Summary:

Fortum Oyj

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**Fortum Oyj**

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<td>Vulnerable</td>
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<th>Financial Risk: Significant</th>
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<td>Highly leveraged</td>
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**Issuer Credit Rating**

BBB/Negative/A-2

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**Credit Highlights**

**Overview**

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<td>Unclear strategy on Uniper integration</td>
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<td>Stable and predictable cash flow generated from district heating activities (12% revenues in 2017)</td>
<td>Highly leveraged following Uniper's acquisition, with an unclear path to reduce leverage</td>
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<td>Low Co2 generation fleet</td>
<td>Inability to capitalize the increase in Nordic prices, due to low price hedging</td>
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<td>Support from the Finnish government, providing one notch uplift from its stand-alone credit profile</td>
<td>Exposure to volatile power generation activities (47% of 2017 EBITDA)</td>
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<td></td>
<td>Exposure to Russian ruble foreign exchange risk (34% of 2017 EBITDA)</td>
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Fortum is a large and clean power player in the Nordics and Russia.

Fortum is the third-largest power generator in the Nordic countries after Vattenfall and Statkraft and the largest electricity retailer. Fortum is the second-lowest emitting generators in Europe (after Statkraft) thanks to its zero-to-low CO2 emission fleet.

The acquisition of Uniper in 2018 materially changed the group's credit profile.

Following the €3.8 billion acquisition of 47.35% of the share capital of Uniper SE, closed in June 2018, Fortum's adjusted debt to EBITDA is expected to increase to about 3.5x in 2018 from 1.6x in 2017. Moreover, given the current stake in Uniper, Fortum lacks control and still has an unclear strategy on Uniper's integration.

The path to debt reduction is long and still uncertain.

Fortum aims to reach 2.5x reported net debt to EBITDA by 2020. The deleveraging strategy focuses on operational excellence, optimization of the generation portfolio as well as prioritization of capital spending (capex).
Fortum is exposed to volatile power generation activities (47% of 2017 EBITDA) as well as benefits from the improving power price environment materializing in 2020.

Power generation is a highly volatile activity with volumes depending on climate changes. With 53.3% of the generation coming from hydropower, Fortum's volumes are expected to be lower in the near future. This should be only slightly offset by the increase in power prices in the Nordics.

Fortum enjoys support from the Finnish government.

The Finnish government is Fortum's major shareholder with a 50.8% share. We therefore incorporate one notch into Fortum's stand-alone credit profile (SACP) to reflect support from the Finnish government.

**Outlook: Negative**

The negative outlook on Fortum chiefly reflects our view that, following its acquisition of a stake of 47.35% in Uniper for around €3.8 billion, the possible remedies to strengthen the balance sheet remain untested and the time to implement them might extend beyond our forecast horizon through 2020, resulting in credit metrics we deem not commensurate for the current rating.

All things remaining equal, our forecasts indicate that Fortum's credit metrics will be below our medium- to longer-term expectations for the 'BBB' rating, including adjusted funds from operations (FFO) to debt well below 25% over 2018-2019. This also means that Fortum has practically no headroom for any financial underperformance against our forecasts.

The negative outlook also reflects the uncertainty regarding how Fortum will manage its investment in Uniper. Notably, this will depend on whether or not the group wants to increase its Uniper stake over the next two years or leave it at the current level in the longer term, with Uniper accounted for as a financial investment in its balance sheet. Finally, the negative outlook reflects our uncertainty about the group's industrial strategy and financial policy.

**Downside scenario**

We could lower the rating if Fortum's credit metrics weaken below our expectations, notably with FFO to debt declining and remaining below 20% over the next two years, or if there aren't signs of a recovery toward about 25% in 2020, a level we view in line with the current ratings over the medium to longer term. This could stem from Fortum materially increasing its stake in Uniper to above 75%, which would markedly increase Fortum's leverage, absent any significant financial remedies.

**Upside scenario**

We could revise the outlook on Fortum to stable if we believe that the group's leverage is gradually declining in line with management's stated intentions, and that adjusted FFO to debt ratio has a clear trajectory toward about 25% by 2020. This could also be supported by Fortum not increasing its stake in Uniper to well above 50% and providing clarity on the strategy and future profile of the relationship with Uniper.
Our Base-Case Scenario

Recent Developments
First-nine-months of 2018 results affected by low hydro volumes.
Fortum's comparable EBITDA in the third quarter of 2018 increased by about 10% year on year to €230 million. The generation division's EBITDA was impacted by low hydro reservoir levels that led to low production. Reported net debt increased to about €5.2 billion from about €1 billion in 2017, leading to reported leverage of 3.6x. Fortum's goal is to reduce that leverage to 2.5x within the next two to three years.

Fortum's 2018 Capital Markets Day in November updated capex and dividend guidance, with no material deviations from our base case.
Fortum estimates it will invest around €600 million until 2019, when investments are expected to decline. Fortum aims to pay stable and sustainable dividend of 50%-80% of earnings per share. Fortum did not update on Uniper's integration within Fortum's group.

<table>
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<tr>
<th>Assumptions</th>
<th>Key Metrics</th>
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<tr>
<td>In our base case for Fortum for 2018-2019, we assume:</td>
<td>(Mil. €)</td>
</tr>
<tr>
<td>• Nordic power prices of €30-€35 per megawatt hour (/MWh) from 2019.</td>
<td>EBITDA</td>
</tr>
<tr>
<td>• The generation segment's Nordic generation hedges approximately 80% hedged at €30/MWh for 2018 and approximately 65% hedged at €30/MWh for 2019.</td>
<td>Debt</td>
</tr>
<tr>
<td>• Consolidation of Uniper in Fortum's accounts under the equity method, as Fortum has neither a majority share of nor control over Uniper.</td>
<td>Capex</td>
</tr>
<tr>
<td>• Revenue growth of about 16% in 2018 and about 9% in 2019. Strong revenue growth mainly owing to higher power prices, larger volumes.</td>
<td>Dividends</td>
</tr>
<tr>
<td>• Average annual capex of €600 million.</td>
<td>FFO to debt (%)</td>
</tr>
<tr>
<td>• Dividends received from equity-associated companies to gradually increase to more than €250 million in 2020 from about €60 million in 2018, according to our estimates.</td>
<td>Debt to EBITDA (x)</td>
</tr>
</tbody>
</table>

*All figures are S&P Global Ratings adjusted. A—Actual. E—Estimate
Company Description

Fortum Oyj is a Finnish Power generator mainly operating in the Nordics and Russia. The group is majority owned by the Finnish government (50.8%).

Fortum focuses on power and heating generation (44% of EBITDA) and city solutions (19% of the EBITDA). The group is also increasing its operations in Russia by building a 823MW capacity windfarm and a 110MW capacity solar energy farm.

Fortum enjoys being one of the key utility companies with almost zero carbon exposure right after Statkraft, as 96% of the company's power generation in the EU is CO2 free.

Business Risk: Satisfactory

Fortum benefits from its diverse generation portfolio, as well as its exposure to different markets with 62% of the power production in the Nordic countries (45 terawatt hours [TWh]), 36% in Russia (26TWh), and 2% split between Poland and Baltic countries (2TWh). However, these strengths are mitigated by the increase in Russian operations, as well as the hedging of sales at low prices because Fortum is unable to capitalize on the increase of electricity prices in the Nordics.

Strong Market Position in the Nordics and Russia

Fortum 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 CO2 emission fleet.

Exposure to volatile power generation

The generation portfolio is still a key diversification strength for Fortum, both in terms of geographic location, as well as power sources.

Unclear strategy on Uniper's investment

The acquisition of a 47.35% stake in Uniper that took place in June 2018 has not affected our assessment of Fortum's business risk. This reflects our assumptions that Fortum will, at least in the near term, not control Uniper, and that synergies between the two companies are likely to be limited under the proposed ownership structure. We note, however, that Fortum has control on Uniper's dividends given 50% majority at a general meeting.

That said, we believe that a potential future combination of the two companies could be negative for Fortum's business risk profile, due to Uniper's exposure to carbon-intensive thermal power generation. The negative effect could be mitigated in part by Fortum's increasing scale and diversity, as well as the scope for material synergies between the two companies.

If Fortum did acquire a larger stake in Uniper, it is likely that our assessment of its business risk profile would weaken within the satisfactory category, due to Uniper's exposure to carbon-intensive thermal power generation.
We understand that Fortum could only secure full control of Uniper if it acquires 75% of the share capital or voting rights in Uniper. If this was the case, we would fully consolidate Uniper in Fortum's accounts.

**Inability to capitalize on the Nordic pool's increase in power prices**
The electricity prices have increased in the Nordic pool and are expected to keep increasing. Fortum has hedged about 80% of its volume to a low price of €30/MWh, which in turn prevents the company from increasing its revenues in correlation with electricity prices.

**Peer comparison**
We see Fortum's business risk profile as weaker than that of its more regulated peers such as CEZ (about 35% of full year 2017 EBITDA from regulated activities) and Verbund (20%). Statkraft has a competitive advantage over Fortum, due to its large, low-cost, and flexible Nordic hydropower assets.

**Financial Risk: Significant**
Our 2018-2019 base-case scenario for Fortum shows credit measures below our thresholds for the current 'BBB' rating. We believe that the possible remedies to strengthen the balance sheet remain unclear, and the time to implement them might extend beyond our forecast horizon through 2020, which we reflect in the negative outlook. Fortum aims to reduce its leverage to 2.5x within the next few years.

Dividends are expected to remain stable at 50%-80% of earnings per share. There is no clear material strategy for Uniper's deleveraging. We note that Fortum's investments are estimated around €600 million until 2019, after which they are expected to decline. This, if coupled with a sustained improvement of the operating performance, should lead to credit metrics in line with the current rating in 2020, notably adjusted FFO to debt of about 25%. We note, however, that the improvement in profits is subject to a reduction in volatility in the power generation markets in the Nordics and Russia, and no substantial devaluation of the ruble.

The debt portfolio consists of euro and Swedish krona denominated bonds (42%) and loans (31%), with an average interest cost of 1.6% as of September 2018 versus 2.4% in 2017.

**Liquidity: Strong**
As of Sept. 30, 2018, we view 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

- Cash and cash equivalents of about €730 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;
- Positive cash FFO, which we estimate will near €1.6 billion in the next 12 months; and
- Working capital inflows in the amount of about €100 million in the next 12 months.

Principal Liquidity Uses

- Debt of about €950 million maturing in the next 12 months, and about €30 million in the following 12 months;
- Annual capex of about €600 million; and
- Dividends of about €1 billion in the next 12 months.

Government Influence

Our rating on Fortum continues to incorporate a one-notch uplift for our view of a moderate likelihood of extraordinary government support if needed, based on Fortum's:

- Strong link with the government, given Finland's 50.8% ownership of the company. We believe that the government is likely to retain its majority stake in Fortum because the government has categorized the group 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 GRE.

A negative reassessment of the likelihood of extraordinary government support would likely lead to a one-notch downgrade of Fortum. This could occur if the government of Finland reduces its stake below 50.1% (currently being at 50.8%), which we consider unlikely at this stage.

Ratings Score Snapshot

Issuer Credit Rating
BBB/Negative/A-2

Business risk: Satisfactory
- Country risk: Intermediate
- Industry risk: Moderately high
- Competitive position: Strong

Financial risk: Significant
• **Cash flow/Leverage:** Significant

**Anchor:** bbb-

**Modifiers**

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **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)

**Related Criteria**

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
Related Research

- German Power And Gas Co Uniper Upgraded To 'BBB' On Reduced Event Risk And Strengthening Business Risk; Outlook Stable; Apr. 27, 2018
- The Fortum-Uniper-E.ON Deal And Its Credit Consequences; Feb. 23, 2018
- Fortum Affirmed At 'BBB' Following Final Outcome Of Takeover Offer For Uniper; Outlook Remains Negative, Feb. 16, 2018
- Fortum Downgraded To 'BBB' On Weakening Credit Metrics After Its Acquisition Of About 47% Of Uniper; Outlook Negative, Jan. 18, 2018

### Business And Financial Risk Matrix

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<thead>
<tr>
<th>Business Risk Profile</th>
<th>Minimal</th>
<th>Modest</th>
<th>Intermediate</th>
<th>Significant</th>
<th>Aggressive</th>
<th>Highly leveraged</th>
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<tbody>
<tr>
<td>Excellent</td>
<td>aaa/aa+</td>
<td>aa</td>
<td>a+/a</td>
<td>a-</td>
<td>bbb</td>
<td>bbb-/bb+</td>
</tr>
<tr>
<td>Strong</td>
<td>aa/aa-</td>
<td>a+/a</td>
<td>a-/bbb+</td>
<td>bbb</td>
<td>bb+</td>
<td>bb</td>
</tr>
<tr>
<td>Satisfactory</td>
<td>a/a-</td>
<td>bbb+</td>
<td>bbb/bbb-</td>
<td>bbb-/bb+</td>
<td>bb</td>
<td>b+</td>
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<tr>
<td>Fair</td>
<td>bbb/bbb-</td>
<td>bbb-</td>
<td>bb+</td>
<td>bb</td>
<td>bb-</td>
<td>b</td>
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<tr>
<td>Weak</td>
<td>bb+</td>
<td>bb+</td>
<td>bb</td>
<td>bb-</td>
<td>b+</td>
<td>b/b-</td>
</tr>
<tr>
<td>Vulnerable</td>
<td>bb-</td>
<td>bb-</td>
<td>bb-/b+</td>
<td>b+</td>
<td>b</td>
<td>b-</td>
</tr>
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