grade.

ISSUER PROFILE

Fortum is a Finnish state-owned energy company engaged in the generation and sale of electricity, heat, cooling, and power products and services. As at end-2021, it had an installed capacity of 47.0GW, out of which 72% related to combined heat and power & condensing power, 18% to hydropower and 10% to nuclear.

SUMMARY OF FINANCIAL ADJUSTMENTS

In the rating committee of June 2021, Fitch introduced an adjustment to consider margining assets and liabilities in the net financial position (as readily available cash and financial debt, respectively).

However, given the recent developments (substantial increase of net margining receivables) and the continuing high energy price environment, we view it more prudent to reverse this adjustment and assume a phased recovery of the net receivables through working capital during the business plan horizon.

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

Fortum has an ESG Relevance Score of '4' for energy management due to the large scale of thermal generation, which has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

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 Negative	Affirmed	BBB Rating Outlook Stable
	ST IDR	F3	Downgrade	F2
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)

Corporate Rating Criteria (pub. 15 Oct 2021) (including rating assumption sensitivity)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub. 15 Oct 2021)

APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.3 (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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