

Research Update:

**Fortum Affirmed At 'BBB' Following
Final Outcome Of Takeover Offer For
Uniper; Outlook Remains Negative**

Primary Credit Analyst:

Massimo Schiavo, Paris +33 144206718; Massimo.Schiavo@spglobal.com

Secondary Contact:

Alf Stenqvist, Stockholm (46) 8-440-5925; alf.stenqvist@spglobal.com

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Overview

- On Feb. 7, 2018, Fortum announced the final outcome of its public takeover offer for Uniper SE, resulting in 47.12% of the share capital and the voting rights of Uniper being tendered, corresponding to a cash outflow of about €3.8 billion.
- The acquisition, still subject to regulatory approvals, will increase Fortum's leverage materially. We now project Fortum's adjusted funds from operations to debt will drop to well below 25% in 2018 from 56% in 2016, and its adjusted debt to EBITDA will jump to almost 4.0x in 2018 from 1.4x in 2016.
- We are affirming our ratings on Fortum at 'BBB/A-2'.
- The outlook remains 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.

Rating Action

On Feb. 16, 2018, S&P Global Ratings affirmed its 'BBB' long-term and 'A-2' short-term issuer credit ratings on Finnish power generator Fortum Oyj. The outlook is negative.

At the same time, we affirmed our 'BBB' issue rating on Fortum's senior unsecured debt.

Rationale

The affirmation follows the announcement of the outcome of Fortum's public takeover offer for Uniper SE. The result is a tender of 47.12% of the share capital and the voting rights of Uniper on Feb. 7, 2018, as we expected in our previous review (see "Fortum Downgraded To 'BBB' On Weakening Credit Metrics After Its Acquisition Of About 47% Of Uniper; Outlook Negative," published Jan. 18, 2018, on RatingsDirect).

Following completion of the €3.8 billion acquisition--which is subject to regulatory approvals that will likely happen in mid-2018--we anticipate that Fortum's leverage will increase significantly. Our updated forecasts, including a review of full-year 2017 results, point to an S&P Global

Ratings-adjusted funds from operations (FFO)-to-debt ratio well below 25% over 2018-2019. In our base case, however, we assume a gradual improvement of the ratio to about 25% by 2020. This will notably stem from improved cash flows from operations (including dividends from Uniper and other associated companies) and reduced investments.

Our 2018-2019 base-case scenario for Fortum shows credit measures below our thresholds for the current 'BBB' rating. We believe that the possible remedies to strengthen the balance sheet remain unclear and the time to implement them might extend beyond our forecast horizon through to 2020, as reflected in the negative outlook.

Fortum's 2017 operating performance was in line with our forecasts. The generation division's reported comparable EBITDA increased to €603 million last year from €527 million in 2016, thanks to slightly better achieved power price (+0.5€ per megawatt-hour [/MWh]) and strong hydrology, as we had anticipated. Fortum reported an increase in comparable EBITDA from its Russian operations to €438 million from €312 million the previous year. This is on the back of having commissioned new units and the positive effect of €31 million from the strengthened Russian ruble.

Still, we note that Fortum's reported net debt increased by about €1 billion, primarily as a result of high net investments (including restructuring of Hafslund ownership), and unchanged dividends of €977 million. Based on the group's results highlights, we estimate that adjusted FFO to debt was about 45% in 2017.

In our base case for Fortum for 2018-2019, we assume:

- Finland's average GDP growth rate of 1.4% annually.
- Finland's consumer price index growth rate, in line with GDP growth of 1.3% on average.
- Approximately €3.8 billion for the Uniper deal to be funded by cash and committed acquisition facilities, 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, as Fortum neither has a majority share of nor control over Uniper.
- Revenue growth of about 16% in 2018 and 5% in 2019. Strong revenue growth mainly due to higher power prices, larger volumes, and a strengthened Russian ruble.
- The generation segment's Nordic generation hedges: approximately 70% hedged at €28/MWh for 2018 and approximately 40% hedged at €25/MWh for 2019, with EBITDA margins in the 30%-35% range.
- Average capital expenditures of €600 million.
- Dividends received from equity-associated companies to gradually increase to more than €250 million in 2020 from about €150 million in 2018, according to our estimates.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures over 2018-2019:

- FFO to debt of 21%-22%.
- Debt to EBITDA of 3.7x-3.8x.

- FOCF to debt of 12% 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.

A negative reassessment of the likelihood of extraordinary government support would likely lead to a one-notch downgrade of 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.

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, an example of which is its negotiation of a €12 billion liquidity facility with 10 international banks. We assume that Fortum would make available an amount of at least equivalent to the Uniper acquisition cost under the facility.

Forecast principal liquidity sources as of Dec. 31, 2017:

- Cash and cash equivalents of about €3.7 billion, excluding restricted cash;
- Access to an undrawn long-term committed facility of €1.75 billion maturing in July 2021, which contains no financial covenants;
- Availability under acquisition facility of at least €3.8 billion; and
- Positive cash FFO, which we estimate will near €1.3 billion in the next 12 months.

Forecasted principal liquidity uses as of Dec. 31, 2017:

- Debt of about €0.8 billion maturing in the next 12 months, and about €0.8 billion in the following 12 months;
- Annual capital expenditures of about €0.7 billion in the next 12 months and €0.5 billion in the subsequent 12 months;
- €3.8 billion for the Uniper deal in mid-2018; and
- Dividends of about €1 billion in the next 12 months.

Outlook

The negative outlook on Fortum chiefly reflects our view that, following its acquisition of a stake of 47.12% 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 forecast horizon, resulting in credit metrics we deem incommensurate for the current rating. All things remaining equal, our forecasts indicate that Fortum's credit metrics will be below our medium- to longer-term expectations for the 'BBB' rating, including adjusted FFO to debt well below 25% over 2018-2019. This also means that Fortum has practically no headroom for any financial underperformance against our forecasts.

The negative outlook also reflects the uncertainty regarding 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.

Downside scenario

We could lower the ratings if Fortum's credit metrics weaken below our expectations, notably with FFO to debt declining and remaining below 20% over the next two years, or if there aren't signs of a recovery toward about 25% in 2020, a level we view in line with the current ratings over the medium to longer term. 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.

Upside scenario

We could revise the outlook on Fortum to stable if we believe that the group's leverage is gradually declining in line with management's stated intentions, and that adjusted FFO to debt ratio has a clear trajectory toward about 25% by 2020. This could also be supported by Fortum not increasing its stake in Uniper to well above 50% and providing clarity on the strategy and future profile of the relationship with Uniper.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Negative/A-2

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Moderately high
- 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 issuer 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

- Fortum Downgraded To 'BBB' On Weakening Credit Metrics After Its Acquisition Of About 47% Of Uniper; Outlook Negative, Jan. 18, 2018
- German Energy Company Uniper 'BBB-' Ratings Affirmed; Outlook Remains Positive, Jan. 18, 2018
- 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

Ratings List

Ratings Affirmed

Fortum Oyj

Issuer Credit Rating
Senior Unsecured

BBB/Negative/A-2
BBB

Additional Contact:

Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

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. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the 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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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