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Research Update:

Fortum Downgraded To 'BBB' On Weakening Credit Metrics After Its Acquisition Of About 47% Of Uniper; Outlook Negative

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Overview

- The first acceptance period for Finnish power generator Fortum's non-binding offer for Uniper's shares ended on Jan. 16, 2018, resulting in Fortum now owning about 47% of Uniper's share capital.
- Consequently, Fortum's leverage has increased materially, reflected in our expectation that Fortum's adjusted funds from operations to debt will drop to below 25.0% in 2018 from 56.1% in 2016 and that its adjusted debt to EBITDA will jump to about 3.4x in 2018 from 1.4x in 2016.
- We are therefore lowering our rating on Fortum to 'BBB' from 'BBB+'.
- The outlook is negative, pointing to the uncertainty on the steps Fortum may take to strengthen its balance sheet and how it will manage its investment in Uniper, as well as our concerns about the group's industrial strategy and financial policy given Uniper's negative reaction to Fortum's investment.

Rating Action

On Jan. 18, 2018, S&P Global Ratings lowered its long-term corporate credit rating on Finnish power generator Fortum Oyj to 'BBB' from 'BBB+'. The outlook is negative. We affirmed the short-term rating at 'A-2'.

At the same time, we lowered our issue rating on Fortum's senior unsecured debt to 'BBB' from 'BBB+'.

We have removed all the ratings from CreditWatch with negative implications, where we placed them on Sept. 22, 2017 (see "Fortum Oyj 'BBB+/A-2' Ratings Placed On CreditWatch Negative On Possible Adverse Impacts Of Planned Uniper Acquisition," published on RatingsDirect).

Rationale

The downgrade reflects our expectation of a pronounced weakening in Fortum's credit metrics following the group's Jan. 9, 2018, announcement of its acquisition of 46.65% in German energy company Uniper SE from German utility E.ON. This transaction corresponds to a cash outflow of about €3.76 billion, according to our estimates, that will likely occur in mid-2018, once all the regulatory approvals are received. We assume that the approximately €1.40 billion of S&P Global Ratings-adjusted EBITDA Fortum will have generated in

2017 will jump to about €1.55 billion in 2018. However, we expect Fortum's credit metrics, considering Uniper as an equity affiliate, to weaken substantially. We project a decrease of adjusted funds from operations to debt to below 25.0% in 2018, from 56.1% in 2016, and an increase in adjusted debt to EBITDA to about 3.4x in 2018 from 1.4x in 2016. In 2016, Uniper generated S&P Global Ratings-adjusted EBITDA of about €2.1 billion, which we forecast will decrease to €1.6 billion-€1.9 billion in 2017-2018.

On Sept. 20, 2017, Fortum announced its intention to acquire E.ON's 46.65% stake in Uniper and additional shares tendered by other shareholders through two different acceptance periods. The first acceptance period started Nov. 7, 2017, and ended Jan. 16, 2018; the second will start Jan. 20, 2018, and end Feb. 2, 2018.

In addition to the weakening credit metrics, we see three main areas of uncertainty related to the Uniper deal:

- Group industrial and financial policy: It is currently unclear whether or not Fortum will increase its stake in Uniper by 2022 and if more investors will ultimately accept the offer by the end of the second acceptance period (Feb. 2, 2018). Because Uniper's share price remains above Fortum's offer, we believe the acceptance level will not materially increase during the remainder of the acceptance period. We note that, since the beginning of the tender offer, Uniper has taken measures to avert a takeover by Fortum.
- Investment in Uniper: With its current stake of about 47%, Fortum could name one director to Uniper's supervisory board if the regulatory approval is received before Uniper's annual general meeting on June 6, 2018. If Fortum's stake in Uniper remained at about 50% over the coming years, Fortum would not have the formal power to influence Uniper's strategic decisions or dividend policy. In 2022, once Uniper's supervisory board is renewed, Fortum, given its current stake, could gain the absolute majority.
- Uncertainty regarding remedies: As of today, Fortum has not announced plans to significantly strengthen its balance sheet. Absent any measures, however, we expect the group to remain above its key financial policy target of comparable net debt to EBITDA of 2.5x, at least until 2020.

Because we treat Fortum's stake of about 47% in Uniper as a financial investment, in our base-case scenario, we have consolidated Uniper in Fortum's balance sheet using the equity method. In addition to the purchase of E.ON's 46.65%, Fortum's offer of €22 per share was accepted only by a minority of Uniper's other shareholders. We also note that 10 shareholders, including Elliot Mangement (with a stake of about 7%) and Monaco-based hedge fund Knight Winke (about 5%), currently control about 23% of Uniper's share capital. This could be a blocking minority shareholder base at the annual general meeting in June if they agree to work together. As per German law governing the Frankfurt stock exchange, Fortum would only have full control if it achieves 75% of the share capital or voting rights in Uniper.

We believe the details regarding the aforementioned areas of uncertainty may continue to evolve, and that our view could change as well, depending on the ultimate percentage of ownership, as well as Fortum's ultimate influence on Uniper and the overall strategy. Given these uncertainties, we have reassessed Fortum's management and governance as fair versus satisfactory previously. Furthermore, we would proportionally consolidate Uniper in Fortum's accounts should the group increase its stake in Uniper markedly above 50%, and we would fully consolidate Uniper should Fortum increase its stake above 75%. Yet, we do not expect our potential change in the consolidation approach to lead to different rating conclusions. We recognize, however, that a higher ownership would likely imply more leverage and therefore weaker credit metrics, ultimately constraining the rating further.

In our base case for Fortum for 2018-2020, we assume:
- Finland's average GDP growth rate to be 1.4%.
- Finland's CPI growth rate, in line with GDP growth of 1.3% on average.
- Approximately €3.8 billion for the Uniper deal to be fully funded by cash, with the cash outflow expected in mid-2018, once all the regulatory approvals are received.
- Consolidation of Uniper in Fortum's accounts under the equity method.
- Revenue growth of about 23%, 16%, and 5% in 2017, 2018 and 2019, respectively. Strong revenue growth mainly due to higher power prices, larger volumes, and a strengthened Russian ruble.
- The generation segment's Nordic generation hedges: approximately 50% hedged at €28 per megawatt hour (/MWh) for 2018 and approximately 30% hedged at €24/MWh for 2019, with EBITDA margins in the 30%-35% range.
- Average capital expenditures of €520 million.
- Dividends received from equity-associated companies to gradually increase to more than €250 million in 2021 from about €150 million in 2018.
- Proceeds from sales of subsidiaries during third-quarter 2017, include the sale of the Polish gas infrastructure company DUON Dystrybucja S.A for €53 million.
- Proceeds from sales of associated companies and joint ventures during the same period, including the sale of Hafslund ASA shares for €687 million.

Based on these assumptions, we arrive at the following adjusted credit measures over 2018-2019:
- FFO to debt of 23%-24%.
- Debt to EBITDA of 3.3x-3.4x.
- FOCF to debt of 13% on average.

Our rating on Fortum continues to incorporate a one-notch uplift for our view of a moderate likelihood of extraordinary government support if needed, based on Fortum's:
- Strong link with the government, given Finland's 50.8% ownership of the company. We believe that the government is likely to retain its majority stake in Fortum because the government has categorized the group as a strategically important entity; and
- Limited role for the government. Notwithstanding Fortum's position as the owner and operator of a sizable share of Finland's nuclear power

capacity, we consider that the group operates in a liberalized electricity market, and that many of its services could be provided by a private-sector entity or another GRE.

Liquidity

We view Fortum's liquidity as strong. This is based on our estimate that its liquidity resources, including cash, FFO, and facility availability, will cover expected cash outflows by at least 1.5x in the next 12 months and more than 1.0x in the following 12 months. Fortum's liquidity continues to be supported by the group's strong standing in capital markets and sound banking relationships. Its debt documents do not contain any financial covenants. With regard to the Uniper acquisition, we note Fortum's commitment to the current liquidity level, with its negotiation of a €12 billion liquidity facility with 10 international banks.

Principal liquidity sources:

- Reported cash and equivalents of around €3.9 billion as of Sept. 30, 2017;
- Access to an undrawn long-term committed facility of €1.75 billion maturing in July 2021, which contains no financial covenants;
- Positive cash FFO, which we estimate will near €1.2 billion in the next 12 months; and
- €187 million of proceeds from asset disposals.

Principal liquidity uses:

- Debt of about €0.8 billion maturing in the next 12 months, and about €0.8 billion in the following 12 months;
- Negative working capital evolution of about €50 million in the next 12 months;
- Annual capital expenditures of about €0.7 billion in the next 12 months and €0.6 billion in the subsequent 12 months;
- Dividends of about €1 billion in the next 12 months; and
- A cash outlay of about €3.8 billion linked to the Uniper acquisition, likely to occur in mid-2018, once all the regulatory approvals are received.

Outlook

The negative outlook on Fortum chiefly reflects our view that, following its acquisition of a stake of about 47% in Uniper for around €3.8 billion, the possible remedies to strengthen the balance sheet remain unclear and the time to implement them might extend beyond our two-year outlook horizon. All things remaining equal, Fortum's credit metrics are already tight at the current 'BBB' rating level, with adjusted FFO to debt below 25% over 2018-2019.

The negative outlook also reflects the unclear strategy with respect to how Fortum will manage its investment in Uniper. Notably, this will depend on whether or not the group wants to increase its Uniper stake over the next two years or leave it at the current level in the longer term, with Uniper accounted for as a financial investment in its balance sheet. Finally, the negative outlook reflects our uncertainty about the group's industrial strategy and financial policy, given the so far negative reaction of Uniper's management to a change of control.

Downside scenario

We could lower the ratings further if Fortum's credit metrics weaken further, notably with FFO to debt declining and remaining below the threshold of about 25% over the next two years. In particular, this could stem from Fortum materially increasing its stake in Uniper to above 75%, which would markedly increase Fortum's leverage, absent any significant financial remedies. Furthermore, a negative reassessment of the likelihood of timely and sufficient state support in the event of financial distress could lead us downgrade Fortum. This could occur if the government of Finland reduces its stake below 50.1% (currently being at 50.8%), which we consider unlikely at this stage.

Upside scenario

We could revise the outlook on Fortum to stable if we expect the group's FFO to debt to steady at about 25% over the next two years. In particular, this could arise if Fortum does not increase its stake in Uniper to well above 50% over the next two years, it increases its industrial cooperation with Uniper, or it provides clarity on the strategy and future profile of the combined entity.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Negative/A-2

Business risk: Satisfactory
- Country risk: Intermediate
- Industry risk: Moderately High Risk
- Competitive position: Strong

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers
- Diversification/Portfolio effect: Neutral(no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable ratings analysis: Neutral (no impact)

Stand-alone credit profile: bbb-
- Sovereign rating: AA+/Stable/A-1+

- Likelihood of government support: Moderate (+1 notch from SACP)

Issue Ratings

Subordination risk analysis

Capital structure

Fortum's capital structure consists of senior unsecured debt issued at the parent level.

Analytical conclusions

The issue rating on Fortum's senior unsecured debt is 'BBB', in line with the corporate credit rating, as no significant elements of subordination risk are present in the capital structure.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- German Energy Company Uniper Ratings Unchanged Following Completed Disposal Of Yuzhno-Russkoye Gas Field, Dec. 1, 2017
- Fortum Oyj 'BBB+/A-2' Ratings Placed On CreditWatch Negative On Possible Adverse Impacts Of Planned Uniper Acquisition, Sept. 22, 2017
- German Energy Company Uniper 'BBB-' Ratings Affirmed; Outlook Remains

Positive Despite Potential Acquisition By Fortum Sept. 22, 2017

Ratings List

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

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

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