

Research Update:

Finland-Based Power Company Fortum 'BBB/A-2' Ratings Affirmed Following Uniper Support Package; Outlook Negative

August 3, 2022

Rating Action Overview

- On July 22, 2022, Germany's chancellor announced a package to support Germany-based gas supplier and international diversified energy company Uniper, including the government taking a 30% equity stake in the company (and reducing Fortum's stake to 56% from 80%), along with other financially supportive and legal measures to address missing Russian gas volumes.
- We believe that the current support package will prevent further incremental costs for Fortum, provided that the European Commission approves the plan.
- The dilution of Fortum's stake in Uniper and the announced withdrawal of further financial support from Fortum to Uniper mean we now see Fortum's financial exposure as capped and deconsolidate the German subsidiary from the Fortum Group.
- Absent other potential strategic shifts, Fortum should become a Nordic power company with predominantly fossil-fuel-free generation from its hydro and nuclear assets, which we believe provide relative cash flow stability despite their market exposure.
- However, the group's business model remains in transition and uncertainties persist about the long-term business and financial implications of Fortum retaining a majority but noncontrolling stake in the German gas operator.
- We estimate that the company will be able to generate funds from operations (FFO) to debt at around 40% in the next two to three years, by activating potential remedy measures.
- As a result, we have affirmed our 'BBB/A-2' ratings on Fortum, despite the much smaller size of the company, and removed the ratings from CreditWatch negative, where we placed them on July 5, 2022.
- The negative outlook reflects the group's significant ongoing transformation, the remaining uncertainties as to Fortum's medium-term strategic focus with its frozen investment in Uniper, and that the German support package still needs approval by the European Commission.

PRIMARY CREDIT ANALYST

Daniel Annas
Stockholm
+46 (8) 4405925
daniel.annas
@spglobal.com

SECONDARY CONTACTS

Per Karlsson
Stockholm
+ 46 84 40 5927
per.karlsson
@spglobal.com

Beatrice de Taisne, CFA
London
+ 44 20 7176 3938
beatrice.de.taisne
@spglobal.com

Rating Action Rationale

The support package reflects Uniper's importance to the German energy markets, and particularly to Germany's energy supply security. Since June 16, 2022, Uniper has received 40% or less of the gas volumes contracted with Gazprom, which we estimate is now resulting in losses of about €50 million-€80 million per day, depending on the volumes of gas flowing, gas prices, and the use of flexibility clauses in Uniper's remaining long-term contracts to procure gas. This, in addition to very volatile gas and power prices, which result in additional margin collateral needs, has led to significant liquidity needs for the company. As a result, it publicly requested government support on July 8, 2022 (see "Uniper 'BBB-' Ratings Affirmed Following German Government Support Package; Outlook Negative," published July 29, 2022, on RatingsDirect).

In response, on July 22, the German government announced measures to support Uniper. The government package includes:

- Increasing a liquidity line by government-owned KfW to €9 billion from €2 billion, which we expect will happen in the next few days.
- A €267 million direct equity injection, whereby the government takes over 30% of Uniper's shares, which will dilute Fortum's stake to 56% from 80%.
- €7.7 billion of mandatory convertible bonds, which the company can draw from as required to cover for the losses on the long-term gas contracts. This implies that equity will cover such losses.

In addition, the package provides for:

- A 90% pass-through of re-procurement costs for the missing Russian gas volumes as of Oct. 1, 2022, according to the recently approved paragraph 26 of Germany's energy security law (§26 of the Energiesicherungsgesetz).
- Fortum's €4 billion shareholder loan remaining drawn by Uniper during the stabilization process.

We believe that the German government would increase the support package if needed.

Beyond immediate issues, we believe Uniper will have significant liquidity needs over the next two years and we expect it will post significant losses, although both will depend on the gas flowing from Russia and prices for gas, electricity, and carbon dioxide. We believe that the package will help mitigate most of the cash flow losses but anticipate that under certain scenarios the support package might need to expand. For example, under a scenario in which gas flows through Nordstream 1 are at 20% capacity and in which Title Transfer Facility (TTF) gas prices remain at €175 per megawatt-hour (/MWh)-€180/MWh until Oct. 1, 2022, we estimate that Uniper would incur losses of about €8.2 billion from June 14-Oct. 1, 2022, thereby potentially exhausting the equity support under the package. However, this outcome depends on multiple factors, including the flexibility on alternative LTCs, use of Uniper's gas storage capacities (currently at 44%), and profits from other segments such as conventional power generation, which we understand is profitable for now.

In our view, this package should address Uniper's current liquidity needs and limit Fortum's exposure to Uniper. As part of the support package, Fortum remains the majority owner of Uniper. Uniper will not pay any dividends and Fortum's €4 billion shareholder loan will remain with

Uniper. On the one hand, this alleviates the concerns we had in July, when we placed Fortum on CreditWatch with negative implications because Fortum faced additional costs from Uniper's market situation (see "Uniper And Fortum Ratings Placed On CreditWatch Negative As Earnings And Liquidity Are Hit By Russian Gas Import Cut, July 5, 2022). But on the other hand, it also means that Fortum's investment in Uniper is frozen and that Fortum will not be able to deploy any capital from this investment, which limits its growth plans. Fortum and Uniper will remain closely linked, although the importance of Uniper to Fortum's strategy is much decreased and the control Fortum has on Uniper is diluted. Even if Fortum remains the majority shareholder of Uniper, it is our understanding that the German stake is large enough to have blocking rights. We therefore view Uniper as moderately strategic to Fortum and we deconsolidate Uniper in our assessment of Fortum's credit profile. Uncertainties remain as to the long-term business and financial implications for Fortum and its retention of a noncontrolling stake in the German gas operator.

Fortum retains very strong position on the Nordic markets. Following the turmoil of this year, Fortum will essentially become a power generating company, with electricity generation representing about 80% of its EBITDA. On average, Fortum Nordic generation is 44-47 terawatt hours (in comparison, the production of electricity in Finland was about 67 terawatt hours in 2020). Its generation capacity is split about 50-50 between hydro and nuclear power, and all of its generation facilities are in Sweden and Finland:

- Hydro generation has low cost of production and high water availability.
- Nuclear has historically been stable with a track record of load factors of about 90%-95%.
- Fortum's equity stake of 25.8% of Teollisuuden Voima (TVO) will lead to additional contributions when the nuclear power plant OL3, with installed capacity of 1,600 megawatts, comes fully on stream. We are incorporating contributions from Fortum's TVO stake starting in 2023, given the current schedule is full commission by December 2022.

Although we expect some volatility in Fortum's 2022 result, we believe the company will be able to maintain FFO to debt of about 40% in the next two-to-three years. We believe that electricity prices will remain elevated because of the scarcity of natural gas pressuring prices. Additionally, Fortum has hedged its generation by about 80% during 2022 at €35/MWh, and 55% for 2023 hedged at €33/MWh. And as hedges are unwinding, we expect to see solid increased earnings to support improved cash flows from its generation activities. Average Nord Pool spot prices have been at €110/MWh and Finnish prices even slightly higher at €120/MWh during 2022, which is significantly higher than historical averages with the five-year average at about €30/MWh-€35/MWh. We expect electricity prices to remain above €100/MWh for the remainder of 2022 and through the winter of 2023, driven by the scarcity of natural gas.

There are uncertainties as to Fortum's medium-term strategy. We expect Fortum will update its strategy as the geopolitical situation evolves. Uncertainties remain as to the future of Fortum's long-term stake in Uniper and its ability to deploy further capital in the energy transition. Indeed, a significant amount of resources have been absorbed by the recent support mechanism to Uniper, until now considered core to the group's strategy (guarantees of about €4 billion and fully drawn €4 billion shareholder loan without near-term repayment). We would expect more clarity on Fortum's long-term strategy toward the end of the year, at which point we will likely review our FFO-to-debt rating trigger, currently set at 40%. We view Fortum's Nordic operations as lower risk than the rest of the operations, including those in Russia and Uniper. We could therefore slightly lower the trigger depending on the group's updated strategy.

Government support leads us to incorporate a one-notch uplift in our assessment of Fortum's stand-alone credit profile (SACP). The Finnish government, with a 50.8% share, is Fortum's major shareholder. We view Fortum as important for the country because it is the largest electricity producer in the country. Our support assumptions for Fortum are unchanged.

Outlook

The negative outlook reflects Fortum's exposure to Uniper until the European Commission approves the support package and the longer-term uncertainties about Fortum's strategy.

It also reflects some remaining uncertainties as to Fortum's financial profile, notably with the impact on its debt from margin calls on its hedging operations.

However, we take in consideration that Fortum is committed to maintaining an investment-grade rating, and that it could enforce remedy measures, such as lower dividends or additional asset sales, to protect the rating.

Downside scenario

We could lower our rating on Fortum if the European Commission does not approve the support package for Uniper or if Uniper's losses from its procurement activities are not absorbed, and instead force Fortum to finance the losses. We could also lower the rating if Fortum's financial profile cannot be restored in the next two to three years.

Upside scenario

We could revise the outlook to stable once the longer term uncertainties mentioned above have lifted and depending on our review of Fortum's business risk profile and resulting FFO-to-debt rating trigger; its financial policy; as well as the impact of macroeconomic conditions on Fortum.

Company Description

In 2021, Fortum reported EBITDA of €3.817 billion. The company was founded in 1998 and is headquartered in Espoo, Finland. On Dec. 31, 2020, the main shareholder was the Finnish government, with 50.76% of the share capital. Fortum had about 8,000 employees when it announced it would divest its Russian assets.

In addition to its strong position in generation, Fortum is the third-largest carbon dioxide (CO₂)-free generator in Europe because of its zero-to-low CO₂-emission fleet, with almost 100% (excluding Russian generation assets) of its generation assets being CO₂-free.

Fortum engages in the generation and sale of electricity and heat in the Nordic countries. Fortum's main activities consist of three segments: Generation, City Solutions, and Consumer Solutions. Electricity generation represents the vast majority of EBITDA. It consists of hydro and nuclear generation. Fortum also has thermal electricity and heat generation in Russia, but we are not including any contribution from those activities to our base case, as there are capital control mechanisms imposed by Russia, and Fortum has announced a disposal process. Fortum owns a 80% stake in Uniper, which we understand will be lowered to 56% because of the German support package. We are treating Uniper as an equity stake and deconsolidating it from Fortum in our forecast.

Liquidity

We view Fortum's liquidity as adequate. This is based on our estimate that its liquidity resources, including cash, FFO, and facility availability, will cover expected cash outflow by more than 1.2x as per our criteria in the 12 months started March 31, 2022.

Principal liquidity sources and uses for the group as of March 31, 2022, on a stand-alone basis are not available publicly. Fortum's liquidity continues to be supported by the group's access to capital markets and sound banking relationships. Our view of the group's sound banking relationships was further supported by our discussions with some of the group's banks. Alongside the long-term credit lines, we note Fortum's access to shorter-term credit facilities. Its debt documents do not contain any financial covenants. We also note that Fortum signed a new agreement on a €5.5 billion revolving credit facility in June 2022, partly replacing the €3.9 billion of undrawn facilities as of March 2022 and maturing after 12 months. Fortum's next bond maturities are €1 billion in September 2022 and €1 billion in February 2023.

Environmental, Social, And Governance

ESG credit indicators: E-4; S-2; G-3

We will be monitoring Fortum's updated strategy and the evolution of Uniper's ownership to reassess our view of Fortum's ESG credit indicators.

Environmental factors are a negative consideration in our credit rating analysis of Fortum, given its relatively high carbon footprint, which has materially increased with the Uniper acquisition. Its carbon intensity increased to 287 grams of CO₂ per gigawatt hour (gCO₂/GWh) in 2020 from 180 gCO₂/GWh in 2019. The generation mix is skewed toward thermal sources, with 73% of 2020 installed capacity stemming from gas and coal (54% if we consider power production).

Fortum targets carbon neutrality of its European generation fleet by 2035 and its entire generation fleet (including Russia) by 2050. It is still unclear how Fortum will decrease carbon emissions notably in Russia. Fortum's ownership in the German company Uniper exposes it to more thermal generation and environmental risks in the rapidly evolving German market.

Governance factors are a moderately negative consideration. We revised downward our management and governance assessment for the company to fair, following the Uniper acquisition in 2018, because we find it difficult to reconcile the transaction with Fortum's plan to be one of the leading green generators.

Ratings Score Snapshot

Issuer Credit Rating	BBB/Negative/A-2
Business risk:	Satisfactory
Country risk	Low
Industry risk	Moderately high
Competitive position	Satisfactory
Financial risk:	Intermediate

Issuer Credit Rating	BBB/Negative/A-2
Cash flow/leverage	Intermediate
Anchor	bbb-
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bbb-
Group credit profile	bbb-
Related government rating	AA+
Likelihood of government support	Moderate (+1 notch)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Research Update: Uniper 'BBB-' Ratings Affirmed Following German Government Support Package; Outlook Negative, July 29, 2022
- Research Update: Uniper And Fortum Ratings Placed On CreditWatch Negative As Earnings And Liquidity Are Hit By Russian Gas Import Cut, July 5, 2022

Ratings List

Ratings Affirmed; CreditWatch Action

	To	From
Fortum Oyj		
Issuer Credit Rating	BBB/Negative/A-2	BBB/Watch Neg/A-2
Fortum Oyj		
Senior Unsecured	BBB	BBB/Watch Neg

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

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