Optimum Solar Kft.
Hungary, Construction

B+ STABLE

Corporate profile

Optimum Solar Kft is one of the leading Hungarian solar EPC (Engineering, procurement and construction) companies, founded in 2011 and privately owned by its management and employees. The company employs 45 full-time employees, generated HUF 15bn of revenues and HUF 1bn of EBITDA in 2018 and is headquartered in Baja, 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 of electric vehicles.

Key metrics

			Scope estimates		
Scope credit ratios	2017	2018	2019F	2020F	2021F
EBITDA/interest cover (x)	10.2x	18.2x	14.6x	3.5x	4.5x
Scope-adjusted debt (SaD)/EBITDA	2.3x	1.8x	2.0x	3.2x	5.3x
Scope-adjusted FFO/SaD	38%	51%	47%	21%	14%
Scope-adjusted free operating cash flow/SaD	40%	-32%	-12%	-7%	-47%

Rating rationale

Scope has monitored the issuer rating of B+/Stable to Optimum Solar Kft.

The B+ issuer rating is supported by Optimum Solar's stable profitability and the supportive regulatory environment in Hungary (National Energy Strategy 2030) that stimulates demand for the sector's services, despite the limited 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 weak diversification, namely a lack of geographical diversification (predominantly active in Hungary), segment concentration and an exposure to counterparties with relatively weak credit quality. The rating is further limited by the anticipated increase in leverage driven by a forecast of negative Scope-adjusted free operating cash flow (SaFOCF) – however, this is a typical feature for growth companies.

Outlook

The Outlook for Optimum Solar is Stable and incorporates our view of a positive politically induced business environment thanks to the National Energy Strategy 2030. Furthermore, we foresee Optimum Solar to benefit from i) the existing market backlog of projects to be fulfilled by 2021 for KAT, the expired Hungarian feed-in tariff scheme; and; ii) the company's expansion into small and medium-sized power plants, supported by existing partners. All aspects should lead to at least stable revenue generation going forward.

Furthermore, the Outlook incorporates a successful placement of a HUF 6bn bond in H1 2020. Proceeds are intended towards covering capex for the company's operational assets, the deposits needed behind bank guarantees, and working capital.

Ratings & Outlook

Corporate rating B+/Stable

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 is seen to be remote, but may be warranted if the company can increase visibility on contracted revenues beyond 2020, via a solid contracted backlog in medium-sized power plants, in addition to reducing its leverage, measured by Scope-adjusted debt (SaD) to Scope-adjusted EBITDA, to below 3.5x on a sustained basis.

A negative rating action could occur if SaD to Scope-adjusted EBITDA were to increase to above 5x on a sustained basis or liquidity were to worsen. This could be triggered by a change in regulatory environment in Hungary not foreseeable as of today. An increase in leverage could be triggered by an adverse operational development leading to reduced profitability and cash flows. Liquidity could worsen if, e.g. 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 limited volatility to continue 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 the strong expected increase 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 • Short contracted backlog providing limited visibility on future revenues • 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
• Increased visibility on revenues beyond 2020 in addition to keeping SaD to Scope-adjusted EBITDA below 3.5x on a sustained basis	• Increased leverage, i.e. SaD to Scope-adjusted EBITDA sustained above 5x • Worsening of liquidity due to, for example, delayed customer payments or cost overruns

Financial overview

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA/interest cover (x)	10.2x	18.2x	14.6x	3.5x	4.5x
Scope-adjusted debt (SaD)/EBITDA	2.3x	1.8x	2.0x	3.2x	5.3x
Scope-adjusted funds from operations/SaD	38%	51%	47%	21%	14%
Scope-adjusted free operating cash flow/SaD	40%	-32%	-12%	-7%	-47%
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA	292	974	1,093	942	1,287
Operating lease payments in respective year	43	94	103	102	134
Other	0	0	0	0	0
Scope-adjusted EBITDA	335	1,069	1,196	1,044	1,421
Scope-adjusted funds from operations in HUF m	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA	335	1,069	1,196	1,044	1,421
less: (net) cash interest as per cash flow statement	-16	-22	-42	-257	-263
less: cash tax paid as per cash flow statement	-4	-12	0	-53	-79
add: depreciation component, operating leases	-17	-36	-40	-39	-52
add: dividends from shareholdings	0	0	0	0	0
Scope-adjusted funds from operations	299	997	1,114	695	1,027
Scope-adjusted debt in HUF m	**2017**	**2018**	**2019F**	**2020F**	**2021F**
Reported gross financial debt	663	1,144	1,679	8,550	8,550
less: hybrid bonds	0	0	0	0	0
less: cash and cash equivalents	-423	-175	-431	-6,881	-3,174
add: cash not accessible	206	261	317	853	1,142
add: pension adjustment	0	0	0	0	0
add: operating lease obligations	334	726	799	787	1,031
Other	0	0	0	0	0
Scope-adjusted debt	779	1,957	2,363	3,309	7,549

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. We incorporate 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 to be 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 in 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

Barriers to entry / Cyclicality	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

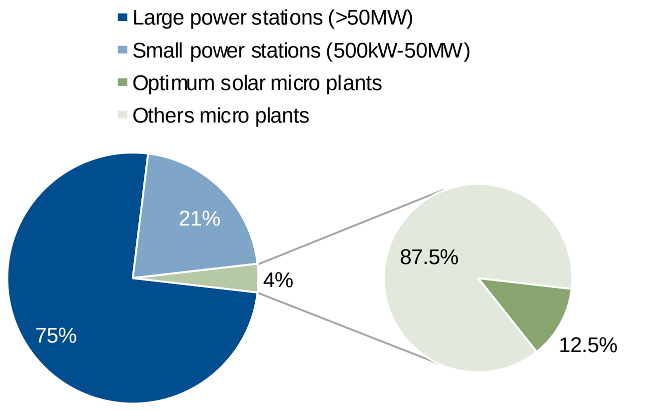
Optimum Solar is a small player in European construction, with HUF 15bn (EUR 50m) of revenues and HUF 1bn (EUR 3m) of Scope-adjusted EBITDA in 2018. Domestically, it is at the lower end of the top 20 construction companies in Hungary – but with a very different focus than most in the list.

Optimum Solar is only active in a niche construction segment: the engineering, procurement and construction (EPC) of solar power plants. 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 (<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 of micro power plants, 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

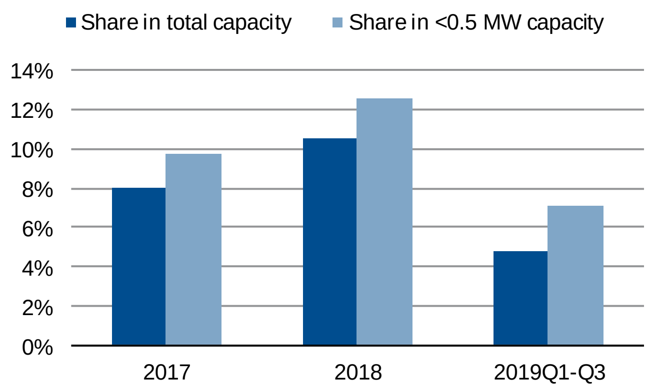
The company will continue to build micro power plants going forward but, on the back of Hungary's ambitious National Energy Strategy 2030, also intends to be involved in small (up to 5MW) and medium-sized (up to 50MW) power plants. Optimum Solar will continue to be the main contractor on the micro power plants and foresees to be the main contractor on the small-sized ones. On the medium-sized plants, it is collaborating with one of the largest global PV panel producer/solar power plant developer and will act as a subcontractor.

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



Source: MAVIR, Scope

Figure 3: Market share in solar power plant installations



Source: KSH, Scope

Limited geographical diversification exposes the company 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 recent introduction of the METAR system (renewable support scheme – tender required to receive premium prices), the company is now translating the experience gained from ~460 small-scale projects to much larger, industrial-size projects. Given the domestic upscaling of projects, the company has also branched out into foreign markets and started constructing a 5MW test site in January 2020 in Ukraine. In addition, The company is in negotiations regarding Croatian activities and has preliminary discussions for operations in Russia and Kazakhstan.

Segment diversification limited, mitigated by favourable environment through political growth targets

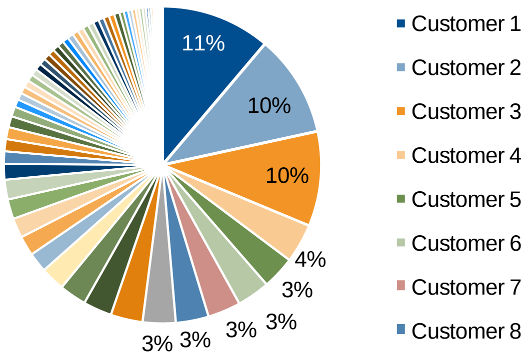
Segment diversification is also limited, with activities solely in the photovoltaic EPC segment. Historically, the company was only active in the sub-segment of micro power plants, only recently branching out into small-scale projects (up to 5MW), with plans of medium-scale projects (up to 50MW) going forward. Mitigating factors are the 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 until 2030, Hungary designed its National Energy Strategy 2030, which will increase the share of renewable energy to 20%. In its national energy and climate plan (NECP), Hungary envisages the construction of 6,645MW of solar power plants between 2020-30, supported through subsidy systems. This in turn reduces the cyclicality/volatility for Optimum Solar given its exposure to only one segment, as growth and the 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 no dominant share of large clients and a diversified tail of small clients. In the assessed timeframe of 2016-19, typical clients were privately held companies or private individuals (96% of revenue), with a much smaller share of municipalities (4%). Top three customers, all of which have several projects, account for 31% of revenues over this timeframe, and top 10 customers for 55%. The credit quality of these customers is difficult to assess, but according to management, receivables have never been impaired.

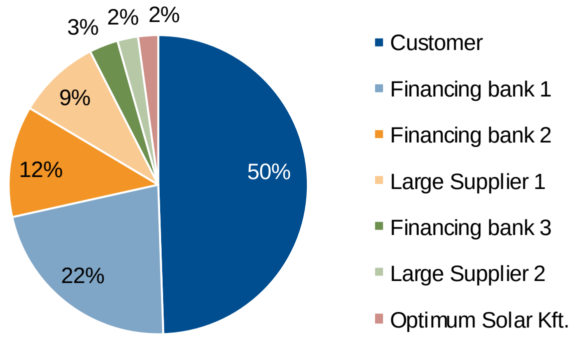
On the pre-financing side, 50% of the assessed projects were pre-financed by the customers themselves, with the remainder by banks and one major supplier.

Figure 4: Project diversification 2016-19 by customer (%)



Source: Optimum Solar, Scope

Figure 5: Diversification in prefinancing 2016-19 (%)



Source: Optimum Solar, Scope

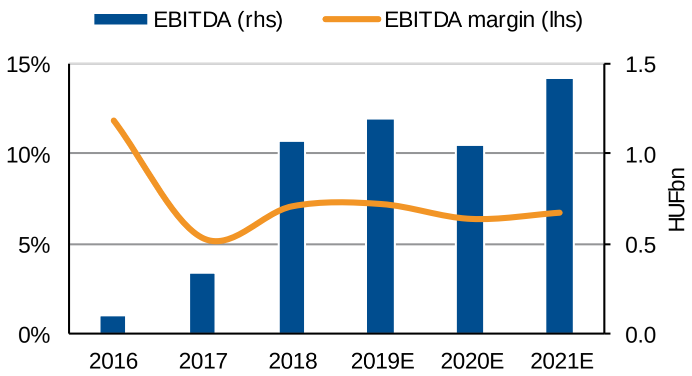
Diversified backlog after the largest project, accounting for 41% of future revenues

We deem Optimum Solar's backlog as concentrated, with its largest project accounting for 41% of future contracted revenues. This project is a 50MW power plant as part of the company's expansion into larger industrial-size projects and will therefore dwarf the remaining backlog, mostly 0.5MW micro plants. The second largest project accounts for 5%, the third largest for 2% and the remaining 54 contracted projects comprise the remaining 52% – which we view as a diversified backlog with 'lumpy' risk relating to one project.

Average and stable profitability margins

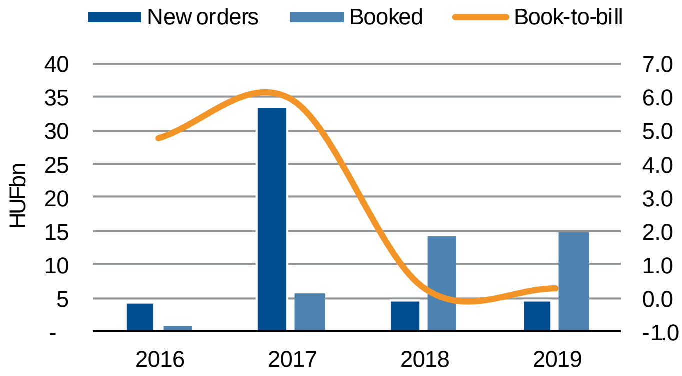
Profitability, at 7%, is average compared to peers, but the stability in margins is positive. While traditional construction peers in Hungary have shown higher margins in the recent boom years, we judge these to be unsustainable once the economy cools as expected – unlike Optimum Solar's margins, which follow 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: OptimumSolar, Scope estimates

Backlog of 1.5 years; volatile book-to-bill ratio

The current signed order backlog equating to HUF 9.5bn at year-end 2019 covers only around 0.6 years of 2020 revenues. The potential backlog – including many micro-plants that require completion by end-2021 to receive the beneficial KAT prices, and medium-scale power plants with letters of credit – covers almost six 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 6x covered book-to-bill in 2017 (extremely strong demand) and below 1x for the coming years (insufficient, weak demand) while the company worked off these orders. Summing up the last four years to smoothen out these distortions, the book-to-bill is 1.3x, showing healthy demand for the company's services. However, the short remaining contracted backlog highlights that the company has not managed to convert letters of credit into signed contracts.

Financial risk profile: BB-

Our rating scenario assumes the following:

- Revenue growth of 10% in 2019, -1.5% in 2020 and 29% in 2021. This is in line with current contracted projects and the letter-of-intent backlog as per year-end 2019.
- EBITDA margin of 7.2% for 2019 in line with historical margins, 6.4% in 2020 and 6.7% in 2021.
- Issuance of a HUF 6bn (~EUR 18m) amortising bond in H1 2020 under the MNB Bond Funding for Growth Scheme, with an expected coupon of 3.5% and a maturity of seven years (planned amortising schedule: 5% after three years, 15% after five years, 20% after six years, and remainder at maturity). Bond proceeds are intended for:
    - Capital expenditure (HUF 800m);
    - Deposits needed as security for bank guarantees, allowing for the redemption of performance guarantees and warranties (HUF 1.5bn); and
    - Working capital, mainly to cover supplier advances (HUF 3.7bn).
- Capital expenditure of around HUF 650m in 2020 and HUF 240m annually thereafter.
- Dividend payouts of 35% of the previous year's net profit 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. With the issuance of a HUF 6bn bond while existing loans were maintained or even increased (for working capital, investment and leasing purposes), debt protection metrics have suffered. We expect Scope-adjusted EBITDA interest coverage to dip below 4x in 2020, before stabilising in 2021 and thereafter.

However, given the still relatively high coverage despite the 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

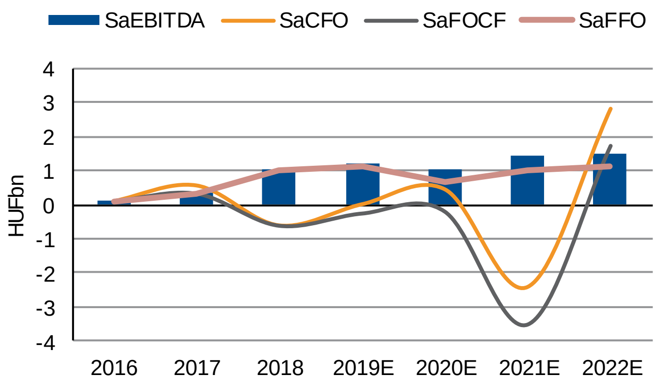
Cash flow as measured by funds from operations has grown very strongly since 2016 and is expected to flatten out, with a dip in 2020. Growth usually translates into a large build-up working capital, evident in the company's negative SaFOCF since 2018. We forecast SaFOCF to remain negative and, with it, Scope's cash-flow metric of SaFOCF/SaD. All capex is planned towards core operations, expanding and modernising headquarters in Baja, investing in a Budapest office and investing in state-of-the-art equipment.

Dividends in the forecast period are assumed to be at the maximum allowed, i.e. 35% of previous year's net profit.

Very negative cash flows constrain the financial risk profile

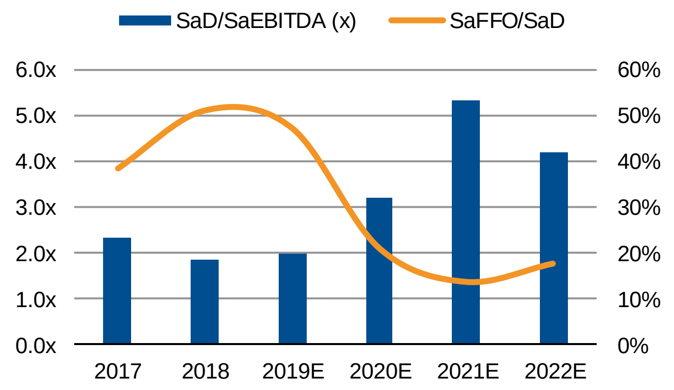
The very negative cash flows that we expect to continue for the duration of the growth strategy constrain the financial risk profile.

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

Scope-adjusted debt to SaEBITDA has historically been around 2x, thanks to the company's modest usage of financial debt in addition to some operating leases. Debt levels are forecasted to significantly increase, because the company's current strategy to establish a foothold in industrial-size solar plants requires a large build-up in working capital and a restricted deposit to cover bank guarantees. With leverage as measured by SaD/SaEBITDA forecasted to increase above 3x in 2020, and cash to be under pressure in 2021, the ratio is forecast to rise to 5.2x before reducing to around 4x. Leverage as measured by funds from operations/SaD will decrease from a comfortable 47% in 2019 to 21% in 2020, then to 14% in 2021 before recovering to levels in the high teens.

Liquidity

Adequate liquidity

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

Figure 10: Liquidity

in HUF m	2019E	2020E
Short-term debt (t)	1,516	860
Unrestricted cash (t)	114	6,027
Open committed credit lines (t)	0	0
Free operating cash flow (t+1)[1]	-188	-3,520
Coverage	**-0.1x**	**2.9x**

Source: Scope estimates

We judge the company's liquidity to be adequate, with unrestricted cash exceeding short-term debt going forward, even if free operating cash flow turns further negative. Given the long maturity of the prospective bond, upcoming short-term maturities are likely to be manageable for the foreseeable future.

Outlook

Outlook: Stable

The Outlook for Optimum Solar is Stable and incorporates our view of a positive politically induced business environment thanks to the National Energy Strategy 2030. Furthermore, we foresee Optimum Solar to benefit from i) the existing market backlog of projects to be fulfilled by 2021 for KAT; and; ii) the company's expansion into small and medium-sized power plants, supported by existing partners. All aspects should lead to at least stable revenue generation going forward. The Outlook also incorporates a successful placement

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

of the HUF 6bn bond in H1 2020. Proceeds are intended towards covering capex for the company's operational assets, the deposits needed behind bank guarantees, and working capital.

A positive rating action may be warranted if the company can increase visibility on contracted revenues beyond 2020, via a solid contracted backlog in medium-sized power plants, in addition to reducing its leverage, measured by SaD to Scope-adjusted EBITDA, to below 3.5x on a sustained basis.

A negative rating action could occur if SaD to Scope-adjusted EBITDA were to increase to above 5x on a sustained basis 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, e.g. i) customers delay payments significantly; or ii) the company becomes exposed to the non-recoverable cost overruns of its projects.

Senior unsecured debt

The rated entity plans to issue a HUF 6bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. The planned bond has a 3.5% coupon and is amortising, starting after 3years, with a tenor until 2027. Proceeds from the bond are earmarked for capex to expand Optimum Solar's operational assets (HUF 800m), for covering deposit needs resulting from bank guarantees, allowing for the redemption of performance guarantees and warranties (HUF 1.5bn), and for financing working capital for supplier advances (HUF 3.7bn).

Senior unsecured debt: B+

Our recovery analysis is based on a hypothetical default scenario occurring at year-end 2021, in which we assume an outstanding senior unsecured bond debt of HUF 6.0bn in addition to the existing HUF 1.3bn of debt positions. 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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