

RatingsDirect®

Fortum Oyj

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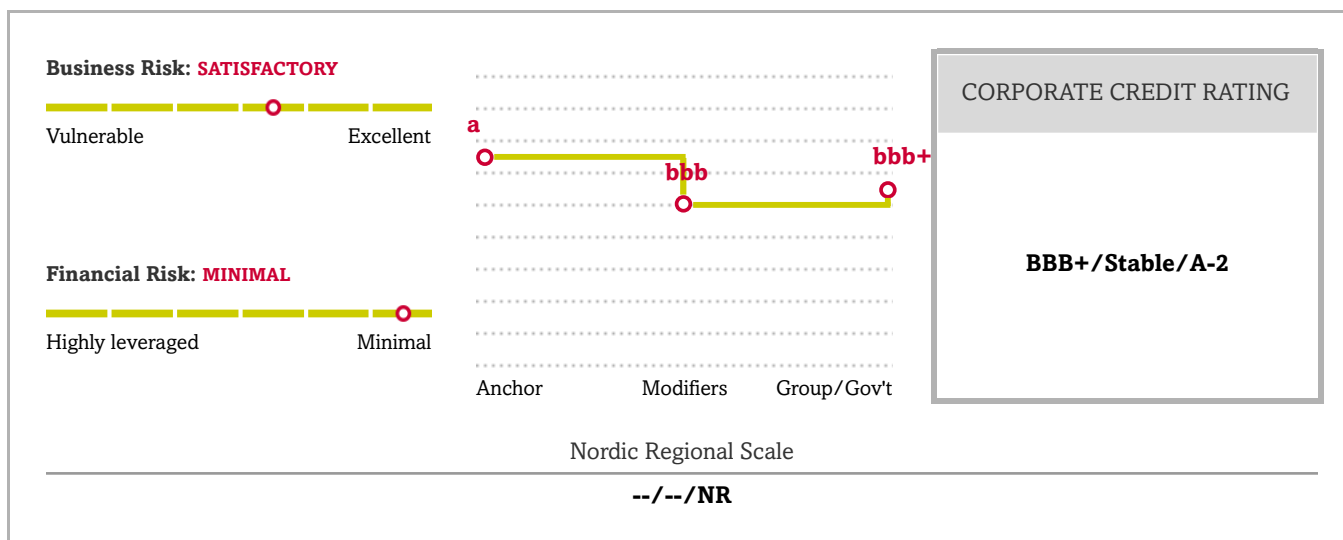
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Fortum Oyj



Rationale

Business Risk: Satisfactory

- A diverse and competitive power generation portfolio and one of the lowest exposures to increases in carbon emission prices in Europe.
- Stable heating operations in the Nordics, Baltics, and Poland.
- Exposure to competitive and increasingly challenging Nordic power markets and volatile power prices.
- Exposure to the higher-risk Russian power market and the Russian ruble.
- Growth investments expected to be within existing product areas and geographical regions.

Financial Risk: Minimal

- Currently significant cash balances expected to be used to fund acquisitions or higher dividends.
- Clear financial policies including a net debt-to-EBITDA target of around 2.5x.
- Very strong credit metrics in the near term due to currently significant cash balance.

Outlook

The stable outlook chiefly reflects S&P Global Ratings' anticipation that Finnish energy company Fortum Oyj's investments in growth would be within existing core product areas and primarily within existing geographical locations. We also assume that investments and dividends will be in line with the company's financial policy. Assuming that the business risk remains unchanged, we anticipate that adjusted funds from operations (FFO) to debt would be at least 30% to be commensurate with the existing ratings.

Downside scenario

We could lower the ratings if Fortum's business risk undergoes additional strain, for example from investments in products or geographical areas that bear higher risks than investments to date. The ratings could also come under pressure if conditions in Fortum's existing business areas deteriorate, for example through a further downturn in

Nordic or Russian market conditions.

In addition, we could lower the ratings if investments or shareholder returns lead to credit measures not commensurate with the ratings. This could be the case if we believe that FFO to debt were to fall and stay below 30%.

We could also lower the ratings if we reassess our view that there is a moderate likelihood of timely and sufficient state support in the event of financial distress. This could occur if the government unexpectedly divests some or all its stake in the company.

Upside scenario

We could raise the ratings if we believe that Fortum has permanently strengthened its financial risk profile beyond the current financial targets. This could occur if we forecast FFO to debt to remain sustainably above 40%.

S&P Global Ratings Base-Case Scenario

Assumptions

- We expect that Fortum's geographical and asset mix will remain broadly unchanged.
- Capital expenditure (capex) relating to existing assets and investment program of about €0.9 billion in 2016.
- Dividends of at least €1 billion in 2016.
- No further acquisitions or other significant growth investments; however, we expect that Fortum may use its significant cash balance to reinvest in new businesses or return to shareholders in 2016 or 2017.

Key Metrics

	2015A	2016E	2017E
EBITDA margin*	36%	35-40%	35-40%
FFO to debt*	Net cash	>60%	>60%
FFO cash interest coverage	4.6x	>7x	>7x

*Fully S&P Global Ratings-adjusted. A--Actual. E--Estimate.

Company Description

Fortum is a publicly listed Finland-based company engaged in the generation and sale of electricity and heat, and operation and maintenance of power plants. It also provides energy-related services. The company's operations are focused on the Nordic and Baltic countries, Russia and Poland. Fortum is the third-biggest power generator in the Nordic region, a midsize European power generation player and a major producer in global heat.

Business Risk

We assess Fortum's business risk profile as being satisfactory. The group benefits from a diverse and competitive generation portfolio and its position as one of the largest power generators in the Nordic region. In particular, a large part of Fortum's Nordic nuclear and hydro power assets are very cost competitive and virtually carbon dioxide free. Within the European power generation industry, Fortum is one of the producers least exposed to higher costs resulting

from increases in carbon emission prices. In addition, Fortum operates a relatively stable heat business in the Nordics, Baltics, and Poland, accounting for about 15% of the company's EBITDA.

These strengths are partly offset by the company's exposure to the competitive and challenging Nordic power markets, volatile wholesale power prices, and the higher-risk Russian market, where the regulatory environment for electricity and heat generation is untested. Profits from Russian operations are also pressured by the weaker ruble when translated into euros.

Fortum finalized the sale of its Swedish electricity distribution business for €6.6 billion in the second quarter of 2015. We expect Fortum to use the proceeds from the disposal to support growth in its existing geographies and businesses, including hydro, nuclear, and combined heat and power production. However, the size and timing of such investments is uncertain.

S&P Global Ratings Base-Case Operating Scenario

- Continued pressure on Nordic power prices owing to low coal and carbon dioxide prices, weak electricity demand and the addition of new generation capacity/
- The generation fleet to maintain solid operating performance.
- Further acquisitions and investments to be within Fortum's existing product areas and geographical regions.

Peer comparison

Table 1

Fortum Oyj -- Peer Comparison				
Industry Sector: Electric Utility				
	Fortum Oyj	Vattenfall AB	Dong Energy A/S	Eesti Energia AS
Rating as of July 15, 2016	BBB+/Stable/A-2	BBB+/Negative/A-2	BBB+/Stable/A-2	BBB/Negative/--
(Mil. €)	--Average of past three fiscal years--			
Revenues	4,534.3	18,290.3	9,432.2	874.4
EBITDA	1,743.0	4,425.7	2,251.1	292.8
Funds from operations (FFO)	1,303.2	3,333.5	1,382.2	242.5
Net income from cont. oper.	684.7	(1,409.3)	(600.4)	119.8
Cash flow from operations	1,498.9	4,500.1	1,688.0	268.7
Capital expenditures	806.7	3,016.1	2,386.9	289.4
Free operating cash flow	692.2	1,484.0	(698.9)	(20.7)
Discretionary cash flow	(314.5)	1,185.1	(746.9)	(90.9)
Cash and short-term investments	4,074.0	4,222.3	3,047.7	114.5
Debt	5,091.9	16,744.9	4,649.4	834.7
Equity	11,787.3	14,330.7	6,444.6	1,579.7
Adjusted ratios				
EBITDA margin (%)	38.4	24.2	23.9	33.5
Return on capital (%)	6.9	6.8	8.6	6.6
EBITDA interest coverage (x)	5.0	4.9	5.3	7.8
FFO cash int. cov. (X)	5.2	9.0	1.8	7.4
Debt/EBITDA (x)	2.9	3.8	2.1	2.9
FFO/debt (%)	25.6	19.9	29.7	29.1

Table 1

Fortum Oyj -- Peer Comparison (cont.)				
Cash flow from operations/debt (%)	29.4	26.9	36.3	32.2
Free operating cash flow/debt (%)	13.6	8.9	(15.0)	(2.5)
Discretionary cash flow/debt (%)	(6.2)	7.1	(16.1)	(10.9)

Financial Risk

Fortum's credit metrics remain very strong given its current significant cash balance. It had a net cash position in 2015, and we consider that it currently has minimal financial risk. This very strong financial position is the result of Fortum's disposal of its Swedish electricity distribution business, which generated proceeds of about €6.6 billion in 2014. However, we assume that Fortum will use these proceeds for investments, or partly return them to shareholders if the company does not find a suitable investment target before the end of 2017. However, we expect that Fortum will remain within its stated financial targets, including net debt to EBITDA of 2.5x.

Since the precise scale and timing of Fortum's likely growth investments are uncertain, we have only included investments related to existing assets and its capex program within our base case. This results in very strong credit measures under our base-case forecasts. However in the medium term we see Fortum returning to leverage more consistent with its financial policies.

S&P Global Ratings Base-Case Cash Flow And Capital Structure Scenario

- Limited revenue growth from existing businesses due to low power prices and stable EBITDA margins of around 35%-40%.
- Capital expenditure (capex) relating to existing assets and investment program of about €0.9 billion in 2016.
- Dividends of at least €1.0 billion in 2016.
- No further acquisitions or other significant growth investments included owing to uncertainties about the exact scale and timing.

Financial summary

Table 2

Fortum Oyj -- Financial Summary					
Industry Sector: Electric Utility					
	--Fiscal year ended Dec. 31--				
	2015	2014	2013	2012	2011
Rating history	BBB+/Stable/A-2	A-/Negative/A-2	A-/Negative/A-2	A-/Negative/A-2	A/Negative/A-1
(Mil. €)					
Revenues	3,459.0	4,088.0	6,056.0	6,159.0	6,161.0
EBITDA	1,257.0	1,552.0	2,420.0	2,498.0	2,559.5
Funds from operations (FFO)	911.7	1,164.5	1,833.4	1,936.2	1,967.6
Net income from continuing operations	(232.0)	1,082.0	1,204.0	1,409.0	1,769.0
Cash flow from operations	1,217.7	1,418.5	1,860.4	1,402.2	1,635.6
Capital expenditures	527.0	622.0	1,271.0	1,422.0	1,285.0
Free operating cash flow	690.7	796.5	589.4	(19.8)	350.6

Table 2

Fortum Oyj -- Financial Summary (cont.)					
Dividends paid	1,155.0	977.0	888.0	888.0	888.0
Discretionary cash flow	(464.3)	(180.5)	(298.6)	(907.8)	(537.4)
Debt	0.0	5,955.9	9,319.8	9,376.9	8,425.5
Preferred stock	0.0	0.0	0.0	0.0	0.0
Equity	13,863.0	10,935.0	10,563.9	10,702.5	10,058.9
Debt and equity	13,863.0	16,890.9	19,883.7	20,079.4	18,484.4
Adjusted ratios					
EBITDA margin (%)	36.3	38.0	40.0	40.6	41.5
EBITDA interest coverage (x)	4.2	4.6	6.0	6.0	7.0
FFO cash int. cov. (x)	4.6	4.7	6.0	6.7	7.8
Debt/EBITDA (x)	0.0	3.8	3.9	3.8	3.3
FFO/debt (%)	N.M.	19.6	19.7	20.6	23.4
Cash flow from operations/debt (%)	N.M.	23.8	20.0	15.0	19.4
Free operating cash flow/debt (%)	N.M.	13.4	6.3	(0.2)	4.2
Discretionary cash flow/debt (%)					
Net cash flow/capex (%)	(46.2)	30.1	74.4	73.7	84.0
Return on capital (%)	5.5	6.7	8.1	8.7	10.1
Return on common equity (%)	(1.9)	10.4	11.9	14.2	19.8
Common dividend payout ratio (un-adj.) (%)	(421.1)	106.7	73.8	63.0	50.2

N.M.--Not meaningful.

Liquidity

We view Fortum's liquidity as strong given its significant liquidity resources--including cash, FFO, and facility availability--will cover expected cash outflows by at least 2x in the next 24 months. We also assume that liquidity sources would exceed uses even if EBITDA were to drop by 50%. We expect that its significant cash balances will diminish over the next two years as they are reinvested or returned to shareholders. Fortum's liquidity continues to be supported by its strong standing in capital markets and solid relationships with banks. Its debt documents do not contain any financial covenants.

Principal Liquidity Sources

- Reported cash and equivalents of around €6.1 billion as of June 30, 2016;
- Access to an undrawn long-term committed facility of €1.75 billion maturing in June 2021, which contains no financial covenants; and
- FFO, which we estimate will be close to €1 billion.

Principal Liquidity Uses

- Debt of about €680 million maturing in the next 12 months, and about €600 million in the following 12 months;
- Acquisition of at least 81% shareholding in Ekokem, a Nordic circular economy and waste management company, for at least €470 million;
- Annual capex of about €0.8 billion in next 12 months and €0.5 billion in subsequent 12 months; and
- Dividend payments of at least €0.8 billion in the next 12 months.

Debt maturities

As of June 30, 2016:

- 2016: €218 million
- 2017: €504 million
- 2018: €588 million
- 2019: €804 million
- 2020: €69 million
- Thereafter: €3,033 million

Other Credit Considerations

We assume that Fortum will eventually use its significant cash balances for investments, or partly return them to shareholders if the company does not find a suitable investments target by the end of 2017. This would also be in line with the company's stated financial targets of comparable net debt to EBITDA of 2.5x. Therefore, we apply a negative modifier for our financial policy analysis, indicating that we believe that leverage could become materially higher than our base-case forecast credit measures. This results in a three-notch downward revision from our 'a' anchor for Fortum.

Government Influence

We consider that there is a moderate likelihood that Fortum would receive timely and sufficient extraordinary support from its 50.8% owner, the Republic of Finland, in the event of financial distress. This is based on our assessment of Fortum's:

- Strong link with the government, which is likely to retain its majority stake owing to its categorization of Fortum 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 government-related entity..

Ratings Score Snapshot

Corporate Credit Rating

BBB+/Stable/A-2

Business risk: Satisfactory

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

Financial risk: Minimal

- **Cash flow/Leverage:** Minimal

Anchor: a

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Negative (-3 notches)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (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)

Reconciliation

Our key analytical adjustments relate to postretirement benefit obligations, surplus cash, operating leases, accrued interest, and consolidation of a share of nuclear operator Teollisuuden Voima Oyj's debt and total assets equivalent to Fortum's 26% ownership stake.

Table 3

Reconciliation Of Fortum Oyj Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. €)							
--Fiscal year ended Dec. 31, 2015--							
Fortum Oyj reported amounts							
	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	6,007	13,794	196	(150)	203	196	1,228
S&P Global Ratings adjustments							
Interest expense (reported)	--	--	--	--	--	(203.0)	--
Interest income (reported)	--	--	--	--	--	51.0	--
Current tax expense (reported)	--	--	--	--	--	(106.0)	--
Operating leases	45.2	--	19.0	5.0	5.0	14.0	14.0
Postretirement benefit obligations/deferred compensation	53.0	--	(4.0)	(4.0)	3.0	(5.6)	(5.6)
Surplus cash	(7,645.0)	--	--	--	--	--	--
Capitalized interest	--	--	--	--	44.0	(44.0)	--
Share-based compensation expense	--	--	19.0	--	--	19.0	--
Dividends received from equity investments	--	--	52.0	--	--	52.0	--

Table 3

Reconciliation Of Fortum Oyj Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. €) (cont.)							
Deconsolidation / consolidation	940.3	--	--	--	--	--	--
Asset retirement obligations	--	--	--	--	44.0	(36.7)	(18.7)
Nonoperating income (expense)	--	--	--	71.0	--	--	--
Noncontrolling Interest/Minority interest	--	69.0	--	--	--	--	--
Debt - Accrued interest not included in reported debt	175.0	--	--	--	--	--	--
EBITDA - Gain/(Loss) on disposals of PP&E	--	--	896.0	896.0	--	896.0	--
EBITDA - Derivatives	--	--	79.0	79.0	--	79.0	--
Total adjustments	(6,431.5)	69.0	1,061.0	1,047.0	96.0	715.7	(10.3)
S&P Global Ratings adjusted amounts							
	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	--	13,863.0	1,257.0	897.0	299.0	911.7	1,217.7

PP&E--Property, plant, and equipment.

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Corporate Methodology, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Country Risk Assessments Update: May 2015, May 29, 2015
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

Business And Financial Risk Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of July 21, 2016)

Fortum Oyj

Corporate Credit Rating	BBB+/Stable/A-2
<i>Nordic Regional Scale</i>	--/--/NR
Senior Unsecured	BBB+

Corporate Credit Ratings History

05-Jun-2015		BBB+/Stable/A-2
18-Mar-2015		A-/Watch Neg/A-2
27-Nov-2012		A-/Negative/A-2
09-Dec-2011		A/Negative/A-1
05-Jun-2015	<i>Nordic Regional Scale</i>	--/--/NR
13-Jan-2003		--/--/K-1

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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