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Research Update:

MVM Energy Private LLC 'BBB-' Ratings Affirmed; Outlook Stable

June 28, 2024

Rating Action Overview

- On June 5, 2024, MVM Energy Private LLC (MVM) announced its intention to acquire a 5% stake in Shah Deniz, one of the largest global offshore gas and condensate fields in Azerbaijan.
- The transaction will moderately increase the group's country risk exposure, because we see Azerbaijan, where initially 10% of operations takes place, as a higher-risk country than Hungary.
- We forecast net debt to remain broadly the same in 2024, at about Hungarian forint (HUF) 1.5 trillion compared with HUF1.6 trillion at year-end 2023 because the acquisition is debt-financed, but cash flow of HUF50 billion-HUF80 billion from Shah Deniz will offset higher debt. We therefore forecast funds from operations (FFO) to debt to remain above 30% for the next two-to-three years, which is our threshold for the current rating.
- We affirmed our 'BBB-' long-term issuer credit rating on MVM and our 'BBB-' issue rating on the company's senior unsecured debt.
- The stable outlook indicates that we expect MVM to show gradual growth from 2024 on, and that its credit metrics will remain commensurate with its 'bbb-' stand-alone credit profile (SACP).

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Rating Action Rationale

We affirmed our ratings on MVM following its agreement to acquire a 5% stake in Shah Deniz from Socar. We view the acquisition as in line with the company's strategy announced in March 2024, with the objective of generating at least 25% of EBITDA outside Hungary by 2035 and to diversify away from Russian natural gas imports. After the acquisition, the EBITDA from the international segment is expected to increase to about 26% compared with about 15 % in 2023. Given the group's strategy, we don't exclude further international acquisitions. We expect the acquisition to close by third-quarter 2024 and for MVM to fund it entirely with debt. From 2024, we consolidate 5% stake in Shah Deniz contributing HUF50 billion-HUF80 billion ($15 million-$22 million) of EBITDA from 2024-2028, and expect the asset to generate stable earnings and cash flow in line with its production profile. We expect capital expenditure (capex) needs for Shah

Deniz to be limited as it would represent 2%-3% of MVM's already-sizable investment plan. Shah Deniz is one of the world's largest offshore gas and condensate fields, discovered in Azerbaijan in 1999. It is currently operated by BP and owned by a consortium of oil and gas companies. We understand this asset is expected to generate cash flow until 2049 and in 2023 it produced 26 billion cubic meters of gas and more than 4 million tons (about 35 million barrels) of condensate in total from the Shah Deniz Alpha and Shah Deniz Bravo platform.

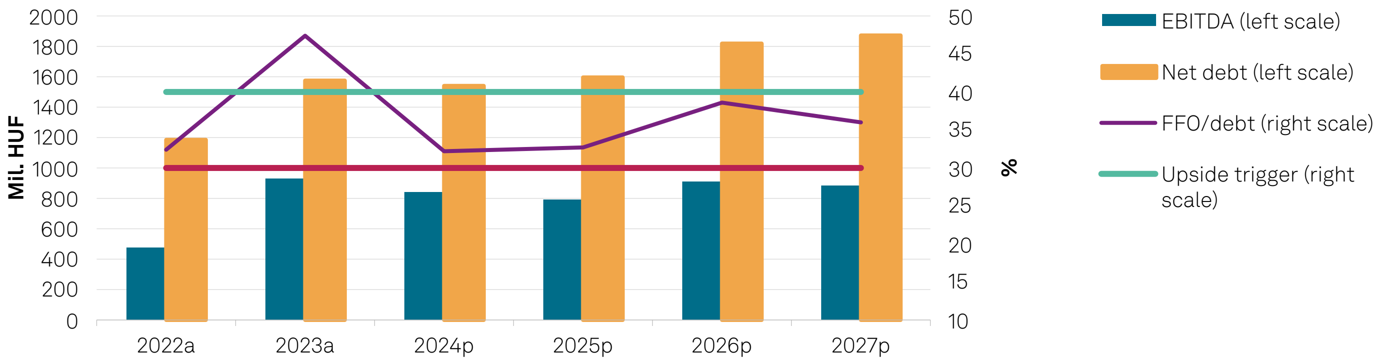
The acquisition weighs on the group's country risk, but has no rating impact. The group is acquiring only 5% of the asset, which is small enough to not affect MVM's creditworthiness. However, we incorporate in our analysis the fact that maximum 10% of group's EBITDA will come from Azerbaijan, which we view as higher risk than the two biggest jurisdictions where MVM operates--Hungary (about 83% of EBITDA) and Czech Republic (about 6%). This prompted us to revise the country risk to moderately high, but this does not affect the group's overall business risk. That said, we understand that in line with Shah Deniz's production profile, the asset will only contribute about 5% of EBITDA in the next three-to-four years.

We forecast FFO to debt will remain above 30% from 2024, down from the 47% peak in 2023. MVM reported record high EBITDA in 2023 of more than HUF900 billion. This constitutes a 100% increase year over year. The driving forces behind this increase in EBITDA to record-high levels are the higher margins in the Czech and regional wholesale markets as well as the lower transmission and distribution system operator costs. Despite the acquisition, we forecast S&P Global Ratings-adjusted EBITDA to decrease to HUF790 billion-HUF840 billion in 2024 and 2025 due to the normalization of commodity prices, then increase to about HUF900 billion in 2026. Furthermore, the Czech government's measures to impose windfall taxes, which remain until 2025, will continue to affect MVM's profitability. At the same time, we forecast the company's net debt will gradually increase year on year as investments increases. Following the acquisition, we forecast that net debt will increase to HUF1.50 trillion-HUF1.60 trillion in 2024 and 2025 and then further increase to HUF1.8 trillion-HUF1.9 trillion in 2026. We forecast that the company's net capex will increase to about HUF470 billion in 2024 and HUF560 billion in 2025 from about HUF335 billion in 2023, leading to slightly positive-to-neutral free operating cash flow (FOCF) on average over 2024-2026. It expects to use its own cash flow, European and government grants, and additional debt to fund growth. We note the healthy positive operating cash flow of the group's business mix. We do not rule out other acquisitions but also note MVM's commitment to the 'BBB-' rating. At the same time, our base-case scenario assumes that MVM will pay dividends of 20% of the year's adjusted profit after tax starting 2025. In 2023, it paid a high dividend on high profits, but this was a one-off. We expect dividends of about HUF15 billion in 2024 and HUF47 billion-HUF58 billion in 2025-2026. Consequently, we expect

FFO to debt to remain above 30% for the next two years, with little headroom and then to increase above 35%, which is above the 30% threshold for the 'bbb-' SACP.

Evolution of credit metrics pre- and post-acquisition

FFO/debt



Source: S&P Global Ratings. FFO--Funds from operations. HUF--Hungarian forint. a--Actual. p--Projected.

We view positively the Hungarian government's commitment to supporting MVM through low dividend distributions and a liquidity line, injecting capital if needed. We understand that the company's sole shareholder, the Ministry of Energy, supports the acquisition as it is in line with MVM’s strategic plan. Still, we do not expect any support from the government for this transaction because FFO to debt remains above 30%, albeit with reduced headroom.

Previous examples of support came in fiscal 2022, where the Hungarian government supported the company through:

- A HUF12 billion contribution in kind, which we do not expect again.
- HUF41 billion capital increase to support further capex, which we similarly do not expect again (unless MVM’s financial performance deteriorates, that is, FFO to debt falling below 30%).

We assess MVM as having a high likelihood of potential extraordinary government support. This is underpinned by:

- The group's strong link with the Hungarian state, which owns 100% of MVM and participates in strategic company decisions. We expect the state to remain the company's major shareholder; and
- MVM's very important role for the government. The company's is the No. 1 generator, No. 1 supplier, a key wholesaler and retailer for the electricity and gas universal service, and sole power transmission system operator (TSO) and dominant 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 to allow it to accumulate and reinvest earnings.

Outlook

The stable outlook reflects our expectations that MVM will achieve its growth plan gradually and protect its credit metrics in line with our assessment of its 'bbb-' SACP. We expect FFO to debt above 30% and debt to EBITDA below 3x for the next two-to-three years, as well as our expectation of ongoing and extraordinary government support if needed to keep FFO to debt above 30%. We think risks from volatile power and commodities prices will remain mitigated by the company's integrated position and strategy to largely hedge its open positions, and relatively stable earnings from its regulated network

Downside scenario

A sovereign downgrade could trigger a downgrade to MVM, although the outlook on our sovereign credit rating on Hungary is currently stable.

Assuming no change in our expectation of a high likelihood of state support, we could downgrade MVM if its financial performance deteriorated enough to lead us to revise its SACP downward to 'bb+' from 'bbb-'. This could occur if the company were to post FFO to debt sustainably below 30% without any prospects of recovery. That could result from:

- Low availability in MVM's generation fleet;
- A large loss of market share in its supply business;
- The company demonstrating poor capex execution under its strategic growth plan; and
- The group engaging in a large debt-funded acquisition.

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 next year, largely because of the company's substantial capex plan.

Company Description

MVM is a 100% state-owned, vertically integrated energy company based in Hungary, and a leading natural gas trader in the Czech Republic. Founded in 1963, it operates in power generation, transmission, distribution, wholesale, and retail; and gas storage, distribution, wholesale, and retail. It has a presence in 23 countries. In 2024, we expect the company to report EBITDA of about HUF840 billion, equivalent to about €2.12 billion.

MVM has activities across the entire electricity value chain. It is the main power generator in Hungary, with installed capacity of 4.3 gigawatts (GW) at year-end 2023. It operates the Paks nuclear plant, which has 2.0 GW of capacity; the Matra coal plant; gas plants; and renewable energy plants. MVM also owns the only power TSO in Hungary and two of the six Hungarian power DSOs (representing 23% of the power DSO market). It is the electricity supplier for universal service clients at a regulated fixed price.

MVM is also integrated within the gas value chain (except transmission) because it owns above 30% of the gas distribution network and 65% of the gas storage market. Furthermore, the company is the sole supplier of natural gas in the retail-universal service segment, has a 70% market share in gas wholesale, and has 50% market share in electricity retail (liberalized) business.

Our Base-Case Scenario

Assumptions

- 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).
- Stable power and gas demand in Hungary, with revenue peaking in fiscal 2023 after normalizing to pre-war levels in 2024 and onward due to decreasing commodity prices.
- Price assumptions: 2024 price average of €51 per megawatt-hour (/MWh) for TTF natural gas and €153/MWh 153 for baseload electricity. VTP gas prices and electricity peak load peak in 2024 at €53/MWh and €182/MWh, respectively. MVM assumes carbon dioxide emission quotas in 2024 of €90 per ton, which we forecast will increase through to 2028 to €105 a ton.
- Regulated EBITDA averaging 25% of the total over 2024-2027, which is in line with the 25% average over the historical period. A regulatory mechanism compensates MVM for any losses incurred in its TSO and DSO activities (for example, network losses and balancing costs) after a two-year lag. The high balancing costs in 2022 will automatically be reimbursed in the tariffs in 2024; however, the regulator decided to allocate these amounts from 2024-2026 to provide stable TSO revenue.
- The rest of EBITDA coming from generation, supply, and trade.
- Stable operating performance across all generation and infrastructure subsegments, although we expect the phase-out of coal by 2029.
- The utility being sole retail provider in Hungary's universal service tariff over the period, and market shares in competitive supply to be stable. Wholesale will be slightly volatile, depending on gas inventories and hedged positions compared with the changing commodity prices.
- The Hungarian government to compensate MVM for losses in its supply segment as long as energy prices remain above regulated prices.
- Capex of HUF339 billion in 2024, increasing to HUF509 billion in 2025, and HUF808 billion in 2026.
- Dividend distribution of HUF15 billion in fiscal 2024, HUF 58 billion in 2025, and HUF47 billion in 2026.
- Total investment of HUF409 billion in 2024, including the acquisition cost of Shah Deniz

Key metrics

MVM Energy Private LLC--Forecast summary

Period ending	Dec-31-2022	Dec-31-2023	Dec-31-2024	Dec-31-2025	Dec-31-2026	Dec-31-2027
(Bil. HUF)	2022a	2023a	2024e	2025f	2026f	2027f
EBITDA	476	931	820-870	770-820	880-930	870-920
Funds from operations (FFO)	384	749	490-510	510-530	690-710	670-690
Capital expenditure (capex)	504	327	330-350	500-520	800-820	740-760

MVM Energy Private LLC--Forecast summary

Free operating cash flow (FOCF)	(1,393)	(9)	470-490	120-140	(20)-(40)	160-180
Dividends	8	417	15	50-60	40-50	50-60
Debt	1,185	1,575	1,500-1,600	1,500-1,600	1,800-1,900	1,800-1,900
Adjusted ratios						
Debt/EBITDA (x)	2.5	1.7	1.5-2.0	1.8-2.3	1.8-2.3	1.8-2.3
FFO/debt (%)	32.4	47.5	31-33	32-34	38-40	35-37
EBITDA margin (%)	6.2	18.3	16-18	14-16	18-20	18-20

All figures are adjusted by S&P Global Ratings, unless stated as reported. A--Actual. e--Estimate. F--Forecast. HUF--Hungarian forint.

Liquidity

We assess MVM's liquidity as adequate. We expect the group's large cash position, annual cash flow, and committed credit facilities to cover expected cash outlays--primarily capex, working capital, and dividends--by more than 1.2x over the next 12 months. We think that MVM, as a 100% state-owned entity in Hungary, has adequate access to bank financing and international capital markets. Also, the company is about to acquire an asset which it is looking to fund through its committed lines.

We forecast the following principal liquidity sources and uses are for the 12 months from March 31, 2024:

Principal liquidity sources

- HUF360.5 billion in cash and liquid investments
- Undrawn bank lines of HUF1.44 trillion
- Cash FFO of about HUF631 billion
- Working of inflows of about HUF140 billion

Principal liquidity uses

- Debt amortization of about HUF960 billion
- Estimated capital spending of HUF382 billion (maintenance)
- Dividends of approximately HUF20 billion
- Acquisition of Shah Deniz.

Covenants

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

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

- EBITDA interest coverage over 3.0x;
- Net debt to net assets under 0.9x; and
- Net debt to EBITDA under 4.5x

Environmental, Social, And Governance

ESG factors have an overall neutral influence on our credit rating analysis of MVM, because 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 comes from its power generation activities. It has total installed capacity of about 4.3 GW, mostly nuclear (2 GW), fossil fuel-fired (1.6 GW, of which coal is 884 MW; and natural gas, biomass, and waste 729 MW), and solar (629 MW).

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 the country'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 at Paks 2.

Rating Component Scores

Foreign currency issuer credit rating	BBB-/Stable/--
Local currency issuer credit rating	BBB-/Stable/--
Business risk	Satisfactory
Country risk	Moderately High
Industry risk	Intermediate
Competitive position	Satisfactory
Financial risk	Intermediate
Cash flow/leverage	Intermediate
Anchor	bbb-
Diversification/portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	bbb-

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- S&P Global Ratings Cuts 2023 European, U.S., And Canadian Gas Price Assumptions On Lower Demand, Feb. 23, 2023
- Hungary Downgraded To 'BBB-/A-3' From 'BBB/A-2' On Inflation And External Pressures; Outlook Stable, Jan. 27, 2023
- EMEA Utilities Outlook 2023: Eastern Europe | Credit Resilience Despite Increasing Affordability Concerns, Jan. 12, 2023

Ratings List

Ratings list

Ratings Affirmed

MVM Energy Private LLC

Issuer Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-