Optimum Solar Kft.
Hungary, Construction

NEGATIVE
B+

Corporate profile

Optimum Solar Kft. is a leading solar engineering, procurement and construction company in Hungary. It was founded in 2011 and is privately owned by its management and employees. The company has 45 full-time employees, generated HUF 13bn of revenues and HUF 1.4bn of EBITDA in 2020 and is headquartered in Baja, in southern Hungary. Optimum Solar provides complex services in the design and construction of solar household-to-utility scale power plants, runs low-power power plants, provides maintenance, scheduling and storage for power producers, and distributes chargers for electric vehicles.

Key metrics

				Scope estimates	
Scope credit ratios	2018	2019	2020	2021E	2022E
EBITDA/interest cover (x)	18.2x	9.2x	9.3x	2.2x	14.6x
Scope-adjusted debt (SaD)/EBITDA	1.8x	1.7x	6.3x	17.2x	4.8x
Scope-adjusted FFO/SaD	51%	55%	15%	3%	18%
Scope-adjusted free operating cash flow/SaD	-32%	-5%	-59%	104%	-34%

Rating rationale

Scope has affirmed the issuer rating of B+ to Optimum Solar Kft. And changed the Outlook to Negative.

The B+ issuer rating is supported by Optimum Solar's profitability of around 7% and the supportive regulatory environment in Hungary (National Energy Strategy 2030), which stimulates demand for the sector's services, indicated by the cash flow visibility from the contracted backlog. The rating is further supported by good EBITDA interest cover and adequate liquidity.

The rating is mainly constrained by the company's small scale in both a European and domestic construction context, with a mono-line focus on photovoltaic power stations. It is further constrained by a lack of geographical diversification (predominantly active in Hungary) and segment concentration. The rating is also limited by the anticipated increase in leverage, driven by a forecast of weak EBITDA and the need for additional debt/guarantees to pre-finance large-scale projects. However, this is a typical feature for growth companies.

Outlook and rating-change drivers

The Outlook for Optimum Solar is Negative due to elevated leverage forecasted for 2021 and an increased risk that leverage will remain above 5x going forward. On the other hand it also incorporates our view of a positive politically induced business environment thanks to the National Energy Strategy 2030. Furthermore, we foresee that Optimum Solar will benefit from: i) the existing market backlog of projects to be fulfilled by 2022 for the KAT system; and ii) the company's expansion into small and medium-sized power plants, supported by existing partners. All of these aspects should lead to increased revenue generation going forward, but with greater associated execution risk as the company enters uncharted territory.

Ratings & Outlook

Corporate rating	B+/Negative
Senior unsecured rating	B+

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Related Methodologies

Corporate Rating Methodology

Rating Methodology European Construction Corporates

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A positive rating action, i.e. a Stable Outlook, may be warranted if the company manages to decrease Scope-adjusted debt (SaD)/Scope-adjusted EBITDA to below 5x on a sustained basis.

A negative rating action could occur if SaD/Scope-adjusted EBITDA were to remain above 5x on a sustained basis paired with low visibility on short-term cash generation or liquidity were to worsen. An increase in leverage could be triggered by an adverse operational development leading to reduced profitability and cash flows. Liquidity could worsen if, for example: i) customers delay payments significantly; or ii) the company becomes exposed to the non-recoverable cost overruns of its projects.

Rating drivers

Positive rating drivers	Negative rating drivers
• Stable profitability at around the sector average, with continued limited volatility thanks to a supportive regulatory environment that stimulates demand for the company's services • Adequate liquidity, with short-term maturities relating to working capital facilities • Healthy debt protection metrics despite sharp expected rise in interest-bearing debt	• Small-scale construction company in a European context, with a lack of geographic and segment diversification, somewhat mitigated by politically induced demand and the good position within a niche market • Negative free operating cash flow, which also translates into negative Scope cash flow metrics; while this is typical for growth companies, it indicates a continued need for debt increases • Future growth at the expense of increased leverage

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Decrease in SaD/Scope-adjusted EBITDA to below 5x on a sustained basis	• Leverage, in terms of SaD/Scope-adjusted EBITDA, remaining above 5x paired with low visibility on short-term cash generation • Worsening of liquidity due, for example, to delayed customer payments or cost overruns

Financial overview

				Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover (x)	9.2x	9.3x	2.2x	14.6x	17.7x
Scope-adjusted debt (SaD)/EBITDA	1.7x	6.3x	17.2x	4.8x	4.3x
Scope-adjusted funds from operations/SaD	55%	15%	3%	18%	20%
Scope-adjusted free operating cash flow/SaD	-5%	-59%	104%	-34%	-1%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020**	**2021E**	**2022E**
EBITDA	974	1,194	1,430	334	2,311
Operating lease payments in respective year	93	103	0	0	0
Other	0	0	0	0	0
Scope-adjusted EBITDA	1,068	1,298	1,430	334	2,311
Scope-adjusted funds from operations in HUF m	**2018**	**2019**	**2020**	**2021E**	**2022E**
EBITDA	1,068	1,298	1,430	334	2,311
less: (net) cash interest as per cash flow statement	-22	-102	-153	-149	-158
less: cash tax paid as per cash flow statement	-12	0	-43	-21	-174
add: depreciation component, operating leases	-36	-40	0	0	0
add: dividends from shareholdings	0	0	0	0	0
Scope-adjusted funds from operations	997	1,226	1,362	164	1,980
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	1,144	1,564	6,643	6,642	6,325
less: hybrid bonds	0	0	0	0	0
less: cash and cash equivalents	-175	-433	-181	-6,107	-1,952
add: cash not accessible	261	317	94	1,791	1,301
add: pension adjustment	0	0	0	0	0
add: operating lease obligations	718	799	0	0	0
Add: guarantees, letters of credit (off balance sheet)	0	0	2,409	3,409	5,409
Other	0	0	0	0	0
Scope-adjusted debt	1,949	2,247	8,966	5,735	11,083

Business risk profile: B

Industry risk: B

While the construction industry is often associated with cyclical features when compared to industries with inelastic demand patterns, these cycles vary depending on the individual business model. Our industry assessment incorporates exposures to economic trends that affect the downside volatility of cash flows. Downside volatility can arise from either: i) volume risks from a high exposure to buildings, industrial construction and public/government customers; or ii) risks from price fluctuations on materials, labour and energy. We view the overall construction industry's cyclicality as high. However, a large share of concession-related and service business can lower a company's exposure to cyclicality, thus reducing industry risk.

Cyclicality (high)

Market entry barriers (low)

The construction sector has low market entry barriers as initial investments are low and proprietary technologies are not needed to enter local markets. This applies in particular to the building segment.

Substitution risk (low)

Substitution risk is low as it is unlikely that any technology will replace the fundamental role played by construction companies in addressing the need for new commercial and residential buildings as well as for heavy and civil engineering (the construction of railway tracks, bridges, highways, tunnels, airports and other functional capital-intensive ventures). Such construction work will be fueled by population growth, globalisation and urbanisation worldwide.

Figure 1: Industry risk assessment: European construction corporates

Cyclicality \ Barriers to entry	Low	Medium	High
High	CCC/**B**	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Source : Scope

Small player both in a European context and domestically for general construction

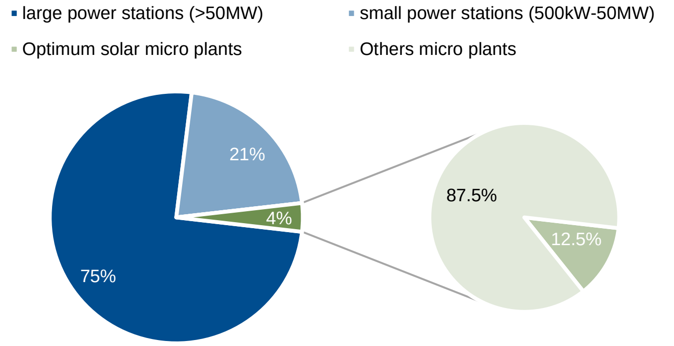
Optimum Solar is a small player in European construction, with HUF 13bn (EUR 37m) of revenues and HUF 1.4bn (EUR 4m) of Scope-adjusted EBITDA in 2020. Domestically, it is at the lower end of the top 20 construction companies in Hungary – but with a very different focus to most of the other companies.

Optimum Solar is only active in a niche construction segment: the engineering, procurement and construction of solar power plants. The total installed energy production capacity in Hungary in 2018 was 9,215MWp, of which 6,923MWp stemmed from large power stations (above 50MW), 1,956MWp from small power stations (500kW-50MW) and 336MWp from micro power stations (under 500kW). The green share of power plants was 41% of small power plants and 100% of micro power plants – all of which generated solar energy under the KAT system and therefore in Optimum Solar's niche sector. Within its niche micro power plant sector, Optimum Solar installed an aggregated 42MW capacity as at YE 2018, 12.5% of the domestic market's capacity.

12.5% domestic market share in installed micro solar plants

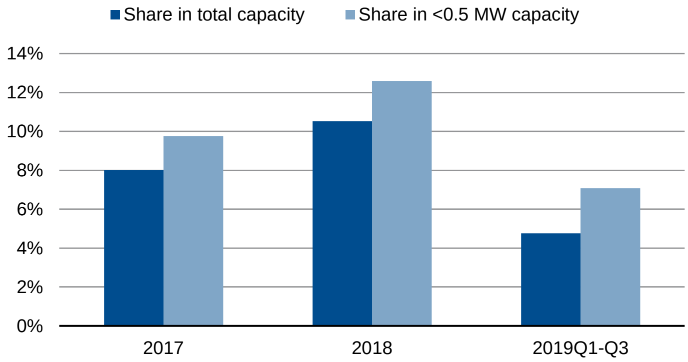
The company will continue to build micro power plants going forward but, on the back of Hungary's ambitious National Energy Strategy 2030, has also become involved in small (up to 5MW) and medium-sized (up to 50MW) power plants. Optimum Solar will continue to be the main contractor for micro power plants and sees itself becoming the main contractor for small-sized ones. As regards medium-sized plants, it is collaborating with several of the largest global photovoltaic panel producers/solar power plant developers and has recently won four tenders for 15-50MW power plants to be developed in 2021/22.

Figure 2: Market share in total power plants installed (%)



Source: MAVIR, Scope

Figure 3: Market share in solar power plant installations



Source: KSH, Scope

Exposed to changes in the domestic subsidy system

The company's geographical diversification is limited, with activities predominantly in southern Hungary due to the better irradiation levels. Under the old KAT system (mandatory off-take with fixed feed-in-tariffs) the company focused on small, household-scale solar power plants. With the introduction of the METAR system (renewable support scheme – tender required to receive premium prices), the company is now translating the experience gained from around 460 small-scale projects into much larger, industrial-size projects.

Limited segment diversification mitigated by favourable environment

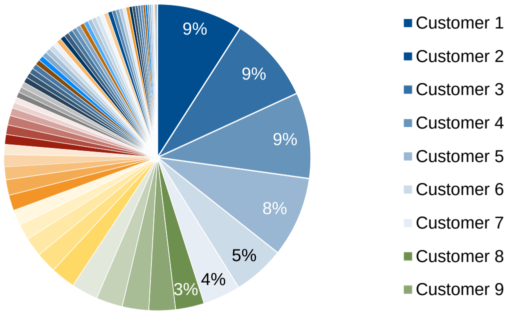
Segment diversification is also limited, with activities solely in the photovoltaic engineering, procurement and construction segment. Historically, the company was solely active in the sub-segment of micro power plants, only recently branching out into small-scale projects (up to 5MW), with some medium-scale projects (up to 50MW) in the early development stage and more to come in that segment going forward. Mitigating factors are Optimum Solar's different roles going forward, i.e. as either the main contractor or sub-contractor in joint ventures on large-scale projects and the National Energy Plan. In connection with the European Union's target of 30% renewables by 2030, Hungary National Energy Strategy 2030 will increase the share of renewable energy to 20%. Hungary's National Energy and Climate Plan envisages the construction of 6,645MW of solar power plants in 2020-30, supported by subsidy systems. This will reduce cyclicality/volatility for Optimum Solar given its exposure to only one segment, as growth and favourable business conditions will be boosted by political policy for the next decade.

Modest customer diversification with mostly private companies or individuals

Customer diversification is assessed as moderate, with only one dominant large client (state-owned MVM Zölgeneráció Kft.) and a diversified group of small clients. In the assessed timeframe of 2016-20, typical clients were privately held companies or private individuals, with a tiny share of municipalities. The top three customers, all of which have several projects, account for 27% (31% 2016-2019) of revenues over this timeframe, and the top 10 customers for 56% (55%). The credit quality of these customers is difficult to assess, but according to management, receivables have never been impaired. Going forward, the large-scale projects are all financially secured with a collateral manager acting as an 'escrow account' and independent validator between Optimum Solar and its clients, mitigating counterparty risk.

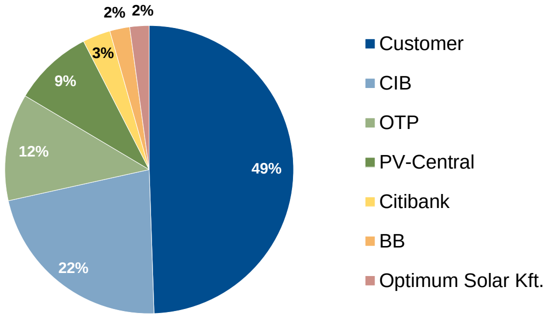
On the pre-financing side, 50% of the assessed projects were pre-financed by the customers themselves, with the remainder pre-financed by banks and one major supplier.

Figure 4: Project diversification 2016-20 by customer (%)



Source: Optimum Solar, Scope

Figure 5: Pre-financing diversification in 2016-19 (%)

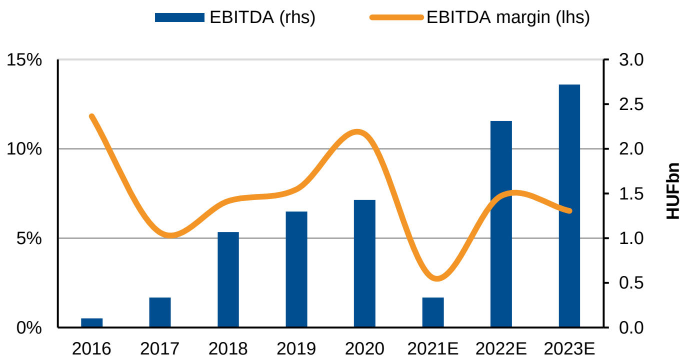


Source: Optimum Solar, Scope

Average and stable profitability margins

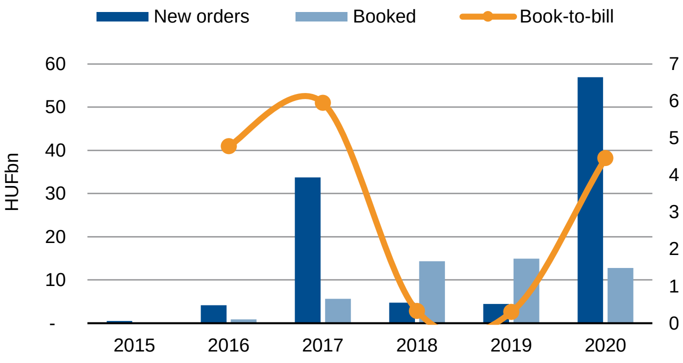
Profitability, at 7%, is average compared to peers, but the margin stability is positive. While traditional construction peers in Hungary have achieved higher margins in recent boom years, we judge these to be unsustainable once the economy cools as expected. In contrast, Optimum Solar's margins have different drivers in the political framework for renewable energy.

Figure 6: EBITDA and EBITDA margin



Source: Optimum Solar, Scope estimates

Figure 7: New orders, booked, and book-to-bill ratio



Source: Optimum Solar, Scope estimates

Backlog of four years; volatile book-to-bill ratio

The current signed order backlog, equating to HUF 56bn at year-end 2020, covers around four years of 2020 revenues, with the lion's share coming from four medium-sized photovoltaic plants. The potential backlog – including many micro-plants that require completion by end-2022 to receive the beneficial KAT prices, and medium-scale power plants with letters of credit – covers over 15 years of revenue.

The book-to-bill ratio is distorted by the huge amount of orders towards the end of 2017 due to the expiry of the KAT system. This resulted in a book-to-bill of 6x in 2017 (extremely strong demand) and below 1x for the coming years (insufficient, weak demand) while the company worked off these orders. The picture brightened again in 2020 when Optimum Solar won several METAR tenders for medium-sized plants, reaching a book-to-bill of 4x for the year. Summing up the last five years to smooth out these distortions, the book-to-bill is 2x, showing healthy demand for the company's services. However, the remaining contracted backlog depends on large contracts with which the company has little experience, resulting in elevated execution risk.

Concentration in management and lack of independent board

Optimum Solar's main owner, Roland Lugos, is also its top management, and there is no independent board to provide an oversight function. While we understand the family-owned nature of the company, an improvement in corporate governance and a broadening of management would be positive to reduce key person risk given its expected growth in scale.

Financial risk profile: BB-

Our rating scenario assumes the following:

- Revenue growth of -21% in 2021, +160% in 2022 and 33% in 2023. This is in line with current contracted projects and the letter-of-intent backlog as per year-end 2020.
- EBITDA margin of 11% for 2020 above historical margins thanks to little construction/more planning, 3% in 2021 due to reversal and around 7% in 2022/23
- Significant build-up of guarantees and off-balance sheet debt related to new projects
- No dividend payouts for 2020 and 2021 with 35% of the previous year's net profit thereafter as per the company's maximum dividend policy and covenant restrictions
- Restricted cash relates to cash pledged as collateral for banks to issue guarantees

Sufficient headroom in debt protection metrics

As Optimum Solar had relatively little debt in the past, interest expenses were modest – hence the very strong average Scope-adjusted EBITDA interest coverage ratio of 12x. The issuance of a HUF 6bn bond, while existing loans were maintained or even increased (for working capital, investment and leasing purposes), has caused debt protection metrics to suffer. Scope-adjusted EBITDA interest coverage held up well in 2020 due to increased EBITDA but is expected to dip to 2x in 2021, before stabilising at high levels again in 2022 and thereafter.

Given the still relatively high coverage despite increased indebtedness, we believe the company can meet its interest payment obligations in the period considered.

Growth-related build-up in working capital results in negative cash flow metrics

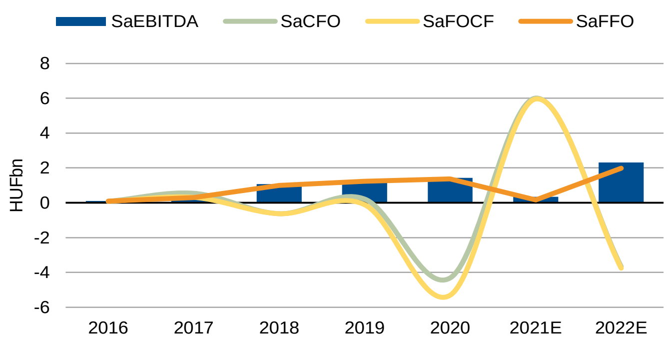
Cash flow as measured by funds from operations has grown very strongly since 2016 and is expected to continue growing, with a dip in 2021. Growth usually translates into a large build-up of working capital, evident in the company's negative Scope-adjusted free operating cash flow (FOCF) in 2018 and especially in 2020 with high pre-financing needs on Optimum Solar's side. We forecast that Scope-adjusted FOCF (and concurrently our cash-flow metric of Scope-adjusted FOCF/SaD) will swing with contract intakes/progress, but that it will mostly remain negative.

Dividends in the forecast period are assumed to be at the maximum allowed, i.e. 35% of the previous year's net profit, once profits allow this from 2022 onwards.

Very negative cash flows constrain the financial risk profile

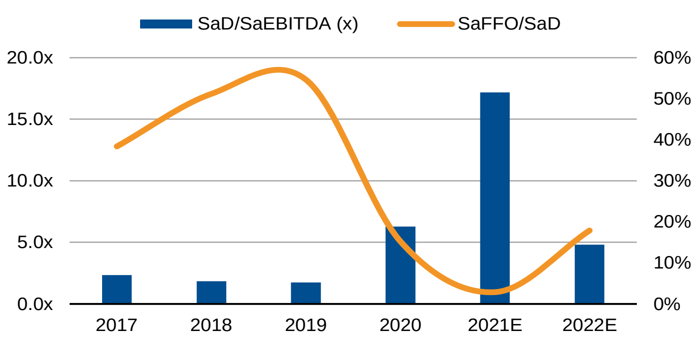
Very negative cash flows, which we expect to continue for the duration of the growth strategy, constrain Optimum Solar's financial risk profile.

Figure 8: Cash flows



Source: Optimum Solar, Scope estimates; 'Sa' = Scope-adjusted

Figure 9: Leverage



Source: Optimum Solar, Scope estimates; 'Sa' = Scope-adjusted

Growth strategy comes at the expense of strongly increased leverage

SaD/Scope-adjusted EBITDA has historically been around 2x, thanks to the company's modest usage of financial debt in addition to some operating leases. Debt levels already increased in 2020 due to the HUF 6bn bond and a build-up of guarantees and other off-balance sheet debt. We forecast that they will rise significantly because the company's current strategy to establish a foothold in industrial-size solar plants requires a large build-up of working capital and a restricted deposit to cover bank guarantees. We forecast that leverage as measured by SaD/Scope-adjusted EBITDA will rise above 15x in 2021, moving outside of our base rating case, before falling again to just below 5x in 2022 based on our forecasts of increased EBITDA. Leverage as measured by funds from operations/SaD will decrease from a decent 15% in 2020 to 3% in 2021, before recovering to levels around 20% thereafter.

Adequate liquidity

We consider Optimum Solar's liquidity to be adequate, in detail:

Figure 10: Liquidity

in HUF m	2021E	2022E
Short-term debt (t-1)	631	631
Unrestricted cash (t-1)	86	4,316
Open committed credit lines (t-1)	645	645
Free operating cash flow (t)[1]	5,965	-3,759
Coverage	**10.6x**	**1.9x**

Source: Scope estimates

We judge the company's liquidity to be adequate, with unrestricted cash and FOCF exceeding short-term debt going forward. Given the long maturity of the bond, with only 5% amortisation due in 2023, upcoming short-term maturities are likely to be manageable for the foreseeable future.

[1] We exclude discretionary expansion capex from our liquidity calculation, as such investments are made only if external financing is available.

Senior unsecured debt

The rated entity issued a HUF 6bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme in May 2020. The bond has a 3.5% coupon and is amortising, starting after three years, with a tenor until 2027.

Senior unsecured debt: B+

Our recovery analysis is based on a hypothetical default scenario occurring at year-end 2022, in which we assume outstanding senior unsecured bond debt of HUF 6.0bn in addition to HUF 3.8bn of secured bank debt and secured guarantee positions, HUF 1.3bn in payables and HUF 1.9bn in off-balance sheet guarantees. We expect an 'average recovery' for the company's unsecured debt, resulting in a B+ rating for this debt class (the same as the issuer rating).

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