FitchRatings

RATING ACTION COMMENTARY

Fitch Revises MVM's Outlook to Negative; Affirms at 'BBB'

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Fitch Ratings - Warsaw - 23 Nov 2022: Fitch Ratings has revised Hungary's largest electricity and gas utility MVM Zrt.'s Outlook to Negative from Stable and affirmed its Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BBB'. A full list of rating actions is below.

The Outlook revision reflects our expectations of a substantial increase in MVM's net debt in 2022, which together with our projections of low funds from operations (FFO) and substantially higher interest costs leave FFO net leverage and FFO interest coverage weak for the rating. Higher net debt is due mainly to increased funding needs for inventories on the back of high gas prices during the year.

We expect profitability and operating cash flow to improve in 2023-2025, but improvement of FFO net leverage in 2023 to within rating sensitivities will depend on supportive regulatory decisions in the infrastructure segment. It will also depend on full and timely compensation for losses on sale of electricity and gas to eligible customers, leading to execution risk. We expect FFO interest coverage ratio to remain weak for the rating in 2023.

KEY RATING DRIVERS

Large Net Debt Increase: MVM's net debt is subject to seasonal swings and is typically at a high point at end-December when gas inventories are close to their peak ahead of strong winter demand. At end-2022 this will be exacerbated by the high cost of gas purchased for storage during 2022. We estimate that at end-2022 most of MVM's debt will be related to gas inventories.

MVM is more exposed to seasonality in working-capital needs than most regional peers given its large gas inventories due to the domestic legislative requirements and its crucial role in the security of gas supply in Hungary.

Loss-Making Retail Compensation: We expect profitability to improve in 2H22, after its considerable weakness in 1H22, due to the recently created utility protection fund by the Hungarian government. The fund, available to MVM from September 2022, will compensate the company for the sale of gas and electricity to eligible customers, mostly households, under a universal service provision, at regulated prices, which in 2022 were substantially below market prices. The fund compensates retroactively losses from January 2022.

However, in August 2022 regulated prices for natural gas and electricity for households were substantially increased for the above-average consumption levels, which has already reduced gas and electricity demand and lowered the compensation needed for MVM.

High Balancing Costs in 2022: MVM's infrastructure segment suffered from sharply increased balancing costs, which are covered at a considerably lower level by the 2022 tariff. The costs will be recovered through tariff increases with a two-year lag, but the regulator agreed to consider about one third of extra balancing costs already in the tariff for 2022, instead of 2024, mitigating the negative impact on MVM.

Leading Market Position: MVM's business profile benefits from its strong market position in Hungary, spanning electricity generation (57% market share, largely from low-carbon generation, including nuclear capacity), gas imports (off-taker in the main gas import contract), gas storage (65%), electricity transmission (100%), electricity and gas distribution (24% and 34%, respectively), as well as electricity and gas wholesale and retail supply as the main company in the market.

Lower Gas Supplies from Russia: MVM has a significant exposure to Russian gas imports as the off-taker in its long-term import contract with Gazprom. Russian gas continues to flow to Hungary through interconnectors with Austria and Serbia with overall supplies to the country only slightly lower than planned. In addition, in 2020 MVM acquired Innogy Czech Republic, a leading supplier of natural gas and one of the suppliers of electricity.

Scenario of Gas Shortages: In a scenario of insufficient gas supplies to Europe where alternative supplies through interconnectors to Hungary and the Czech Republic and substantial gas currently held in storage in both countries are not able to fully replace halted Russian supplies, we assume cuts to supplies for some of MVM's customers, such as large industrial companies. We assume that the negative cash flow impact would be manageable and mitigated by MVM's business diversification.

Rated on Standalone Basis: MVM's Long-Term IDRs are at the company's Standalone Credit Profile (SCP) of 'bbb'. The company benefits from tangible support from its sole owner, the Hungarian state (BBB/Stable), but the linkage currently has no impact on MVM's IDRs, as Hungary's IDR and MVM's SCP are at the same level.

Moderately Strong State Links: Fitch applies its Government-Related Entities (GRE) Rating Criteria in its analysis of MVM's linkage with the Hungarian state. We assess status, ownership and control as well as support track record as 'Strong'. The latter was increased from 'Moderate' due to additional support in the form of a large equity injection in December 2021. We view the socio-political implications of MVM's default as 'Moderate', whereas the financial implications of MVM's default for the Hungarian government as 'Weak'. This assessment results in a support score of 15 points, indicating moderately strong links with the state.

This would result in a bottom-up plus one-notch rating approach if MVM's rating was lower than the state's albeit subject to a cap at the state's minus one notch.

Financial Policy Consistent with Rating: MVM's management targets net-debt-to-EBITDA of up to 2.5x in its current business plan until 2025, which is consistent with the 'BBB' rating. The plan was approved by the state as the sole shareholder. We assume the state will continue to support MVM in case of need given MVM's strategic role in maintaining energy security.

DERIVATION SUMMARY

MVM's central European peers are PGE Polska Grupa Energetyczna S.A. (PGE, BBB+/Stable), ENEA S.A. (BBB/Stable), TAURON Polska Energia S.A. (Tauron, BBB-/Stable) and Bulgarian Energy Holding EAD (BEH, BB/Positive, SCP: b+).

MVM has better integration and business diversification than PGE, ENEA and Tauron, which are focused on a specific line of business, such as electricity generation or distribution, and also have higher exposure to coal.

BEH is more comparable to MVM in business diversification, as its activities include generation, transmission and supply of electricity, as well as transmission, transit and supply of gas, on top of lignite mining. However, BEH is a negative outlier in the peer group in leverage, cash-flow predictability and corporate governance.

MVM's balance sheet and working-capital are highly exposed to changes in gas inventories due to seasonality and changes in gas prices. This results in a higher volatility of MVM's leverage compared with peers'. Also, MVM's net debt and leverage at year-end is higher than when gas inventories are lower during the course of the year.

MVM's peers are all state-controlled (either by the Polish or Bulgarian governments). The Polish peers are rated at a standalone level without any uplift for state links, while the 'BB' rating of BEH includes a two-notch uplift for links with the Bulgarian state. We assess BEH's links with the state as stronger than MVM's, but MVM's 'bbb' SCP is also much stronger than BEH's 'b+'.

KEY ASSUMPTIONS

The key assumptions within our rating case for the issuer are as follows:

- Generation EBITDA growth driven by stable contribution from nuclear power plants and renewables, with high EBITDA from coal-fired assets in 2023 following CO_2 prices being hedged at low levels in 2023 and high market prices

- Negative EBITDA in infrastructure in 2022 due to high balancing costs being recognised in tariffs with a two-year lag (about one third of extra costs already recognised in 2022)

- High EBITDA in wholesale gas and electricity in 2022-2023 due to higher electricity margins and better performance of gas storage, followed by more normalised EBITDA from 2024

- Total capex averaging about HUF370 billion per year in 2022-2025

- Maintenance capex at about 60%-70% of total capex, mostly focused on power plants and network assets to ensure proper and safe supply of electricity

- Development capex focusing on decarbonisation (replacing coal fired assets with gas-fired assets), as well as digitalisation and infrastructure development

- Capex partly funded by domestic and EU grants to a total amount of HUF300 billion over 2022-2025

- Low dividends at about HUF8 billion a year in 2022-2023

- No equity injections by the state over 2022-2025, except for the small in-kind contribution received in 1H22

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- An upgrade of MVM is unlikely due to the Negative Outlook and also the cap by the sovereign rating, driven by strong linkage between MVM and the state assessed under our Parent and Subsidiary Linkage Rating Criteria

- We would revise the Outlook to Stable if financial performance normalises, together with leverage and interest coverage improving to within our negative sensitivities

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- FFO net leverage above 3.5x and FFO interest cover below 6x on a sustained basis

- Substantial adverse change in the business profile, such as a material reduction in the share of regulated or quasi-regulated business in total EBITDA

- Negative rating action on Hungary would lead to similar rating action on MVM as the latter's rating would start to be capped at the sovereign level due to the strength of linkage between MVM and the state

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Solid Liquidity: MVM has a solid liquidity position. At end-June 2022, it had unrestricted cash of HUF402 billion and undrawn committed facilities of HUF978 billion, of which HUF238 billion was short-term lines. This liquidity is sufficient to cover debt maturities of HUF8 billion in 2H22 and HUF21 billion in 2023, and Fitch-projected negative free cash flow in 2H22 and 1H23, driven by large negative changes in working capital and capex.

ISSUER PROFILE

MVM is Hungary's largest electricity and gas utility.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
MVM Zrt.	LT IDR	BBB Rating Outlook Negative	Affirmed	BBB Rating Outlook Stable
	LC LT IDR	BBB Rating Outlook Negative	Affirmed	BBB Rating Outlook Stable
senior unsecured	LT	BBB	Affirmed	BBB

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Parent and Subsidiary Linkage Rating Criteria (pub. 01 Dec 2021)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 28 Oct 2022)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.3 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

MVM Zrt.	EU Issued, UK Endorsed

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