S&P Global Ratings

Research

Research Update:

Hungarian Public Integrated Utility MVM Group Assigned 'BBB-' Rating; Outlook Stable

June 22, 2021

Rating Action Overview

- MVM Group (MVM), the largest integrated utility in Hungary with networks regulated under a supportive framework representing a third of its activities, operates a low-carbon-dioxide nuclear-generation fleet. Its position as the leading wholesaler and supplier in Hungary is moderated by its geographic concentration and relatively small size.
- MVM's expansion strategy focuses on sizable acquisitions in Central and Eastern Europe, the development of its infrastructure, and decarbonization of its generation fleet.
- We expect MVM to maintain prudent financial leverage, because its healthy operating cash flow, careful risk management, and ongoing support from its sole shareholder, the Hungarian state, support its ambitious investment plan.
- We assigned our 'BBB-' long-term issuer credit rating to MVM.
- The stable outlook indicates that MVM will maintain its profitability and deliver on its strategy, while generating operating cash flow (OCF) of about Hungarian forint (HUF) 200 billion annually (about €575 million), and S&P Global Ratings-adjusted funds from operations (FFO) to debt sustainably above 30%.

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Rating Action Rationale

MVM's credit quality reflects its leading position in the Hungarian energy market. We view positively MVM's strong presence in Hungary's national electricity market, where it produces on average 62% of the country's total electricity needs and traded volumes are almost equal to Hungarian total consumption. MVM generates annual EBITDA of approximately HUF230 billion, or €700 million. The company's profile has significantly grown with the two-step acquisition of Hungarian retail leader NKM between 2017 and 2019, and gas and electricity supplier Innogy #eská Republika a.s., which closed in October 2020 (with EBITDA of €131 million in 2020). MVM is a key supplier of electricity and gas to the universal service residential clients (16% and 100% market share, respectively), a sticky customer base benefiting from a fixed price set by the Ministry for Innovation and Technology. The negative margins under the electricity universal service price somewhat offset this strength. Within the liberalized and competitive supply market, MVM holds strong positions, with 28% of market share in electricity and 35% in gas.

MVM's vertical integration is a key advantage. It allows the group to fully contract its electricity production to cover internal supply needs. Vertical integration also allows the group to naturally hedge commodity prices through its wholesale business. Nuclear and thermal production is contracted under three- and five-year agreements, indexed to market prices with companies of the group, while most renewables benefit from feed-in tariff schemes, which set predictable margins. A minority share of MVM's production has to be sold to external suppliers through auctions, as a result of an EU competition ruling. The company's hedging positions within the wholesale division are reviewed quarterly on its exposure to electricity, gas, and emission allowance prices, and can induce some volatility year-on-year depending on the market environment. Volatility could also come from retail and other competitive services. We expect merchant-exposed liberalized retail activities will continue to represent about 10% of EBITDA.

In our view, the company's business risk profile is constrained by its smaller-than-peers' scale and limited geographic exposure. MVM shows relative diversification in its activities, with exposure to nuclear, gas, and renewables; regulated transmission and distribution grids; regulated retail; and a liberalized market. However, it is small compared with major integrated utilities such as Engie or EDF. In addition, MVM's earnings are concentrated in Hungary (more than 80% of EBITDA) and neighboring countries.

The group's generation fleet is transitioning toward low carbon dioxide and no coal, in line with the Hungarian energy plan. About 30% of MVM's EBITDA is derived from its power-generation activities. The group has total installed capacity of about 3.8 gigawatts (GW), mostly comprising nuclear (2 GW), fossil-fired (1.4 GW), and solar (0.2 GW). We see Hungarian nuclear as a strategic asset for MVM, providing some cash flow stability and less-specific additional risks compared with other nuclear actors in Europe, because its end-of-life liabilities are covered by the state, albeit with annual contributions from MVM. The nuclear-generation plant, Paks, is well invested. All four of Paks' units have had a 20-year life extension, from 2012-2017 until 2032-2037, and there is potential for a further extension. Hungarian nuclear is very well placed at the lower end of the merit order. It has shown a historically high load factor, above 90%, and provides cash flow stability, in our view. Since nuclear is seen as a long-term strategic fit within Hungary's energy mix, the government supports the industry and bears most of the heavy asset retirement obligations linked to nuclear plants. A separate state entity has undertaken construction of new reactors, Paks 2.

MVM expects to build up its solar capacity gradually over 2021-2025 to about 800 megawatts (MW). Generation is transitioning toward a lower carbon dioxide-emitting fleet with the decommissioning of the Matra 950 MW plant (884 MW coal and 66 MW gas) expected in 2025. It will be replaced by 500 MW highly efficient combined-cycle gas turbine and 200 MW of solar plants, partly funded by European and Hungarian government grants. MVM is investing in infrastructure, digitalization, and renewables that should support the country's energy transition and its economy's electrification, as outlined in the Hungarian government's energy plan. The company's solar capacity plans are in line with Hungary's target of 6.5 GW capacity by 2030, from 2 GW in 2020.

A large share of revenue comes from regulated activities and supports cash flow stability. MVM is the monopolistic operator of the transmission grid in Hungary and operates 48% and 12% of the gas and electricity distribution networks, respectively. Gas and electricity networks are key pillars of the company's growth under its current strategy. The acquisition of EMASZ distribution network was agreed in April 2021, and we expect that, following its integration, the regulated activities will contribute about one-third of the total EBITDA by 2022. The framework has been in place since 2003 and improves with each four-year regulatory period with the inclusion of the capital asset pricing model, operating expenditure benchmarking, and additional incentives. Network revenue is governed under regulated tariff, which is set for the period, ensuring predictable cash flow in the medium term with almost full costs recovered and investments taken included in the regulated asset base (RAB; about HUF994 billion at second-quarter 2021). RAB is adjusted for inflation with the Consumer Price Index (CPI) and includes year-one commissioned investments. The current regulatory periods for electricity and gas started, respectively, in October 2021 and April 2021, and will end in December 2025 and October 2025, with overall stability over the parameters and remuneration. The framework's key weaknesses are the two-year lag in adjustment of volumes in the price cap formula, and some element of costs not included in the formula, notably the special energy tax and poor-quality efficiency incentives in place (for gas).

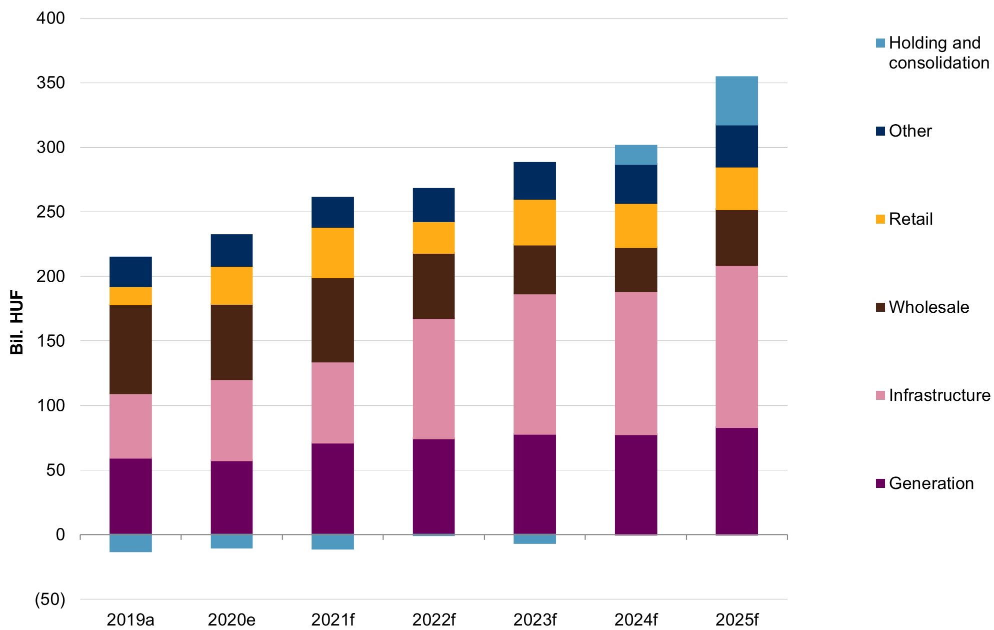
Generation mix and regulatory framework are key comparison factors among MVM's closest Eastern European peers. MVM's business is much less volatile than that of HEP (EBITDA €511 million in 2020). The latter operates in a less protective regulatory framework, and its generation fleet is characterized by very volatile hydro production. Compared with CEZ (EBITDA €2.5 billion), MVM is smaller, and both companies benefit from a stronger regulatory framework.

MVM's ambitious expansion plans underpin our significant financial risk assessment. Although we view positively the company's actions to expand its infrastructure and renewable generation, the high investment plan and increasing financial leverage constitutes a credit weakness. We expect MVM's capital expenditure (capex) to increase to HUF250 billion-HUF300 billion from 2023, staying elevated and leading to neutral free operating cash flow (FOCF) on average over 2021-2023. In addition, MVM's growth plan is underpinned by sustained acquisitions every year within the company's core businesses. The company aims to extend within the region with a target of 25% of EBITDA from outside Hungary by 2025. With the acquisition of Innogy CR in 2020, and once the EMASZ acquisition finalizes, we expect the company will have reported gross debt of about €520 million at year-end 2021, with limited potential for debt reduction depending on the pace of investments and acquisitions. It expects to use its own cash flow, European and government grants, and additional debt to fund growth. We note the healthy positive operating cash flow of the existing business mix. There is a track record of successful integration of acquired companies within recent years, notably with the integration of NKM in 2019, one of the biggest Hungarian distribution and retail companies.

We expect a significant increase in leverage in the next two to three years. FOCF (operating cash flow minus capital spending) will be minimal over 2021-2023. We expect FFO to debt at about 40% on average in 2021-2023, decreasing to almost 30% by 2024, and debt to EBITDA at about 2x, expected to increase and remain about 2.5x from 2022.

Chart 1

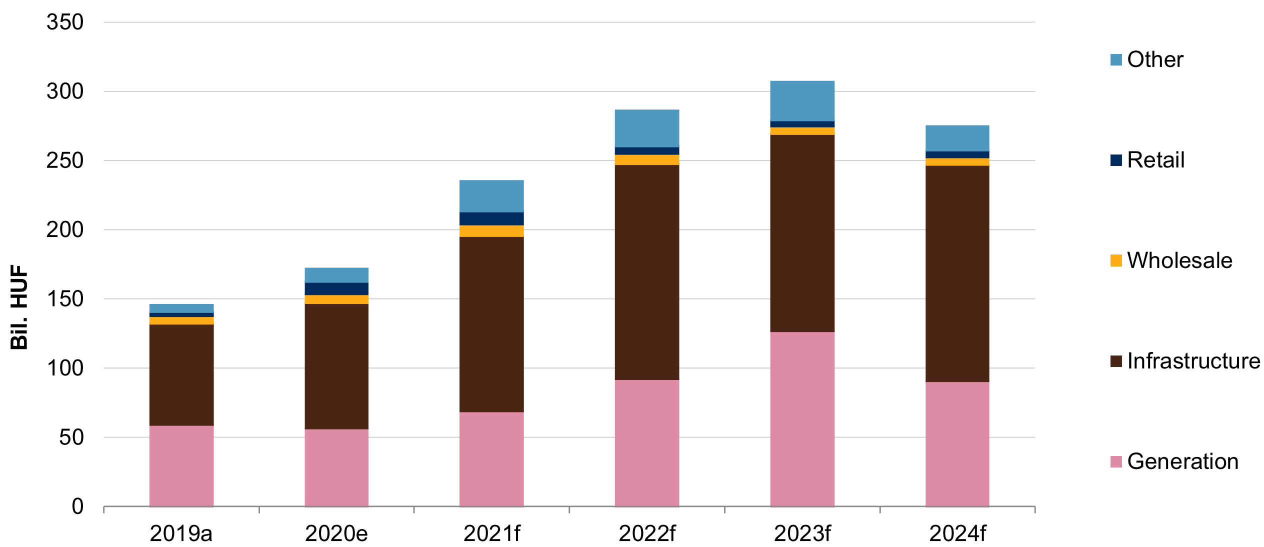
MVM Group EBITDA Evolution



a--Actual. e--Estimate. f--Forecast. HUF--Hungarian forint. Source: S&P Global Ratings.

Chart 2

MVM Group Capital Expenditure Evolution



a--Actual. e--Estimate. f--Forecast. HUF--Hungarian forint. Source: S&P Global Ratings.

We view positively the Hungarian government's commitment to supporting MVM's growth, maintaining low dividend distribution, and potentially injecting capital if needed. The Hungarian state has given ongoing support to MVM's strategic plan, and shown willingness to provide full long-term support, because MVM plays a crucial role in achieving the country's energy plan, demonstrated by the funding of nuclear asset retirement obligations (AROs). Dividends are kept stable, between HUF7 billion-HUF9 billion per year, and we do not expect the payout to change substantially because there is a supportive financial policy from the sole shareholder and MVM's cash flows are primarily used to fund the growth plan. Our assessment of a high likelihood of potential extraordinary government support for MVM is underpinned by:

- The company's strong link with the Hungarian state, which owns 100% of MVM and participates in strategic company decisions. The state is supporting the country's nuclear industry by bearing the full AROs and new builds. We expect the state to remain MVM's major shareholder; and
- Very important role for the government. MVM is the No. 1 generator, No. 1 supplier, a key wholesaler and retailer for the electricity and gas universal service, and sole power transmission system operator (TSO), gas and power distribution system operator (DSO) in Hungary. MVM's operations are strongly aligned with the government's interests; particularly in ensuring Hungary's self-sufficiency in electricity. We expect the company's dividend policy to continue allowing the utility to accumulate and reinvest earnings. We observe this, for example, in the company's metrics over 2019 and estimated for 2020, because MVM plans to finance capex largely with its own accumulated cash, while dividends remain stable.

We will continue to monitor the evolution of the government's energy policy and mechanisms available to the government to support companies such as MVM in line with the EU framework.

Outlook

The stable outlook reflects our expectations that MVM will achieve its growth plan on a gradual basis and protect its credit metrics in line with our assessment of its 'bbb-' stand-alone credit profile (SACP). This reflects FFO to debt above 30% and debt to EBITDA below 3x, as well as our expectation of ongoing and extraordinary government support. We believe that, over the next two to three years, risks from volatile power and commodities prices will remain mitigated by the company's integrated position and strategy to largely hedge its open positions, and by relatively stable earnings from its regulated network.

Upside scenario

A positive rating action on Hungary would result in a similar rating action on MVM.

We could also upgrade MVM following further improvement of its SACP, with FFO to debt above 40%. However, we consider this unlikely in the short term, largely because of the company's substantial capex plan.

Downside scenario

Rating downside is limited. A downgrade could materialize because of diminishing state support (such as post-election changes in government policy) combined with weakening stand-alone performance, as heavy capex could weaken FFO to debt sustainably below 30%.

Assuming no change in our expectation of a high likelihood of state support, we could downgrade MVM if its financial performance deteriorated enough to lead us to revise our assessment of its SACP to 'bb-' (from 'bbb-'), which is far from our base-case scenario.

A downgrade could also stem from a two-notch sovereign downgrade, which is not our base-case scenario given our stable outlook on the sovereign. A one-notch downgrade of Hungary would not result in a downgrade of MVM if the company's stand-alone fundamentals remain unchanged.

We could revise down our view of MVM's SACP to 'bb+' from 'bbb-' if the company were to post FFO to debt sustainably below 30%; for example, because of poor availability in its generation fleet or a large loss of market share in its supply business, and if the company demonstrates poor capex execution under its strategic growth plan.

Company Description

MVM is a 100% state-owned, vertically integrated energy company based in Hungary. Founded in 1948, it operates in power generation, transmission, distribution, wholesale, and retail, as well as gas storage, distribution, wholesale, and retail. MVM took control in 2018 and 2019 of NKM, Hungarian biggest gas retail company, financed through a HUF13.4 billion capital increase provided by the government. Upon this acquisition, MVM became the largest operating energy holding in Hungary, with a presence in 18 countries. In 2020, we expect EBITDA of about HUF220 billion, equivalent to about €650 million.

The company has activities across the entire electricity value chain: it is the main power generator in Hungary with installed capacity of 3.8 GW at year-end 2020; and operator of the Paks nuclear plant of 2.0 GW, Matra coal plant (to be closed in 2025), gas plants, and RES. As the monopolistic power TSO in Hungary, one of the six Hungarian power DSOs representing 12% of the power DSO market, electricity supplier both for universal service clients (at a regulated fixed price) and on the liberalized market, it represents 85% of power wholesale market.

It is also integrated within the gas value chain (except exploration and production, and transmission), because it owns 50% of the gas distribution network, 65% of the gas storage market, gas retail (both universal and liberalized), and 100% of gas wholesale universal service activities.

Our Base-Case Scenario

Assumptions

- There is no strong link between GDP and the issuer's EBITDA due to the low volatility of its contracted/regulated activities (TSO, DSO, contracted generation, and contracted wholesale). COVID-19 had no significant impact in 2020 retail activities and there was no material observed change in collection on payments.
- Wholesale Hungarian base load power price of €50 per megawatt hour (/MWh) in 2021, and €52/MWh in 2022 and 2023.
- Power and gas demand in Hungary will likely be stable in 2021 compared with 2020, due to gradual recovery from COVID-19-related economic fallout. We expect demand to recover by low single digit percentage in 2021 and be close to 2019 levels by 2022.
- International power prices increasing by 8%-10% in 2021 to result in higher margins only from 2022 for MVM due to a high hedging strategy.
- Stable nuclear generation in 2021-2023 and closure of coal plants in 2025. However, we expect thermal generation to compensate for this. Gradually growing renewable asset base over the plan.
- MVM's transmission and distribution business accounting for 35%-40% of consolidated EBITDA in 2022-2023, with the rest coming from generation, supply, and trade.
- The utility retaining its leading market shares in Hungary's universal service retail over the period, and stable market shares in competitive supply. Wholesale is assumed slightly volatile depending on gas inventories and hedged positions compared with commodity prices evolution. Positive cash flow from changes in working capital needs, mostly due to reduction of gas inventories in 2021 and 2022.
- Capex increasing to HUF210 billion in 2021 and increasing to about HUF250 billion in 2022.
- Integration of part of E.On distribution activities and EMASZ in 2021, contributing fully to revenues and EBITDA from 2022, and capital injection from the state to support the acquisition funding.
- Reflected in 2020's numbers are the acquisition of Innogy Czech Republic and the capital injection that will finance 100% of EMASZ and 25% of E.On Hungaria acquisitions and some infrastructure capex.
- Forecasted renewable and E.On-related acquisitions for a total of HUF110 billion-HUF120 billion on average on 2021-2023.

- Dividend distributions to Hungary of HUF7 billion in 2021, then at similar levels over the following two years.

Key metrics

Table 1

MVM Group--Key Metrics*

	--Fiscal year ended Dec. 31--				
(Bil. HUF)	2019a	2020e	2021f	2022f	2023f
Revenue	1,325.5	1,550-1,650	2,200-2,300	2,300-2,500	2,400-2,600
EBITDA	201.9	200-250	220-270	250-300	250-300
EBITDA margin (%)	15.5	12-15	10-12	10-12	10-12
Funds from operations (FFO)	200.2	150-200	180-230	200-250	200-250
Net capital expenditure	148.8	165.6	200-230	230-270	250-300
Free operating cash flow (FOCF)	(264.1)	Positive	Negative	Negative	Negative
Dividends (cash)	3.8	7.5	0-10	0-10	0-10
Debt to EBITDA (x)	2.1	1.5-2.0	1.5-2.0	2-3	2-3
FFO to debt (%)	47.4	40-45	40-45	30-35	>30

*IFRS Accounts: All figures adjusted by S&P Global Ratings. Debt adjustments: Reported leases of HUF14.7billion under IFRS16, pensions of HUF16.9billion, AROs of HUF58.6billion driven by the closure and recultivation related to both Matra and Vertescoal power plants as well as soil recultivation where gas plants were installed. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess the company's liquidity as strong. We expect the group's large cash position, annual cash flow generation, and committed credit facilities to cover expected cash outlays--primarily capex and dividends--by more than 1.5x over the next 12 months. We believe that as a 100% state-owned entity in Hungary, MVM has adequate access to bank financing and plan going to the market.

Principal liquidity sources for the 12 months from March 31, 2021:

- Accessible cash and liquid investments of HUF93.1 billion;
- Undrawn committed bank lines of HUF418 billion;
- Adjusted FFO of about HUF199 billion projected over the next 12 months; and
- Expected government capital injection of about HUF1 billion.

Principal liquidity uses for the same period:

- About HUF88 million of debt maturity;
- About HUF216 billion of capex;
- Acquisition of part of E.On's Hungarian distribution activities estimated at more than HUF100 billion; and

- Dividends of about HUF4 billion.

Covenants

We understand that the company has financial covenants in some of its loan agreements. We assume that the company will continue to adhere to these covenants, and take any appropriate measures to ensure adequate headroom, should operating cash flow reduce more than anticipated. MVM will maintain the group's net debt to EBITDA below 4.5x.

MVM's financial debt, whether term loans, syndicated revolving credit facility (RCF), or overdraft facilities are under three covenants:

- EBITDA interest cover > 3x
- Net debt/net assets < 0.9x
- Net debt/EBITDA < 4.5x

Environmental, Social, And Governance

We believe that MVM's main environmental, social, and governance (ESG) risk is governance.

We score management and governance in line with MVM's Eastern European peers, mainly underpinned by the lack of track record on strategic plan execution. Positively, we highlight the supportive financial stance of the Hungarian government and alignments of interests between MVM and government objectives. We believe there is strong support for the nuclear industry in Hungary, given its economic and social stakes. Hungary's energy policy has the key objective of transitioning toward a low cardon dioxide-emitting fleet, and the decommissioning of Matra power plant will be effective by 2025. We understand that the coal industry is to be reorganized in the country with help from state directives.

With a large nuclear-generation fleet (2 GW capacity and 60% of output) MVM's carbon footprint is markedly advantageous. The company does not have to bear the environmental and social risks relating to the future long-term storage of nuclear waste from Paks nuclear plant's large end-of-cycle liabilities, of both decommissioning and nuclear waste storage. The strategic goals of renewables capacity embedded in the Hungarian energy plan and solar plan (6.5 GW capacity by 2030) support MVM's focus on diversifying its energy mix and concentrating on low-carbon sources. Overall, the environmental score of MVM is in line with the industry.

Social factors are important to our assessment of MVM's standing with the Hungarian state. The company is operating its network activities at levels in line with regulator expectations, and with short interruption times.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/--

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb-

- Sovereign rating: BBB/Stable/A-2
- Likelihood of government support: High

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- 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

- Hungary 'BBB/A-2' Ratings Affirmed; Outlook Remains Stable, Feb. 12, 2021

Ratings List

New Rating	
MVM Magyar Villamos Muvek Zrt.	
Issuer Credit Rating	BBB-/Stable/--