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Research Update:

Finnish Power Company Fortum Affirmed At 'BBB+/A-2' On Healthy Financial Position; Outlook Stable

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Research Update:

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Overview

- Following a series of investments and acquisitions, Fortum's credit metrics have weakened, but the company still has a solid financial position with a sizable cash balance.
- We expect Fortum's leverage ratio will increase further as the company finances external growth or, potentially, returns to shareholders over the coming year.
- We are affirming our 'BBB+/A-2' ratings on Fortum.
- The stable outlook reflects our assumption that Fortum will stick to its public financial policy and investment criteria, and that its operating performance in generation, growth in the City Solutions segment, and business in Russia under capacity support agreements will remain supportive over the next two years.

Rating Action

On June 28, 2017, S&P Global Ratings affirmed its 'BBB+/A-2' long- and short-term corporate ratings on Finnish power company Fortum Oyj. The outlook is stable.

Rationale

The affirmation reflects our expectation that Fortum's performance will remain supported by its well-placed low-cost Nordic hydro assets and competitive nuclear generation portfolio. We also expect continued stable contributions from the widening scope of the company's City Solutions segment, comprising cash flows from district heating and expansion into waste-to-energy activities with generally high barriers to entry. We also expect Fortum's Russian operations--mainly gas-fired combined heat and power plants under long-term capacity support agreements (up to 10 years)--will add stability to this segment's cash flows.

Following a series of investments and acquisitions over the past year, Fortum's forecast credit metrics have weakened, compared with funds from operations (FFO) to debt at 56.1% in 2016, and we expect this ratio will stay modest in the coming years at about 45%. However, Fortum has maintained a strong financial position, with a large amount of cash on hand (€5.22 billion)

as of March 31, 2017.

Given the company's financial policy, which targets net debt to EBITDA of around 2.5x, we continue to expect that Fortum will use its cash balance for further investments or acquisitions within its core product areas, primarily in current locations, or potentially for returns to shareholders over the coming year.

In our view, Fortum's investments and acquisitions over the past year, in particular the widening of the City Solutions segment's scope, support our assessment of business risk at the upper end of the satisfactory category. In August 2016, Fortum acquired leading Nordic circular economy company Ekokem, which specializes in the recycling of hazardous waste and enjoys high barriers to entry with healthy growth prospects. Another strong supportive factor is the restructuring announced in April this year of Fortum's ownership of Hafslund, one of the largest listed power groups in the Nordics, including integration of a stable heat business and the City of Oslo's waste-to-energy company.

We continue to view the group's diverse and competitive generation portfolio as a key competitive strength. The generation portfolio consists of both low cost and virtually carbon-dioxide free hydro and nuclear assets that are well placed in the merit order. Fortum's nuclear assets include highly efficient Finnish nuclear units Loviisa 1 and 2, and Olkiluoto 1 and 2 with load factors over 90%, although this positive factor is somewhat offset by less efficient plants in Sweden. Fortum is also one of the least exposed to higher costs resulting from increases in carbon emission prices within the European power generation industry. Another important competitive strength is the contribution from stable district heating, which enjoys a supportive regulatory framework, and the waste-to-energy activities in the City Solutions segment. Together, these activities contribute about 20% of Fortum's EBITDA.

Fortum's exposure to the competitive and challenging Nordic power markets and volatile wholesale power prices increases its business risk. However, this is partly mitigated by active hedging, comprising 55% of expected generation volumes in 2017 at €29 per megawatt hour (/MWh) and 45% in 2018 at €27/MWh. We also view the activities in Russia as higher risk, due to unhedged ruble exposure and a largely untested regulatory environment for electricity and heat generation, although long-term capacity support agreements for up to 10 years reduce some of the risk. The EBITDA contribution from Russia now accounts for about 30% of the total and may increase further if Fortum wins new wind auctions. We remain cautious about such exposure, which in our view dilutes the strength of Fortum's business risk profile.

The company's financial position remains healthy although credit metrics have weakened over the past year. However, we continue to assume that Fortum will take on additional debt to fund investments and acquisitions, or to finance higher returns to shareholders if it does not find suitable targets within a reasonable time frame. The size and timing of Fortum's growth investments are, however, uncertain. We continue to regard the company's financial policy as

negative because we believe the targeted financial risk metrics to be commensurate with intermediate risk. At year-end 2016, the net debt to EBITDA ratio was 0.0x according to Fortum's definitions and about 1.4x after our adjustments (which include Fortum's 26% share in Finnish energy company Teollisuuden Voima Oyj, accrued interest expenses, operating lease adjustments, and pension and other postretirement obligations).

We view Fortum as a government-related entity (GRE), for which we see a moderate likelihood of receiving timely and sufficient extraordinary support from the Republic of Finland, in the event of financial distress. This is based on our assessment of 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.

In our base case for Fortum, we assume:

- Increasing EBITDA in 2017 as a result of higher contributions from the generation segment, based on higher volumes and power prices, increasing contributions from the City Solutions activities, and a higher contribution from Russia in euro terms.
- Capital expenditures relating to existing assets and planned investments of about €0.8 billion in 2017 and slightly lower in 2018.
- Dividends of about €1 billion yearly in 2017 and 2018.

Based on these assumptions, we arrive at the following credit measures:

- FFO to debt of about 45% in 2017 and 2018.
- Net debt to EBITDA of about 1.7x in 2017 and 2018.

Liquidity

We view Fortum's liquidity as strong, owing to its significant liquidity resources, including cash, FFO, and facility availability, which together cover expected cash outflows by at least 2.0x 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 Fortum's significant cash balances will diminish over the next two years as cash is reinvested or returned to shareholders. Fortum's liquidity remains supported by the company's strong standing in capital markets and solid banking relationships. Its debt documents do not contain any financial covenants.

As of March 31, 2017, Fortum's liquidity sources include:

- Reported cash and equivalents of around €5 billion;
- Access to an undrawn long-term committed facility of €1.75 billion maturing in July 2021, which contains no financial covenants; and
- FFO, which we estimate will be close to €1.2 billion.

Principal liquidity uses include:
- Debt of about €0.8 billion maturing in the next 12 months, and about €0.9 billion in the following 12 months;
- Annual capital expenditure of about €0.8 billion in the next 12 months and €0.6 billion in the subsequent 12 months; and
- Dividend payments of about €1 billion in the next 12 months.

Outlook

The stable outlook chiefly reflects our anticipation that Fortum's investments in growth would be within its core product areas and primarily in current locations over the next two years. We also assume that investments and dividends will be in line with the company's financial policy, which stipulates net debt to EBITDA of 2.5x. Assuming that the company's business risk profile remains at least satisfactory, an adjusted FFO to debt figure comfortably above 30% would be commensurate with the current ratings.

Downside scenario

We could lower the ratings if Fortum's business risk profile weakened substantially, for example due to investments or major acquisitions in products or geographic areas that carry higher risks than before. The ratings could also come under pressure if conditions in Fortum's existing business areas deteriorated, for example following a downturn in the Nordic or Russian market, or if investments or shareholder returns led to credit measures that are not commensurate with the ratings. This could be the case if we believe that Fortum's FFO to debt would decline and stay below 30%.

Furthermore, if in our view the likelihood of Fortum receiving timely and sufficient extraordinary state support had reduced, we could lower our ratings on the company. This scenario could unfold if the government were to unexpectedly divest some or all its stake in the company.

Upside scenario

We could raise the ratings if we believed that Fortum had permanently strengthened its financial risk profile, exceeding its current financial targets, and we forecast that FFO to debt would remain sustainably above 40%.

Ratings Score Snapshot

Corporate Credit Rating: BBB+/Stable/A-2

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

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Negative (-1 notch)
- 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)

Related Criteria

- 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: Industry Risk, 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
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

Fortum Oyj	
Corporate Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+

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