

Research Update:

Fortum Oyj 'BBB' Rating Affirmed On Russian Regulatory Approval; Outlook Negative As Material Uncertainties Remain

March 19, 2020

Rating Action Overview

- We expect Finnish power group Fortum Oyj to increase its stake in Uniper SE to 69.6% from 49.99%, now it has achieved all of the necessary regulatory approvals. The second tranche, a minimum of 1.0% and a maximum of 3.8% of shares, is due to be closed within two months after the first tranche's closure. With the approximately €2.3 billion transaction up to a maximum of €2.6 billion, Fortum adds significant scale to its power-generation portfolio.
- Over 2020 and 2021, we expect Fortum to undertake significant credit remedy measures, including continued material asset disposals and flexibility to substantially reduce capital expenditure (capex), to strengthen its balance sheet to a level required to maintain the current rating. This shows Fortum's strong commitment to the current rating.
- We are affirming our 'BBB' long-term issuer credit rating on Fortum.
- The negative outlook reflects volatile market conditions, declining power prices, and the execution risk related to Fortum's ongoing strategic review, which we expect will lead to disposals.

Rating Action Rationale

Fortum will increase its stake in Uniper to above 70%, becoming one of Europe's largest power generators, but still not directly controlling Uniper. We expect Fortum will pay about €2.3 billion up to a maximum of €2.6 billion for the combined shareholding, corresponding to €29.93 per share, which compares with an average acquisition price of €23.97 per share for the whole stake. As the transaction will be fully cash financed, we expect Fortum's S&P Global Ratings-adjusted debt will increase to about €8.4 billion, up from €6.5 billion at year-end 2019. We understand Fortum has already secured ample underwritten credit facilities, which we view positively in terms of liquidity. We will fully consolidate Uniper in Fortum's accounts once the transaction closes.

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The transaction provides Fortum with significant scale and geographic diversification, and could improve operating efficiency, because the combined group will have greater fleet optionality. The combined generating capacity will be larger than all European peers except EDF.

We expect the combined nuclear and hydro fleets will improve Fortum's base load capacity and therefore its positioning in the merit order, because it will have greater priority in power dispatching. Additionally, Fortum will have some exposure to the midstream business, which provides some business line diversity in key markets such as Russia, Sweden, and Germany. At the same time, despite having a stake of about 70% in Uniper, and after investing more than €6 billion in total to acquire the stake, Fortum will not be able to directly control Uniper. As a result, Fortum will have limited influence on Uniper's strategic decisions.

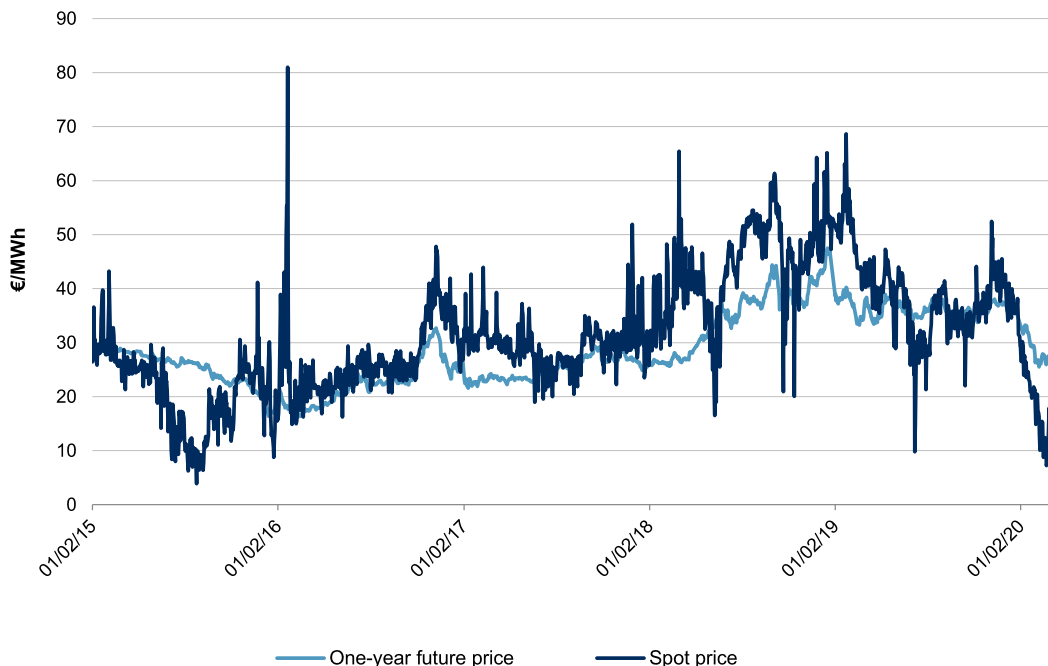
We understand Fortum will require proportionate board representation at Uniper's annual general meeting in May 2020, but to achieve direct control it will need to launch a domination agreement for the remainder (about 30%) of Uniper's share capital. In our base case, we expect Fortum will not launch a domination agreement before end-2021.

Fortum is strongly committed to maintaining the current rating, and delivery on the disposal plan will be key to achieving that goal. In 2019, Fortum announced, with final closing in 2020, the disposal of its district heating business in Joensuu and sold a stake of 80% in its Nordic wind portfolio for a total consideration of €780 million. In January 2020, Fortum announced its intention to extend the strategic assessment, including potential disposals, to include district heating and cooling businesses in all Baltic countries, in Poland, and in Järvenpää, Finland. These disposals alone will not be sufficient to maintain the current credit rating. We therefore expect Fortum to enact other significant remedy measures in order to achieve the adjusted funds from operations (FFO) to debt of 35%, and debt to EBITDA of below 2.5x, which are required for maintaining the rating in 2021. We forecast FFO in the range of €2.4 billion–€2.5 billion for 2020 and 2021; this suggests that Fortum would need to lower its debt by about €2 billion in 2021 to achieve FFO to debt of about 35% in 2021. We believe this is achievable, combining free cash flow after capital expenditure (capex), dividends, and continued assets sales. While we acknowledge Fortum's strong, public commitment to maintaining the 'BBB' rating and its capacity to eventually reduce capex or dividends, we also note that current market conditions mean there is a risk that disposals could face delay, or the expected proceeds could be reduced.

2019 results were above our expectations thanks to power prices, which now are falling. In 2019, Fortum reported results above our previous expectations, owing to better-than-expected power prices, with EBITDA increasing 5% year on year to €1,766 million, compared with €1,675 million in 2018. As a result, adjusted FFO to debt was at 25.7%, compared with our expectation of 24.2%. However, Nordic power prices have been weak year-to-date. Spot prices are at three-year lows, and forward prices down about 20% since the start of 2020 (at about €25 per megawatt hour, or /MWh, for 2021). Fortum is 75% hedged for 2020 at €34/MWh and 40% for 2021 at €33/MWh, which offers support for this year's achieved price, but marking-to-market current forwards still pose some earnings downside. In particular, should the power prices remain at the current weak level, we expect an annual EBITDA effect on Fortum of about €100 million in 2021. In the longer term, low power prices could mean much lower cash flow generation for an almost pure player in the electricity and gas markets.

Chart 1

Nord Pool Power Prices



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Strategic uncertainties could create additional downside risks. On March 2, 2020, Pekka Lundmark stepped down as CEO of Fortum, with a six-month notice period. This departure creates additional uncertainty in a crucial period where Fortum needs to execute its disposal strategy and when the company should accelerate its discussions with Uniper, despite not having the direct control. In addition, in our view, the Uniper acquisition creates the following downside risks to Fortum:

- The addition of Uniper's assets increases Fortum's carbon footprint substantially. Previously, Fortum had been among the lowest carbon generators in Europe, but Uniper owns a significant fossil generation fleet (29 gigawatts of capacity). In our opinion, Fortum's generation mix will shift to a higher share of coal and gas, comparing unfavourably with sizable generators such as Orsted (100% offshore wind) and EDP (39% wind and solar sources). This weakens Fortum's competitive advantage somewhat, in terms of the energy transition;
- Fortum's profile will evolve as a pure generator, as most of its earnings will be merchant-exposed, with inherent volatility risks associated with its predominantly thermal-generation fleet (74% combined capacity estimated post-transaction) and its existing hydro/nuclear fleet. This leaves Fortum's earnings exposed to fluctuating power prices in three main pools: the Nordics, Germany, and Russia. Although, in Russia, volatility is mitigated by capacity supply agreement contracts, Fortum is exposed to foreign exchange risk. Fortum's profile as a pure generator compares unfavorably with European peers, notably CEZ and

Verbund (which have higher shares of regulated activities-- about 35% and 20%, respectively);
and

- Fortum will be exposed to Uniper's sizable commodities business, which is inherently volatile, although we note Uniper's significant progress in achieving cash flow stability.

Outlook

The negative outlook on Fortum chiefly reflects our view that, following its acquisition of a stake of about 70% in Uniper (total acquisition cost more than €6 billion), Fortum's credit quality is heavily dependent on the successful execution of remedy measures to improve the balance sheet. In particular, the company has initiated a strategic review. The timing and total proceeds of disposals will be key to maintaining the current 'BBB' rating, for which we expect an adjusted FFO to debt of above 35% in 2021, coupled with an adjusted debt to EBITDA of below 2.5x. The negative outlook takes into account the uncertainty arising from volatile market conditions and COVID-19 restrictive measures across Europe, which could add complexity to the execution of the disposal plan.

Other than credit remedy measures, credit metrics' improvement relies on the power price environment, with falling power demand and prices in the Nordic region. We have factored an EBITDA decline in 2020 and 2021 of about €100 million per year to reflect this within our base case, noting that Fortum has 75% and 40% of its generation production hedged for 2020 and 2021, respectively. If market conditions deviate materially from this assumption, this will negatively weigh on the ratings.

The negative outlook also reflects the lack of clarity about how Fortum will manage its investment in Uniper. In particular, while having a stake of about 70%, Fortum still does not directly control Uniper, and in our base case we expect cooperation discussions to accelerate. However, we do not expect Fortum to launch a domination agreement before November 2021. Finally, the negative outlook reflects our uncertainty about the effect of the CEO departure on the group strategy.

We will continue to monitor the Finnish government's willingness to support Fortum in case of financial distress, which currently results in a one-notch uplift from the 'bbb-' stand-alone credit rating.

Downside scenario

We could lower the ratings if Fortum's credit metrics weaken below our expectations; notably, if we see a risk that FFO to debt will remain below 35% or debt to EBITDA will remain above 2.5x in 2021.

This could stem from Fortum continuing to face declining power prices in Europe and Russia, or receiving a lower-than-expected amount in the announced disposal program, on which we do not expect any delay. Finally, this could occur should Fortum increase its stake in Uniper to well above 75%, which would markedly increase its leverage, absent any significant financial remedies.

Upside scenario

We could revise the outlook on Fortum to stable if we believe that its leverage is gradually declining in line with management's stated intentions, and that adjusted FFO to debt shows a clear trajectory toward about 35% by 2021, coupled with debt to EBITDA below 2.5x. This could

also be supported by Fortum not increasing its stake in Uniper to well above 75%, and providing clarity on the strategy and future shape of the relationship with Uniper.

Company Description

Fortum Oyj is the third-largest power generator and the largest electricity retailer in the Nordic countries after Vattenfall and Statkraft. In addition to its strong position in generation, Fortum is the second-lowest emitting generator in Europe (after Statkraft), thanks to its zero-to-low carbon dioxide (CO₂) emission fleet, with 96% of its European generation fleet being CO₂-free.

Fortum engages in the generation and sale of electricity and heat in the Nordic countries, Russia, Poland, India, other parts of the Baltic Rim area, and internationally. It has the following four segments:

- The Generation segment (51% of 2019 EBITDA) generates power through nuclear, hydro, wind, and thermal resources;
- City Solutions (16%) develops solutions in the areas of heating, cooling, waste-to-energy, biomass, and other circular economy solutions, as well as solar power production;
- Consumer Solutions (8%) engages in electricity and gas retail businesses in the Nordics and Poland, including the provision of invoicing, debt collection, and customer services, and electricity and related value-added products, as well as digital services; and
- The Russia segment (25%) generates and sells power and heat.

In 2019, Fortum reported EBITDA of €1,766 million. The company was founded in 1998 and is headquartered in Espoo, Finland. As of Dec. 31, 2019, the main shareholder is the Finnish state, with 50.76% of the share capital.

Our Base-Case Scenario

In our base case for Fortum for 2020-2021, we assume:

- Finland's average GDP growth rate of 1.0% annually;
- Finland's consumer price index growth rate of 1.4% on average;
- Consolidation of Uniper in Fortum's accounts under the full consolidation method, starting from January 1, 2020;
- Fortum's generation segment's Nordic generation hedges: approximately 75% hedged at €34/MWh for 2020, and approximately 40% hedged at €33/MWh for 2020;
- The tough power market conditions in Europe and lower power demand from COVID-19 restrictive measures having a maximum annual effect on Fortum's EBITDA of €100 million in 2020 and 2021; and
- Remedy measures to offset additional stake increase in Uniper executed on time and with proceeds not affected by current tough market conditions.

Based on these assumptions, we arrive at the following S&P Global Ratings-adjusted credit measures over 2020-2021:

(Mil. €)	2019a	2020e	2021e
EBITDA	2,008	2,900-3,100	2,900-3,100
Debt	6,478	8,000-9,000	6,000-7,000
Capex	695	1,200-1,500	1,200-1,500
Dividends	1,000	1,000-1,200	1,000-1,200
FFO to debt (%)	25.7	25.0-28.0	30.0-35.0
Debt to EBITDA (x)	3.2	2.5-3.0	2.0-2.5

a--Actual. e--Estimate. Capex--Capital expenditure. FFO--Funds from operations.

Liquidity

We assess 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 24 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.

Principal liquidity sources as of Dec. 31, 2019:

- Cash and cash equivalents of about €1,435 million, excluding restricted cash;
- Access to an undrawn long-term committed facility of €1.75 billion maturing in June 2023, which contains no financial covenants;
- Access to €5.3 billion committed undrawn facilities related to the Uniper acquisition, maturing after one year;
- Positive cash FFO, which we estimate will near €2.4 billion in the next 12 months; and
- Working capital inflows in the amount of about €170 million in the next 12 months.

Principal liquidity uses as of Dec. 31, 2019:

- Debt of about €556 million maturing in the next 12 months, and about €526 million in the following 12 months;
- Annual capex of about €1,500 million;
- Acquisition of a 25% stake in Uniper for about €3.0 billion; and
- Dividends of about €1 billion in the next 12 months.

Environmental, Social, And Governance

Finland-based Fortum's environmental risks are broadly in line with those of peers. On one hand, its European capacity has a zero to low-CO2 emission fleet (mostly hydro and nuclear), generating scope 1 emission of 180 CO2 per gigawatt hour (/GWh) in 2019, of which less than 26 CO2/GWh is generated in Europe. Nuclear risks and waste management, however, represent environmental and financial concerns. At the same time, nuclear companies in Finland are overfunded in terms of future waste management, and they are also well provided for in Sweden.

Fortum's approximately 70% stake ownership of German company Uniper exposes it to more thermal generation and environmental risks in the rapidly evolving German market.

Fortum's management and governance assessment was revised to fair following the Uniper acquisition because we find it difficult to reconcile with Fortum's plan to be one of the leading green generators. This could be mitigated in part by Fortum's increasing scale and diversity, as well as scope for material synergies between the two companies. On the governance side, the recently announced CEO departure creates additional uncertainty in a crucial period where Fortum needs to execute its disposal strategy and when the company should accelerate its discussions with Uniper, despite not having direct control over the company.

Issue Ratings - Subordination Risk Analysis

Capital structure

At group level, we consider €6,688 million of consolidated debt at Fortum plus the €1,107 Uniper debt as of year-end 2019. Fortum has €5,550 million at parent level and €1,107 million from Uniper at subsidiary 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.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Negative/A-2

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Moderately high
- Competitive position: Strong

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate (Standard volatility table)

Anchor: bbb-

Modifiers:

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

- Stand-alone credit profile : bbb-
- Related government rating: AA+
- Likelihood of government support: Moderate (+1 notch from SACP)

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak in June or August, and we are using this assumption in assessing the economic and credit implications of the pandemic. We believe measures to contain COVID-19 have pushed the global economy into recession and could cause a surge of defaults among nonfinancial corporate borrowers (see "COVID-19 Macroeconomic Update: The Global Recession Is Here And Now" and "COVID-19 Credit Update: The Sudden Economic Stop Will Bring Intense Credit Pressure," published on March 17). As the situation evolves, we will update our assumptions and estimates accordingly.

Related Criteria

- 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: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

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

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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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