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Summary:

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

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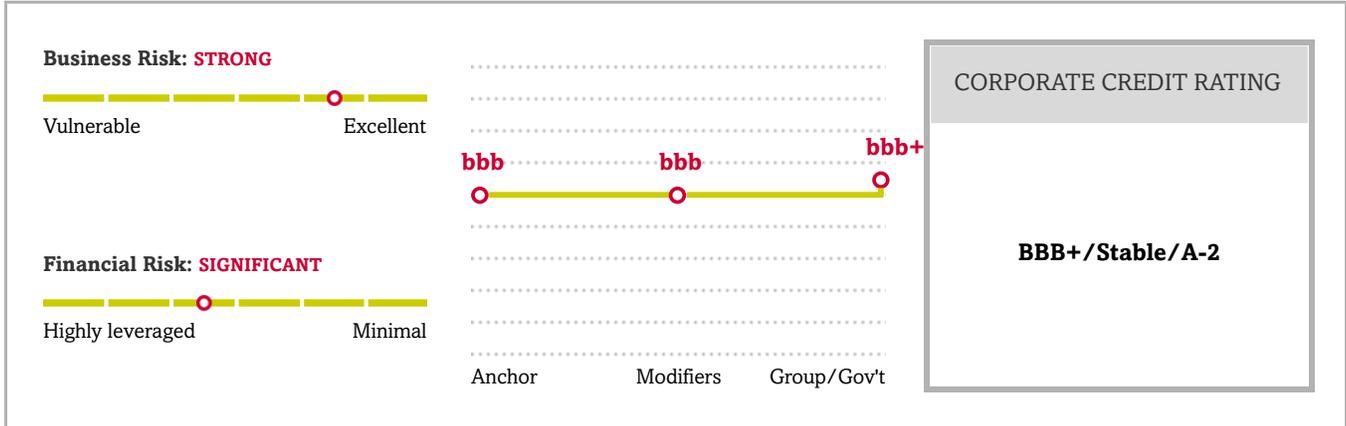
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Summary:

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 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

S&P Global Ratings' 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 revise down our assessment of the likelihood of extraordinary support.

Our Base-Case Scenario

Assumptions	Key Metrics			
<ul style="list-style-type: none"> • Low single digit revenue growth over the next two years. • EBITDA margin between 46%-50% over the forecast period, improving with the increase of fossil free fuel mix. • Annual capex of roughly SEK2 billion over the next two years. • Ongoing dividends of SEK400 million annually. 		2016A	2017F	2018F
	EBITDA Margin (%)	41.5	46.5-48.5	46.5-48.5
	FFO-to-debt (%)	19.6	20-22	20-22
	FFO cash interest (x)	18.7	12.5-14.5	14.5-16.5
A--Actual. F--Forecast.				

Business Risk: Strong

Fortum Varme's business risk profile reflects its 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, and recent investment in new plant should also support operating efficiency.

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 financial risk profile is constrained by relatively high debt leverage, with funds from operations (FFO) to debt at 19.6% in 2016. The fully debt-funded investment in the new CHP plant has continued to put pressure on credit ratios, but we expect these will improve because the CHP plant has started operations and is performing better than expected. We expect FFO to debt to improve to between 20%-22% in 2017-2018. The new plant is increasing cash flows through additional 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.

Liquidity: Adequate

Fortum Varme's adequate liquidity reflects our view that available liquidity sources in terms of cash, committed credit facilities, and operating cash flow will exceed 1.1x of forecast near-term cash outflows, such as debt repayments and committed capex. 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 SEK2.6 billion in 2017.• An unused SEK3 billion committed overdraft facility maturing in June 2020.	<ul style="list-style-type: none">• Expected capex of around SEK1.7 billion in 2017.• SEK1.6 billion of loans maturing in 2017.• Forecast working capital outflow of about SEK40 million in 2017.• Expected dividend payments of SEK400 million.

Government Influence

The ratings on Fortum Varme currently benefits from one notch uplift from its SACP, based on our view that there is a moderate likelihood of extraordinary support from the City of Stockholm in case of financial distress. This is based on our assessment of Fortum Varme's:

- Strong link to the City of Stockholm, reflecting the city's 50% ownership of the company. Following the renewed shareholder agreement with the other owner, Fortum Oyj (Fortum) , the two parties have 50% of both shares and votes each 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, we assess that, given the joint ownership with Fortum, the city is primarily interested in Fortum Varme's operations, and that its services could be provided by a private sector entity.

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

- 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

- Swedish District Heating Company Fortum Varme Holding samagt med Stockholms stad Affirmed At 'BBB+/A-2'; Outlook Stable, April 1, 2016

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-

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