

Research Update:

Finland-Based Fortum Upgraded To 'BBB+' On Prudent Balance Sheet And Financial Policy; Outlook Stable

March 25, 2024

Rating Action Overview

- Nordic power generator Fortum Oyj will maintain its strong balance sheet, according to our projections of S&P Global Ratings-adjusted EBITDA of 1.0x-1.3x over 2024-2026, even though we expect that softer power prices will reduce the group's annual EBITDA to €1.6 billion-€1.4 billion over the same period, from €1.9 billion in 2023.
- We expect Fortum's funds from operations (FFO) to debt to remain at 60%-80% on the back of management's disciplined approach to investment and expansion at pace with demand growth, without any major acquisition. Positively, Fortum has already decarbonized most of its generation.
- We therefore raised our long-term ratings on Fortum and its senior unsecured debt to 'BBB+' from 'BBB', and we affirmed the 'A-2' short-term rating on the company.
- The stable outlook indicates our assumption Fortum will sustain S&P Global Ratings-adjusted FFO to debt comfortably above 40% despite a fairly aggressive dividend policy and expectations about continued volatile power price.
- We also reassessed Fortum's liquidity position to strong from adequate and its management and governance to neutral from moderately negative.

PRIMARY CREDIT ANALYST

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

SECONDARY CONTACT

Emmanuel Dubois-Pelerin
Paris
+ 33 14 420 6673
emmanuel.dubois-pelerin
@spglobal.com

ADDITIONAL CONTACT

Corporate and IFR EMEA
RatingsCorpIFREMEA
@spglobal.com

Rating Action Rationale

The upgrade reflects that we expect Fortum will sustain its strong balance sheet over 2024-2026. We view Fortum's balance sheet as strong and credit ratios well in line with our 'BBB+' rating. S&P Global Ratings-adjusted net debt to EBITDA stood at 0.9x at end-2023, and we forecast the ratio to weaken only gradually to 1.0x-1.3x over 2024-2025. The slight weakening stems from modest negative discretionary cash flow of €150 million-€300 million annually. We expect cash flow to cover annual capital expenditure (capex), which we assume will be €500 million-€600 million considering the group recently lowered its 2024-2026 spending to €1.7

billion. But still-high dividends will ultimately increase debt due to negative discretionary cash flow. Overall, we assume Fortum will deliver on the lower range of its financial policy target of max net debt of EBITDA of 2.0x; and we assume those levels to be only temporary.

Fortum's strong balance sheet provides good protection from the impact of volatile Nordic power prices. The group's metrics could nevertheless shift due to the continued price volatility, notably since Fortum, in contrast to many peers, as a pure power producer, lacks the stability that regulated operations typically provides. In our base case we assume Nordic power prices will normalize at €40/MWh-€45/MWh over 2024-2025, which is higher than pre-2020 prices but much lower than last year's €56/MWh. The group could, however, continue to feel the impact of fluctuating prices, particularly on a quarterly basis. In our view, Fortum's strong balance sheet gives the group headroom to absorb an EBITDA decline of 25%-30% from our base-case projection of €1.6 billion in 2025 while maintaining credit ratios in line with our updated minimum expectation of not materially lower than 40% funds from operations (FFO) to debt.

We think Fortum's strategy reinforces its core position in the Nordics, its home market.

Fortum's Nordic growth strategy, announced about a year ago, contrasts with its 2017-2022 strategy that involved the unsuccessful acquisition of Uniper. Of the €7 billion paid by Fortum, only about €500 million was recovered by the German government's acquiring of Uniper (see "Full Impact Of Fortum's Uniper Divestment Still To Be Determined," published Sept. 29, 2022, on RatingsDirect). We consider Fortum's current focus, purely on the Nordic market, as much less risky. A majority of investments, €1.7 billion in total over 2024-2026, is directed toward Fortum's core areas, namely hydro and nuclear, notably the Loviisa life expansion. We understand investment in onshore wind and solar will happen only on customer demand, meaning firm power price agreements signed (i.e. no merchant exposure) before investments are embarked. As Fortum builds up a higher share of power purchase agreements (PPAs), in line with its strategy, its business risk profile could strengthen within our current satisfactory assessment; Fortum will likely need a share of PPAs solidly above 30% for that. Despite the recent start-up of TVO's nuclear plant (in which Fortum owns a 25% stake), Finland remains a net power importer, albeit lower than in the past, and Fortum typically covers about 35% of the Finnish power demand. Together with hedged volumes, in 2023 Fortum achieved a high price realization of €63/MWh. This was also thanks to its flexibility and low emission generation. In late 2023 Fortum revised its guidance for its optimization into the range of €6/MWh-€8/MWh above the system prices. We see this as a key strength, reflecting its generation flexibility--mainly hydro--although we think it lower than Statkraft's and Verbund's, which operate only hydro assets. In the current environment, flexible production has clearly become more attractive. For 2024 and 2025, Fortum has hedged 70% and 40% of expected production at €47/MWh and €43/MWh, respectively. This gives good visibility and support to near-term cash flow and profitability. Furthermore, 15% has 10-year rolling hedged for 2024-2033.

We still see some risk of underinvestment, but can understand management's prudent

approach. We continue to note that Fortum's investment levels are lower than most peers', while its dividends are high, reflecting its 60%-90% payout policy. Positively, this implies lower dividend in case of lower earnings, stabilizing discretionary free cash flow. In our base case we assume that Fortum will payout about €1 billion annually, or about a high two-thirds of EBITDA. This indicates dividends exceeding capex, which differs from the approach of peers Vattenfall, Statkraft, and Verbund. For Fortum, this results in weak supplementary ratios such as discretionary cash flow to debt, which weighs on our financial risk assessment.

We view positively, however, that Fortum's requirement to invest into the net zero transition is very low. This is in contrast to most European peers since Fortum does not need to invest to replace emitting production capacity; hence investment requirements are lower. Fortum's generation assets of 9.248GW consist mainly of hydro and nuclear; in 2023 the group generated about 45% and 53%, respectively, of the power generation. This implies that Fortum, again in contrast to most other sector participants, has no exposure to replacement risk, and less exposure to construction risk. In 2023 this led to substantial write-downs for some of its peers such as Vattenfall and Orsted; and we believe we will see more revised investment strategies in sector participants over 2024. Fortum has brought forward its target to reach carbon neutrality by 2030, across all three scopes, focus on providing reliable clean energy and drive decarbonization across industries in the Nordics. The targets aim to achieve emission levels of less than 20 grams of carbon dioxide equivalent per kilowatt hour (gCO₂/kWh) for total energy production and below 10gCO₂/kWh for power generation alone by 2028.

Current market prices have also softened to levels that make investments in renewables

riskier. The breakeven cost for solar, offshore wind and nuclear are well above current market prices in Finland and price area SE2 and SE3 where Fortum's main operations are located. This implies that new investments could jeopardize profitability and cash flow. Onshore wind is likely around breakeven with today's prices, at best. We therefore assume that management will stick to a disciplined approach to investment, not pursuing further growth in Finland and Sweden, where prices are very competitive, but to embark on larger projects only when there are credit-supportive offtake agreements. Growth rate in power demand in the Nordic region, however, is forecast to increase substantially over 2025-2030, suggesting the potential of higher power prices. We don't rule out that, over time, and when demand starts to pick up, likely as a result of the large industrial decarbonization projects in Northern part of Sweden and Finland, Fortum could embark on a larger project, such as nuclear power plants constructions. If so, we expect dividend pay-out to be lower. Nevertheless, we assume any firm investment decisions are at least five years out and would likely only come with risk-sharing mechanisms in place.

We continue to incorporate one notch of uplift to our stand-alone credit profile (SACP)

assessment for Fortum. 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 robust, albeit potentially very volatile, through 2025. We anticipate total investment (maintenance and growth) of close to €1.7 billion in aggregate over 2024-2026, which, given its relatively low initial debt, can comfortably be financed while keeping FFO to debt well above the 40% 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 significantly below 40% without signs of recovery. This could follow electricity price decreases more than we anticipate or debt-funded investments, which we see as unlikely over 2024 or 2025. We could also lower the rating if our assessment of government support weakens, although we view this as very unlikely.

Upside scenario

Further upside potential is likely limited, given Fortum exposure to power prices and lack of regulated earnings. We also take into account the company's financial policy, which we think could lead net debt to EBITDA to approach at least 2.0x-2.5x temporarily.

Company Description

Fortum engages in the generation and sale of electricity and heat in the Nordic countries. Its main activities consist of three segments: 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. In 2023, Fortum reported EBITDA of €1.9 billion; the main shareholder is the Finnish state, with 51.26% of the share capital. Fortum is the third-largest carbon dioxide (CO₂)-free generator in Europe because of its zero-to-low CO₂-emission fleet, with almost all of its generation assets being CO₂-free.

Our Base-Case Scenario

Assumptions

- A Nord Pool system price averaging €40/MWh-€45/MWh in 2024 and 2025.
- Total annual production volume of 44 TWh-46 TWh, with about 50% each from hydro and nuclear.
- Approximately 75% of estimated Nordic generation hedged at €47/MWh for 2024 and approximately 40% at €43/MWh for 2025.
- Margin call inflows of €400 million-500 billion in 2024.
- Annual capex of €500 million-€600 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
- Larger acquisitions are not included in our base case.

Key metrics

Fortum Oyj--Key metrics

(Mil. €)	2021a	2022a	2023a	2024f	2025f
EBITDA	4,683	2,249	1,914	1,600-1,800	1,400-1,600
Funds from operations (FFO)	3,988	1,881	1,232	1,350-1,550	1,200-1,400
Debt	10,972	4128,2	1,754	1,500-1,700	1,700-1,900

Fortum Oyj--Key metrics (cont.)

(Mil. €)	2021a	2022a	2023a	2024f	2025f
Adjusted ratios					
Debt/EBITDA (x)	2.3	1.8	0.9	0.9-1.3	1.0-1.3
FFO/debt (%)	36.3	45.6	70.0	80.0-100.0	60.0-80.0
DCF/Debt (%)	23.9	13.0	18.2	(15.0-20.0)	(5.0-10.0)

All figures are adjusted by S&P Global Ratings, unless stated as reported. Uniper is no longer consolidated from end-2023 a--Actual. e--Estimate. f--Forecast. In 2024 we assume some marginal collateral receivables inflow.

Liquidity

We have revised Fortum's liquidity to strong, as the ratio of cash sources to cash needs are very robust and closer to 3.0x for the next 12 month, above our 1.5x minimum expectation, and the ratio exceeds 1x for the second year out despite both revolving credit facilities (RCFs) maturing.

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 its marginal requirements. During the energy crisis, several bank lines were renewed and increased, which 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. In our understanding, its debt documents do not contain any financial covenants. Fortum relies on two key RCFs, in total €3.2 billion that matures in June 2025. Debt maturities are relatively low over the next two years, with about €1.3 billion in 2024 and €500 million 2025, and could be covered with cash in hand if needed (€4.2 billion). In line with its normal prudent behavior, we expect management to proactively start to extend the RCF.

We estimate that Fortum's principal liquidity sources as of end-2023 include:

- Our estimate of cash and cash equivalents of about €4.2 billion;
- Access to €3.2 billion of undrawn facilities maturing after 12 months;
- Positive cash FFO, which we estimate will near €1.4 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 €1.3 billion maturing in the next 12 months;
- Capex of about €660 million; and
- Dividends of about €1 billion in the next 12 months.

Environmental, Social, And Governance

We now assess Fortum's management and governance as neutral, versus moderately negative previously. We think Fortum, following the Uniper acquisition attempt, has put in a more

conservative strategy. As presented in 2023, it has now been in place for a year and focuses more on Fortum's core market and core expertise, which we view as less risky.

Furthermore, we believe that Fortum is among the best-positioned power generators in Europe to deliver net zero emission, given it has one of the lowest carbon footprints per produced electricity unit among rated utilities, with CO2 emissions per MWh of power generation of 16 kilograms during 2023. 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.

Ratings Score Snapshot

Issuer Credit Rating	BBB+/Stable/A-2
Business risk:	Satisfactory
Country risk	Very low
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	Strong (no impact)
Management and governance	Neutral(no impact)
Comparable rating analysis	Positive (+1 Notch)
Stand-alone credit profile:	bbb
Related government rating	AA+
Likelihood of government support	Moderate (+1 notch)

Related Criteria

- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- 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

- Nordics Utilities Outlook 2024: Increasing Volatility Fuels Uncertainty, Feb. 15, 2024
- Industry Credit Outlook 2024: EMEA Utilities, Jan. 9, 2024

Ratings List

Upgraded		
	To	From
Fortum Oyj		
Issuer Credit Rating	BBB+/Stable/A-2	BBB/Stable/A-2
Senior Unsecured	BBB+	BBB

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