FitchRatings

FITCH AFFIRMS FORTUM AT 'A-'; NEGATIVE OUTLOOK

Fitch Ratings-London-18 November 2014: Fitch Ratings has affirmed Finland-based utilities group Fortum Oyi's (Fortum) Long-term Issuer Default Rating (IDR) and senior unsecured rating at 'A-' and its Short-term IDR at 'F2'. The Outlook is Negative.

The affirmation takes into account higher business risk, following the disposal of regulated network activities in Sweden - expected to be completed over the next 12 months - and de-consolidation of Fortum Varme, which is balanced by the resulting material financial flexibility. Activities will be dominated in the medium term by market-based earnings from low carbon generation assets in the Nordic region (just under 60% of EBITDA), substantial new production capacity in Russia that receives capacity payments (around 25%), some district heating (around 15%) and sales activities (around 2%) in the Nordic region and the Baltics.

Following completion of restructuring Fitch expects the guideline for funds from operations (FFO) adjusted net leverage for the 'A-' rating for the group to tighten to 2.5x from 3.5x. Assuming a sale price of EUR3bn for the Swedish network assets, current capital expenditure guidance and steady dividend pay-out of EUR1.10 per share, the rating forecast indicates that the group should be able to comfortably operate inside the 2.5x FFO net leverage threshold over the medium term.

A revision of the Outlook to Stable is contingent on the following events:
-Completion of the disposal of the Swedish network assets. We note that market participants are speculating that the sale price may be in the region of EUR5.5bn-EUR6bn as opposed to the EUR3bn assumed for Fitch's rating forecast
-Deployment of sale proceeds, including a return to shareholders via dividend. The quantum of any such dividend pay-out over and above the annual EUR1.10 will determine our view on the Outlook
-An update on the group's strategy that provides for a medium-term view on capital expenditure/ growth aspirations

KEY RATING DRIVERS

Cash Flow Generative Business
Fortum is the Finnish electric utility. It produces power (10.9GW capacity) and heat (8.2GW capacity) in the Nordic region, the Baltics and Poland; generation assets include 7.9GW of low-cost nuclear and hydropower, highly cash-generative assets. The group has 17.7GW of electricity and heat capacity in Russia and is finalising its EUR2.5bn investment programme. Other activities include district heating and sales activities in the Nordic region and the Baltics.

Weaker Operating Environment in Scandinavia
Nordpool baseload power continues to see higher spot prices than forward prices, with the latter as low as EUR29-EUR30/MWh. In the past Fortum was able to achieve higher than system prices, due to differences in area prices, production management and a successful hedging strategy. Recently the forward hedged volumes have somewhat declined, leaving a higher portion of electricity exposed to market prices. Elsewhere, in Sweden the new government is discussing an increase in the tax on installed nuclear capacity and potential taxation on nuclear waste.

Disposal Timing Uncertain
The legal process in Sweden concerning the remuneration included in the tariff settlement for the period 2012-2015 was concluded on 10 November in favour of the industry players. A revised tariff methodology is due to be published for the period 2016-2019. The disposal process may have been slightly delayed due to legal and regulatory uncertainty. We assume that the disposal will go through

in 2015 with a conservative multiple of around 8x, which is materially below equity consensus and below the price achieved for Fortum's Finnish networks.

Financials Dependent on Disposal Proceeds

Fortum's FFO adjusted net leverage for 2013 was 3.9x, in line with Fitch's expectations and above the ratio guideline of 3.5x applicable before disposal of the network businesses. We expect gearing to improve visibly with the deployment of disposal proceeds for deleveraging and the de-consolidation of Fortum Varme.

Political and Exchange Rate Risk

Fortum's new gas-fired combined heat and power plants (CHPs) in Russia are contracted under capacity supply agreements, which allow for recovery of capital costs, including a target return of around 12%. The division's profitability has increased due to new units being commissioned and receiving capacity payments despite a weakening rouble. Nevertheless, Fitch takes a cautious view on the Russian business, with our forecast based on modest increases in spot price and local gas price, on a potential downward review of capacity payments in the long term and on a rouble to euro exchange rate of 50.

Deconsolidation of Fortum Varme

Under the previous shareholder agreement with the city of Stockholm, Fortum Oyi had a 50% commercial interest in Fortum Varme and all important decisions had to be taken with a qualified majority, but clauses in the agreement required full consolidation and debt funding through Fortum Oyj. Following re-negotiation of the agreement Fortum Varme will be re-financed on a standalone basis and treated as a joint venture for accounting purposes/equity consolidated.

Fitch will follow the accounting treatment, but has reflected in the revised FFO net leverage guideline of 2.5x that a lower proportion of earnings will be derived from the monopolistic business.

RATING SENSITIVITIES

Negative: Future developments that could lead to negative rating actions include:
- FFO adjusted net leverage above 2.5x on a sustained basis
- FFO fixed charge cover below 6.0x on a sustained basis (2013: 5.1x)

These are the guidelines applicable to the group following disposal of the Swedish network assets and de-consolidation of Fortum Varme.

Positive: The current Outlook is Negative. As a result, Fitch's sensitivities do not currently anticipate developments with a material likelihood, individually or collectively, of leading to a rating upgrade. Future developments that may nonetheless lead to a revision of the Outlook to Stable include:
- The successful sale of the Swedish distribution networks, at a multiple equal or higher than 8.0x and a future business strategy that preserves financial flexibility within the ratio guidelines cited above.

LIQUIDITY AND DEBT STRUCTURE

As of 30 September 2014, the group had available EUR2,157m of cash and equivalents, of which EUR259m was held by OAO Fortum, the Russian part of the business. Additionally, EUR2bn of committed and undrawn revolving credit facilities were in place with maturity in July 2017 and EUR0.2bn short-term overdraft facilities. This funding position will provide sufficient liquidity for scheduled debt maturities, operating requirements, capex and dividends until the end of 2016.

Contact:

Principal Analyst

Ana Gaspar
Associate Director
+44 20 3530 1601

Supervisory Analyst
Oliver Schuh
Director
+44 20 3530 1263
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Committee Chairperson
Arkadiusz Wicik
Senior Director
+48 22 338 6286

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria, 'Corporate Rating Methdology', dated 28 May 2014, are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=749393