



## RATING ACTION COMMENTARY

# Fitch Removes Fortum's Ratings from Watch Negative; Affirms at 'BBB' with a Negative Outlook

Mon 06 Apr, 2020 - 3:13 PM ET

Fitch Ratings - Milan - 06 Apr 2020: Fitch Ratings has removed Fortum Oyj's ratings from Rating Watch Negative (RWN) where they were placed in October 2019. Fitch has also affirmed the Long-Term Issuer Default Rating (IDR) at 'BBB' with a Negative Outlook and senior unsecured rating at 'BBB'.

The Negative Outlook mainly reflects the execution risk embedded in the company's deleveraging plans after it acquired a 19.6% stake in Uniper SE and the resulting full consolidation of the German utility. According to our expectations, this will lead FFO net leverage to spike to 3.3x in 2020, while market conditions will affect the deleverage pattern mainly through low power prices.

The rating affirmation mainly reflects the company's profitable hydro and nuclear assets, its strong competitive positioning in the combined group's key countries, and the management's commitment to the current rating (partially confirmed by already realized disposals). The affirmation also reflects the largely unregulated profile of

the combined group's business, its sizeable coal exposure and fairly high starting leverage.

We have tightened Fortum's leverage guidelines by 0.2x, only to mirror the reduction in the company's leverage deriving from Fitch's change in the approach towards lease transactions (now fully considered as opex with no capitalisation, compared with the previous capitalisation of the rent through a multiple).

## KEY RATING DRIVERS

Rating Approach: Fortum now owns 69.6% of Uniper, up from 49.99% before the transaction closed. This may rise by an additional 1.0%- 3.8% in a couple of months, bringing the total amount invested in Uniper up to a maximum EUR6.5 billion. Fortum now fully consolidates Uniper in its accounts and we keep the same approach for rating purposes, due to Uniper's strategic importance for the company and our opinion that Fortum soon will be adequately represented on Uniper's supervisory board, allowing it to determine its strategy.

Fortum has ruled out any domination and/or profit-and-loss transfer agreement or squeeze-out of minority shareholders until end-2021, and we assume no cash-out in this respect throughout the rating horizon. A sizeable increase of the stake held in Uniper would be credit-negative for Fortum.

Combined Business Profile: Fitch views Uniper's standalone business profile as riskier than Fortum's, due to its higher proportion of thermal capacity and exposure to CO2 prices, challenges related to coal generation (including decommissioning) and the volatile gas midstream and commodity trading business. The combined installed capacity of the group is about 50GW, of which thermal sources represent about 70%. The share of coal in total generation, currently negligible for Fortum, will represent around 12% in the combined group.

The enlarged group has very strong market positioning, in particular in Germany (second-ranked), Nordics (second) and Russia (third), with a sizeable presence also in the UK and Benelux. The group has the third-largest generation fleet in Europe, with a sizeable gas fleet, which we believe will be important in the European energy transition.

**Focus on Generation:** Both Uniper's and Fortum's EBITDA (as reported to investors) for 2019 was EUR1.5 billion-EUR1.8 billion, so they have a broadly similar weight in the assessment of the combined business risk profile. Uniper's generation business is much more exposed to thermal sources than Fortum's, a factor which is mitigated by some long-term contracts in Germany. The business in Russia, which contributes about EUR800 million EBITDA based on our estimates, has a similar fundamental risk for both companies, with margins derived mainly from capacity-supply agreements.

Uniper's commodity trading creates earnings volatility and Fitch does not assign any debt capacity to this business at investment-grade level. Electricity generation accounts for around 75% of the combined group's EBITDA, with the rest related to supply-and-trading and city solutions (mainly district heating and waste). We estimate a share of 30%-35% of contracted and incentivised EBITDA for the group.

**ESG Influence:** We updated the Energy and Fuel Management score to '4', owing a high amount of coal in the generation mix - due to the Uniper acquisition - and this leads to higher exposure to ETS price and commodities. This is one of the factors that led to a moderate tightening of the guidelines for the combined group (negative sensitivity at 3.2x, from 3.8x for Fortum standalone). We are now updating the guidelines to 3.0x, but only to reflect the change in our approach to leases; therefore there is no impact on the company's headroom.

**Deleveraging Capacity:** We expect Fortum's funds from operations (FFO) net leverage to peak at 3.3x in 2020, due to the Uniper stake acquisition, partially compensated by the cash-in of EUR780 million related to the sale of a district heating network in Finland (already closed) and Nordics wind business (agreed but not closed). We expect the company to focus on deleveraging, and in our rating case we assume that Fortum will sell the assets under strategic review (district heating networks in Baltics, Poland, and Jarvenpaa (Finland)), with leverage returning below our negative sensitivity of 3.0x in 2022.

**Weak Price Environment:** Our rating case takes into account recent electricity demand and price turmoil. This volatility in particular will hit price-taker technologies, such as hydro and nuclear, which are the largest producers for Fortum. This is mitigated by hedging transactions, covering 75% of 2020 output for Fortum and 75%-100% for Uniper; this decreases respectively to 40% and 15%-45% for 2021.

We believe the current scenario increases downside risks to our rating case, potentially through pressure on working capital and delays in concluding the strategic review of district heating networks. Our rating case does not envisage any major problem in operating the asset base. The management has flexibility to counterbalance the impact of a particularly harsh market, for example through growth- capex postponement (we include an average of EUR1.1 billion capex in 2020-2022), the sale of additional assets, cost-cutting, and dividends revision.

**Growth Plans:** Fortum's growth focuses mainly on renewables (around EUR200 million expected in 2020); the business model foresees the development of assets and the retention of a minority stake on-balance sheet, to take advantage of the company's technical know-how while limiting capital deployment. Uniper's plan foresees growth capex of more than EUR1.5 billion cumulatively in 2020-2022, related to some legacy projects (including the Datteln 4 coal-fired plant in Germany), the modernisation of the Russian fleet, and the upgrade of some thermal plants in Germany, among others.

**Solid 2019 Performance:** Both companies posted a good performance in 2019. Fortum's EBITDA rose by 16% yoy to EUR1.77 billion, mainly on higher power prices, with double-digit growth also at the FFO level. Working capital generated cash of more than EUR300 million and the company posted a positive free cash flow (FCF) of more than EUR200 million. FFO net leverage was 2.8x. Uniper posted broadly flat yoy EBITDA at EUR1.56 billion, with stable results across all divisions. FCF was broadly neutral, and at year-end 2019 the company had net cash of about EUR300 million, based on Fitch's definition.

**No GRE Impact:** Fortum is 50.8%-owned by Finland (AA+/Stable). We assess all factors under our Government-Related Entities (GRE) Ratings Criteria as 'weak' or 'moderate', resulting in no uplift to Fortum's ratings.

## **DERIVATION SUMMARY**

Compared with the wider top European utilities peer group, Fortum's share of regulated and contracted income is among the lowest. Fortum's good-quality fleet of mainly hydro and nuclear plants will weaken as a consequence of Uniper's large thermal exposure. Among Nordic peers, Statkraft AS (BBB+/Stable) benefits from its long-term contracts and low-cost hydro asset base as well as a one-notch uplift for sovereign support. EDP - Energias de Portugal S.A. (BBB-/Positive) has a higher debt

capacity due to a more defensive business mix, with networks and contracted renewables making up most activity, partially offset by a mix of weaker countries. EDP's lower rating is entirely due to higher leverage (on adjusted FFO basis 4.5x on average versus 3.2x for Fortum).

## KEY ASSUMPTIONS

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

- EBITDA (excluding IFRS 16 impact) of the new group in the range of EUR2.6 billion- EUR2.7 billion in 2020-2023
- Annual capex at around EUR1.1 billion on average in 2020-2022
- Disposal of assets currently under strategic review and other non-core assets
- Dividends distributed by Fortum at around EUR1 billion a year
- Minority dividends related to Uniper of around EUR150 million-EUR300 million

## RATING SENSITIVITIES

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

Stabilisation of the Outlook - We would affirm the rating if the company is on track to achieve FFO net leverage below 3.0x on a sustained basis, FFO interest coverage above 5.0x on a sustained basis, and in the absence of significant deterioration of the political, economic or regulatory environment in Russia or significant structural decline in Nord Pool power prices

Upgrade - Rating upside is limited due to risks related to the integration of the Uniper business and the incremental debt related to the acquisition. However we could upgrade the rating with FFO net leverage lower than 1.5x and FFO interest coverage above 6.0x, all on a sustained basis

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

- FFO net leverage above 3.0x on a sustained basis, FFO interest coverage cover below 5.0x on a sustained basis
- Significant deterioration of the political, economic or regulatory environment in Russia or significant structural decline in Nord Pool power prices
- Problems with Uniper's integration leading to a change of our view of a consolidated perimeter for the ratings and / or change in debt capacity

## BEST/WORST CASE RATING SCENARIO

Ratings of non-financial corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings <https://www.fitchratings.com/site/re/10111579>.

## LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: Fortum's reported cash and cash equivalents was EUR1.4 billion at end-December 2019, and with committed undrawn credit lines of around EUR4.6 billion (EUR2.8 billion maturing in October 2021 with a one-year extension option and EUR1.8 billion maturing in June 2023), total available liquidity was EUR6 billion. This compares with short-term maturities of EUR478 million at end-December 2019. Fortum funded the Uniper transaction, closed on 26 March 2020, through cash and additional credit facilities. Uniper's liquid funds at end-December 2019 amounted to around EUR890 million. Combined with a EUR1.8 billion available loan

facility (maturing in 2023), Uniper's liquidity is sufficient to cover short-term liabilities of around EUR200 million (excluding lease liabilities).

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG CONSIDERATIONS

Fortum Oyj has an ESG Relevance Score of 4 for Energy Management due to increased share of coal-fired power generation subject to ETS price and commodities, which has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY/DEBT	RATING		
Fortum Oyj	LT IDR	BBB	Affirmed
	ST IDR	F2	Affirmed
● senior unsecured	LT	BBB	Affirmed

[VIEW ADDITIONAL RATING DETAILS](#)

Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)

## APPLICABLE CRITERIA

[Corporates Notching and Recovery Ratings Criteria \(pub. 14 Oct 2019\) \(including rating assumption sensitivity\)](#)

[Government-Related Entities Rating Criteria \(pub. 13 Nov 2019\)](#)

[Short-Term Ratings Criteria \(pub. 06 Mar 2020\)](#)

[Corporate Rating Criteria \(pub. 27 Mar 2020\) \(including rating assumption sensitivity\)](#)

## APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

## ADDITIONAL DISCLOSURES

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Fortum Oyj

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