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## Research Update:

# Swedish District Heating Company Fortum Varme Holding samagt med Stockholms stad Affirmed At 'BBB+/A-2'; Outlook Stable

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## Table Of Contents

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Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria And Research

Ratings List

## Research Update:

# Swedish District Heating Company Fortum Varme Holding samagt med Stockholms stad Affirmed At 'BBB+/A-2'; Outlook Stable

## Overview

- Fortum Varme's new combined heat and power plant is nearing completion, according to plan.
- We believe that the commissioning of the plant will improve Fortum Varme's cash flows and credit metrics, owing to increased electricity production and decreased fuel costs.
- We are affirming our 'BBB+/A-2' and 'K-1' ratings on Fortum Varme.
- The stable outlook reflects our expectation that the company's cash flows will continue to be supported by its stable district heating operations.

## Rating Action

On April 1, 2016, Standard & Poor's Ratings Services affirmed its 'BBB+/A-2' long- and short-term corporate credit ratings on Sweden-based district heating company Fortum Varme Holding samagt med Stockholms stad (publ), AB (Fortum Varme). The outlook remains stable.

At the same time, we affirmed our 'K-1' short-term Nordic regional scale rating on Fortum Varme.

## Rationale

The affirmation follows Fortum Varme's successful progression with the construction of a new combined heat and power (CHP) plant in Värtan, which is nearing completion, according to plan. Although we note that the company's credit measures have been under pressure from the debt-funded investment of the new CHP plant, we expect they will improve once the plant goes into operation, providing increased capacity and a less costly fuel mix.

Unusually warm weather hampered Fortum Varme's revenue in 2015, resulting in lower-than-expected heat volumes. Profitability has, however, remained relatively stable, demonstrating the flexibility in production. The company benefits from a diverse fuel split, which enables it to react to fuel price fluctuations by switching between different fuel types.

The ratings continue to reflect Fortum Varme's satisfactory competitive position in district heating operations, which account for about 90% of the company's revenues and EBITDA. Although 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, which brings stability to the business. The stable operating environment is, however, somewhat offset by 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, but we note that the company's operating profit has historically been relatively stable.

Fortum Varme's significant financial risk profile is constrained by relatively high debt leverage, with funds from operations (FFO) to debt at 16% in 2015, down from 19% in 2014. The decline in this metric stems from the unusually warm weather in 2015, as well as an extraordinary interest expense related to early repayment of shareholder loans. The fully debt-funded investment in the new CHP plant has continued to put pressure on credit ratios, but we expect the metrics to improve once the new CHP plant starts operations in the first half of 2016. We expect FFO to debt to improve to about 20% in 2016, barring any new significant debt-funded acquisition or increased shareholder dividends. Although the new plant will replace existing capacity, it is also expected to increase cash flow through additional electricity production and lower fuel costs. In addition, the company's successful refinancing of high-cost shareholder loans by issuing external debt at low interest rates will also help strengthen its credit measures. We also take into account the company's medial cash flow volatility, resulting from the relative stability of its district heating operations, which adds stability to its credit measures.

We view Fortum Varme as a government-related entity (GRE) that we believe has a moderate likelihood of receiving extraordinary support from the City of Stockholm, based on our assessment of its:

- Strong link to the city, which owns 50% of the company, as confirmed in the renewal of the shareholder agreement with the other owner, Fortum Oyj, as of Jan. 1, 2016; and
- Limited importance for the City of Stockholm. Although Fortum Varme provides the vast majority of heating in the city, we consider that, given the joint ownership with Fortum, the City of Stockholm is primarily interested in Fortum Varme's operations, and that the company's services could be provided by a private-sector entity or another GRE.

In our base case, we assume:

- A heat sales volume increase of about 15%-20% in 2016, given normal weather conditions (in line with historical averages) and the new CHP coming on line in the first half of the year.
- A slight decrease in district heating prices because of competitive pressure from alternative heating sources, and stable sales volumes and prices in 2017.
- A 30% increase in electricity production in 2016 after the CHP plant in Värtan starts production.
- Annual capital expenditure of about Swedish krona (SEK) 2.0 billion (about €0.2 billion) in 2016 and SEK1.8 billion in 2017.

Based on these assumptions, we arrive at the following credit measures in 2016 and 2017:

- FFO to debt of about 20%-22%; and
- FFO cash interest coverage of about 15x-20x.

## **Liquidity**

We view Fortum Varme's liquidity as adequate. We estimate that available liquidity sources in terms of cash, committed credit facilities, and operating cash flow will be in excess of 1.1x of forecast near-term cash outflows, such as debt repayments and committed capital expenditures. We also expect that liquidity 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:

- Forecast FFO of about SEK2.7 billion in 2016.
- An unused SEK3.0 billion committed overdraft facility maturing in June 2020.

Principal liquidity uses:

- Expected capital expenditure of about SEK2.0 billion in 2016, which we believe could be reduced in a stress scenario.
- SEK1.26 billion of loans maturing in 2016, of which SEK200 million relate to commercial paper.
- Forecast working capital outflow of below SEK100 million in 2016.
- Expected dividend payments of SEK400 million, which we anticipate could be cancelled or deferred in a stress scenario.

## **Outlook**

The stable outlook reflects our expectation that Fortum Varme's operating cash flows will continue to be supported by its stable heating operations. It also reflects our expectation that the company's credit measures will remain appropriate for its significant financial risk profile, with FFO to debt comfortably exceeding 15%.

## **Downside Scenario**

We could consider a negative rating action if Fortum Varme's credit metrics were to deteriorate substantially, with FFO to debt below 15% with low prospects for a swift recovery. This could result, for example, from 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 revise down our assessment of the likelihood of extraordinary support.

## **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.

## Ratings Score Snapshot

	Scores
Country Risk	Very Low
Industry Risk	Very Low
Competitive Position	Satisfactory
Cash Flow/Leverage	Significant
<b>Anchor</b>	bbb
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)
Related Government Rating	AAA
Likelihood of Government Support	Moderate (+1 notch)

## Related Criteria And Research

### Related Criteria

- General Criteria: Standard & Poor's National And Regional Scale Mapping Tables - January 19, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue -

April 15, 2008

## Related Research

- Country Risk Assessments Update: December 2015, Dec. 21, 2015
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

## Ratings List

	Rating	
	To	From
Fortum Varme Holding samagt med Stockholms stad (publ), AB		
Corporate Credit Rating		
Foreign and Local Currency	BBB+/Stable/A-2	BBB+/Stable/A-2
Nordic Regional Scale	--/--/K-1	--/--/K-1
Senior Unsecured		
Foreign and Local Currency	BBB+	BBB+

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