THURSDAY, 14/04/2022 - Scope Ratings GmbH

Scope downgrades Optimum Solar's issuer rating to C and keeps the Outlook Negative

The downgrade is driven by a much weaker financial risk profile as customers of Optimum Solar find it hard to finance projects, hampering its operations. Other problems include poor governance and imminent default risk due to a lack of liquidity.

The latest information on the rating, including rating reports and related methodologies, is available on this **LINK**.

Rating action

Scope Ratings GmbH (Scope) has today downgraded the issuer rating of Hungarian construction company Optimum Solar Zrt. to C from B+ while keeping the Outlook at Negative. Scope has also downgraded senior unsecured debt rating to C from B+.

Rating rationale

Optimum Solar's business environment significantly weakened in 2021. As outlined last year, with tightened credit conditions, several projects were delayed due to clients' inability to obtain financing. With interest rates rising in the second half of 2021, the risk appetite to pursue projects diminished and Optimum Solar was approached for alternative financing structures on some framework agreements. This led to most of the large projects being postponed to 2023/24 from 2021/22 as originally guided by the company. In 2021, Optimum Solar only completed fourteen 0.5MW plants and a 1.3MW power plant in Békéscsaba as part of a SmartCity project and acted as a consortium partner in an R&D energy storage project. This resulted in HUF 3.7bn in revenues in 2021 (compared to HUF 12bn forecasted in May 2021) and negative Scope-adjusted EBITDA of HUF 147m (HUF 334m forecasted).

2021 was to be a transitional year, with Scope forecasting a strong recovery into 2022 based on framework agreements from last year. However, as per the guidance above, most of the framework contracts will at best materialise in 2023, with only one 25MW plant with MVM Zöldgeneráció Kft being developed this year. Scope's base case for 2022 is therefore more muted, with revenue expected at HUF 7bn and EBITDA at HUF 476m – well below pre-pandemic levels. With over 80% of forecasted revenues stemming from one single contract, execution risk is high.

Optimum Solar's business risk profile (assessed at B-, down from B) has weakened because of a significant reduction in both the top line and the backlog, the latter of which is already highly concentrated (subject to high execution risk), making profitability even more volatile. Profitability as measured by the Scope-adjusted EBITDA margin was negative in 2021 but is expected to return to previous levels of 7% in 2022 if the single large project performs as expected. That said, there remains severe downside risk due to cost inflation and delays due to difficulties in obtaining supplies and/or financing significant working capital needs. Deducting uncertain framework agreements from the backlog, signed contracts cover 2021 revenues by only 1.8x.

Optimum Solar's financial risk profile (assessed at CC, down from BB-) has weakened significantly, with adverse credit metrics for 2021 compared to last year's base case and a lack of recovery expected for 2022 and beyond. Leverage as measured by Scope-adjusted debt/Scope-adjusted EBITDA was negative in 2021 (negative EBITDA) and is expected at an elevated 13x in 2022; leverage as measured by Scope-adjusted funds from operations/Scope-adjusted debt is expected at a low 4% going forward. Interest was not covered by Scope-adjusted EBITDA in 2021 but should recover to above par in 2022 and beyond while remaining below 2x. Cash flow coverage was negative 30% in 2021 and is expected to remain volatile and negative over the cycle.

Given the negative cash flows and deterioration in credit metrics, preserving enough liquidity to get through this trough will be crucial. Scope calculates available sources of liquidity to consist of HUF 25m of cash as at 7 April 2022 and HUF 15m of overdrafts (if still available). These will need to cover quarterly fixed costs of around HUF 120m and an upcoming bond interest payment of HUF 210m in May 2022. Based on these figures, Optimum Solar will struggle to service its debt in May. Scope therefore views liquidity as inadequate, which weighs negatively on the financial risk profile and overall rating.

Optimum Solar recently received a subsidy from Hungary's Ministry of Innovation and Technology covering up to 75% of an R&D project; the remainder will have to be financed by the company. A first tranche of HUF 604m was transferred in late March 2022. Based on the subsidy agreement, using such funds to service debt would constitute a serious misuse of proceeds. As at early April, subsidy funds were mostly paid to Optimum Solar's strategic partner, PV Central, and to Lugos Renewables Kft. Scope was unable to verify that those funds were subsequently applied to the R&D project and that related bank guarantees and mandatory own funds were in place.

A board of directors was put in place in 2021, but it consists of company employees and the board's chair is Optimum Solar's main owner, Roland Lugos. This means there are no independent board members to provide oversight (ESG factor: credit-negative) and these actions do not improve corporate governance. Scope's review revealed many connected entity transactions and transactions indicating non-disclosed interest-bearing financial debt to a limited liability company that Scope was not aware of (which might be a breach of soft covenants according to the bond prospectus), raising concerns on transparency and corporate governance (ESG factor: credit-negative).

Optimum Solar has done a lot of planning and engineering work for the large framework contracts reported on the balance sheet as accrued income and prepayments. While Scope expected cash conversion from this work, accruals instead further increased during 2021, based only on hours worked. It is unclear when the company will be able to invoice and monetise these accruals, if at all, raising further concerns on transparency and prudent financial accounting (ESG factor: credit-negative).

It has been reported that Optimum Solar has become the owner of the Ujpest football club and a currently non-operating airport in Taszár, Hungary. Bank accounts show significant payments towards the football club and the airport's previous owner, SGF Silu Global Fund Holding Zrt. Scope was unable to verify the M&A-related documents to ascertain whether further payments are due. (ESG factor: credit-negative).

Scope takes off one notch for the supplementary rating driver of governance and structure to reflect the agency's concerns highlighted above.

One or more key drivers of the credit rating action are considered an ESG factor.

Outlook and rating-change drivers

The Outlook for Optimum Solar is Negative as Scope forecasts that the company will be unable to cover the upcoming bond interest payment of HUF 210m in May 2022 using liquidity available in mid-April. Further, the company's performance in 2022 depends on the successful execution of one large project that accounts for over 80% of projected revenues. This project also needs to obtain working capital financing, which Optimum Solar is currently unable or unwilling to do itself but has entered a letter of intent with its strategic partner, PV Central. Working capital financing will also require a bank guarantee, which will tie up HUF 125m of cash.

A negative rating action could occur if the company cannot secure the liquidity needed to service debt and potential restructuring agreements in the short term and lenders decline to waive their requirement to accelerate repayment. The bond prospectus specifies a repayment of the total bond nominal amount within 10 working days, which applies to the assigned rating today. Such a scenario is therefore likely to result in a corporate default.

A positive rating action that stabilises the Outlook may be warranted if enough liquidity, such as via a substantial capital injection, is secured to cover upcoming debt interest payments until proceeds from the large contract materialise later this year and lenders agree that the company does not have to repay the nominal bond amount.

Long-term and short-term debt ratings

The rated entity issued a HUF 6bn senior unsecured corporate bond under the Hungarian Bond Funding for Growth Scheme in May 2020. The bond has a 3.5% coupon and starts to amortise three years after issuance, with a tenor until 2027.

Scope's recovery analysis is based on a hypothetical default scenario occurring in late April/May 2022, which assumes outstanding senior unsecured bond debt of HUF 6.0bn in addition to HUF 734m of secured bank debt, HUF 380m in payables, HUF 3.5bn in advances and HUF 2.6bn in guarantee positions (amounts are based on preliminary unaudited 2021 accounts). Scope expects a 'below average' recovery for the company's unsecured debt. Given the imminent default potential, this results in a C rating for this debt class (aligned with the issuer rating).

Stress testing & cash flow analysis
No stress testing was performed. Scope Ratings performed its standard cash flow forecasting for the company.

Methodology
The methodologies used for these Credit Ratings and/or Outlook, (Corporate Rating Methodology, 6 July 2021; Rating Methodology: Construction and Construction Materials, 25 January 2022) are available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
Scope Ratings GmbH and Scope Ratings UK Limited apply the same methodologies/models and key rating assumptions for their credit rating services, while Scope Hamburg GmbH's methodologies/models and key rating assumptions are different

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Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. Also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information
The Credit Ratings were not requested by the Rated Entity or its Related Third Parties. The Credit Rating process was conducted:

With the Rated Entity or Related Third Party participation	YES
With access to internal documents	YES
With access to management	YES

The following substantially material sources of information were used to prepare the Credit Ratings: public domain, the Rated Entity, the Rated Entities' Related Third Parties, third parties and Scope Ratings' internal sources
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Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and/or Outlook and the principal grounds on which the Credit Ratings and/or Outlook are based. Following that review, the Credit Ratings were not amended before being issued.

Regulatory disclosures
These Credit Ratings and/or Outlook are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and/or Outlook are UK-endorsed.
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The Credit Ratings/Outlook were first released by Scope Ratings on 4 February 2020. The Credit Ratings/Outlook were last updated on 17 May 2021.

Potential conflicts
See www.scoperatings.com under Governance & Policies/EU Regulation/Disclosures for a list of potential conflicts of interest related to the issuance of Credit Ratings.

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