

RatingsDirect®

Summary:

Fortum Varme Holding samagt med Stockholms stad (publ), AB

Primary Credit Analyst:

Alf Stenqvist, Stockholm (46) 8-440-5925; alf.stenqvist@standardandpoors.com

Secondary Contact:

Lovisa Forsloef, Stockholm +4684405908; lovisa.forsloef@standardandpoors.com

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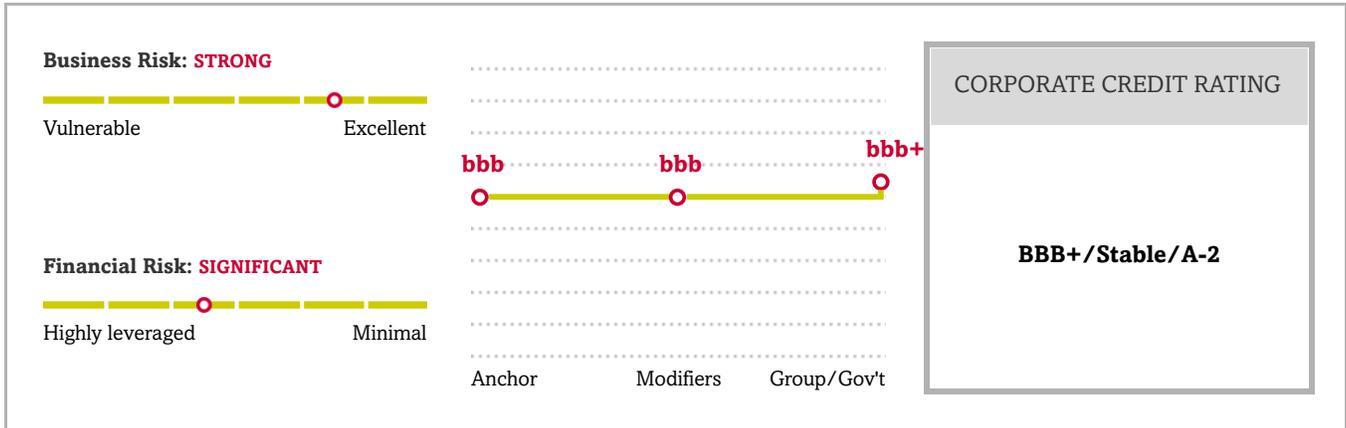
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Summary:

Fortum Varme Holding samagt med Stockholms stad (publ), AB



Rationale

Business Risk: Strong	Financial Risk: Significant
<ul style="list-style-type: none"> • Stable district heating business accounts for about 90% of operations. • Diverse customer base and fuel mix. • Limited geographic diversification with all operations in the Stockholm region. 	<ul style="list-style-type: none"> • Relatively high debt following the significant debt-funded investment in the new combined heat and power plant. • Medial cash flow volatility supporting stability in credit measures. • Strong interest coverage for the "significant" financial risk profile.

Outlook: Stable

Standard & Poor's Ratings Services' stable outlook reflects our expectation that Sweden-based district heating company Fortum Varme Holding samagt med Stockholms stad (publ), AB's (Fortum Varme) operating cash flows will continue to be supported by its stable heating operations. It also reflects our expectation that credit measures will remain appropriate for the "significant" financial risk profile, with FFO-to-debt comfortably exceeding 15%.

Upside scenario

We could consider an upgrade if Fortum Varme's financial policy supported a sustainable improvement of its financial position to a level we view as commensurate with an "intermediate" financial risk profile. This could materialize, all else being equal, if the company's adjusted FFO-to-debt ratio were to exceed 23% on a sustainable basis.

Downside scenario

We could consider a negative rating action if credit metrics were to deteriorate substantially, with FFO to debt below 15% with no expectation of a swift recovery. This could result, for example, from any significant further debt-funded investment, operational underperformance, or higher-than-expected dividends. In addition, we could lower the ratings if the City of Stockholm's ownership stake decreased, because this could lead us to review and revise down our assessment of the likelihood of extraordinary support.

Standard & Poor's Base-Case Scenario

Assumptions	Key Metrics																				
<ul style="list-style-type: none"> We expect about a 5%-10% increase in heat sales volume in 2015, assuming average weather conditions. We also assume a slight decrease in district heating prices because of higher competition from lower electricity prices. We forecast a marginal increase in sales volume and prices in 2016. A 15% increase in electricity production in 2015 as the combined heat and power (CHP) plant in Brista completes its first full year of operations. Annual capital expenditures (capex) of about Swedish krona (SEK) 2.6 billion in 2015 and SEK1.5 billion in 2016. <p>Based on these assumptions, we arrive at the following credit measures for 2015 and 2016:</p> <ul style="list-style-type: none"> Funds from operations (FFO) to debt of about 18.5%-24.0%. FFO cash interest coverage of about 7.5x-12.5x. 	<p>C:\Key Metrics template (Word table).doc</p> <table border="1"> <thead> <tr> <th></th> <th colspan="3">Table</th> </tr> <tr> <th></th> <th>2014a*</th> <th>2015f</th> <th>2016f</th> </tr> </thead> <tbody> <tr> <td>EBITDA margin (%)</td> <td>43.1</td> <td>44.0-46.0</td> <td>47.0-49.0</td> </tr> <tr> <td>FFO-to-debt (%)</td> <td>18.6</td> <td>18.5-20.5</td> <td>22.0-24.0</td> </tr> <tr> <td>FFO cash interest (x)</td> <td>6.6</td> <td>7.5-9.5</td> <td>10.5-12.5</td> </tr> </tbody> </table> <p>*Fully Standard & Poor's-adjusted. a--Actual. f--Forecast.</p>		Table				2014a*	2015f	2016f	EBITDA margin (%)	43.1	44.0-46.0	47.0-49.0	FFO-to-debt (%)	18.6	18.5-20.5	22.0-24.0	FFO cash interest (x)	6.6	7.5-9.5	10.5-12.5
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Business Risk: Strong

Fortum Varme's "strong" business risk profile reflects its "satisfactory" competitive position in district heating operations. This segment accounts for about 90% of revenues and EBITDA, and we assess it as having "very low" industry risk. While there is no defined regulatory framework for district heating in Sweden, the company is the sole district heating network operator in its area, with implicit oversight from the Swedish Competition Authority. We view the current market-based framework for district heating as predictable, because it has remained largely unchanged since the 1950s, which brings stability to the business. We also assess the risk of any negative political intervention as limited.

The stable operating environment is somewhat offset by the volume and fuel price risks related to district heating, with warmer or colder winters leading to volume volatility. The absence of a defined tariff regulation for cost cover means there is no guarantee that the company could recover costs arising from the aforementioned volatility, however we note that the company's operating profit has been historically relatively stable.

Fortum Varme's business risk profile is further supported by its diverse customer base, which mainly consists of real estate companies and housing associations. Such customers generally exhibit more stable demand than industrial customers. The company also benefits from a diverse fuel split, which enables it to react to prevailing fuel prices by switching between different fuel types. The company is, however, exposed to geographic concentration because all of its operations are in the City of Stockholm region. This concentration is partly mitigated by the region's very strong and dynamic local economy.

Financial Risk: Significant

Fortum Varme's "significant" financial risk profile is constrained by the company's relatively high debt leverage, with FFO to debt at 19% in 2014. The company has recently completed a new CHP plant in Brista, and is currently constructing an additional CHP plant, which is expected to be fully operational by the first quarter of 2016. The fully debt-funded investment in this new plant has put pressure on credit ratios. We expect FFO to debt to stay at about 19% in 2015 before improving to above 22%-24% in 2016, barring any new significant debt-funded acquisition or increased shareholder dividends. Although the new plant will replace existing capacity, the new plant is also expected to increase cash flow through added electricity production and lower fuel costs. We also take into account the company's medial cash flow volatility, resulting from the relative stability of its district heating operations, which also add to stability in credit measures.

Liquidity: Adequate

We view Fortum Varme's liquidity as "adequate," under our criteria. We believe that available liquidity sources in terms of cash, committed credit facilities, and operating cash flow should be in excess of 1.1x of forecast near-term cash outflows, such as debt repayments and committed capital expenditures. We also expect that sources will exceed uses even if EBITDA declines by 10%. We believe that the company has sound relationships with banks, generally prudent risk management, and no restrictive financial covenants in its loan documentation.

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none">• Forecast FFO of around SEK2.5 billion in 2015.• An unused SEK3.0 billion committed overdraft facility maturing in June 2019.• SEK650 million long-term financing available under loan facilities from the European Investment Bank for the ongoing CHP project.	<ul style="list-style-type: none">• Expected capex of around SEK2.6 billion in 2015, which we believe could be reduced under a stress scenario.• SEK2.7 billion of loans maturing in 2015, of which SEK1.7 billion is made up of shareholder loans from Fortum.• Forecast working capital outflow of about SEK200 million-SEK250 million in 2015.• Expected dividend payments of SEK400 million, which we anticipate could be scrapped in a stress scenario.

Government Influence

In accordance with our criteria for government-related entities (GREs), our view that there is a "moderate" likelihood of extraordinary support from the City of Stockholm is based on our assessment of Fortum Varme's:

- "Strong" link to the City of Stockholm. This is based on the City of Stockholm's effective ownership of 50% of the company. While Stockholm currently owns 9.9% of Fortum Varme's shares, it has 49.9% of the votes, and

preference shares which gives it access to 50% of the company's profits. It also has subscription rights that, if exercised, bring Stockholm's ownership to 50%. Following a renewed shareholder agreement with the other owner, Fortum Oyj (Fortum), the City of Stockholm will exercise its subscription rights, and the two parties will each have 50% of both shares and votes as of Jan. 1, 2016.

- "Limited importance" for the City of Stockholm. Although Fortum Varme provides the vast majority of all heating in the City of Stockholm, we assess that, given the joint ownership with Fortum, the City of Stockholm is primarily interested in Fortum Varme's operations, and that its services could be provided by a private sector entity or another GRE.

Ratings Score Snapshot

Corporate Credit Rating

BBB+/Stable/A-2

Business risk: Strong

- **Country risk:** Very low
- **Industry risk:** Very low
- **Competitive position:** Satisfactory

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:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : bbb

- **Related government rating:** AAA
- **Likelihood of government support:** Moderate (+1 notch from SACP)

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, Mar. 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Standard & Poor's National And Regional Scale Mapping Tables, September 30, 2014

- Group Rating Methodology, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Country Risk Assessments Update: February 2015, Feb. 27, 2015
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

Business And Financial Risk Matrix						
Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Additional Contact:

Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com

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