22 June 2023 Corporates

ALTEO Energiaszolgáltató Nyrt
Hungary, Utilities

SCOPE BBB- STABLE

Key metrics

			Scope estimates	
Scope credit ratios	2021	2022	2023E	2024E
Scope-adjusted EBITDA/interest cover	17	>20	>20	20
Scope-adjusted debt/EBITDA	1.6	0.6	0.5	1.5
Scope-adjusted free operating cash flow/debt	15%	88%	126%	11%
Liquidity	>200%	>200%	>200%	>200%

Rating rationale

The BBB- issuer rating is supported by our view about ALTEO's improved financial risk profile that is bolstered by a sustainably strengthened leverage and interest coverage over the medium term. Moreover, the backing from the new shareholder consortium that holds 73.8% of the utility provides good comfort about a reduced probability of default over the next few years. This view primarily pertains to the backing from Hungarian oil and gas incumbent MOL via its subsidiary MOL RES Investments Zrt. Still ALTEO's overall outreach and scope, current concentration risks in its core business power generation and the limited outreach beyond Hungary remain rating constraints.

Outlook and rating-change drivers

The Stable Outlook reflects our expectation that ALTEO's financial position will remain solid amid its expansion strategy as displayed by medium-term leverage (Scope-adjusted debt/Scope-adjusted EBITDA) settling at below 3.0x and an EBITDA interest coverage staying around 7x. Moreover, the Stable Outlook incorporates a broadly unchanged shareholder structure.

A positive rating action is deemed remote in the foreseeable future, due to the company's limited scale and outreach.

We emphasise that following the strong improvement of the utility's financial risk profile and the new shareholder structure the headroom to a negative rating action is substantial. A negative rating action could be warranted if the execution of the company's growth strategy or its operating performance resulted in a deteriorating financial risk profile as displayed by a Scope-adjusted leverage of more than 4.0x or an EBITDA interest coverage that dropped to below 4.0x on a sustained basis.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
22 Jun 2023	Upgrade	BBB-/Stable
12 Dec 2022	Under Review placement	BB+/Under review for a possible upgrade
04 Oct 2022	Affirmation	BB+/Stable
30 Jun 2022	Affirmation	BB+/Stable
29 Jul 2021	Affirmation	BB+/Stable

Ratings & Outlook

Issuer	BBB-/Stable
Short-term debt	S-2
Senior unsecured debt	BBB-

Analyst

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Related Methodologies and Related Research

General Corporate Rating Methodology; July 2022

European Utilities Rating Methodology; March 2023

ESG considerations for the credit ratings of utilities; April 2021

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Bloomberg: RESP SCOP

Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Gradually growing and solidly balanced energy generation portfolio for regulated renewable energy generation capacities with a remaining regulatory life of around nine years as well as unregulated renewable energy and thermal generation capacities • Ability to provide reserve capacity which provides cash flow upside from the provision of balancing services thanks to the operation of gas-fired power plants and a 'virtual power plant' across Hungary, including volatile renewables and peak-load gas-fired power plants (ESG factor: credit-positive environmental factor) • Exposure to quasi-monopolistic heat generation and supply • Integrated business model with coverage of generation, supply, supplemented by energy and waste management services • Execution of updated HUF 65bn investment plan, which earmarks a high share for bolt-on acquisitions, expected to increase outreach, reduce asset concentration risks and maintain double-digit EBITDA margin • Strong financial metrics pertaining to leverage and debt protection along with a sound liquidity profile • Shareholder structure with significant stake from Hungary's oil&gas incumbent MOL	• Status as a small, niche energy supplier with insignificant share of Hungary's electricity generation and energy supply markets • Almost entire business exposure relating to Hungary in the foreseeable future which could particularly create regulatory risks for regulated renewable energy capacities under the KÁT and METAR system • Margin dilution from supply and energy services as well as the tariff expiry for ALTEO's largest wind farm (Bőny) • Asset concentration and production risks stemming from wind generation, which is likely to decrease with the execution of the investment strategy • Higher regulatory risks in Hungary than in most western European markets (e.g. Robin Hood tax on utilities, new solar tax, new balancing tax) • PAKS II extension could alter the merit order in Hungary in the long term • Deleveraging potential to be subdued with the large investment programme • Weakening of debt protection metrics (EBITDA interest coverage) following the significant ramp of gross financial debt that on average carries much higher interest rates than seen in the past

Positive rating-change drivers	Negative rating-change drivers
• Deemed remote considering the company's medium-term scale and outreach	• Leverage deteriorating to close to 4.0x or EBITDA interest coverage dropping close to 4.0x on a sustained basis which is also deemed remote over the next few years

Corporate profile

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 possible.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	8.1	17.3	>20.0	>20.0	19.7	7.4
Scope-adjusted debt/EBITDA	4.0	1.6	0.6	0.5	1.5	2.5
Scope-adjusted free operating cash flow/debt	-4%	15%	88%	126%	11%	7%
Liquidity	>100%	>200%	>200%	>200%	>200%	>200%
Scope-adjusted EBITDA in HUF bn						
EBITDA	5.4	12.9	20.2	17.9	20.1	19.6
Adjustments[1]	0.3	0.3	1.1	0.3	1.1	0.6
Scope-adjusted EBITDA	**5.7**	**13.2**	**21.3**	**18.1**	**21.1**	**20.2**
Funds from operations in HUF bn						
EBITDA	5.4	12.9	20.2	17.9	20.1	19.6
less: (net) cash interest paid	-0.7	-0.7	-0.9	-0.1	-1.0	-2.6
less: cash tax paid per cash flow statement	-0.9	-1.2	-2.9	-5.6	-5.6	-3.4
Funds from operations (FFO)	**3.9**	**10.9**	**16.4**	**12.1**	**13.4**	**13.7**
Free operating cash flow in HUF bn						
Funds from operations	3.9	10.9	16.4	12.1	13.4	13.7
Change in working capital	0.3	-4.8	-17.0	6.0	4.2	0.4
Non-operating cash flow	0.5	0.5	15.8	1.1	1.8	1.3
less: capital expenditure (net)	-5.6	-3.5	-3.6	-7.1	-16.0	-12.0
Free operating cash flow (FOCF)	**-1.0**	**3.1**	**11.6**	**12.2**	**3.5**	**3.4**
Net cash interest paid in HUF bn						
Interest paid	0.7	0.8	0.9	1.3	1.8	2.9
less: interest received	-0.0	-0.0	-0.5	-1.2	-0.8	-0.3
add: interest component on asset retirement obligations	0.0	0.0	0.0	0.0	0.1	0.1
Net cash interest paid	**0.7**	**0.8**	**0.4**	**0.2**	**1.1**	**2.7**
Scope-adjusted debt in HUF bn						
Reported gross financial debt	25.6	23.9	29.1	25.5	36.2	53.8
less: cash and cash equivalents	-3.5	-3.7	-16.5	-16.7	-5.8	-6.8
add: non-accessible cash	-	-	-	-	-	-
add: asset retirement obligations	0.7	0.7	0.9	1.2	2.3	2.9
less: derivatives/margining	-0.2	-	-0.3	-0.3	-0.3	-0.3
Scope-adjusted debt (SaD)	**22.6**	**20.9**	**13.2**	**9.7**	**32.3**	**49.6**

[1] Adjustments for profit/loss on derecognising fixed assets, provisions and share-based payments

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Environmental, social and governance (ESG) profile[2]

Environment		Social		Governance	
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)		Labour management		Management and supervision (supervisory boards and key person risk)	
Efficiencies (e.g. in production)		Health and safety (e.g. staff and customers)		Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)	
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)		Clients and supply chain (geographical/product diversification)		Corporate structure (complexity)	
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	

Legend

Green leaf (ESG factor: credit positive)

Red leaf (ESG factor: credit negative)

Grey leaf (ESG factor: credit neutral)

Virtual power plant enhances ALTEO's market position and cash flow profile

Our assessment of a positive environmental credit driver relates to ALTEO's combined operations of volatile renewable energy power plants and cogeneration and storage facilities, which are operated individually but also as a combined 'virtual power plant' through the company's own Power Plant Control Centre. The virtual power plant is a technical and commercial solution that allows multiple small stand-alone power plants to enter the electricity and system services market as a single, large power plant, thereby implementing very effective, flexible and economical energy production technology. As such ALTEO can cover outright demand and provide balancing capacity to the national grid operator, thereby supporting its credit quality in terms of market position, profitability and cash flow.

ALTEO can deal with regulatory risks

The Hungarian energy sector is widely exposed to regulatory risk, pertaining to licensing, tariff setting and taxation. As such, ALTEO faces the risk of adverse changes on applicable tariffs for electricity generated from some of its power plants and higher taxes. For the time being, ALTEO's cash flow profile can digest such risk, e.g. the newly introduced extra tax on balancing power.

No credit-negative aspects from Governance

ALTEO has implemented a Corporate Governance Practise based on the Corporate Governance Recommendations of the Budapest Stock Exchange. Moreover, we highlight the newly implemented long-term incentives that have been set for ALTEO's Board of Directors. Such incentives pertain to (1) financial KPIs and (2) sustainability targets. As such, we have become more confident that ALTEO's operations will be steered in a prudent and conservative fashion in the interest of creditors.

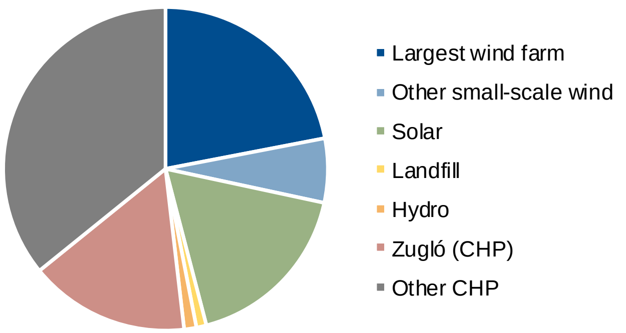
[2] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e. those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.

Business risk profile: BB+

Asset growth amid substantial investment phase gradually reducing concentration risks

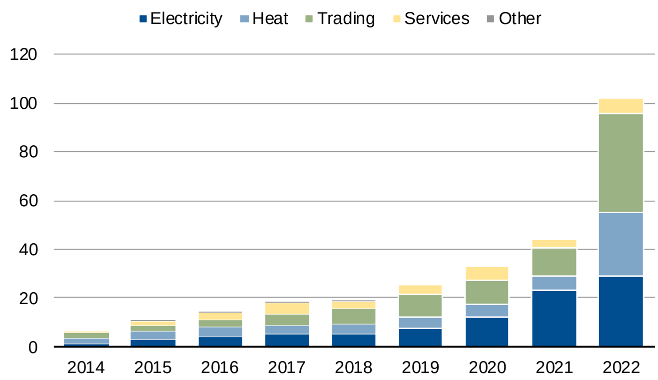
While the assessment remains constrained by ALTEO's limited geographical outreach and still comparatively small scale, we expect the company's competitive position to be further enhanced during its substantial investment phase over the next few years. The investment focus is to ramp up renewables capacity and to diversify the conventional generation capacity, thereby reducing the concentration risks pertaining to single assets within the current power generation portfolio (see Figure 1). The recent acquisition of a ready-to-build 20 MW solar power plant project (Edelyn Solar Kft) will materially boost the company's renewables generation portfolio to more than 90 MW. As such, the company's consistently growing exposure to renewable energy generation capacities, combined with its capacity to providing grid balancing, ensures a solid market position and reduces transition risks. Moreover, the company could achieve further growth through a widening of its business outreach pertaining to energy services and waste management, which would diversify ALTEO's cash flow streams and make it less dependent on external non-controllable parameters such as weather developments, fluctuating energy prices and gas procurement or government interventions.

Figure 1: Asset concentration by generation capacity



Sources: ALTEO, Scope

Figure 2: Revenue split by segment (in HUF bn)

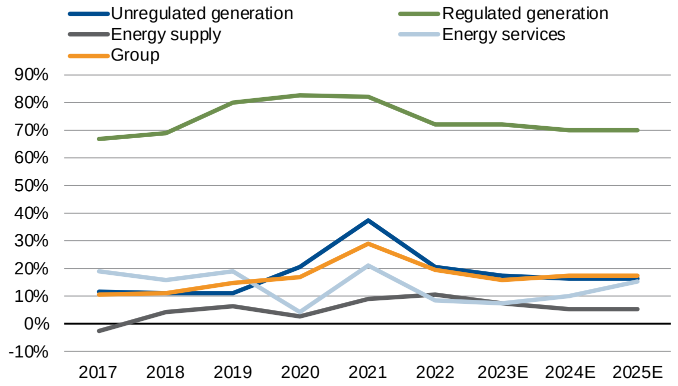


Sources: ALTEO, Scope

Solid margin profile

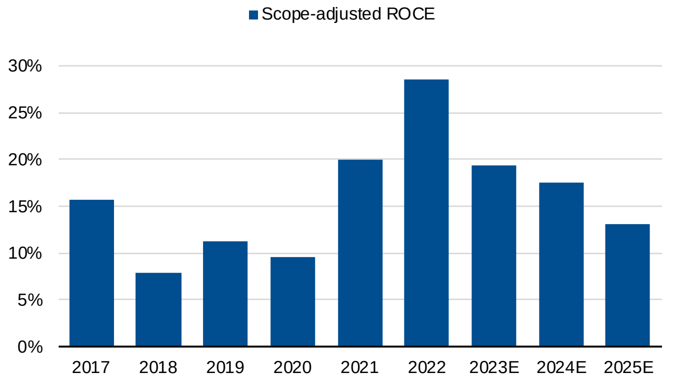
While the company has performed very well amid the persistent energy crisis in Europe as it benefits from increased power prices (particularly in its energy trading and supply division) and the provision of balancing power, it is not immune to deteriorating macroeconomic conditions and potentially stricter regulation/higher taxation of Hungary's energy market or to the increased risk of receivables write-offs over the next few years. However, we believe that ALTEO can cope with such potential adverse factors considering its solid finances and the important earnings contribution from regulated and unregulated electricity and heat generation, providing 80-90% of recurring EBITDA. This is also displayed by a solid group EBITDA margin which we regard to be sustained within a range of 15-20% as well as a strong Scope-adjusted return on capital employed of 10-15% (see Figures 3 + 4).

Figure 3: ALTEO's EBITDA margin per segment



Sources: ALTEO, Scope estimates

Figure 4: Scope-adjusted ROCE



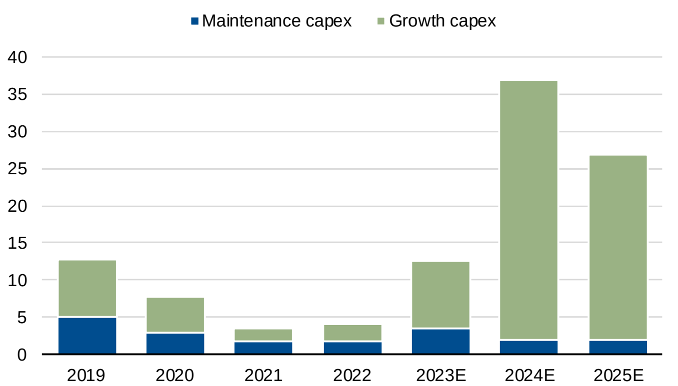
Sources: ALTEO, Scope estimates

Financial risk profile: BBB+

FRP assessment based on medium-term forecasts

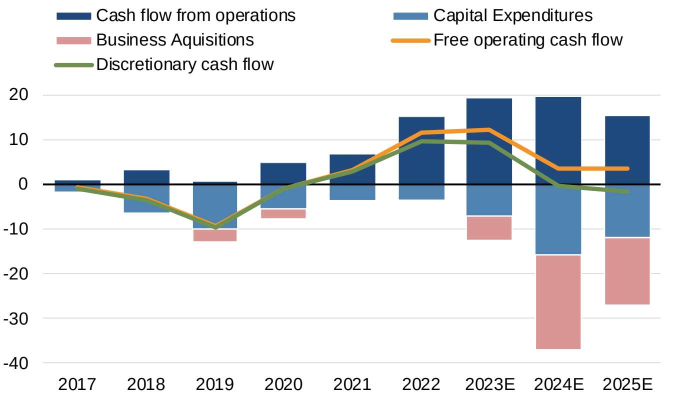
ALTEO's rating is strongly supported by its solid financial risk profile assessment. While the very strong financials reported in 2021/2022 and those expected for 2023/2024 are not deemed representative of the company's medium-to-long-term financial setup, we expect sustainably improved credit metrics over the medium term. We highlight the company's ambitious capex plan that primarily relates to organic and dynamic growth capex, which overall could exceed HUF 65bn between 2023 and 2025 (see Figure 5).

Figure 5: Steep ramp-up of capex programme (HUF bn)



Sources: ALTEO, Scope estimates

Figure 6: ALTEO's cash flow profile (HUF bn)

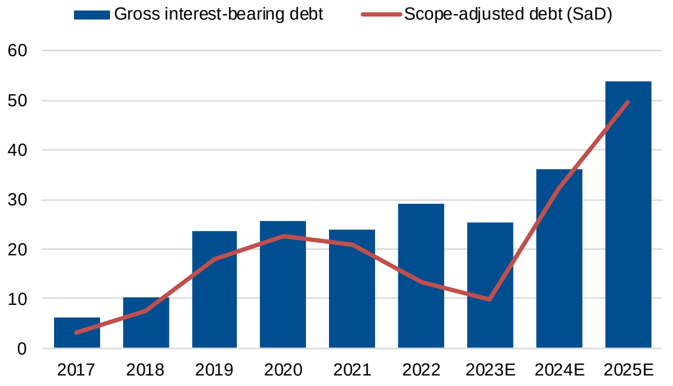


Sources: ALTEO, Scope estimates

Substantial expansion of debt exposure resulting affecting medium-term leverage forecast

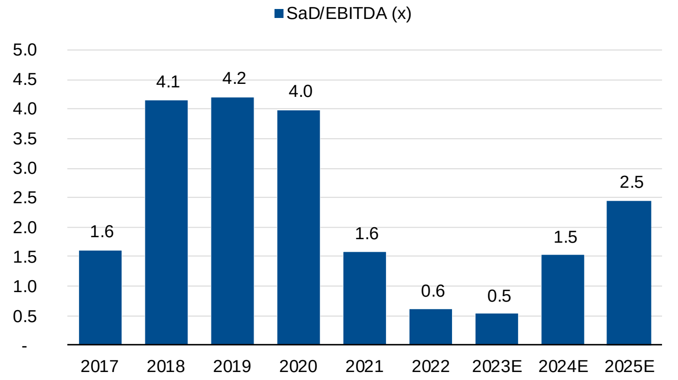
Whilst we expect this heavy investment programme to be funded substantially by ongoing operating cash flow and the large cash buffer of more than HUF 20bn as of today, a large portion of capex will likely be funded by newly raised debt (under the company's HUF 20bn bond programme launched in Sep 2022). Consequently, the agency assumes the company's gross debt exposure to increase materially to about HUF 54bn by YE 2025 from HUF 29bn at YE 2022 (see Figure 7). However, this debt increase can be digested comfortably by the expected operating performance of the company as displayed by a sustained EBITDA of around HUF 20bn over the medium term. As such, we project leverage – as measured by Scope-adjusted debt/Scope-adjusted EBITDA – settling at 2.5-3.0x over the medium term, up from 0.6x in 2022 (see Figure 8).

Figure 7: Development of indebtedness (in HUF bn)



Sources: ALTEO, Scope estimates

Figure 8: Expected development of leverage



Sources: ALTEO, Scope estimates

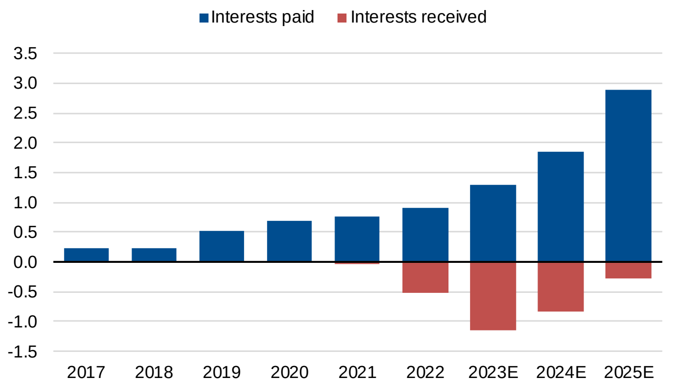
Free operating cash flow expected to be retained in positive territory during investment phase

We believe that ALTEO will continue to have sufficient internal funding capacity to fully fund maintenance and organic growth capex, thereby maintaining free operating cash flow in the positive territory. However, discretionary capex spending for dynamic growth is likely to require new external funding.

Interest coverage to remain solid amid changed interest rate environment

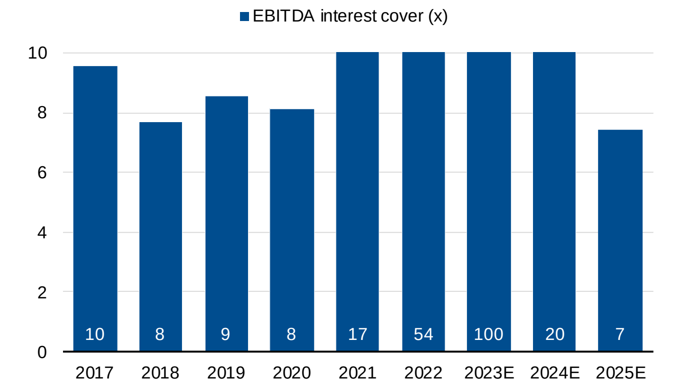
Medium-term debt protection – as measured by Scope-adjusted EBITDA interest coverage – is expected to settle at around 7x (see Figure 10). While debt protection in the short-term is largely supported by the company's low indebtedness and substantially positive interest income earned on the cash buffer, ALTEO's interest coverage is expected to be affected by the growing debt exposure and overall increasing average interest rates on outstanding debt positions. ALTEO's net interest burden is likely to increase from an insignificant amount of less than HUF 400m in 2022 and 2023 to about HUF 2.7bn in 2025 (see Figure 9), which still should result in a solid interest coverage.

Figure 9: Development of net interest (in HUF bn)



Sources: ALTEO, Scope estimates

Figure 10: Expected development of debt protection



Sources: ALTEO, Scope estimates

Adequate liquidity

ALTEO's liquidity remains ample, limiting concerns about sufficient capex and debt maturity coverage over the next few years. Upcoming debt maturities in 2023-2025 amount to HUF 1.9bn, after the HUF 6.0bn short-term shareholder loan from ALTEO's previous majority shareholder Wallis Asset Management has already been redeemed in full during H1 2023 from cash sources. Remaining upcoming debt maturities are expected to be comfortably covered by positive annual free operating cash flow, the remaining cash buffer of HUF 26.2bn as of March 2023 and freely available credit facilities of about HUF 3.0bn.

Larger debt refinancing will arise in 2029 when the bullet payment of the first MNB bond (HUF 8.6bn) is due. From today's perspective, we are confident about a successful refinancing of this maturity, particularly after the change in the company's shareholder structure.

We recognise that credit facilities from Erste Bank and OTP are provided on a rolling basis only. They are somewhat equivalent to committed lines as most have been in place for at least five years. However, we believe ALTEO will not need them in 2023-2025 as internal liquidity is sufficient.

Despite its small size, ALTEO has decent access to external financing, as displayed by its continued issuance of bonds (first bond scheme in 2011) and well-established lending relationships not only with Hungarian banks like MTB and OTP but also Austria's Erste and Italy's Unicredit. ALTEO retains good refinancing alternatives in case bridge funding is required. External funding channels would also serve as a backup for the refinancing of ALTEO's interest-bearing bonds (HUF 8.6bn in 2029 and HUF 3.8bn in 2031), provided the utility's business model and market position does not significantly deteriorate until then.

Balance in HUF bn	2022	2023E	2024E
Unrestricted cash (t-1)	3.7	16.5	16.7
Open committed credit lines (t-1)	2.6	3.0	3.0
Free operating cash flow (t)	11.6	12.2	3.5
Short-term debt (t-1)	3.0	7.9	0.8
Coverage	**>200%**	**>200%**	**>200%**

Supplementary rating drivers: +/- 0 notches

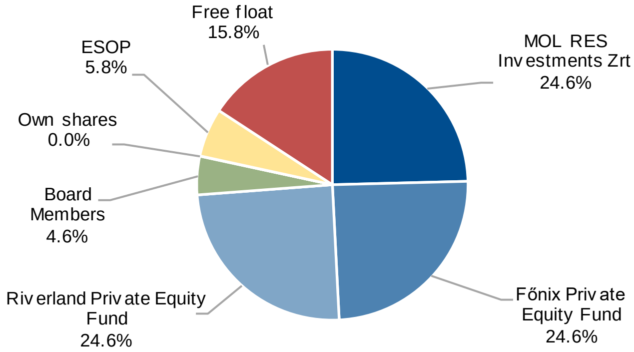
Financial policy: credit-neutral

ALTEO maintains a prudent financial policy that we do not expect to change with the new shareholder structure. While the company envisions the aforementioned heavy capex programme over the next few years, which includes dynamic growth opportunities, M&A activities will likely relate to smaller bolt-on acquisitions, e.g. ready-to-build projects or smaller operating ventures in the utility's core segments, generation or services. We do not see major integration risks or larger delays on earnings accretion; hence acquired businesses will likely provide extra impetus to earnings growth. We expect shareholder remuneration to remain aligned with ALTEO's operating performance and unlikely to compromise credit quality. Shareholder remuneration would likely be adjusted if required to preserve the company's credit profile, which is deemed to be a clear focus for management, as happened in 2020 during the Covid-19 crisis. Ultimately, we highlight the newly implemented long-term incentives that have been set for ALTEO's board of directors. Such incentives pertain to i) financial KPIs and ii) sustainability targets. As such, we have become more confident that ALTEO's operations will be steered in a prudent and conservative fashion in the interest of creditors.

No direct rating impact from shareholder structure

The utility's shareholder structure is reflected as credit-neutral in the rating, not providing any rating adjustments to its standalone credit assessment. Since the execution of the tender offer from the new shareholder consortium that has been led by MOL RES Investments Zrt, there is no factual majority shareholder that obtained control over ALTEO (each of the three shareholders including Főnix Private Equity Fund and Riverland Private Equity Fund hold 24.6%). Nonetheless, we consider Hungary's oil and gas incumbent MOL (the ultimate parent of MOL RES Investments Zrt) the leader among the new shareholders. We assume MOL to have a long-term investment horizon for ALTEO and to regard the utility as an associated subsidiary that could strengthen MOL's ambitions to diversify outside of its core business. The agency regards MOL's creditworthiness to be slightly better than ALTEO's standalone credit profile, with much stronger financial power in the context of size and funding channels. This implies that MOL would likely be able to provide funding support to ALTEO, if needed, on either the execution of capex or refinancing needs. While overall, the shareholder structure does not result in any rating adjustments, it justifies ALTEO's investment-grade rating.

Figure 11: ALTEO's new shareholder structure as of Q1 2023



Sources: ALTEO, Scope

Long-term and short-term debt ratings

Senior unsecured debt rating: BBB-

Senior unsecured debt issued by ALTEO is rated at the same level as the issuer rating. This is aligned with our general rating approach for senior unsecured debt of investment-grade rated issuers.

Short-term debt rating: S-2

ALTEO's short-term debt rating is based on the underlying BBB-/Stable issuer rating and the company's solid liquidity profile, characterised by consistently strong liquidity and an adequate access to external funding channels.

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