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Research Update:

Hungarian Integrated Utility MVM Group 'BBB-' Rating Affirmed; Outlook Stable

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Rating Action Overview

- MVM Group (MVM), the largest integrated utility in Hungary with 65% of the gas storage market, is highly dependent on Russian gas imports. However, we think its exposure to the Russia-Ukraine conflict, though material, is manageable.
- We believe that the ongoing elevated gas and power prices will impair MVM's 2022 financial performance. For 2022, we forecast working outflows to increase significantly to about Hungarian forint (HUF) 740 billion, because of gas stocking for winter in 2022, along with a lower EBITDA because of the power transmission system operator's (TSO's) higher balancing costs. As a result, we anticipate that S&P Global Ratings-adjusted funds from operations (FFO) to debt will dip temporarily to about 23%, below the 30% threshold for the 'BBB-' rating.
- We understand that the Hungarian government is working on a mechanism to compensate MVM for any losses caused by the sale of energy at subsidized tariffs for households through the recently created utility cut protection fund (UPF). Furthermore, TSO activities will recover the extraordinary costs through the tariff-adjustment mechanism, embedded in Hungary's regulatory framework with a two-year lag (by 2024 at the latest).
- We therefore affirmed our 'BBB-' long-term rating and 'BBB-' senior unsecured rating on MVM.
- The stable outlook reflects our expectation that MVM's financial performance will only temporarily deteriorate before the support mechanism kicks in. This should mean that adjusted FFO to debt for 2022 will remain well below the 30% threshold for the 'BBB-' rating (about 23%) then rebound above 30% from 2023.

Rating Action Rationale

MVM's exposure to the ongoing elevated energy prices exacerbated by the Russia-Ukraine conflict is material, but manageable, in our view. Hungary is highly dependent on Russian gas imports since about 85% of its gas supply comes directly or indirectly from Russia. MVM is Hungary's main natural gas importer; 4.5 billion cubic meters per annum (bcm/a) of MVM's natural gas supply comes from the 15-year take-or-pay contract with Gazprom Export signed in

September 2021 to deliver gas through Serbia (the so-called South Stream Lite or Balkan Stream pipeline) and Austria. As a result of the new contract, since Oct. 1, 2021, Hungary does not receive any direct Russian gas supply via Ukraine. The volumes delivered by Gazprom allow the supply of about half of Hungary's annual gas import needs and about 42%-45% of its annual consumption. From June 2022, MVM has observed an approximately 40% reduction in its Russian daily gas supply in Austria (supposedly due to limited Russian gas flows via Nord Stream), which we understand translates to an estimated 12%-13% reduction of total volumes from Gazprom.

The reduced supply can be partly mitigated by recently improved gas network links between Hungary and Croatia. We understand that MVM has secured long-term capacity bookings at the Krk liquefied natural gas terminal, which annually contributes 1 bcm of natural gas into MVM's portfolio. This helps MVM to diversify its gas sourcing from Russia. Moreover, the Hungarian state will maintain around 1.2 bcm of strategic reserves until September 2022 that can be used in case of emergency. Should the Russian gas supply halt completely, we believe that the European governments, including Hungary, will step in to prevent systemic risks and allow for operational functioning.

MVM's wholesale business faces extra financing needs to fill gas storage facilities, thereby weighing on cash flows. The group supplies gas to residential consumers under a fixed-tariff natural gas universal service (100% of market share), exposing it to the incapacity of pass-through if there is an increase in gas procurement costs. In addition, MVM operates four gas storage facilities in Hungary with total capacity of 4.43 bcm (65% market share) and, like the majority of other European utilities, has accelerated the filling of its gas storage to prepare for the upcoming winter, as well as for any possible interruption of Russian gas flowing to Hungary. We understand the Hungarian storage capacity is filled at around 40% as of June 2022. As a result, we expect MVM to experience a large operating cash outflow in 2022 of about HUF740 billion (€1.8 billion), largely driven by working capital because of elevated commodity prices. A key driver of working capital swings is the change in gas prices, especially for gas inventories and trade receivables and payables. We forecast that this will result in FFO to debt decreasing to about 23%, which is below our threshold of 30% for the 'BBB-' rating.

Notably for the supply business, we expect losses incurred by MVM's universal service providers portfolio to be covered by the UPF. MVM's customer base is sticky and benefits from a fixed price set by the Ministry for Technology and Industry. MVM holds strong positions within the liberalized and competitive supply market, with 34% of market share in electricity and 32% in gas. Because MVM is the sole gas supplier under the universal service obligation, a regulated segment, it has the obligation to supply the entitled customer group (mainly residential customers) for a regulated price well below the current market price. The mismatch between buying gas at spot market price and selling gas at a regulated tariff will result in MVM incurring losses. That said, we understand that the Hungarian government's recently created UPF will support utilities like MVM, and will cover any losses that might incur. We expect the funds to be available to MVM from September 2022, and that the government will compensate the group retroactively. The fund mirrors the pre-approved tool presented by the European Commission to support utilities amid the increased energy prices, hence there is no state-aid issue. For business-to-business customers, we understand that MVM will be able to pass on to customers the higher costs for unhedged volumes sold.

We expect the group's strong liquidity to mitigate the potentially high margin call requirements arising from gas hedging contracts. MVM's gas hedge contracts are subject to margining payments until the moment of physical delivery. If there are severe gas curtailments, this could result in financial losses if MVM is unable to recover margins. That said, as of June 20, 2022, MVM's margin position was net positive at €530 million. MVM posted a positive margin of €1.1 billion at the end of 2021 thanks to manageable initiation margins, despite gas increases and a spike in volatility. We think that MVM is prudently managing the liquidity risk associated with commodity price fluctuations, demonstrated by our view of strong liquidity with about €2.5 billion of unused credit committed lines in place as of March 31, 2022.

We view positively the Hungarian government's commitment to supporting MVM through low dividend distribution, and potentially injecting capital if needed. In 2021, the Hungarian government supported MVM through a capital increase of:

- HUF4 billion and contribution in kind in April 2021; and
- HUF208 billion capital increase in December 2021 to support further capital expenditure (capex).

MVM is essential to the government's energy security and decarbonization agenda and, as mentioned previously, the government is committed and willing to support MVM's losses that result from the sale of gas at subsidized tariffs for households. The UPF will come into force in September 2022 and will cover any losses that MVM incurs through elevated energy prices, as well as covering any retrospective losses.

We do not expect the dividend pay out to change substantially, because there is a supportive financial policy from the sole shareholder and MVM's cash flows are primarily used to fund its growth plan. Dividends are kept stable, between HUF7 billion-HUF9 billion per year. Our assessment of a high likelihood of potential extraordinary government support for MVM is underpinned by:

- The group's strong link with the Hungarian state, which owns 100% of MVM and participates in strategic company decisions. The state supports the country's nuclear industry by bearing the full asset retirement obligations and new builds. We expect the state to remain MVM's major shareholder; and
- MVM's very important role for the government. MVM is the No. 1 generator, No. 1 supplier, a key wholesaler and retailer for the electricity and gas universal service, and sole power TSO and gas and power distribution system operator (DSO) in Hungary. MVM's operations are strongly aligned with the government's interests; particularly in ensuring Hungary's self-sufficiency in electricity. We expect the group's dividend policy to continue allowing the utility to accumulate and reinvest earnings. We observe this, for example, in the group's metrics over 2021 and our estimates for 2022, because MVM plans to finance capex largely with its own accumulated cash, allowing dividends to remain stable.

The current elevated gas and power prices have had mixed indirect effects on the rest of MVM's activities, but its solid business fundamentals support the rating. MVM's large integrated positions in gas and electricity naturally hedge volatility in commodity prices, while one-third of its activities are network regulated under a supportive framework with low volume and price risk. Finally, MVM operates a low-carbon-dioxide nuclear-generation fleet, which gives more room for maneuverer compared with more gas-dependent European generators. Because of the integrated nature of MVM's operations, there are several indirect effects of the energy price spike on its asset portfolio, including those of its power generation, electricity transmission activities, and gas and power distribution activities.

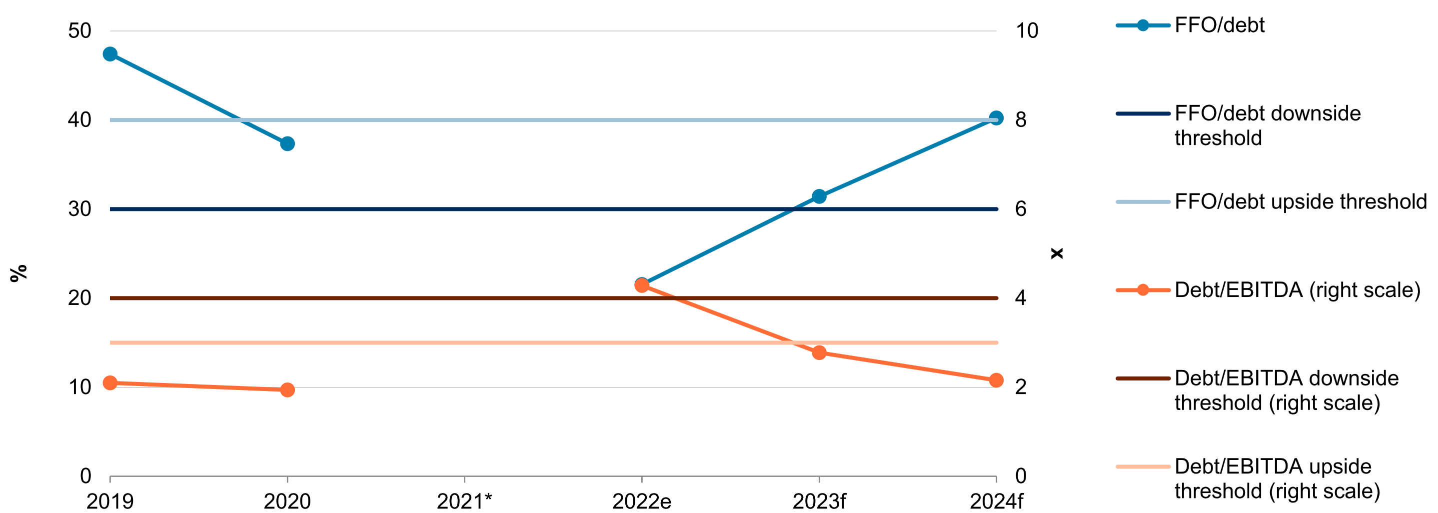
One-half of MVM's capacity comes from the Paks nuclear power plant (NPP), which sources its nuclear fuel from Russia. We understand that there has been no interruption on the nuclear fuel delivery so far; the last shipment of nuclear fuel was in April 2022. Moreover, due to regulatory requirements, the Paks NPP has two years' worth of nuclear safety stock at the site, which alleviates the risk of it running out of fuel. We expect that, due to high electricity prices, MVM's power TSO Mavir Ltd. will incur substantially higher balancing costs, which will lead to marginally negative EBITDA in 2022. Nevertheless, these extraordinary costs will be fully compensated by regulation with a two-year time lag, resulting in a neutral impact from a credit perspective. We also expect that the power distribution segment will incur higher network losses but, again, will be fully compensated by regulation with a two-year lag. MVM's vertical integration is a key advantage, in our view, and its credit profile will benefit from the group's integrated nature. For example, it allows the group to fully contract its electricity production to cover internal supply needs.

MVM's ambitious expansion plans underpin our significant financial risk assessment, and we expect leverage to stabilize from 2023 after a weak 2022. Although we view positively the company's actions to expand its infrastructure and renewable generation, the high investment plan and increasing financial leverage constitutes a credit weakness. We expect MVM's capex to increase to HUF250 billion-HUF300 billion from 2023, staying elevated and leading to neutral free operating cash flow (FOCF) from 2023 to 2026. In addition, MVM's growth plan is underpinned by sustained acquisitions every year within the company's core businesses. Combining the working capital burden of inflated gas inventory with neutralized supply losses by the UPF, and incorporating the EON and ÉMÁSZ acquisitions made in 2022 and 2021, respectively, we expect the group will have reported gross debt of about HUF1,000 billion at year-end 2022.

We expect that FOCF will be negative over 2022-2023. We also anticipate that FFO to debt will dip to about 23% on average in 2022, then increase to slightly above 30%-35% over 2023-2024. We forecast debt to EBITDA to follow the same trajectory-–increasing to above 4x in 2022 but then decreasing to below 3x in 2023 and remaining at about 2.5% from 2024.

Chart 1

MVM's FFO To Debt And Debt To EBITDA Evolution



*2021 ratios are marked as exceptional due to margins received. e--Estimate. f--Forecast.
FFO--Funds from operations. Source: S&P Global Ratings.

Outlook

The stable outlook reflects our view that MVM's financial performance will only temporarily deteriorate to about 23% in 2022 and that its exposure to the Russian gas market is manageable, thanks to the group's diversified and integrated position throughout the energy supply chain. It also reflects the commitment from the Hungarian government to support MVM for the supply losses it might incur during the current elevated energy prices. We expect the credit metrics to recover to above 30% from 2023, which is in line with the current rating.

Downside scenario

A lowering of the rating on MVM is limited given the nature of the rating and high level of support from the Hungarian state. A downgrade could materialize if:

- Support from the state diminished (not our base case) along with weakened stand-alone performance, because elevated commodity prices for a prolonged period of time could weaken FFO to debt sustainably below 30%;
- MVM's financial performance deteriorated enough to lead us to revise our assessment of its stand-alone credit profile (SACP) to 'bb-' from 'bbb-', which is far from our base-case scenario;
- There is a two-notch sovereign downgrade, which is not our base-case scenario given our stable outlook on the sovereign. A one-notch downgrade of Hungary would not result in a

downgrade of MVM if the company's stand-alone fundamentals were unchanged; and

- The company were unable to recover its credit metrics from 2023, notably FFO to debt rebounding to above 30%. In this event, we could revise down our view of its SACP to 'bb+' from 'bbb-'; this could be a result of losses incurred in the supply segment absent of state intervention or gas supply cuts.

Upside scenario

A positive rating action on Hungary would result in a similar rating action on MVM.

We could also upgrade MVM following further improvement of its SACP, with FFO to debt above 40%. However, we consider this unlikely in the short term, largely because of the company's substantial capex plan.

Company Description

MVM is a 100% state-owned, vertically integrated energy company based in Hungary. Founded in 1948, it operates in power generation, transmission, distribution, wholesale, and retail, as well as gas storage, distribution, wholesale, and retail. MVM took control in 2018 and 2019 of NKM, Hungary's biggest gas retail company, financed through a HUF13.4 billion capital increase provided by the government. Upon this acquisition, MVM became the largest operating energy holding in Hungary, and now has a presence in 18 countries. In 2021, MVM posted adjusted EBITDA of HUF246 billion, equivalent to about €610 million.

The company has activities across the entire electricity value chain: it is the main power generator in Hungary with installed capacity of 3.9 gigawatts (GW) at year-end 2020; and operator of the Paks nuclear plant of 2.0 GW, the Matra coal plant (to be closed in 2025), gas plants, and renewable energy sources. As the monopolistic power TSO in Hungary, one of the six Hungarian power DSOs representing 12% of the power DSO market, and the electricity supplier for universal service clients (at a regulated fixed price).

It is also integrated within the gas value chain (except exploration and production, and transmission), because it owns 50% of the gas distribution network, 65% of the gas storage market, gas retail (both universal and liberalized), and 100% of gas wholesale universal service activities.

Our Base-Case Scenario

Assumptions

- There is no strong link between GDP and the issuer's EBITDA due to the low volatility of its contracted/regulated activities (TSO, DSO, contracted generation, and contracted wholesale).
- Wholesale Hungarian base load power price of €375 per megawatt hour (/MWh) in 2022, and €370/MWh in 2023 and 2024.
- Price volatility of power and gas due to the uncertainty over supply caused by the Russia-Ukraine conflict. We expect demand for energy to remain stable over the next two years.
- Lower margins in 2022 despite an increase in energy prices due to the high hedging strategy,

which will cause a negative effect on working capital in 2022 and 2023.

- Regulated EBITDA (transmission and distribution network business) represents an average of 26% between 2022-2024, in line with the 25% average between 2019-2021. The rest of EBITDA comes from generation, supply, and trade.
- Stable operating performance across all generation and infrastructure subsegments, with coal expected to be phased-out by 2026.
- Stable nuclear generation in 2021-2023 and closure of coal plants in 2025. However, we expect thermal generation to compensate for this. Gradually growing renewable asset base over the plan.
- The Hungarian government to compensate MVM for losses incurred in its supply segment.
- The utility retaining its leading market shares in Hungary's universal service retail over the period, and stable market shares in competitive supply. Wholesale is assumed slightly volatile depending on gas inventories and hedged positions compared with commodity prices evolution.
- Capex of about HUF220 billion in 2022, increasing to about HUF250 billion where it will remain between 2023 and 2024.
- Stable dividend distribution of HUF8 billion between 2022-2024.

Key metrics

MVM Group--Key Metrics*

	--Fiscal year ended Dec. 31--				
Bil. HUF	**2020a**	**2021a**	**2022e**	**2023f**	**2024f**
EBITDA	216.9	246.4	220-270	350-400	420-470
EBITDA margin (%)	15.20	8.60	4.0-6.0	6.0-8.0	8.0-10
Funds from operations (FFO)	157.2	168.7	200-230	320-350	370-400
Net capital expenditure	166.6	238.2	210-240	240-270	240-270
Free operating cash flow (FOCF)	126.6	406.9	Negative	Negative	Positive
Dividends (cash)	7.7	0.2	0-10	0-10	0-10
Debt to EBITDA (x)	1.7	0	3.5-4.5	3.5-3.0	2.0-2.5
FFO to debt (%)	43.2	N.M.**	20-25	30-35	>30

*All figures adjusted by S&P Global Ratings. **Due to the large cash balance from margins received as of Dec. 31, 2021, net debt is close to zero. a--Actual. e--Estimate. f--Forecast. N.M.--Not meaningful.

Liquidity

We assess the company's liquidity as strong. We expect the group's large cash position, annual cash flow generation, and committed credit facilities to cover expected cash outlays--primarily capex and dividends--by more than 1.5x over the next 12 months. We believe that as a 100% state-owned entity in Hungary, MVM has adequate access to bank financing and recently demonstrated good standing in the market by its inaugural bond issuance.

Principal liquidity sources as of March 31, 2022, include:

- HUF428,435 million in cash and liquid investments;
- Undrawn bank lines of HUF947,850 million; and
- FFO of about HUF99,992.8 million.

Principal liquidity uses as of March 31, 2022, include:

- Debt amortization of HUF 15,840 million;
- Working capital outflow of HUF630,500 million;
- Estimated capital spending of HUF227,750 million;
- HUF28,000 million from acquisitions; and
- Dividends of approximately HUF8,000 million.

Covenants

We understand that the company has financial covenants in some of its loan agreements. We assume that MVM will continue to adhere to these covenants and take any appropriate measures to ensure adequate headroom should operating cash flow reduce more than anticipated. MVM will maintain the group's net debt to EBITDA below 4.5x.

MVM's financial debt, whether term loans, syndicated revolving credit facility (RCF), or overdraft facilities are under three covenants:

- EBITDA interest cover: >3x
- Net debt/net assets: <0.9x
- Net debt/EBITDA: <4.5x

Environmental, Social, And Governance

ESG credit indicators: E-2, S-2, G-2

ESG factors have an overall neutral influence on our credit rating analysis of MVM, since we perceive the entity as better positioned on climate transition risks than peers in the energy industry, which faces increasingly stringent greenhouse gas regulations.

The group's generation fleet is transitioning toward low carbon dioxide and no coal, in line with the Hungarian energy plan. About 30% of MVM's EBITDA is derived from its power-generation activities. It has total installed capacity of about 3.9 GW, mostly nuclear (2 GW), fossil fuel-fired (1.4 GW: natural gas and oil 729 MW; coal, biomass and waste 884 MW), and solar (0.2 GW). All four units at the Paks nuclear power plant have had a 20-year life extension, from 2012-2017 until 2032-2037, and there is potential for a further extension. Nuclear is a very well-placed source of energy in Hungary's energy market, at the lower end of the merit order. Since nuclear is seen as a long-term strategic fit within Hungary's energy mix, the government supports the industry--as much as it is compatible with the internal market under the EU rules--and contributes accordingly to the heavy asset-retirement obligations linked to nuclear plants. A separate state-owned legal entity--not owned by MVM or its subsidiaries--has undertaken construction of new reactors, Paks 2.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of December 2021, MVM's consolidated debt amounts to HUF1.38 billion, of which HUF182 million consists of its €500 million 0.875% notes due 2027 and a HUF55 billion local bond. The rest are multiple bank loans.

Analytical conclusions

The utility centralizes all debt issuance at the holding level. Because we do not see any factors leading to structural subordination, we rate MVM's bond issuance 'BBB-', the same as the issuer credit rating.

Ratings Score Snapshot

Issuer Credit Rating	BBB-/Stable/--
Business risk:	Satisfactory
Country risk	Intermediate
Industry risk	Intermediate
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	bbb-
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Strong (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bbb-
Related government rating	BBB/Stable/--
Likelihood of government support	High (no impact)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Ratings Affirmed	
MVM Energy Private LLC	
Issuer Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-