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Research Update:

Finnish Power Generator Fortum Oyj 'BBB' Rating Affirmed; Outlook Negative

December 18, 2020

Rating Action Overview

- Fortum's financial leverage remains high from the Uniper acquisition, resulting in limited investment capacity, given the group's aim to first restore its balance sheet.
- We see the strategic review of its consumer solutions business as Fortum's latest move to decrease debt, but believe a disposal would also reduce cash flow diversification.
- The consolidated group's large share of carbon-intensive and merchant generation assets and the lower-than-sector-average investment capacity limit its growth prospects, but we believe this is mitigated by the group's financial policy and strong commitment to the current rating level.
- We are affirming our 'BBB' long-term rating on Fortum.
- The negative outlook signals the group's limited rating headroom over 2020-2021, as Fortum continues to execute its disposal program (€1.2 billion announced so far) to reach the 35% adjusted funds from operations (FFO) to debt required for the rating. Once disposals are executed, we will need to understand the long-term prospects of the Fortum-Uniper group within the European decarbonization targets.

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Rating Action Rationale

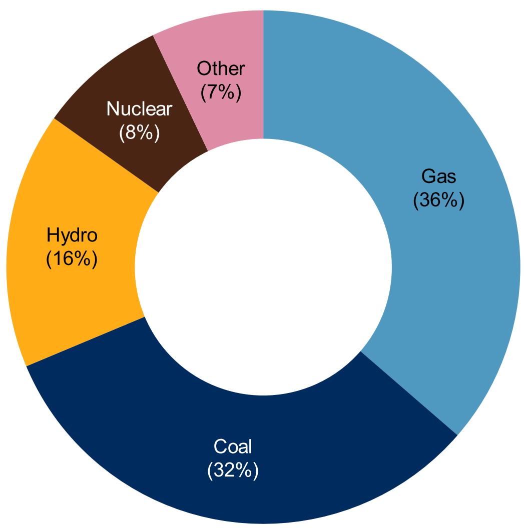
Fortum aims to decarbonize its generation fleet with limited growth capital expenditure (capex), under its new strategic plan. Fortum's carbon footprint increased significantly following the consolidation of Uniper as a subsidiary from end-March 2020, with Scope 1 emissions more than tripling from the 180 grams of carbon dioxide per gigawatt hour (gCO2/GWh) Fortum reported on a stand-alone basis at end-2020. We also acknowledge with the Uniper acquisition, Fortum increased its carbon-free generation by 60%.

Fortum aims to achieve carbon neutrality for the group at the latest by 2050, and carbon neutrality in its European generation fleet at the latest by 2035. Most emission reductions will first come from plant closures. We note the group plants to invest only €3.0 billion over 2021-2025 (about the same amount of the combined annual EBITDA), of which about 50% will go to renewables in

Europe, Russia, and India. About one-third of Fortum-Uniper's current portfolio (see chart below) stems from coal, notably in Germany, which will be mostly phased-out by 2025; and another one-third from gas, whose growth in Europe is likely over and long-term decline looks inevitable (see "As Europe's Gas Markets Slowly Stall, Gas Producers' And Utilities' Business Risks May Rise" published Nov.16, 2020, on RatingsDirect). This signals the potential for a shrinking generation asset base, with Fortum planning to install only 2 gigawatt (GW) of renewables in the next five years, while Uniper plants to phase-out 6 GW of coal (out of total coal capacity of 8 GW). As part of its new plan, Fortum also announced an increase in the dividend per share (DPS) for 2020 (€1.12 up from €1.10 in 2019). Assuming a 1% compound annual growth rate in the dividend payout over 2021 and 2025, we note 2022 dividends would be equivalent to investments. This comes at a time when most European utilities are accelerating investments to accompany the energy transition, with investments representing about 3x the dividends on average.

Chart 1

Combined Generation Split
Based on December 2019 capacity



Source: S&P Global Ratings.

The sale of its consumer solutions business slightly weakens Fortum's business risk and could create more cash-flow volatility, with a generation portfolio that is two-thirds fossil fuels. As part of the new strategic plan, Fortum has announced the strategic review of its consumer solutions business. We see this potential sale as being slightly negative for business risk. While it is a relatively small part of the business (about 9% of its 2020 expected EBITDA for Fortum on a stand-alone basis, about 5% for the combined group), it provided cash flow diversification and vertical integration.

This would leave Fortum even more exposed to declining power prices in the Nordics, with Fortum's profile as a pure generator comparing unfavorably with European peers', notably CEZ and Verbund (which have higher shares of regulated activities; about 35% and 20%, respectively). In our assessment, we take into account the announced disposal of district heating assets in the Nordic region that--despite their relatively small size compared with Fortum and Uniper's combined EBITDA--provided a stable and predictable source of cash flow. Pressure on Fortum's generation profitability could potentially weaken further post-2023, as new interconnector capacity will be added in Finland, and prices become more aligned with Nord Pool.

Fortum targets €50 million of annual synergies with Uniper by 2023, and €100 million per year by 2025. Within the new strategic plan, Fortum emphasized the acceleration of discussions with Uniper. While the estimated synergies seem achievable, we note they might only partially offset the aforementioned potential increased in pressure in the generation portfolio's earnings, stemming from the increasing interconnection capacity in Finland, with pressure on power prices post-2023.

Fortum will continue to have limited rating headroom over 2020-2021, with deleveraging that is highly dependent on disposals. In our 2020-2021 base case for Fortum, we estimate credit measures close to our thresholds for the 'BBB' rating, given that Uniper's acquisition fully eroded Fortum's financial headroom back in 2018. We see credit metrics as still weak for the rating and see some execution risk to successfully achieve targeteddebt reduction, notably related to the timing of the transactions, which we reflect in our negative outlook. Over 2020 and 2021, we expect Fortum will undertake significant credit-remedy measures, including continued material asset disposals and flexibility to substantially reduce capex, to strengthen its balance sheet to a level required to maintain the current rating. Although we understand no decision has yet been taken, in July 2020 Fortum announced that it is assessing strategic options for its 50% stake in Stockholm Exergi Holding AB. With reported EBITDA (not consolidated by Fortum) of Swedish krona (SEK)2.8 billion (about €280 million), such a disposal could accelerate credit metrics' improvement, notably taking into account high multiples for district heating assets in the Nordic region.

We also note that improvement in profits and credit metrics are also subject to a reduction in volatility in the power generation markets, both in terms of price and volume generated, in the Nordics and Russia, and no substantial devaluation of the Russian ruble. As seen in the third-quarter 2020 results, Fortum is sensitive to foreign-exchange movements, notably in Russia, with a negative foreign-exchange impact of €5 million on the comparable operating profit in the region (€40 million for third-quarter).

Fortum announced a DPS of €1.12 for 2020 (before it was at €1.10). Moreover, Fortum updated its financial target of reported financial net debt to comparable EBITDA to below 2.0x, before for Fortum on a stand-alone basis the target was adjusted net debt to EBITDA of about 2.5x. Since the new target excludes nuclear provisions and other debt adjusted at Uniper (about €2.0 billion), there is 0.7x difference between Fortum's reported and S&P Global Ratings-adjusted net debt definition for 2021.

Outlook

The negative outlook on Fortum chiefly reflects our view that, following its acquisition of a stake of about 75% in Uniper (total acquisition cost of about €6.5 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 a strategic review ongoing to which Fortum has recently added the consumer solutions business. The timing and total proceeds of disposals will be key to maintaining the '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-related 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 in an EBITDA decline in 2020 and 2021 of about €100 million per year to reflect this in our base case, noting that Fortum has 85% and 75% of its generation production hedged for 2020 and 2021, respectively. If market conditions deviate from this assumption, this will weigh on the ratings. Should Fortum sell other assets than those currently under strategic review, including the consumer solutions business, we will reassess its creditworthiness.

The negative outlook also reflects the lack of clarity on how Fortum will manage its investment in Uniper. In particular, Fortum does not directly control Uniper, and in our base case we expect cooperation discussions to accelerate, as signaled at the Dec. 3, 2020, Capital Markets Day. We do not expect Fortum to launch a domination agreement before end-2021. We will continue to monitor the Finnish government's willingness to support Fortum in case of financial distress, which currently results in one notch of uplift from the 'bbb-' stand-alone credit rating.

Downside scenario

We could lower the ratings if Fortum's credit metrics were to 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. This could also 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. The sale of the stake in Stockholm Exergi will be a key milestone in our rating assessment. This could also be supported by Fortum not increasing its stake in Uniper to well above 75%, and providing clarity on the 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 emission fleet, with 96% of its European generation fleet being carbon dioxide-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:

- Generation (47% of 2019 EBITDA): produces power through nuclear, hydro, wind, and thermal resources;
- City Solutions (18%): 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 (7%): 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
- Russia (28%): 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.

Fortum holds 75.01% in Uniper since August 2020. Uniper was created in 2016 from the spinoff of the gas and power activities of E.ON SE. It is an international, diversified energy company that operates in more than 40 countries and has about 11,000 employees. Its operations include power generation, commodity trading, energy storage, energy sales, and energy services. Its core markets are Germany, Russia, the U.K., Sweden, the Netherlands, and North America.

The company owns and operates a well-diversified power generation portfolio, including facilities running on fossil fuels such as gas (17.4 GW) and coal (9.2 GW), as well as hydroelectric (3.6 GW as of end-2019) and Swedish nuclear (1.4 GW). It has a total generation capacity of 23.5 GW based in Europe and another 10.8 GW in international generation, based in Russia. In 2019, Uniper reported adjusted EBITDA of €1,561 million (see "Uniper SE," published Aug. 31, 2020).

Our Base-Case Scenario

Assumptions

In our base case for Fortum through 2022, we assume:

- Finland's GDP will contract by about 4.5% in 2020 with a 2.3% rebound in 2021, followed by a 1.4% average growth over 2022-2023.
- The consolidation of Uniper in Fortum's accounts under the full consolidation method, starting from Jan. 1, 2020.
- Fortum's generation segment's Nordic generation hedges: approximately 85% hedged at €34 per megawatt-hours (MWh) for 2020, and approximately 75% hedged at €33/MWh for 2021.
- A challenging power market in Europe and lower power demand from pandemic-related restrictive measures, reducing Fortum's EBITDA by €100 million per year at most in 2020 and 2021.
- Remedy measures to offset additional stake increase in Uniper executed on time and with proceeds not affected by the tough market conditions.
- Divestment of the customer solutions business in 2021.
- No impact from an EU classification system for sustainable activities (EU taxonomy).
- A 1% increase of DPS over 2021-2025, starting at €1.12 in 2021.

Key metrics

	--Fiscal year end Dec, 31--				
	2018a	2019a	2020e	2021f	2022f
(Mil. €)					
EBITDA	1,567	2,008	3,000-3,200	2,700-2,900	2,900-3,100
EBITDA margin (%)	30	37	4-5	4-6	4-7
Funds from operations (FFO)	1,292	1,666	2,400-2,600	2,200-2,400	2,300-2,500
Capital expenditure	579	695	1,500-1,700	1,200-1,400	1,100-1,300
Dividends	977	1,000	1,000-1,200	1,000-1,200	1,000-1,200
Debt	6,803	6,478	8,000-9,000	6,500-7,500	6,000-7,000
Debt to EBITDA (x)	4.3	3.2	2.5-3.0	2.2-2.7	2.0-2.5
FFO to debt (%)	19.0	25.7	25-30	30-35	35-40

*All figures adjusted by S&P Global Ratings. Full consolidation of Uniper from 2020 fiscal year. a--Actual. e--Estimate. f--Forecast.

Liquidity

As of Sept. 30, 2020, we view Fortum's liquidity as strong, taking into account the company's commitment to maintaining strong liquidity. This is based on our estimate that its liquidity resources, including cash, FFO, and facility availability, will cover expected cash outflows by about 2.4x in the next 12 months and 2.0x in the next 24 months.

Fortum's liquidity, of Sept. 30, 2020, 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

- Cash and cash equivalents of about €2,474 million, excluding restricted cash;
- Access to an undrawn short-term committed facility of €1.45 billion maturing in November 2021;
- Access to €3.65 billion undrawn facilities maturing beyond 24 months; and
- Positive cash FFO, which we estimate will near €2.5 billion annually.

Principal Liquidity Uses

- Debt of about €1,410 million maturing in the next 12 months, and about €1,000 million in the following 12 months;
- Annual capex of about €1,200-€1,500 million; and
- Dividends of about €1.1 billion in the next 12 months.

Issue Ratings - Subordination Risk Analysis

Capital structure

Fortum's capital structure consists of senior unsecured debt issued at the parent level. After consolidation of Uniper as a subsidiary, the priority debt ratio is well below 30%.

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)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb-

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

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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- How Hydrogen Can Fuel The Energy Transition, Nov. 19, 2020
- As Europe's Gas Markets Slowly Stall, Gas Producers' And Utilities' Business Risks May Rise, Nov. 16, 2020
- Fortum Oyj, Nov. 9, 2020
- Teollisuuden Voima Oyj Ratings On CreditWatch Negative After Announced Additional Delay Of Up To 11 Months, Sept. 4, 2020
- Uniper SE, Aug. 31, 2020
- Fortum Oyj 'BBB' Rating Affirmed On Russian Regulatory Approval; Outlook Negative As Material Uncertainties Remain, March 19, 2020

Ratings List

Ratings Affirmed	
Fortum Oyj	
Issuer Credit Rating	BBB/Negative/A-2
Senior Unsecured	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.