Fitch Ratings

Fitch Affirms Fortum at 'BBB'; Outlook Stable

Fitch Ratings - London - 03 June 2019:

Fitch Ratings has affirmed Finnish-based Fortum Oyj's (Fortum) Long-Term Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook, and senior unsecured rating at 'BBB'. Fitch has also upgraded Fortum's Short-Term IDR to 'F2' from 'F3'.

The affirmation reflects Fortum's strong and well-managed generation fleet and solid recent trading driven by a supportive power price environment. In addition, hedging mitigates the impact of price volatility in the Nordic region. We assume higher Nord Pool prices compared with recent years and expect Fortum to apply high capex scrutiny in the medium term, to see positive free cash flows (FCF) and to remain within our rating sensitivities with moderate leverage headroom.

Discussions between Fortum and Uniper for cooperation are continuing. In our rating case we continue to treat Uniper as a financial investment and we believe that Uniper's control and full consolidation would likely impact Fortum's debt capacity, but not necessarily the ratings.

Key Rating Drivers

Evolving Business Mix: After the acquisition of Uniper's 49.99% stake in 2018, Fortum's strategy will focus on operational efficiency of current generation assets, portfolio optimisation, continued investment in renewables and building options for new businesses. The latter includes waste-to-energy generation but also pure recycling, waste treatment and other related services to increase non power price-linked EBITDA contribution.

As for renewables, the company's target is to develop a multi-gigawatt portfolio in wind and solar whose recurring contribution to EBITDA will however be fairly limited in the medium term, due to the use of joint ventures and implementation of asset-rotation transactions.

Moderate Leverage Headroom: Fortum's main financial targets remain unchanged and include a dividend payout of 50%-80% and a net debt/EBITDA of around 2.5x (3.6x in 2018), consistent with our current rating sensitivities. Management expects to reach its leverage target in two to three years, due mainly to decreasing capex from 2020 (the company guides EUR600 million-EUR650 million in 2019) and improving business performance linked to favourable prices and managerial actions to boost efficiency. Our rating case, which includes more conservative assumptions on margins, foresees average FCF of almost EUR100 million and a funds from operations (FFO)-adjusted net leverage of 3.3x on average for 2019-2023, with moderate headroom to our negative sensitivity of 3.8x.

Improving Relationship with Uniper: Based on our expectations, dividends received from Uniper should increase to an average of around 15% of Fortum's FFO in 2019-2023. We expect also greater cooperation between the two companies after the appointment of Uniper's top management from June 2019. At present Fortum is prevented from increasing its stake above 50%, due to provisions of the Russian law related to some Russian assets owned by Uniper. We do not include in our forecasts any change to Uniper's status as an associate of Fortum. We believe that a full consolidation of Uniper into Fortum's accounts would most likely lead to a downward revision of the group's debt capacity.
Solid Current Trading: Fortum's EBITDA grew 19.5% to EUR1.5 billion in 2018 and exceeded our expectations by roughly EUR100 million. This was mainly driven by generation on the back of high power prices in the Nordic region, which has continued into 2019. Earnings in City Solutions grew due mainly to full-year consolidation of Hafslund in 2018. With an improved hedging position in March 2019 (compared with a year ago), estimated healthy growth for generation, and more moderate growth for City and Consumer Solutions, we expect a 2019 EBITDA of around EUR1.6 billion.

Nordic Power Prices to Ease: Cold and dry weather in the Nordic region, together with an increase in coal and CO2 prices, moved the Nord Pool area price up to EUR44/MWh in 2018. The continued increase in marginal cost of coal kept prices high at EUR47/MWh in 1Q19. Forward contract prices suggest a decline in prices over the next few years, albeit remaining above EUR30/MWh. Prices in the region will continue to be volatile given a large share of hydro in the generation mix and large temperature swings. Differentials between price areas could decrease in the future, as further investments in transmission capacity support the availability of cheaper hydro across the region.

Steady Contribution from Russia: Fortum's Russian activities contribute around 25% to the group's EBITDA, based on our projections. Installed power capacity stands at almost 5GW while heat capacity contributes an additional 8.6GW. EBITDA in Russia is mainly sustained by long-term capacity supply agreements (CSA), which underpins stability of results and partially offset risks related to the weaker Russian operating environment and FX. Capacity income in Russia is currently the main source of quasi-regulated income for Fortum at 15%-20% of EBITDA. Fortum also operates some renewables plants in Russia (70MW) and has a 50/50 joint venture with a total pipeline of more than 1,800 MW of CSA-backed wind capacity.

No Impact from GRE: Fortum is 50.8%-owned by Finland (AA+/Positive). We assess all factors under our Government-Related Entities 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; however, this is to some extent offset by Fortum's good quality fleet of mainly hydro and nuclear plants with high historical load factors, particularly in Finland. 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. Vattenfall AB (WD; affirmed at BBB+/Stable before rating withdrawal) is more integrated through its regulated network operations (representing almost 30% of EBITDA), placing its rating one notch above Fortum's. Furthermore, about a quarter of Fortum's earnings are generated in Russia, which we see as increasing Fortum's business risk relative to Nordic peers'.

Based on our assessment of Fortum's strong financial flexibility and adequate financial structure, the higher of the two Short-Term IDRs mapping to the current Long-Term IDR has now been assigned. Any material weakening in financial flexibility, financial structure or operating environment conditions could lead to the assignment of the lower of the two Short-Term IDRs corresponding to the current Long-Term IDR.

Key Assumptions

- 75% of 2019 volumes hedged at EUR32/MWh, 55% of 2020 volumes at EUR31/MWh and 20% of 2021 volumes at EUR31/MWh
- Power prices based on Nord Pool forwards, with a EUR3/MWh premium on Finland area prices in 2019, and premium declining to EUR2.6/MWh by 2023 for unhedged volumes

- In Russia, capacity payments on a declining trend

- RUB/EUR rate of around 80

- Moderate growth at City and Consumer Solutions, driven by growth in waste/recycling and other value added services

- Capex as per management's guidance for 2019, before gradually declining towards maintenance capex levels

- Dividends stable at EUR977 million per year

RATING SENSITIVITIES

Rating upside is limited due to risks related to the integration of the Uniper business and the incremental debt related to the acquisition. However, Developments That May, Individually or Collectively, Lead to Positive Rating Action are

- FFO adjusted net leverage below 3.0x and FFO fixed charge cover above 6.0x, all 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

- Significant deterioration of the political, economic or regulatory environment in Russia

- Significant structural decline in Nord Pool power prices

- Control and full consolidation of Uniper, which could lead to a tightening of our rating sensitivities

Liquidity and Debt Structure

Adequate Liquidity: Fortum’s reported cash and short-term investments stood at EUR1.7 billion at end-March 2019 and with committed unused credit lines of EUR1.8 billion (maturing in June 2023), total available liquidity was a strong EUR3.5 billion. This compares with short-term maturities of EUR821 million at end-March 2019. In February 2019, Fortum issued EUR2.5 billion of new bonds with coupons around 2%. The proceeds were used to repay a bridge facility drawn for the Uniper transaction, and to repay a EUR750 million 6% coupon bond in February. This should lower Fortum’s interest expenses, and we project FCF to be positive over the next four years.

Sources of Information
RATING ACTIONS

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Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Government-Related Entities Rating Criteria (pub. 29 Mar 2019)
Corporate Rating Criteria (pub. 19 Feb 2019)
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