ALTEO Energiaszolgáltató Nyrt Hungary, Utilities

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	2018	2019	2020E	2021E
EBITDA/interest cover (x)	7.7	8.6	5.7	6.0
Scope-adjusted debt (SaD)/EBITDA (x)	4.1	4.2	3.8	4.4
Free operating cash flow (FOCF)/SaD	-44%	-53%	7%	-5%
Liquidity	-7%	-236%	>200%	>200%

Rating rationale

Scope has affirmed the BB+/Stable issuer credit rating of Hungary-based utility ALTEO Energiaszolgáltató Nyrt (ALTEO) along with its BBB- long-term senior unsecured debt rating and S-3 short-term debt rating.

The issuer rating is largely supported by ALTEO's balanced mix of regulated and unregulated activities in electricity and heat generation, and energy supply and services, resulting in a solid cash flow profile. While Covid-19-related lockdowns will continue to have a negative impact on some of ALTEO's energy clients (primarily small and mid-sized companies), the overall cash flow impact is expected to remain limited and counterbalanced by the growth in power generation.

Reflecting the updated investment plan, which earmarks HUF 20bn of investments for organic growth and smaller bolt-on acquisitions – primarily single generation projects in renewables and/or cogeneration – until 2024, we expect credit metrics to support the current rating. While investments are expected to be funded primarily through new debt (non-recourse project finance debt and senior unsecured bonds), we expect that Scope-adjusted leverage and debt protection will be kept at a level commensurate with the current rating, bolstered by significant EBITDA growth. ALTEO's liquidity profile is expected to remain sound, with no major concerns regarding the refinancing of upcoming debt maturities over the next three years.

The Stable Outlook reflects our expectation that the largely debt-financed execution of ALTEO's investment plan will not significantly burden the financial profile, with leverage as measured by Scope-adjusted debt/EBITDA expected to remain at around 4.0x and debt protection as measured by EBITDA interest coverage to remain above 5.0x.

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, though this is unlikely over the next two years in light of the updated, increased investment plan.

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 if further debt-financed M&A projects weigh on leverage, resulting in a Scope-adjusted debt/EBITDA of above 4.5x and EBITDA interest coverage of below 5x for a prolonged period.

Ratings & Outlook

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

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Related Methodologies

Corporate Rating Methodology

European Utilities

European Renewable Energy Corporates

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Bloomberg: SCOP

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 more than ten 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 (ESG factor: credit-positive environmental factor) • Exposure to quasi-monopolistic heat generation • Integrated business model with coverage of generation, supply, supplemented by energy and waste management services • Execution of updated HUF 20bn investment plan expected to increase outreach, reduce asset concentration risks and maintain double-digit EBITDA margin • Sound debt protection and liquidity profile • Comparatively low impact from Covid-19-related lockdowns	• 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, which is likely to decrease with the execution of the new investment strategy • Higher regulatory risks in Hungary than in most western European markets • PAKS II extension could alter the merit order in Hungary • Deleveraging efforts to be subdued with the large updated investment programme that will temporarily burden free operating cash flow and is expected to result in a Scope-adjusted leverage of around 4.0x (SaD/EBITDA)

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 5.0x for a prolonged period

Financial overview

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EBITDA/interest cover (x)	7.7	8.6	5.7	6.0	5.9
Scope-adjusted debt/EBITDA (x)	4.1	4.2	3.8	4.4	3.9
Free operating cash flow/Scope-adjusted debt (%)	-44%	-53%	7%	-5%	10%
Liquidity (internal and external)	-7%	-236%	>200%	>200%	>200%
Scope-adjusted EBITDA (HUF bn)					
Recurring EBITDA	1.8	3.9	4.4	5.2	5.8
Operating lease payments in respective year	-	-	-	-	-
Other adjustments*	0.0	0.4	0.1	0.1	0.1
Scope-adjusted EBITDA	1.8	4.3	4.5	5.3	6.0
Interest (HUF bn)					
Interest paid	0.2	0.5	0.8	0.9	1.0
Interest received	0.0	0.0	0.0	0.0	0.0
Interest component, asset retirement obligations (estimate)	0.0	0.0	0.0	0.0	0.0
Scope-adjusted interest expenses	0.2	0.5	0.7	0.8	1.0
Scope-adjusted debt (HUF bn)					
Gross financial debt	10.4	23.6	23.0	29.3	29.7
deduct: margining/derivative liabilities	0.6	1.1	1.1	1.1	1.1
deduct: cash and cash equivalents	2.6	4.8	5.3	5.3	5.9
add: restricted cash	-	-	-	-	-
add: operating lease obligations (estimated NPV and IFRS 16 amount for 2018-2021E)	0.1	-	-	-	-
add: unfunded asset retirement obligations (Scope approach)	0.1	0.4	0.5	0.6	0.7
Scope-adjusted debt (SaD)	7.4	18.1	17.0	23.5	23.5

* Adjustments for profit/loss on derecognising fixed assets, provisions, share-based payments

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 more than 11 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, which is expected to safeguard the company's generation business (ESG factor: credit-positive environmental factor);
- 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);
- Exposure to SMEs in energy supply, which is particularly vulnerable as shown by the effects of Covid-19-related lockdowns;
- 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; and
- 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 55 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$_e$)	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 within a virtual power plant

Despite its small scale in power generation, the company is able to provide reserve (balancing) capacity to national transmission grid operator MAVIR, by way of so-called ‘virtual power plants’ through the company’s own Power Plant Control Centre thanks to cogeneration plants within Hungary. 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 one large power plant, thereby implementing very effective, flexible and economical energy production technology. 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), which we consider supportive for credit quality (ESG factor: credit-positive environmental factor).

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.

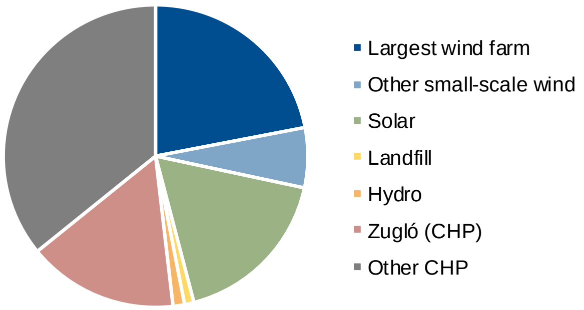
Overall diversification a rating constraint

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.

New investment phase expected to gradually improve diversification

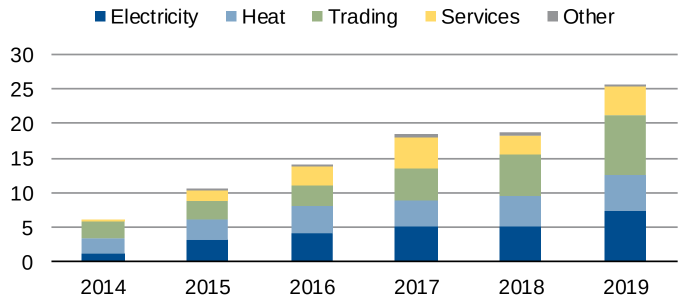
In light of the updated HUF 20bn investment strategy, we expect diversification issues and asset concentration risks to decrease gradually with the addition of small-scale power plants but also the potential expansion of supplementary business in waste management. Hence, we believe that cash flow risks from single assets as well as single business segments will gradually fade over time.

Figure 2 – Asset concentration as measured by generation capacity



Source: ALTEO, Scope

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



Source: ALTEO, Scope

Limited negative effect from Covid-19 in the short term

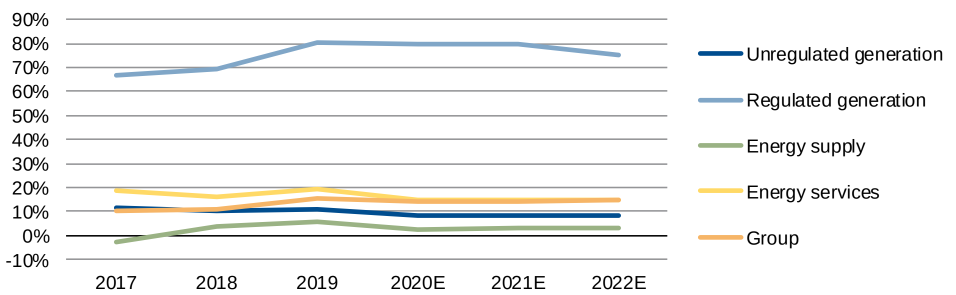
The negative effect from Covid-19-related lockdowns on ALTEO's business is expected to be limited considering the company's dominant exposure to largely unaffected segments like power generation. While the lockdowns will continue to have a negative impact on some of ALTEO's clients in energy supply (primarily small and mid-sized companies) and lead to project delays in energy services, the overall cash flow impact is expected to remain limited and counterbalanced by the growth in power generation. The exposure to vulnerable customers within ALTEO's client portfolio is small and has been managed well through extended payment terms. As larger projects in energy services are with reputable and creditworthy companies, we do not expect major project cancellations or non-payment. Overall, any increase in bad debt from non-payment/defaulted customers is digestible, in our view.

Group margin of around 15% to be retained considering the increased exposure to high-margin regulated renewables

We expect that group margin to remain at around 15% in the years 2020-2022, based on the most recent expansion of regulated, high-margin renewable plants and our expectations regarding the company's growth focus on power generation. 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.

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[1]. However, we expect that such risks are likely to be addressed by 2022 through the ongoing business expansion within the company's power generation portfolio.

Figure 4 – EBITDA margin on the group level



Source: ALTEO, Scope expectations

[1] While first construction works of the PAKS II have started in 2019, it remains uncertain when exactly the new nuclear power plant units will commence.

Financial risk profile (BB+)

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.

Deleveraging subdued

The updated HUF 20bn investment plan, while unlikely to help with deleveraging over the next three years as it is largely debt-financed, is expected to give a material boost to operating performance, due to its focus on organic growth (primarily in power generation) and smaller bolt-on acquisitions of single generation projects in renewables and/or cogeneration.

Financials strongly impacted by ongoing investment phase

ALTEO's leverage tends to be volatile in light of the company's size and the developing business model. While our initial rating case assumed the end of a comparatively large investment programme (more than HUF 20bn invested between 2017 and 2019) and deleveraging thereafter, the updated HUF 20bn is expected to weigh on the company's leverage over the next three years.

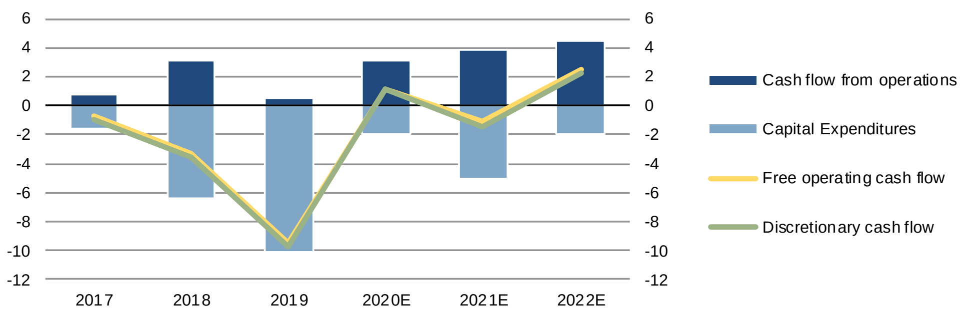
Scope deems ALTEO's future cash flow development to be driven by:

- Continued revenue growth reflecting full consolidation of acquired/inaugurated generation assets in 2020 and execution of earnings-enhancing capex plan;
- Minor negative Covid-19-related effect on ALTEO's revenues from lower supply volumes, expected to be counterbalanced by growth in core segments;
- Continued positive EBITDA contribution from (low single-digit margin) in energy supply reflecting the changed hedging/procurement strategy;
- Retention of low double-digit group EBITDA margin bolstered by the growing share of high-margin business from regulated power generation;
- Execution of HUF 16bn in investments (capex and M&A) during 2020-2022 (80% of medium-term investment plan);
- Investment funding with 30/70 equity/debt;
- Resumption of dividend pay-outs at around HUF 250m per annum, after dividend cut for 2020; and
- Debt repayments in line with assumed maturity schedule.

Good access to external financing expected

The comparatively large investment programme will likely require continued external financing, with an envisaged funding structure of 30% equity and 70% debt, a reasonable level for such infrastructure assets. As a backdrop, free operating cash flows are expected to fluctuate around breakeven for an extended period, strongly depending on the share amount used for organic and dynamic growth. External financing is not expected to be a major concern assuming ALTEO primarily seeks non-recourse secured project debt.

Figure 5 – Investment phase 2020-2022E expected to require significant external financing as displayed by pressured free operating cash flows (in HUF bn)

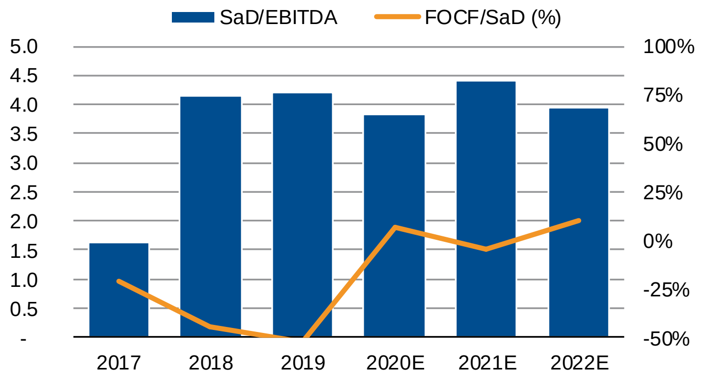


Source: Scope calculations

Scope-adjusted leverage expected to remain around 4.0x; debt protection expected to remain solid

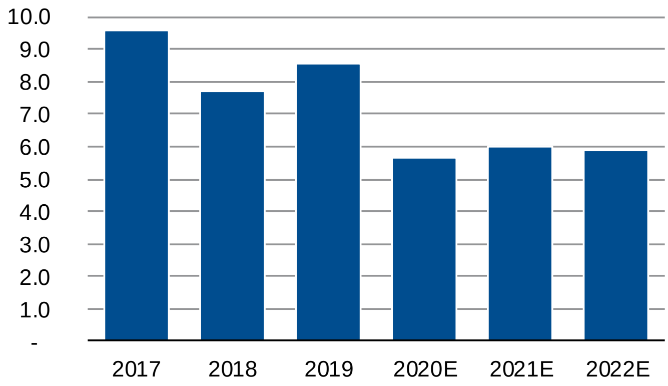
Given the nature of such investments with fast earnings contributions, ALTEO's leverage is expected to fluctuate at around 4.0x over the next few years, which is fair for an integrated utility with a large exposure to regulated business. Debt protection as measured by Scope-adjusted EBITDA interest coverage is expected to remain at a comfortable level of around 6.0x, reflecting gradual EBITDA growth and cheaper refinancing (particularly the 4.49% HUF 2.15bn bond due in September 2020).

Figure 6 – Leverage (Scope adjusted debt/EBITDA)



Source: Scope calculations

Figure 7 – Debt protection (EBITDA/interest cover)



Source: Scope calculations

Robust liquidity

We regard ALTEO's liquidity position to be sound. 2018 and 2019 are not deemed as representative for the company's liquidity position given the significantly negative free operating cash flow that resulted from the execution of the first capex programme.

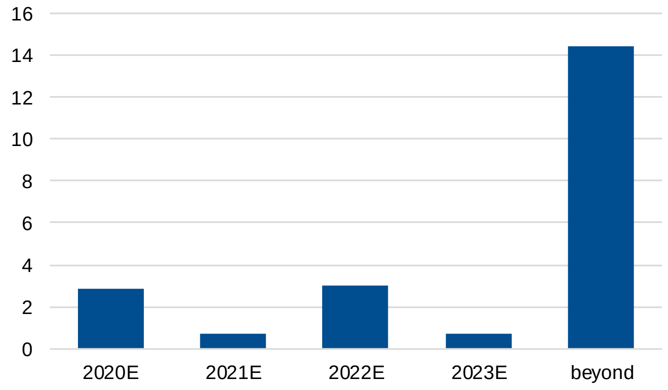
Sound liquidity profile after early refinancing of several debt positions in 2019

The debt profile has become well balanced after HUF 7bn of amortising project finance debt was refinanced early via a HUF 8.6bn 10-year bond issued under the Bond Funding for Growth Scheme of the Hungarian National Bank. Upcoming debt maturities are expected to be covered reliably by available liquidity sources. The HUF 2.15bn ALTEO 2020/I bond is likely to be redeemed using the remaining HUF 4.8bn cash buffer at YE 2019. Furthermore, the amortising project finance debt of around HUF 500m-600m annually and the two zero-coupon bonds (ALTEO 2022/I and ALTEO 2022/II) totalling HUF 2.3bn in 2020 are expected to be covered by free operating cash flow and more than HUF 2bn of committed bank facilities. However, we believe that outstanding capital market debt and the investment programme are likely to be (re)financed via new bond issues and loans with established banks.

Well-established bank relationships as fallback

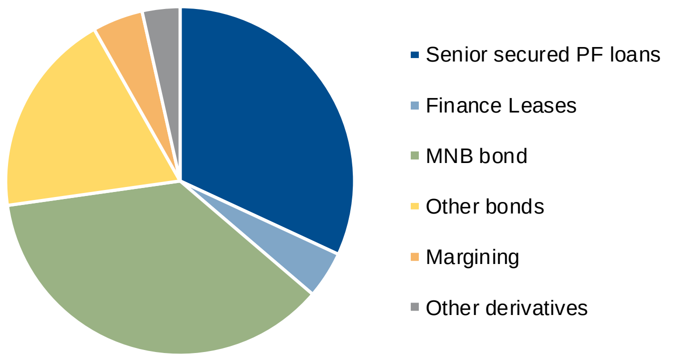
Despite its small size, ALTEO has decent access to external financing as displayed by continued bond issuing activities (first bond scheme in 2011) and well-established lending relationships not only with Hungarian banks like MTB and OTP but also Austrian Erste and Italy's Unicredit. While we believe that the next larger maturities – the two zero-coupon bonds ALTEO 2022/I (HUF 650m) and ALTEO 2022/II (HUF 1.7bn) – will likely be refinanced by new public bond(s), ALTEO retains good refinancing alternatives in case bond market will not be accessible.

Figure 8 – Expected maturity schedule (in HUF bn)



Source: ALTEO, Scope expectations

Figure 9 – Financing structure as of YE 2019



Source: ALTEO, Scope

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.

Long-term and short-term debt ratings

Above-average recovery expectations for senior unsecured debt

We retain our view on an 'above-average recovery' for senior unsecured debt, even after senior secured debt (primarily non-recourse project finance debt and finance leases) has fully been covered. Recovery expectations are based on an expected liquidation value in a hypothetical default scenario of around HUF 23bn after administrative claims. Hence, we have affirmed the BBB- rating for the senior unsecured debt category.

The S-3 short-term debt rating has been affirmed, reflecting ALTEO's sound liquidity profile with the expectation of comfortable internal and external liquidity metrics and good access to external funding (i.e. banks and capital markets).

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