

# FITCH DOWNGRADES FORTUM TO 'BBB'; STABLE OUTLOOK

Fitch Ratings-London/Warsaw-28 June 2018: Fitch Ratings has downgraded Finland-based Fortum Oyj's Long-Term Issuer Default Rating (IDR) to 'BBB' from 'BBB+', senior unsecured rating to 'BBB' from 'BBB+' and Short-Term IDR to 'F3' from 'F2'. The IDRs and senior unsecured rating have been removed from Rating Watch Negative (RWN), and the Long-Term IDR has been assigned a Stable Outlook.

The ratings downgrade reflects the completion of the acquisition of a 47.35% stake in Uniper SE, which has changed Fortum's business profile and raised its leverage. As a result of this transaction, we estimate that about 12% of Fortum's cash flows will come from Uniper's dividends. Further to this, about a quarter of Fortum's cash flows will come from its Russian operations, and about 45% will be linked to Nordic generation.

Fortum continues to benefit from a strong and well-managed generation fleet; however, it remains exposed to power price fluctuations, which increase the volatility of its earnings. We assume some improvement in the Nordpool power price environment over the next five years; however, under current assumptions, we see no rating headroom for Fortum at 'BBB'.

## KEY RATING DRIVERS

**Uniper's Largest Shareholder:** On 26 June 2018, Fortum announced the acquisition of a 47.35% shareholding in Uniper from E.ON SE (BBB+/Rating Watch Negative) for a total consideration of EUR3.7 billion, paid for with EUR1.95 billion of cash and EUR1.75 billion in bridge loan financing from committed credit facilities. Fortum has become the largest shareholder in Uniper and will treat it as an associated company. The company is allowed to purchase additional shares up to 50% (maximum Russian regulatory approval).

**Uniper Transaction Impact:** Fitch will treat Uniper as a financial investment and will therefore adjust Fortum's funds from operations (FFO) calculation to reflect Uniper's estimated dividends, which we will consider as recurring. Both Fortum and Uniper are exposed to power prices, Swedish nuclear developments and the Russian regulatory environment. Consequently, we believe that risks associated with these factors will have a higher effect on Fortum, indirectly also taking into account Uniper's exposure. Our rating case assumes that Fortum will not attempt to materially increase its stake in Uniper in the short term.

**No Rating Headroom:** Following the completion of the transaction and as previously anticipated, the agency has set Fortum's negative rating guideline at 3.8x FFO net adjusted leverage for the 'BBB' rating level. We estimate that all rating headroom at the 'BBB' level is eliminated, reflecting our forecast for leverage slightly above the guideline over the next two years. However, this is also due to our assumption that Fortum will maintain constant dividends despite the shift in business profile. We believe that Fortum has some flexibility over its dividends should the company wish to protect its balance sheet; we have therefore assigned a Stable Outlook after the downgrade.

**Evolving Strategy:** Fortum's strategy has been evolving since the disposal of its Nordic network assets, and the strategic target of carrying out at least one sizeable acquisition has been executed through the Uniper investment. The other strategic cornerstones outline Fortum's focus on growth in wind and solar, growth in City and Consumer Solutions (heating, cooling, recycling and waste management solutions as well as digital energy-related solutions), and new start-ups/innovation. In our estimates, we expect a 6% compound annual growth rate (CAGR) from City Solutions and a 20% CAGR in Consumer Solutions, both organically and through announced acquisitions.

**Russia Increases Business Risk:** Fortum's assets in Russia compare well with peers' thanks to the high percentage of newly commissioned assets to the fleet and the strategic location of its plants in strong industrial zones. However, Fitch views the rating upside for Russian utilities as restricted by the regulatory and operating environment. With about a quarter of EBITDA generated by its Russian unit, we evaluate Fortum's profile as riskier than other Nordic peers'. The Russian operations are also exposed to exchange rate risk. We estimate that a 25% depreciation in the EUR/RUB rate would have a 7% negative impact on earnings.

**Power Prices:** We assume that Nordpool power prices will increase to about EUR28/MWh by 2021 in order to reflect higher carbon dioxide prices, improved interconnector capacity and a potentially better power price environment in Germany as the nuclear plants are coming offline by 2022. We also assume that Fortum will continue to achieve a slight premium to system prices thanks to the strategic location of its power plants relative to area prices but also through efficient hedging. Nonetheless, Nordpool power prices remain more volatile than many EU areas due to the high proportion of hydro in the generation mix, which can oscillate by up to 40TWh depending on reservoir levels.

**Strong Nuclear Fleet:** In 2017, Fortum generated 23TWh from its nuclear plants with an aggregate load factor of over 80%. It owns the Loviisa power plant in Finland and is a shareholder in three other nuclear plants in Finland (Olkiluoto) and Sweden (Oskarshamn and Forsmark). The infrastructure for nuclear decommissioning is well established in the Nordic region, based on very detailed cost estimates. There are already solutions for the final storage sites for which funds are transparently accumulated and segregated externally. Liabilities are updated every third year; those in Sweden have just been updated in 2017, while the last update in Finland was in 2016.

## DERIVATION SUMMARY

The percentage of earnings from power generation is higher for Fortum than most utilities peers (for example, Sweden's Vattenfall AB; BBB+/Stable). However, this fact is mitigated by Fortum's good-quality fleet of mostly hydro and nuclear with high historical load factors, particularly in Finland. Following the disposal of the regulated networks, we see Fortum as less integrated than peers. Compared with Statkraft AS (BBB+/Stable), Fortum has a more diversified portfolio. However, a quarter to a third of Fortum's cash flows are generated in Russia, which limits its overall debt capacity compared with Statkraft. We assess Fortum as having moderate to weak links with 50.1% shareholder the Finnish state (AA+/Stable) under our Government-Related Entities criteria, resulting in no uplift to the company's rating.

## KEY ASSUMPTIONS

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

- Fortum will continue to achieve a small premium over the Nordpool power price
- Slightly improving trend in Nordpool power prices to about EUR28/MWh in 2021
- EUR/RUB exchange rate of 69

## RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

Rating upside is limited due to the risks related to the integration of the Uniper business and the incremental debt related to the acquisition. However, developments that could lead to a positive rating action include:

- FFO adjusted net leverage below 3.0x on a sustained basis and FFO fixed charge cover above 6.0x on a sustained basis

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 3.8x on a sustained basis
- FFO fixed charge cover below 4.0x on a sustained basis
- a significant deterioration of the political, economic or regulatory environment in Russia

- a significant structural decline in Nordpool power prices

## LIQUIDITY

Adequate Liquidity: As at 26 June 2018, cash and short-term investments stood at EUR950 million, and committed unused credit facilities at EUR1.8 billion maturing in 2023. This liquidity position is post-acquisition of the 47.35% shareholding. Fortum has used both available cash of EUR1.95 billion and the EUR1.75 billion bridge loan due in 2021 for the Uniper transaction of EUR3.7 billion. We expect Fortum to remain free cash flow-negative during the next few years due to ongoing projects. However, we believe short-term liquidity will remain manageable, backed by committed credit facilities.

## FULL LIST OF RATING ACTIONS

Fortum Oyj

- Long-Term IDR downgraded to 'BBB' from 'BBB+' and removed from Rating Watch Negative (RWN); Stable Outlook assigned
- Senior unsecured rating downgraded to 'BBB' from 'BBB+' and removed from RWN
- Short-Term IDR downgraded to 'F3' from 'F2' and removed from RWN

Contact:

Principal Analyst

Harry Monthen

Analyst

+44 20 3530 1247

Supervisory Analyst

Victoria Munarriz

Associate Director

+44 20 3530 1419

Fitch Ratings Limited

30 North Colonnade

London E14 5GN

Committee Chairperson

Arkadiusz Wicik

Senior Director

+48 22 338 62 86

Media Relations: Adrian Simpson, London, Tel: +44 203 530 1010, Email:

[adrian.simpson@fitchratings.com](mailto:adrian.simpson@fitchratings.com).

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Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018)

<https://www.fitchratings.com/site/re/10023785>

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)

<https://www.fitchratings.com/site/re/10024585>

Government-Related Entities Rating Criteria (pub. 07 Feb 2018)

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