ALTEO Energiaszolgáltató Nyrt
Hungary, Utilities

SCOPE BB+ STABLE

Corporate profile

ALTEO Energiaszolgáltató Nyrt (ALTEO) is an integrated utility with operations in regulated and unregulated power generation, energy supply (electricity and gas) and energy services. While the company has grown strongly through a multi-billion HUF investment plan, it will focus on organic growth over the next few years, with only opportunistic acquisitions.

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**
EBITDA/interest cover (x)	9.5	7.7	4.7	5.3
Scope-adjusted debt (SaD)/EBITDA (x)	1.6	4.2	4.6	3.1
Free operating cash flow (FOCF)/SaD	-22%	-44%	5%	11%
Liquidity	115%	-7%	>200%	>200%

Rating rationale

Scope has assigned a BB+ first-time issuer credit rating to Hungary-based ALTEO with a Stable Outlook. Concurrently, we have assigned a BBB- rating for senior unsecured debt.

The issuer rating is largely supported by ALTEO's increasing cash flow exposure to regulated renewable power generation, its quasi-monopolistic position in heat generation and supply, and comfortable level of interest coverage. Moreover, the company's creditworthiness is stabilised by its integrated energy utility model supplemented by energy services. Margins should remain stable overall – despite cash flows in unregulated power generation remaining vulnerable to merchant risks inherent to the Hungarian market – helped by high-margin regulated renewables and the company's new strategy to mitigate energy supply risks.

The rating is constrained by ALTEO's limited overall corporate outreach and regional risk mitigation, and by asset concentration risks in power generation. The financial risk profile represents another rating constraint, but we expect gradual improvements over the next three years through the company's focus on organic growth and curtailment of opportunistic external growth. This should boost free and discretionary cash flows to a level which allows deleveraging. The liquidity situation is also expected to ease, following the early refinancing envisaged for the senior unsecured bond and senior secured project finance debt, through a newly issued corporate bond under the MNB Bond Funding for Growth Scheme.

The Stable Outlook reflects our expectations regarding the organic growth focus, the aforementioned deleveraging over the next few years and an EBITDA interest coverage of sustainably above 5x. A positive rating action is likely to be warranted if leverage reduced below 3.5x and EBITDA interest coverage improved to around 7x for a prolonged period. A negative rating action could be required if growth does not materialise as expected, e.g. through significantly lower earnings contributions from the new solar and wind assets, or further debt-financed M&A projects that weigh on leverage, which will remain above 4.5x for the next few years and EBITDA interest coverage deteriorated to below 5x for a prolonged period.

Ratings & Outlook

Corporate rating	BB+/Stable
Senior unsecured rating	BBB-
Short-term rating	S-3

Analysts

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Related Methodologies

Corporate Rating Methodology

European Utilities

European Renewable Energy Corporates

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Rating drivers

Positive rating drivers	Negative rating drivers
• Increasing share of EBITDA and cash flow contribution from prioritised feed-in under guaranteed tariffs with a remaining regulatory life of 10 years for existing renewable energy plants • Ability to provide reserve capacity from gas-fired power plants and a virtual power plant across Hungary, including volatile renewables and peak-load gas-fired power plants • Exposure to quasi-monopolistic heat generation • Deleveraging efforts following the finalisation of the expansion phase, as shown by recent capital increase and target equity ratio of 30%, with strong commitment of anchor investor Wallis • Integrated business model with coverage of generation, supply, supplemented by energy and waste management services • Decreased liquidity risks over the next few years after the envisaged refinancing through a HUF 9.3bn bond under the MNB Bond Funding for Growth Scheme	• Status as a small, niche energy supplier with insignificant share of Hungary's electricity generation and energy supply markets • Entire business exposure relating to Hungary for the foreseeable future • Margin dilution from supply and energy services • Asset concentration and production risks stemming from wind generation • Higher regulatory risks in Hungary than in most western European markets • PAKS II extension could alter the merit order in Hungary • High leverage following the completion of the large multi-billion HUF capex programme; however, leverage is expected to gradually decrease

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Leverage of below 3.5x and EBITDA interest coverage to around 7x for a prolonged period	• Leverage to remain above 4.5x and EBITDA interest coverage deteriorated to below 5x for a prolonged period

Financial overview

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA/interest cover (x)	9.5	7.7	4.7	5.3	6.5
Scope-adjusted debt/EBITDA (x)	1.6	4.2	4.6	3.1	2.3
Free operating cash flow/Scope-adjusted debt (%)	-22%	-44%	5%	11%	17%
Liquidity (internal and external)	115%	-7%	>200%	>200%	>200%
Scope-adjusted EBITDA (HUF bn)					
Recurring EBITDA	1.9	1.8	2.8	3.8	4.5
Operating lease payments in respective year	-	-	-	-	-
Other adjustments	0.1	-0.0	-	-	-
Scope-adjusted EBITDA	2.0	1.8	2.8	3.8	4.5
Interest (HUF bn)					
Interest paid	0.2	0.2	0.6	0.7	0.7
Interest received	0.0	0.0	0.0	0.0	0.0
Interest component, asset retirement obligations (estimate)	-	-	-	-	-
Scope-adjusted interest expenses	0.2	0.2	0.6	0.7	0.7
Scope-adjusted debt (HUF bn)					
Gross financial debt	6.3	10.4	16.9	16.4	15.7
Thereof, non-recourse project finance debt (estimated)	2.2	5.5	4.8	4.2	3.7
deduct: margining/derivative liabilities	0.3	0.6	0.6	0.6	0.6
deduct: cash and cash equivalents	2.8	2.6	3.5	3.9	4.8
add: restricted cash	-	-	-	-	-
add: operating lease obligations (estimated NPV and IFRS 16 amount for 2018-2021E)	-	0.1	0.1	0.1	0.1
add: unfunded asset retirement obligations (Scope approach)	0.1	0.1	0.1	0.1	0.1
Scope-adjusted debt (SaD)	3.2	7.4	13.1	12.0	10.5

Source: ALTEO, Scope expectations

Business risk profile (BB+)

We regard ALTEO's market position to be supported by the following:

- Widely protected position in heat generation and supply;
- Significant exposure to regulated renewable energy generation in Hungary, which we expect to increase following the latest portfolio additions in wind and solar;
- Remaining regulatory life of around 10 years for existing renewables assets;
- Advantageous market structures relating to chronic energy shortage in Hungary (constantly a net importer), which to some extent secures good utilisation of the non-regulated power generation fleet;
- Combined generation portfolio of volatile renewable assets and peak-load-capable, combined heat power (CHP) gas-fired power plants providing a competitive edge to act as a reserve capacity in a 'virtual power plant' in Hungary;
- New setup of the energy business (gas/electricity supply), with the immediate hedging of contracted supply volumes.

Nevertheless, ALTEO's market position is hampered by:

- Industry-inherent volatility for unregulated power generation, with higher price volatility in Hungary than in other European markets (related to the merit order);
- Limited corporate outreach/scale overall and insignificant market share of less than 1% in electricity and gas supply in Hungary;
- Renewables portfolio strongly skewed towards the newly acquired 25MWp wind farm (~50% of expected future generation);
- Extension of PAKS II nuclear power plant (2,400 MWp) with expected start after 2024, which could significantly alter the merit order in Hungary, resulting in lower electricity prices and a substantial deterioration in the financials of gas-fired power plants;
- Higher regulatory risks assumed than in western European countries.

Remaining regulatory life of renewables assets at around 10 years

The major part of ALTEO's renewable energy assets (aggregated production capacity of 56 MWp) will continue to benefit from i) the mandatory take-off of electricity generated under the KÁT or METÁR system; and ii) a fixed remuneration for a predefined period. Based on production capacities, ALTEO's existing renewables assets have a remaining regulatory life of about 10 years; only a few power plants are unregulated. The guaranteed take-off and remuneration largely protect cash flow, with strong growth expected in the EBITDA contribution from regulated renewables in 2019/2020, to 40-50% up from around 15% in 2018. In Hungary, there are no signs of drastic changes planned for the regulatory framework for renewables, given a desperate need to address the chronic electricity shortage and the country's strategy to increase renewables use. In any case, adverse changes affecting ALTEO's generation assets cannot be ruled out.

Figure 1 – Prioritised feed-in (METÁR) and/or remuneration at fixed regulated tariffs (KÀT)

Power plant	Capacity (MW_e)	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039	2040	2041	2042	2043	2044
Solar																											
Domaszék	2.0	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓		
Monor (IT-Solar és Monsolar)	4.0	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	
Balatonberény	7.0	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Nagykőrös	7.0	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Wind																											
Janossomorja	1.8																										
Acs	2.0																										
Papakovacsi	2.0																										
Törökszentmiklos	1.5	✓	✓	✓	✓																						
Euro Green Energy Kft	25.0	✓	✓	✓	✓																						
Hydro																											
Felsődobsza	0.9	✓	✓	✓	✓																						
Gibárt	0.5		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓					
Landfill																											
Debrecen - CIVIS	0.6	✓																									
Debrecen - ALTSOLAR	0.5	✓	✓	✓	✓																						

Source: ALTEO, Scope

Total generation portfolio enabling the company to provide reserve capacity

Despite the small scale in power generation, the company is able to provide reserve (balancing) capacity to national transmission grid operator MAVIR, by way of a so-called ‘virtual power plants’ thanks to the extra 50 MW_e CHP (thermal) and 2MW_e biomass power plants that ALTEO operates mostly as heat providers. ALTEO can use these plants to broaden its cash flow profile and consequently improve profitability – unlike pure renewable energy independent power producers, which do not own base- and peak-load capacities.

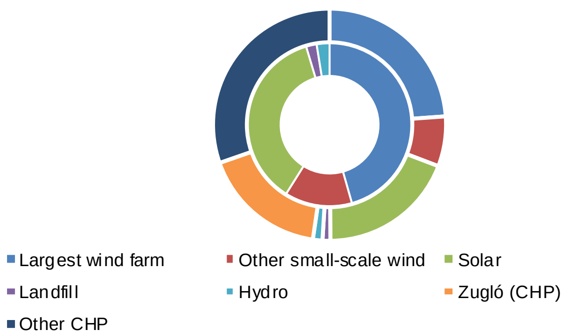
CHP plants provide stability in heat but add volatility for electricity

ALTEO’s market position is further enhanced by the quasi-monopoly it holds through its CHP plants, with a thermal generation capacity of around 200 MW_{th}, operated to provide district heating or process heat for industrials. While these plants provide extra income, they also add cash flow volatility from electricity generation and sales, given the high merchant/price risks inherent to the Hungarian power market.

Overall diversification a rating constraint

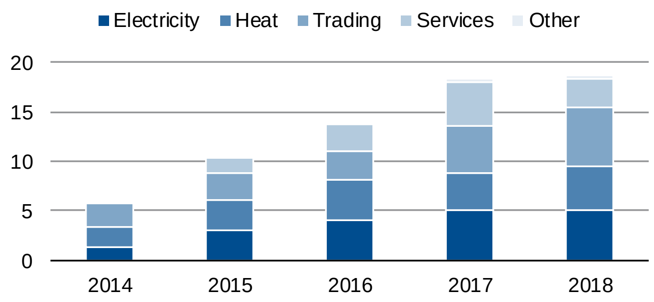
ALTEO’s diversification remains a major credit weakness, even with business risks being spread across different activities along an energy utility’s value chain (from generation to supply) and being supplemented by energy storage, energy services and waste management. This weakness is driven by: i) a sole regional exposure (Hungary), ii) limited outreach in energy supply (electricity and gas); and iii), most importantly, the meaningful asset concentration risks relating to the new 25 MW wind park, at around 50% of renewable capacities and 25% of total generation capacity. From our perspective, the latter could significantly harm ALTEO’s overall cash flow in the event wind yield is much lower than expected in meagre wind years. Moreover, the lacking contribution from regulated tariffs of this large wind farm after 2022 will have a significant impact on total cash flows.

Figure 2 – Asset concentration: inner circle = renewables only; outer circle = total generation capacities



Source: ALTEO, Scope

Figure 3 – Revenue split between different segments (in HUF bn)



Source: ALTEO, Scope

Energy supply highly fragmented and dominated by incumbents

ALTEO's outreach in energy supply (electricity and gas) is very limited: around 4,500 different commercial and industrial customers, covering less than 1% of the Hungarian market which limits the ability to realise economies of scale. However, we deem the company's changed approach to procurement and hedging in energy supply to be risk averse and no longer a significant burden on the business risk profile. This stands in contrast to the years before 2018, when ALTEO could have suffered operating losses in energy supply due to the adverse movement in non-hedged, required procurement volumes.

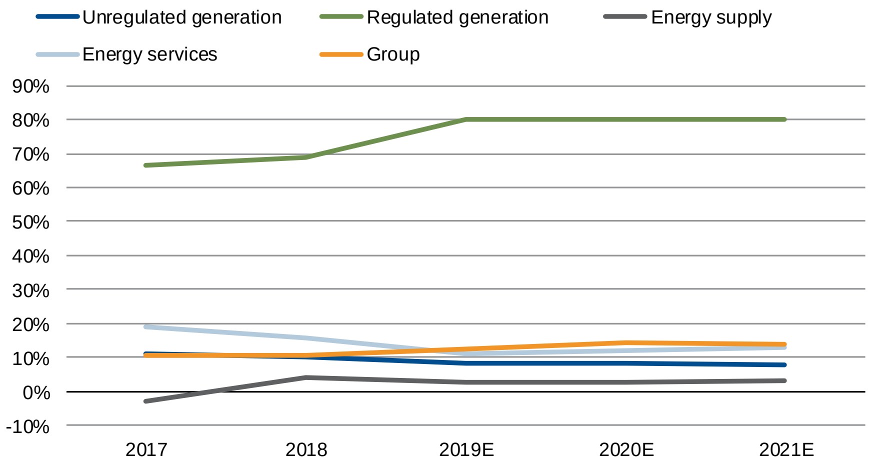
New outreach to energy-related business services to provide recurring income

ALTEO's exposure to energy services (operation and maintenance of generating assets; EPC services; waste management), which has been developed quickly as a meaningful cash flow contributing business segment over the past 4 years, as being supportive for its business risk profile. While some exposures relate to non-recurring activities such as EPC works, we believe a larger share relates to recurring services for third-parties under medium-to-long-term contracts.

Group margin of around picking up due to the increased exposure to high-margin regulated renewables

Operating profitability differs widely between regulated and unregulated energy generation, energy supply and services, reflecting the different natures of regulation, competition and capital-intensity. We expect that group margin to improve from around 10% in 2017/18 to around 15% in the years 2019-2021, based on the most recent expansion of regulated, high-margin renewable plants (4+7+7 MWp solar and 25 MWp wind capacity) and our expectations regarding the company's organic growth in energy supply and services. Margin volatility may stem from higher-than-expected volatility of achievable prices for unregulated electricity generation and/or lower-than-expected output from wind farms. However, our sensitivity analysis on revenue and margin development shows that stressed credit metrics would not worsen our assessment of the financial risk profile. We emphasize that major risks regarding group profitability and credit metrics are expected for beyond 2022, when i) several plants switch from availability-based to market-based remuneration (i.e. the 25 MWp wind farm and several low-scale biomass and hydro power plants); and ii) the potential for Hungary's merit order system to change significantly, to the detriment of ALTEO's generation assets in case the PAKS II nuclear extension is realised after 2024.

Figure 4 – EBITDA margin on the group level



Source: ALTEO, Scope expectations

Financial risk profile (BB+)

Deleveraging after huge investment phase

ALTEO's financial risk profile is deemed to be commensurate with a BB+. This accounts for the gradual deleveraging over the next few years following the broad finalisation of the company's multi-billion HUF investment programme in 2018 and 2019.

Early refinancing plan through the issuance of a new bond

ALTEO intends to issue up to HUF 9.3bn of senior unsecured debt under the MNB Bond Funding for Growth Scheme in one or two tranches, with a maturity of 7 to 10 years depending on market conditions. We understand that roughly 90% of the expected proceeds are intended for early refinancing (outstanding senior unsecured bonds totalling HUF 2.8bn [ALTEO 2020/I and ALTEO 2022/I bonds] and early redemption of some HUF 5.5bn senior secured project debt). This will result in reduced liquidity risks over the next three years.

Non-recourse project debt is driving up leverage

Net financial debt is impacted by a substantial amount of non-recourse senior secured project debt (loans on the project level). Regarding the financing of different renewables plants, the group has prevented the creditors of project debt from having recourse to companies other than the respective borrowers.

Scope deems ALTEO's future cash flow development to be driven by:

- Issuance of a long-term (7 to 10 years depending on market conditions) senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme with a face value of HUF 9.3bn and assumed coupon of 4.5%;
- Early refinancing of HUF 5.5bn project debt and HUF 2.2bn existing bonds with the proceeds of the new bond;
- Strong revenue growth in 2019 and 2020 as a result of the huge expansion of the regulated power generation portfolio;
- Expectations of positive low-single-digit margins in energy supply, reflecting the changed hedging/procurement strategy;
- Slight improvement of group profitability due to growing share of high-margin regulated power generation;
- Strong reduction of annual capex to HUF 1bn;
- Dividend pay-outs of around HUF 300m per annum, assuming stable share price development and low-single-digit dividend yield;
- No further business acquisitions and focus on integration and organic growth, allowing for deleveraging;
- Debt repayments in line with assumed maturity schedule following the above-mentioned early refinancing and no further external debt financing needed over the next few years.

Deleveraging following the conclusion of large investment programme

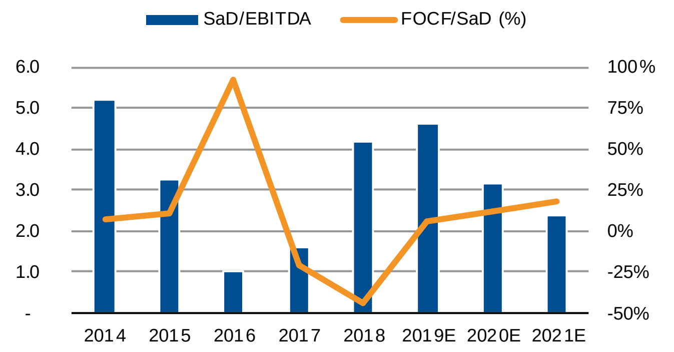
ALTEO's leverage tends to be volatile in light of its size and developing business model. Following the comparatively large investment programme of more than HUF 15bn during 2017-19, ALTEO's leverage – as measured by Scope-adjusted debt/EBITDA – strongly increased from below 2.0x in 2017 to more than 4.0x in 2018/2019. This was driven by a lag in cash flow from new activities such as Zugló-Therm and the acquired solar and wind power plants.

Expected free operating and discretionary cash flows providing headroom for deleveraging

We understand that ALTEO will focus on organic growth over the next few years and will limit opportunistic growth ventures. Bolstered by earnings from new activities from 2019 onwards, leverage is expected to gradually improve to below 3.0x (2020E: 3.1x; 2021E: 2.3x). We expect free operating cash flows and discretionary cash flows to stand above HUF 1bn in 2020 and 2021, thus providing room for deleveraging. Furthermore, the company's active deleveraging strategy is already evident with its HUF 2bn capital increase in Q1 2019, in line with targeted equity ratio of around 30%.

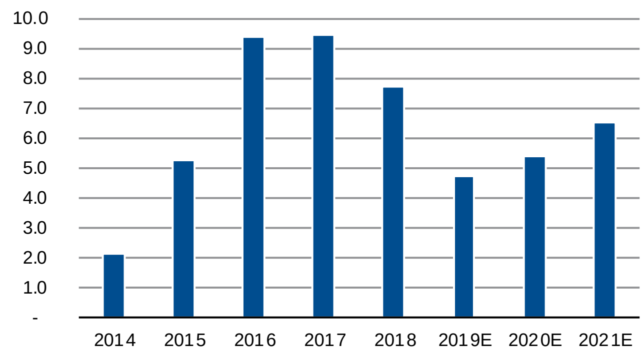
Debt protection as measured by a Scope-adjusted EBITDA interest coverage remains comfortable at above 5x.

Figure 5 – Leverage (Scope adjusted debt/EBITDA)



Source: Scope calculations

Figure 6 – Debt protection (EBITDA/interest cover)



Source: Scope calculations

Robust liquidity

We regard ALTEO's liquidity to be sound. 2018 and 2019 were the exceptions, with significantly negative FOCF resulting from the execution of the aforementioned capex programme.

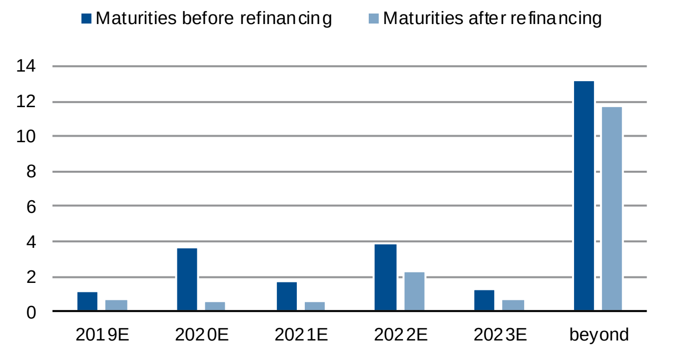
Early refinancing of bond and project finance loan reduces liquidity risks over next few years

Following the envisaged refinancing of the HUF 5.5bn non-recourse project finance debt and early redemption of the HUF 0.65bn ALTEO 2022/I and HUF 2.15bn ALTEO 2022/I corporate bonds, ALTEO has to cover the remaining amortisation in 2019-21 for several project finance loans, at around HUF 600m a year. The debt repayments are expected to be covered by free operating cash flows from project entities and more than HUF 3bn of unrestricted sustainable cash. Moreover, ALTEO can access working capital facilities with a total unused volume of HUF 1.75bn at YE 2018. While such facilities are only on a rolling basis, they are similar to committed lines, as most have been in place for at least five years. However, we believe ALTEO does not need these facilities in 2019-21 as internal liquidity sources are sufficient.

Well-established bank relationships as fallback

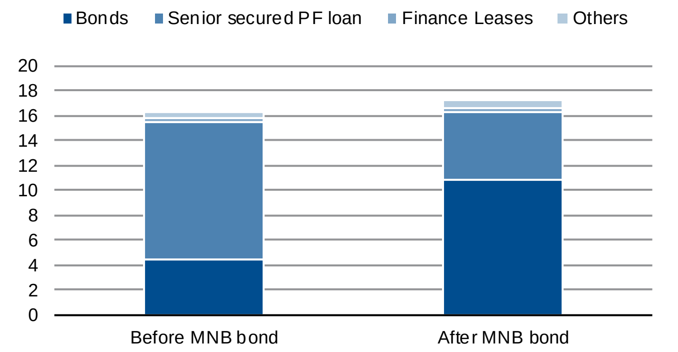
Despite its small size, ALTEO has decent access to external financing, as displayed by continued bond issuances (first bond scheme in 2011) and well-established lending relationships with not only Hungarian banks like MKB and OTP but also Austria's Erste Bank and Italy's Unicredit. While we believe the next large maturity – the new HUF 1.7bn zero-coupon bond ALTEO 2022/II in 2022 – will be refinanced by a new public bond, ALTEO has good options for refinancing outside the bond market if necessary.

Figure 7 – Expected maturity schedule (in HUF bn)



Source: ALTEO, Scope expectations

Figure 8 – Financing structure before and after envisaged bond issue (in HUF bn)



Source: ALTEO, Scope expectations

Supplementary rating drivers

No rating impact from shareholder structure

ALTEO's majority shareholder (64%) is investment holding company Wallis Asset Management Zrt. However, Wallis has only partial control of ALTEO as the latter's management and supervisory board structure allows for its independence. We do not rule out Wallis' willingness to provide extra financial support if needed, as hinted by its participation in the most recent capital increase and the holding's long-term investment approach. However, we have no visibility on the holding company's ability to provide financial support, e.g. a cash injection in a scenario of severe liquidity constraints.

Outlook and rating-change triggers

Stable Outlook

The Stable Outlook reflects our expectations regarding the organic growth focus, the aforementioned deleveraging over the next few years and an EBITDA interest coverage of sustainably above 5x.

Positive rating triggers

A positive rating action is likely to be warranted if leverage reduced below 3.5x and EBITDA interest coverage improved to around 7x for a prolonged period.

Negative rating trigger

A negative rating action could be required if growth does not materialise as expected, e.g. through significantly lower earnings contributions from the new solar and wind assets, or further debt-financed M&A projects that weigh on leverage, which will remain above 4.5x for the next few years and EBITDA interest coverage deteriorated to below 5x for a prolonged period.

Senior unsecured debt ratings (BBB-)

Above-average recovery expectations for senior unsecured debt

We expect an 'above-average recovery' for existing and future senior unsecured debt such as the HUF 1.7bn zero-coupon ALTEO 2022/II bond and the planned HUF 9.3bn MNB bond, even after senior secured debt is covered fully (non-recourse project finance debt and finance leases). Such recovery expectations translate into a BBB- rating for the senior unsecured debt category. Our recovery expectations are based on an expected liquidation value in a hypothetical default scenario, around HUF 15bn in 2021, and a 10% reduction on that value for administrative claims in a liquidation.

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