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Research Update:

Finland-Based Power Co. Fortum Outlook Revised To Stable From Negative; 'BBB/A-2' Ratings Affirmed On Strategy Update

March 9, 2023

Rating Action Overview

- On March 2, 2023, Fortum unveiled its 2023-2025 strategy plan, which entails focused investment in its core Nordic area, a clear commitment to net zero by 2030, and a financial policy of net debt to EBITDA below 2.5x--factors we believe support the 'bbb-' stand-alone credit profile (SACP) our 'BBB' rating.
- We expect about 90% of our forecast EBITDA (about €2.0 billion-€2.2 billion over 2023-2024) to be geared toward Nordic power prices, exposing the business to potential cash flow volatility, since power prices are likely to remain volatile. Fortum's dividends will also be among the highest in the rated European utilities peer group relative to its EBITDA and funds from operations (FFO).
- These challenges are offset by Fortum's strong position in the Nordic markets, with sizable production, the largest generator in Finland, and an already very low emission profile, that support the satisfactory business risk profile, and our belief that management aims to lower price risk over time by signing various long-term off-taking agreements for a material part of production.
- Fortum's planned growth capital expenditure (capex) of €1.5 billion during 2023-2025, in combination with our expectations of continued strong operating performance, should allow net debt to EBITDA of about 0.5x-1.0x over 2023-2024, which is well below its expressed commitment of not higher than 2.5x.
- We revised our outlook on Fortum to stable from negative and affirmed the 'BBB/A-2' long- and short-term issuer credit ratings.
- The stable outlook reflects that we expect FFO to debt of clearly above 30% to support this rating level and the associated 'bbb-' SACP.

PRIMARY CREDIT ANALYST

Per Karlsson
Stockholm
+ 46 84 40 5927
per.karlsson
@spglobal.com

SECONDARY CONTACTS

Gerardo Leal
Frankfurt
+ 49 69 33 999 191
gerardo.leal
@spglobal.com

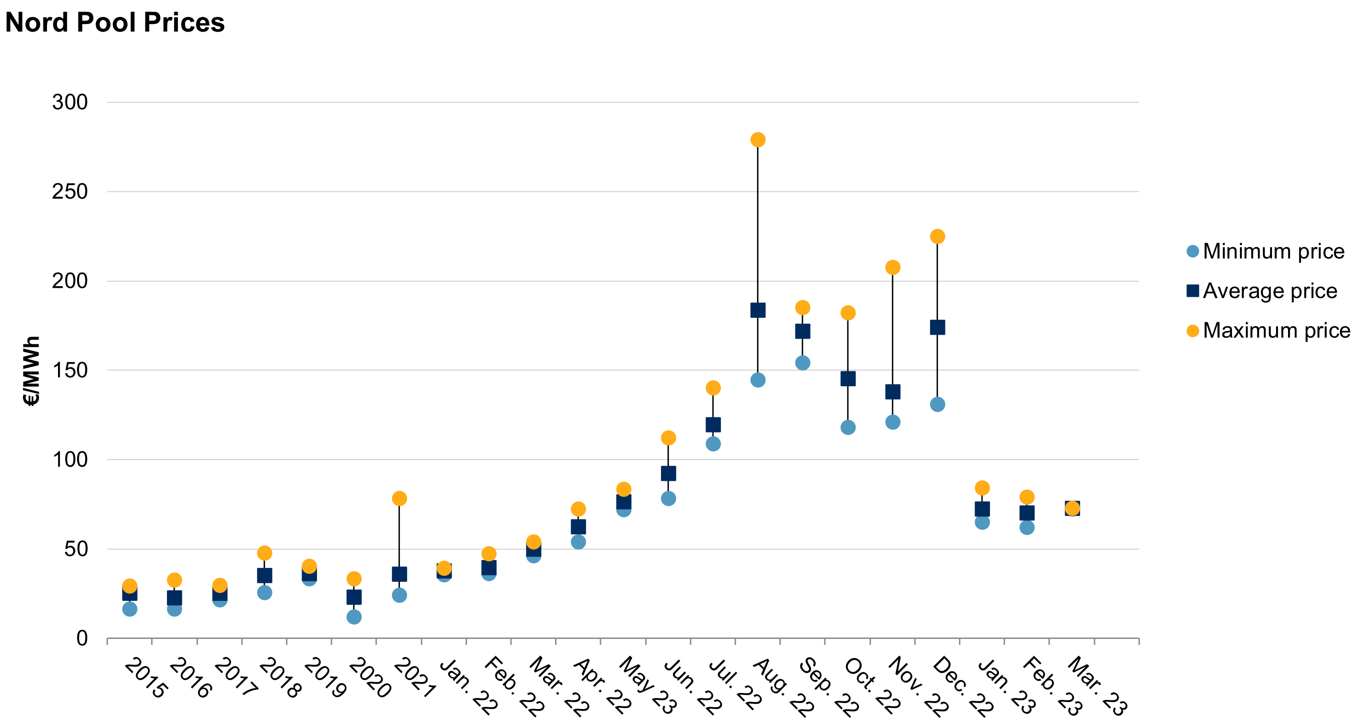
Beatrice de Taisne, CFA
London
+ 44 20 7176 3938
beatrice.de.taisne
@spglobal.com

Rating Action Rationale

Fortum's updated strategy should reinforce its core position in the Nordics. Following last year's turmoil that resulted in Fortum ultimately selling its shares in Uniper to the German government (see "Finland-Based Power Company Fortum 'BBB/A-2' Ratings Affirmed Following Uniper Support Package; Outlook Negative," published Aug. 3, 2022, on RatingsDirect), Fortum presented an updated strategy on March 2, 2023. Management will steer Fortum as a clean power generator, which will represent about 90% or more of its EBITDA depending on power prices. Fortum has a very strong position in its home market, with an emission intensity that is among Europe's five lowest (excluding its Russian operation) at about 25 grams of carbon dioxide equivalent per kilowatt hour (gCO2e/KWh) in 2022. Last year, Fortum generated 44.2 terawatt hours (TWh) of electricity, down from 47 TWh in 2021, positioning it as one of the top three players in the wider Finland-Sweden region. Its generation capacity is mainly derived from hydro and nuclear power, at about 53% and 43% each, all located in Sweden and Finland, and operating costs are low. We expect high power demand growth in that region over the next decade, due to the electrification of industrial operators, in addition to electrification trends common with the rest of Europe. Fortum is well placed to benefit from this with its current position, strategy, and investment plan. It has also signaled a strong commitment to become carbon neutral by 2030 under scope 1, 2, and 3 emissions. We believe the path is credible but could be demanding because it will also require the company's supply chain to be scope 3 carbon neutral, which Fortum can influence but not control. This target also assumes it successfully disposes its Russian assets. Overall, the meaningful commitment places Fortum ahead of many European peers, given very few have made a full commitment to net zero (including scope 3 emissions). Fortum will also commit to set emission reduction targets based on climate science (Science Based Targets initiative 1.5 degrees Celsius scenario), which assumes a full exit from Russia.

We believe the group's earnings will be more volatile than peers' because of its exposure to volatile power prices. Fortum disposed most of its district heating operations over 2016-2022 to finance the €6 billion acquisition of Uniper. As a result, the group does not have a material share of regulated earnings, nor any material long-term power price contracts in place. Hedges give good protection over the next one-to-two years but not beyond. We therefore see a risk that earnings will be more volatile than peers like Vattenfall, CEZ, and Orsted as those either are more integrated or have longer-term contracts in place. Nordic power prices have become more volatile in recent years (see chart 1), albeit at much higher levels than historically. This volatility could provide optimization opportunities. We don't fully exclude that prices could return to historical levels but it's not our base case. As a result, we see a risk that the company's current very strong ratios might not be sustainable. Fortum has a strong track record in current market and with its hedge strategy. Hedges in place enhance near-term protection, with approximately 75% of production hedged at €58 per MWh (/MWh) for 2023 and approximately 45% at €42/MWh for 2024, but this won't provide long-term earnings protection. The Consumer Solutions business segment also provides a degree of natural hedge, depending on volatility in the market. As part of the new strategy, we understand management intends for a meaningful share of the business to be from long-term power contracts with large industrial players. We believe this could strengthen its position but only within the existing satisfactory business risk profile, once the share is sizable enough, which realistically will take a few years.

Chart 1



*March 2023 is until March 3, 2023. €/MWh--Euros per megawatt hour. Source: S&P Global Ratings.

Higher power prices and disciplined investments result in financial headroom for our 'BBB' rating on Fortum over 2023-2025. We forecast EBITDA of €2.0 billion-€2.4 billion annually over 2023-2025, supported by continued high power prices in the regions where Fortum operates, compared with €2 billion in 2022 (all data excluding Russian operations and Uniper). We expect that sustained EBITDA, coupled with annual capex of about €800 million including growth investments of €500 million, will result in ample balance-sheet headroom, at least in the near term. This is despite relatively large dividends of as much as €800 million-€1,100 million per year in our base case. We now forecast FFO to debt of over 100% for 2023, well above the downside trigger for the 'BBB' rating that we set at clearly above 30%. This assumes that most of Fortum's outstanding margin receivables of about €2.3 billion will flow back over 2023 and 2024. The temporary 30% windfall income tax is on top of the normal 20% tax rate in Finland recently approved by parliament and will somewhat weaken Fortum's cash conversion but not enough to materially affect our main credit metrics.

The company's stated dividend policy is now set at 60%-90% of earnings per share, leading us to forecast it will slightly exceed capex over the next three years. This is more aggressive than what we forecast for any of Fortum's main peers, who tend to distribute half as much as they invest, at least over time. We view the policy as aggressive, corresponding to about half of expected FFO over 2023 and 2024 and leading to weak discretionary cash flow (DCF). Our DCF to debt metric is likely to be well below 10% on average for the coming three years. Being proportional to earnings, dividends should, however, automatically reduce if power prices fall, which somewhat mitigates our view of the new dividend policy as credit dilutive.

Management is very committed to the 'BBB' rating. On top of a strong public commitment, we note the near-term hedge level is higher than typical and investment levels should allow net debt to be well below the company's tolerance. Management has set its planned investment hurdles at a weighted average cost of capital (WACC) plus 150 basis points (bps)–400 bps compared with a WACC of plus 100 bps-200 bps previously, which also highlights a disciplined approach to capital allocation. However, we see a risk that initial investment levels are too low in relation to EBITDA and FFO, and since demand growth is likely to be high over the coming years and peers are investing aggressively. Although understandably, the Uniper investment-and-divestment sequence has taken a lot of management time and attention in recent years, and it might take time to ramp up investment for project management rather than financial reasons, if there was sustained underinvestment in the business over time it could undermine Fortum's competitive and overall business position. This is notable in relation with the relatively aggressive dividend policy that strongly reduces the potential to invest free cash flow. However, low investment levels are partly mitigated by Fortum's already good position to achieve net zero emissions by 2030, which allows its investment to be more focused on capacity increases rather than the replacement seen for most European peers. Moreover, Fortum's new strategy is more focused on its low-country-risk home market than peers in general.

The key uncertainties in our base case are power prices, the Russian operations, and investment levels.

- At this stage, we believe the risk of falling power prices is one of the sensitivities for our base case. If power prices fall from about €60/MWh-€80/MWh in our base case to €50/MWh for 2023 and 2024, we estimate an EBITDA impact of €400 million-€600 million. Although this demonstrates the company's exposure to volatility, we still expect ratios to remain well within rating thresholds. This scenario takes into account current high hedge levels, which leave the group more exposed to lower power prices after mid-year 2023.
- Selling the Russian operations could provide some upside but it is not part of our assumptions due to high uncertainty. We do not include a disposal in our base case, nor any EBITDA or cash flow effect. Management treats it as a ringfenced business and we understand it has no intention to support the operation even if needed. The financial effects of a sale are very difficult to forecast. In 2022, the operations generated about €400 million in EBITDA.
- Over time, we don't rule out that investment or acquisitions could be scaled up and sizable, but see it as unlikely over the coming two-to-three years. Fortum has started some nuclear pre-studies, but any firm investment decision is realistically several years out. Fortum also has a right to first offer in case Uniper intends to divest all or parts of its Swedish hydro and nuclear assets. A lifetime extension for the Loviisa nuclear power plant in Finland is already approved, with total capex over the extension period of approximately €1 billion.
- Higher power prices would force Fortum to increase its collateral, which could significantly increase short-term debt and temporarily weaken the credit ratios. At year-end 2022, the outstanding amount was about €2.25 billion, compared with €2.9 billion at Sept. 30, 2022. The reduction reflects lower power prices and delivered power during the period. In our forecast, we assume the outstanding amount will flow in over the coming two years, although this is based on power prices staying at about current levels.
- The likelihood of a new power market design over the medium term continues to add complexity. However, since Finland recently implemented a 30% energy tax, this is likely somewhat more remote.

We continue to incorporate one notch of uplift to our assessment of Fortum's SACP. The Finnish government, with a 51.26% share, is Fortum's major shareholder. We view Fortum as important for the country because it is the largest electricity producer.

Outlook

The stable outlook reflects our assumption that cash flow from Fortum's generation segment will remain significant, albeit very volatile, throughout 2023 and 2024, with electricity prices well above historical levels. We anticipate new investment of close to €2.4 billion over 2023 and 2025. Thanks to increasing electricity prices and the company's relatively low debt levels, we expect ample headroom, with FFO to debt well above the 30%-45% that is commensurate with the rating. We also expect the utility's relationship with the Finnish government to remain stable.

Downside scenario

We could lower the ratings if Fortum's FFO to debt deteriorates below 30% without signs of recovery. This could follow electricity price decreases or debt-funded investments, which we see as unlikely over 2023 or 2024. We could also lower the rating if our assessment of government support weakens, although we view this as very unlikely. Should Fortum provide support to its Russian operations, it could also lead to negative rating actions, since we now fully disregard them in our analysis and, like management, see Fortum as ring-fenced from them.

Upside scenario

Prospects for a higher rating are constrained by the company's financial policy, which we think will lead net debt to EBITDA to approach at least 2.0x-2.5x temporarily, which should translate to FFO to debt of about 30%-45%. Our current view of Fortum's business risk and its exposure to power prices also somewhat mute upside potential. Furthermore, any rating upside would hinge on clarity on long-term investment plans.

Company Description

In 2022, Fortum reported EBITDA of €2.0 billion, excluding its Russian operations. The company was founded in 1998 and is headquartered in Espoo, Finland. At Dec. 31, 2022, the main shareholder was the Finnish government, with 51.26% of the share capital. Fortum had about 5,000 employees, excluding Russia, on the same date. In addition to its strong position in generation, Fortum is the third largest carbon dioxide (CO_2)-free generator in Europe because of its zero-to-low CO_2-emission fleet, with almost all (excluding Russian generation assets) of its generation assets being CO_2-free. Fortum engages in the generation and sale of electricity and heat in the Nordic countries. Its main activities consist of three segments: Generation, City Solutions, and Consumer Solutions. From March 1, 2023, the new structure will be Generation, Consumer Solutions and Other (which includes Circular Solutions).

Electricity generation represents the vast majority of EBITDA. It consists mainly of hydro and nuclear generation. Fortum also has thermal electricity and heat generation in Russia but we do not include any contribution from those activities to our base case, since they are sanctioned and the company has said it will dispose the assets as soon as it receives permission from the Russian regulator. In December 2022, Fortum sold its 80% stake in Uniper to the German government for €500 million, which transformed the group's operations.

Our Base-Case Scenario

Assumptions

- Finnish GDP growth of 0% in 2023, and 1.3% in 2024.
- A Nord Pool system price averaging €70/MWh-€80/MWh in 2023, and about €65/MWh-€75/MWh in 2023 and 2024.
- Total annual production volume of about 44 TWh-46 TWh, with about 50% each from hydro and nuclear.
- Approximately 75% of estimated Nordic generation hedged at €58/MWh for 2023 and approximately 45% at €42/MWh for 2024.
- Margin call inflows of about €1.7 billion and €600 million respectively in 2023 and 2024.
- Annual capex of about €800 million, both growth and maintenance capex, which could include smaller acquisitions.
- Dividends based on 60%-90% of comparable earnings per share/net profit.
- The 20% corporate tax and another 30% temporary windfall tax on Finnish power sales that is payable in 2024
- Larger acquisitions are not included in our base case.

Key metrics

Fortum Oyj--Key Metrics

Bil €	2021	2022*	2023e	2024f
EBITDA	4,683	2,382	2,300-2,800	2,000-2,500
Fund from Operations (FFO)	3988	2,014	1,750-2,250	1,500-2,000
Debt	10,972	4,127	1,300-1,800	300-800
FFO to Debt (%)	36.3	48.8	100-150	>200
Debt to EBITDA (x)	2.3	1.7	0.5-1.0	0.2-0.8

*Based upon preliminary numbers released March 2022 e--Estimate. f-Forecast.

Liquidity

We view the consolidated Fortum's liquidity as adequate. This is despite our estimate that its liquidity sources, including cash, FFO, and facility availability, will cover expected cash outflows about 3.0x in the 12 months started Dec. 31, 2022, which is a high ratio. However, we believe there is uncertainty on the development of power prices, which could lead to margin call outflows if prices spike again.

Nevertheless, Fortum's liquidity remains supported by sound relationships with its core banks, and its owner. This was proven in 2022 when Finland, via Solidium Oy, provided a bridge financing arrangement to Fortum of €2.3 billion, needed to help the group meet it marginal requirements. Also, several bank lines were renewed over 2022, a year that could be viewed as a stress test because of the great volatility in the market. Alongside the long-term credit lines we weigh into our calculation, we note Fortum has access to shorter-term credit facilities that fall due within one year, and we therefore don't include them in our calculations. Its debt documents do not contain any financial covenants. Fortum relies on two key revolving credit facilities (RCFs), one of €3.1 billion maturing in June 2024 and the other of €2.4 billion maturing in June 2025. Debt maturities are somewhat concentrated over the next two years, with about €2 billion annually over 2023 and 2024. In line with its normal prudent behavior, we expect management to proactively start to extend the debt maturity profile shortly.

Principal liquidity sources for the group as of Dec. 31, 2022, include:

- Our estimate of cash and cash equivalents of about €3.6 billion, excluding cash held in Russia;
- Access to €4.40 billion of undrawn facilities maturing after 12 months;
- Positive cash FFO, which we estimate will near €2 billion in the next 12 months; and
- Some working capital inflows.

Principal liquidity uses for the group as of the same date include:

- Debt of about €2 billion maturing in the next 12 months;
- Capex of about €700 million; and
- Dividends of about €800 million in the next 12 months.

Environmental, Social, And Governance

ESG credit indicators: To E-2, S-2, G-3; From E-4, S-2, G-3

Environmental factors have been strengthened by the strategy update. We revised up our environmental credit indicator to 'E-2' from 'E-4' as an effect of the Uniper disposal and the expected sale of Russian assets. The Russian operations account for more than 90% of the group's emissions today. We believe that Fortum is among the best-positioned power generators in Europe, given it has one of the lowest carbon footprints per produced electricity unit among rated utilities, with CO_2 emissions per MWh of power generation of 25 kilograms during 2022. This allows Fortum to focus more on growth, and not on transitioning its generation fleet, unlike other generators that have thermal generation to be phased out or transitioned to renewable sources of fuel.

Governance factors are a moderately negative consideration. We revised down our management and governance assessment for the company to fair, following the Uniper acquisition in 2018.

Ratings Score Snapshot

Issuer Credit Rating	BBB/A-2Stable
Business risk:	Satisfactory
Country risk	Very Low risk

Issuer Credit Rating	BBB/A-2Stable
Industry risk	Moderately High
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	bbb-
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bbb-
Group credit profile	bbb-
Related government rating	AA+
Likelihood of government support	Moderate (+1 notch)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Finland-Based Power Company Fortum 'BBB/A-2' Ratings Affirmed Following Uniper Support Package; Outlook Negative, Aug. 3, 2022

Ratings List

Ratings Affirmed		
Fortum Oyj		
Senior Unsecured	BBB	
Ratings Affirmed; Outlook Action		
	To	**From**
Fortum Oyj		
Issuer Credit Rating	BBB/Stable/A-2	BBB/Negative/A-2

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; or Stockholm (46) 8-440-5914