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RATING ACTION COMMENTARY

Fitch Rates Hungary's MVM's Domestic Senior Unsecured Bonds at 'BBB'

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Fitch Ratings - Warsaw - 27 Aug 2021: Fitch Ratings has assigned Hungary's largest electricity and gas utility MVM Zrt.'s (BBB/Stable) up to HUF60.5 billion bonds a local-currency senior unsecured rating of 'BBB'.

The volume of the bonds (ISIN Code: HU0000360730) will amount to up to HUF55 billion plus, and subject to over-allotment in the planned auction, an additional amount of up to HUF5.5 billion. The bonds will pay a fixed coupon of 3.25% per year and have a 10-year tenor with an amortising repayment schedule. Ten per cent of the face value of the bonds will become due every year between 2028 and 2030 and the remaining 70% in 2031.

The rating of the bonds is at the same level as MVM's Long-Term Local-Currency Issuer Default Rating (IDR), as the bonds will constitute direct, unconditional, unsecured and unsubordinated obligations of MVM.

The proceeds from the bonds will be used to finance general corporate purposes. However, MVM undertakes that it will not use any part of the bond proceeds to finance the operations, technological development or capacity expansion - including the addition of any new capacities - of MVM group's coal-fired power plants or any other coal-based facilities.

For more information on MVM's rating see https://www.fitchratings.com/entity/mvm-zrt-97221306 and our rating action commentary "Fitch Assigns MVM First-Time 'BBB' IDRs; Outlook Stable" published on 22 June 2021.

KEY RATING DRIVERS

Leading Market Position: The business profile of MVM benefits from its strong market position in Hungary, spanning electricity generation (62% market share), gas imports (off-taker in the main gas imports contract), gas storage (65% market share), electricity transmission (100% market share), electricity and gas distribution (12% and 48%, respectively), as well as electricity and gas wholesale and retail supply as the main company in the market.

As a result, MVM has better integration and business diversification in electricity and gas than most of its central European peers. However, the ratings also incorporate MVM's smaller size of operations and lower financial transparency than some regional peers'.

Substantial Regulated and Quasi-Regulated Business: MVM's business profile also benefits from an estimated 45% average share of regulated and quasi-regulated EBITDA under the Fitch rating case over 2020-2023. The regulated component contains electricity transmission and electricity and gas distribution, while the quasi-regulated contribution comes primarily from gas storage and renewable generation.

RAB-remunerated Networks: The regulatory framework for networks in Hungary is based on a regulatory asset base (RAB) concept and matches the EU's standards. The framework benefits from full insulation from volume risk through a two-year correction mechanism, which is supportive of the business profile of MVM's regulated networks.

Low-Carbon Generation: MVM has lower exposure to rising CO2 costs and is better positioned in the energy transition than most of its Fitch-rated central European peers. This is attributed to the low carbon footprint of the company's 3.8GW generation fleet, which is based on nuclear generation (53% of 2020 generation capacity), natural gas and other (19%) and renewables (5%), complemented by coal, biomass and waste (23%).

The carbon footprint will decrease further upon the planned phase-out of coal by 2025 by replacing its Matra coal-fired power plant with combined cycle gas turbine (CCGT) capacity, which will be positive for the business profile of MVM's electricity generation.

Expansion in Central Europe: MVM's strategy provides for expansion in central Europe, so that by 2025 25% of EBITDA should be generated abroad. The international expansion would improve geographical diversification, but would also lead to execution and profit-dilution risks; we therefore currently view it as largely neutral for MVM's credit profile. In late 2020, MVM acquired Innogy Czech Republic, a leading Czech supplier of natural gas and electricity, which was its first large international acquisition.

Financial Policy Consistent with Rating: MVM's management targets net-debt-to-EBITDA of up to 2.5x in the current business plan until 2025, which is consistent with the 'BBB' rating. The plan was approved by the state as the sole shareholder. Net debt/EBITDA was at 1.4x in 2020 based on preliminary numbers under IFRS. Management expects to reach the maximum 2.5x in 2024 due to an ambitious capex and acquisitions plan. We assume that the company has some flexibility to reduce or postpone capex and acquisitions or consider equity funding, if needed, to maintain net debt/EBITDA within the limit.

Expected Leverage Increase: We expect MVM's FFO net leverage to increase to about 3.3x in 2022-2023 from about 1.5x in 2020, reducing rating headroom, but still supporting Stable Outlook. Large capex and acquisitions will be driven by investments in low-carbon generation (construction of two CCGT plants), expansion of transmission and distribution networks, nuclear safety and regional acquisitions.

Rated on Standalone Basis: MVM's Long-Term IDRs are at the company's Standalone Credit Profile (SCP) of 'bbb'. The company benefits from tangible support from its sole owner, the Hungarian state (BBB/Stable), but the linkage currently has no impact on MVM's IDRs, as Hungary's IDR and MVM's SCP are at the same level.

Strong State Links: Fitch applies its Government-Related Entities (GRE) Rating Criteria in the analysis of MVM's linkage with the Hungarian state. We assess status, ownership and control links as 'Strong', and support track record as 'Moderate'. We view the socio-political implications of MVM's default as 'Moderate', whereas the financial implications of MVM's default for the Hungarian government as 'Weak'. This assessment results in a support score of 12.5 points, indicating moderately strong links with the state.

Strategic Position: MVM is Hungary's national energy utility and is 100% government-owned. It has strategic importance for the economy, it consolidates most of the country's energy sector and is the government's tool in implementation of energy and climate policies.

Tangible State Support: MVM has historically benefited from substantial tangible support from the state, most recently through large equity injections in 2020 totalling about HUF230 billion (EUR0.65 billion), mainly related to the acquisition of a stake in E.ON Hungary, the acquisition of EMASZ electricity distributor, and investments in distribution. State support, particularly that provided in 2020, improved MVM's balance sheet, which would have otherwise substantially deteriorated if the acquisitions were fully debt-funded.

DERIVATION SUMMARY

MVM's central European peers are PGE Polska Grupa Energetyczna S.A. (PGE, BBB+/Stable), Polskie Gornictwo Naftowe i Gazownictwo S.A. (PGNiG, BBB/Stable), ENEA S.A. (BBB/Stable), TAURON Polska Energia S.A. (Tauron, BBB-/Stable) and Bulgarian Energy Holding EAD (BEH, BB/Positive, SCP: b+).

MVM has better integration and business diversification than PGE, ENEA and Tauron, which are focused on a specific line of business, such as generation or distribution, and also have higher exposure to coal. MVM's business is also more diversified than gas-oriented PGNiG, although the latter also runs oil and gas upstream operations. However, MVM has smaller size of operations than PGE, PGNiG, ENEA and Tauron, and also lower financial transparency (eg, lack of interim results and longer time to prepare annual financial statements).

BEH is more comparable to MVM in business diversification and size, as its activities include generation, transmission and supply of electricity, as well as transmission, transit and supply of gas, on top of lignite mining and telecom operations. However, BEH is a negative outlier in the peer group in leverage, cash- flow predictability and corporate governance.

MVM's leverage is higher than PGNiG's, comparable to that of PGE and ENEA, lower than Tauron's and much lower than BEH's.

MVM peers are all state-controlled (by Polish or Bulgarian government, respectively), but listed in a stock exchange with the state owning a controlling stake (the exception is BEH, which is, similarly to MVM, 100% controlled by the state).

The Polish peers are rated at a standalone level without any uplift for state links, while the 'BB' rating of BEH includes a two-notch uplift for links with the Bulgarian state. We assess BEH's links with the state as stronger than MVM's, but MVM's 'bbb' SCP is also much stronger than BEH's 'b+'. While the sovereign ratings of Bulgaria and Hungary are the same at 'BBB', no rating uplift is applicable to MVM.

KEY ASSUMPTIONS

The key assumptions within our rating case for the issuer are as follows:

- Infrastructure EBITDA growth driven by the recognised operating expenditure and capex effect on tariffs and acquisition of EMASZ electricity distributor from E.ON in 3Q21

- Generation EBITDA growth driven by contribution from renewables

- Planned restructuring of the public-utility cable tax and the special income tax for energy suppliers, starting from 2023, reducing MVM's tax burden

- Total capex and acquisitions for 2021-2024 averaging about HUF370 billion per year

- Maintenance capex accounting for about 50% of total capex (falling to 22% by 2025), mostly focused on planned maintenance of power plants and network assets to ensure proper and safe supply of electricity

- Development capex focusing on decarbonisation, digitalisation and future-oriented infrastructure development

- Capex partly funded by domestic and EU grants and subsidies in a total amount of HUF273 billion over 2021-2025

- Maintenance of a low dividend policy by the state (HUF7.5 billion per year)

- No equity injections by the state over 2021-2025 (except for a small cash injection and contribution in kind already received in April 2021)

Fitch projections are prepared under IFRS.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- FFO net leverage below 2.5x on a sustained basis, supported by management's conservative financial policy, together with a stronger business risk profile, for instance, due to increased share of regulated and quasi-regulated businesses in EBITDA, may be positive for MVM's SCP. However, the rating will be capped by the sovereign rating, due to strong linkage between MVM and the state assessed under the Parent and Subsidiary Linkage Rating Criteria, unless Hungary's rating is upgraded.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Deterioration of credit ratios, including FFO net leverage above 3.5x and FFO interest cover below 6x on a sustained basis, for example, due to lower margins in generation, losses in gas wholesale and retail supply, large investments not adequately compensated by EBITDA increase or an aggressive dividend policy

- Substantial adverse change in the business profile, such as a material reduction in the share of regulated or quasi-regulated business in total EBITDA

- Negative rating action on Hungary would lead to similar rating action for MVM as the latter's rating would start to be capped at the sovereign level due to the strength of linkage between MVM and the state under our assessment

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Solid Liquidity: MVM has a solid liquidity position. At end-2020 it had unrestricted cash of HUF246 billion (according to IFRS, including about HUF2 billion of cash held at project-finance companies) and undrawn committed facilities of about HUF263 billion, excluding facilities expiring in 2021. This liquidity is sufficient to cover debt maturities, negative free cash flow and net acquisitions until at least end-2022 under a conservative scenario assuming no debt refinancing, and no inflows from subsidies and grants to co-fund capex.

The three main revolving credit facilities (two syndicated facilities in euros and in Hungarian forint, respectively, and the Bank of China's facility) expire between 2023 and 2026 when exercising the extension option.

In March 2021, MVM signed a new HUF100 billion, 10-year acquisition facility to refinance the acquisition of Innogy Czech Republic, which further improved its liquidity position.

ISSUER PROFILE

MVM is Hungary's largest electricity and gas utility, operating in electricity generation, gas imports, gas storage, electricity transmission, electricity and gas distribution, as well as electricity and gas wholesale and retail supply.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING		
MVM Zrt.			
• senior unsecured	LT	BBB	New Rating

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Parent and Subsidiary Linkage Rating Criteria (pub. 26 Aug 2020)

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

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Corporate Finance Utilities and Power Europe Hungary