Pick Szeged Zrt.
Hungary, Consumer Products

SCOPE BB- POSITIVE

Corporate profile

Pick Szeged Zrt. manufactures processed meat for wholesale distribution and is the market leader in its segment. The company, founded in 1869, celebrated its 150th anniversary in 2019. Pick Szeged is owned 99.987% by Bonafarm Zrt., which itself is owned indirectly by renowned businessman and banker Dr Sándor Csányi through holding company Bonitás 2002 Zrt. Pick Szeged was acquired by Bonafarm Zrt. in the 2000s and has been consolidated in Bonafarm Group since 2009.

Pick Szeged owns four subsidiaries in Hungary (local handball team PICK Kézilabda Zrt. and some smaller subsidiaries), two in Germany (PICK Deutschland GmbH and PICK Szeged (Deutschland) GmbH), one in Slovakia (PICK SLOVAKIA s.r.o.), one in Romania (PICK ARAD S.R.L.), and one in Russia (Magyar Élelmiszerek és Technológiák Zrt.) for distribution and sales purposes. Pick Szeged owns two major brands, PICK and Herz. The company's key product is PICK winter salami, which is also the flagship product for Bonafarm Group and enjoys 'Hungaricum' status as a commodity representing Hungarian heritage. There are four production sites, all in southern Hungary: two in Szeged, one in Baja and one in Alsómocsolád.

Rating rationale

Scope has affirmed the BB- rating of Pick Szeged along with the BB- senior unsecured debt rating. The Outlook has been lifted to Positive from Stable.

The affirmed BB- rating and changed outlook mirrors the rating of Pick Szeged's parent, Bonafarm Zrt., based on the parent's unconditional and irrevocable guarantee. The Positive Outlook reflects the improving financial figures, also well above forecasts, which indicate the potential for an upgrade. However, Pick Szeged's large, once-in-a-lifetime capex programme has again been delayed. The investment still is not contracted although construction costs have been soaring. Hence, the budget may change.

The rated entity's business risk profile reflects a strong presence both in the Hungarian market through its 150-year-old brand and in key export markets such as Germany for its famous winter salami. However, volatile profitability coupled with improving margins and limited diversification temper the rating. Pick Szeged has a strategic partnership with MCS Slaughterhouse, which is also owned by Bonafarm Zrt.'s ultimate owner, Dr Sándor Csányi. We note that one-third of Pick Szeged's output and only certain parts of the pork meat are purchased from MCS Slaughterhouse at market price; yet MCS Slaughterhouse has not been profitable since it started production in 2016 while Pick Szeged's margins have been improving.

Pick Szeged can access a cash pool provided by its parent for investments and thus does not carry its own investment burden. As a result, its financial risk profile mirrors that of the parent. A HUF 27bn bond under the Hungarian National Bank's Bond Funding for Growth Scheme (HU0000359336) was the first time Pick Szeged issued debt. Overall, Pick Szeged's rating remains in line with the parent's, affirmed at BB-.

Ratings & Outlook

Corporate rating	BB-/Positive
Senior unsecured rating	BB-

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Related Methodologies

Corporate Rating Methodology, July 2021

Consumer Products Methodology, September 2020

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Outlook and rating-change drivers

The Outlook for Pick Szeged has been raised to Positive from Stable, mirroring that of the parent due to its ownership and guarantee.

An upgrade or downgrade of the parent could result in the same rating action for Pick Szeged.

Rating drivers

Positive rating drivers	Negative rating drivers
• Market leader in Hungary in processed meat, enabling pricing power • Access to group cash pool for working capital and investments • Strong parent support from Bonafarm Zrt. and from the ultimate beneficial owner	• Negative free operating cash flow/Scope-adjusted debt due to heavy investment phase • EBITDA vulnerability to market price changes, especially the recently increasing ZMP index (German slaughter pigs index) and increasing labour costs • Delayed investment to replace old production technologies in the context of soaring construction prices, mitigated by higher-than-expected subsidy and owner's equity contribution • Higher production-related headcount than peers due to delayed investments, low automation and production sites situated at multiple locations • Lack of transparency and discrepancies in past and forecasted financial disclosures

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Upgrade of parent	• Downgrade of parent

Business risk profile

Industry risk profile

We categorise Pick Szeged as a producer of non-durable consumer goods. We see substitution risk as high because Pick Szeged has a limited product range (processed meat). Other suppliers are available, but consumers perceive Pick Szeged's meat products as unique. However, we note the recent shift among consumers to substitute processed meat for other types of foods.

High cyclicality

Input prices for meat, the key ingredient, are strongly cyclical. While both agribusiness and commodity food products are non-discretionary and hence normally have low cyclicality, strong supply swings introduce significant volatility to both costs and prices and hence to both revenues and EBITDA. Both expected (crop forecasts) and unexpected events (bad weather, diseases) can lead to volatility, with supply shortages (increasing prices) and supply gluts (decreasing prices) causing price volatility well above more general price changes. The industry is also subject to volume volatility.

Medium entry barriers

Market entry barriers for non-durable consumer goods are medium. The limited product range leads to an inherent risk of product substitution. Consumer preferences change over time and the processed meat segment is no exception, with the availability and consumption of alternatives on the rise.

High substitution risk

While alternative foods do not share the same attributes as processed meat, they are readily available. For this reason and the above factors, we view substitution risk as high. Pick Szeged's ability to generate high volumes at a high quality (important for wholesalers) mitigates this risk. Bonafarm Group also provides the necessary value chain certification for non-GMO products that cannot be easily reproduced with alternative inputs.

Stable outlook on core Hungarian market despite negative Covid-19 effect

Pick Szeged's home market is Hungary, where PICK winter salami has been granted 'Hungaricum' status as a commodity representing the local heritage. The country's economic growth, despite the negative effects of the Covid-19 pandemic, remains relatively robust, but is challenged by an ageing workforce. Productivity growth to meet this challenge has been strong. The Hungarian economy is open and medium-sized, with cyclical behaviour matching that of the eurozone in general. Robust wage growth, aided by productivity increases, has helped consumer demand grow strongly in recent years. Access to EU markets and a sound infrastructure support the robust outlook.

Our public finance rating for Hungary is BBB+/Stable, reflecting the country's track record of public debt reduction, robust capital inflows of foreign direct investment and EU funds supporting growth potential, and increased resilience against external shocks. Following years of above-trend growth, Hungary's highly open economy, with a large exposure to cyclical industries, has been severely affected by the Covid-19 pandemic and associated mitigation measures. A large and effective set of monetary and fiscal intervention was implemented to support the healthcare sector, businesses and households, cushioning the economy from the pandemic's impact. These factors, combined with the unprecedented EU-wide monetary and fiscal stimulus in response to the crisis, underpin our view that the country is well positioned to weather the Covid-19 crisis and will return to robust growth from 2021 onward.

Consumer product companies with strong brands benefit from pandemic

Market development continues to reflect slow changes in consumer preferences. The pandemic has increased food consumption at home rather than in restaurants. At the same time, the government has supported local production with subsidies and grants and, if needed, loans and financial guarantees from state-owned banks. Pick Szeged has profited greatly from this due to its leading position in Hungary's processed meat market and its strong brand.

Negative value chain effect evident in strategic partner's sector

Access to key markets (China, Japan) is still an issue because certain parts of pork are sold frozen due to African Swine Fever. The effect is seen on the results of pig slaughterhouse MCS Vágóhíd, a strategic partner owned by Dr Sándor Csányi but not part of Bonafarm Group.

Domestic market leader and strong export focus towards Germany

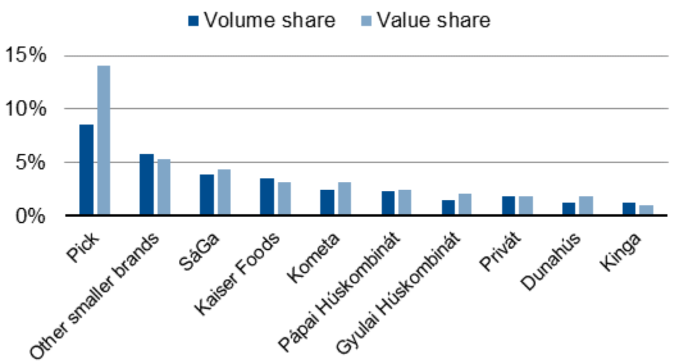
Pick Szeged continues to dominate its market, though its capacity development plans are rather moderate compared to those of its ambitious competitors.

Geographical diversification is concentrated on Hungary and export sales are moderate at more than a quarter of revenues (mainly to Germany for the salami product).

In Hungary's processed meat market, volumes decreased by 0.8% and value increased by 0.5% in the first half of 2021.

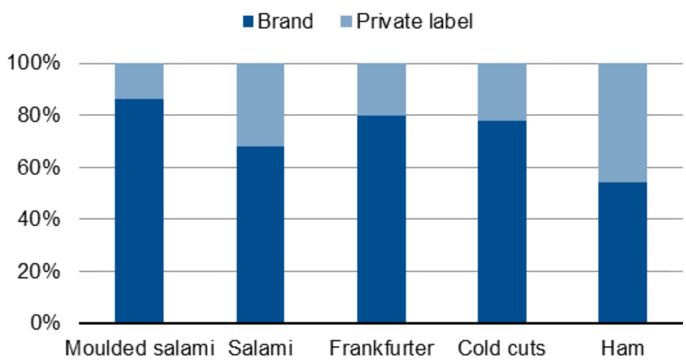
The private label segments could grow in the first half of the year. Pick Szeged's share of the private label market decreased by market value but increased by volume. For branded products, Pick Szeged's share by market value decreased by 0.38pp but increased by market volume by 0.57pp compared to 2020 levels. The difference is because Pick Szeged's ownership of Hungary's top processed meat brand allows it to outperform the profitability of competitors, as seen on Figure 1. We note Pick Szeged's low share of brands relating to ham and premium protein-based products. This is because salami accounts for more than half of its business and the remainder on cold cuts and mid-priced ham.

Figure 1: Market share of Pick Szeged, H1 2021



Source: Bonafarm/Pick

Figure 2: Pick Szeged's share of branded and private label sales by turnover, H1 2021



Source: Bonafarm/Pick

Product diversification constrained

Pick Szeged's customer base is highly diversified, including all relevant retail chains in Hungary. Sales are balanced among retailers as the PICK brand is in high demand in Hungary. Despite this and Pick Szeged's broad supplier base, the concentration on a single sector, meat products (with focus on salami), constrains diversification and a significant cluster risk remains. This is mitigated somewhat by a relatively good international standing. Other constraints include a potential shift in consumer sentiment away from meat products, a concentration towards higher-protein products in industrialised countries, unfavourable domestic demographic trends, and a continued inability to access key Asian growth markets.

Improving profitability in line with other consumer product companies during pandemic

EBITDA margins are moderate with 5%-6% during 2015-18, improving to 9% in 2020. EBITDA is fairly volatile, mainly reflecting cost changes outside the company's control such as increasing labour costs and input costs. A large portion of saw meat is bought from MCS Slaughterhouse at an arm's length basis. Nevertheless, MCS Slaughterhouse has an inferior margin to Pick Szeged's, but it could become profitable this year for the first time since its establishment in 2016.

Slow execution of investments allow competition to gain market share

Pick Szeged is one of the largest employers in Hungary, with a headcount of more than 2,000. However, the ratio of revenue to headcount is half the level of main competitors. The low efficiency is due to the old technology used in production facilities, whose modernisation has also been delayed, facilities being situated in multiple locations, and the nature of the products (salami production). The large headcount in production will not be solved in the medium term as the new government subsidies come with headcount requirements. For the medium term, Pick Szeged aims to increase output capacity by one-quarter. At the same time, some competitors in processed pork and poultry products in Hungary are to double their capacity.

Strong brands enable pricing power in Hungary

Pick Szeged is the market leader in Hungary with high-quality products and high brand awareness. The market leading position enables premium pricing for its salami and certain processed meat products despite lower operating efficiencies compared to competitors, which the group is using well in negotiations with retailers. We see the sustained market leadership by both sales and brand as key to maintaining pricing power.

Financial risk profile

Financial risk assumptions

Our key financial assumptions are: i) no major restructuring of the company or subsidiaries; ii) mergers or acquisitions of up to HUF 8bn, resulting in Scope-adjusted debt/EBITDA staying below 3.5x in line with group financial policy; iii) continuity of management; iv) modest top-line sales growth until investments materialise; v) return to market growth, low unemployment and strong wage growth in Hungary, combined with the central bank continuing to keep interest rates within targets and exchange rates stable; vi) no major agribusiness-related event (e.g. drought, disease); vii) investment plans executed as presented with no meaningful operational or financial risks; and viii) continuity of financial policy, especially in terms of no dividends and no new large debt issuances, while Scope-adjusted debt/EBITDA stays below 3.5x at group level.

Improving leverage ahead of large brownfield investment

The consortial secured financing provided by CIB Bank Zrt (member of Intesa Group) and Raiffeisen Bank Zrt of HUF 44.7bn (EUR 139.8m) is jointly, severally, irrevocably and unconditionally guaranteed by Bonafarm Group. The covenants of the consortium credit line for the group are i) an equity ratio of at least 30%; ii) maximum indebtedness of 4x; iii) two-year average net operating cash flows of at least HUF 9bn; iv) annual debt service coverage ratio of at least 1.05x; and v) total assets to shareholder equity of at least 45%. According to the 2020 compliance certificate, all covenants were fulfilled with good headroom. Ongoing capex will negatively affect credit metrics.

We assign Pick Szeged with the same issuer rating as its parent, Bonafarm Zrt. as the subsidiary can access the group cash pool to finance investments and working capital.

Strong interest cover coupled with greater cash flow headroom

EBITDA/Interest cover has always been strong at Bonafarm Zrt and by extension at Pick Szeged. The low interest rate regime and state-subsidised financing have allowed Bonafarm Group to contract debt with an average interest burden of 1.24%, calculated for 2020 on the drawn exposure. Further, Pick Szeged's 10-year senior unsecured bond has a fixed coupon of 2%. Most of the committed financing facilities are at a fixed interest rate. Hence, we expect the increasing base rate in Hungary to have no major impact.

Pick Szeged's issued HUF 27bn bond is repayable only at maturity in 2029, which provides great cash flow headroom.

Negative free operating cash flow/Scope-adjusted debt due to investments

Pick Szeged has several large production sites in need of modernisation. As such, we expect very negative free operating cash flow/Scope-adjusted debt figures once the large investment kicks in.

The heavy investment phase continues to influence our assessments of cash flow coverage and free cash flow generation. The ratios are highly variable, reflecting the deeply negative investment cash flow. Once this phase ends, we expect a robust return to positive cash flow, but this will only happen beyond the rating horizon.

Increasing constructions costs mitigated by increased subsidy

Since the plans for the Pick Szeged facility were made and the related bond was issued in 2019, construction costs in Hungary have soared. The Hungarian Investment Promotion Agency recently granted a HUF 10.6bn non-refundable investment subsidy to the HUF 39bn investment budget; the previous plan calculated conservatively only a HUF 2bn subsidy, leaving room for cost overruns.

Adequate liquidity supported by group cash pool

As per our corporate rating methodology, the minimum entity level at which issuer ratings apply is based on cash-pooling agreements, such as the one between Bonafarm Zrt. and Pick Szeged. For this reason, we assess Pick Szeged's liquidity as equal to its parent's.

Supplementary rating drivers

Neutral financial policy, coupled with discrepancies in disclosures

Group financial policy continues to have the aims of a strong expansion of core businesses (primarily Pick Szeged) and organic growth overall. The Pick Szeged investment focuses on strategic modernisation and expansion of a production plant built in the 1970s. Bonafarm Group carries all group debt. We view financial policy as largely prudent as management is committed to keeping leverage at a maximum of 3.5x. Loan covenants allow up to 4x. We also have moderate expectations for top-line growth until investments materialise. The group has implemented IT system SAP for reporting and controlling production costs. Even so, financial planning, financial reporting and detailed notes for audit disclosures still have room for improvement. We did not adjust the rating for financial policy or governance.

Parent support

Dr Sándor Csányi was for a long time Hungary's richest individual; currently he is second. Forbes magazine estimated his wealth in 2021 at HUF 420bn (around EUR 1.2 bn). Dr Csányi has several other interests not consolidated in Bonafarm Group. These include MCS Vágóhíd, one of the region's largest pig slaughterhouses; KITE, which trades agricultural goods and machinery; and Hungerit, one of Hungary's largest chicken processing and production companies. Dr Csányi fully owns Bonafarm Group through Bonitás 2002 Zrt. And has supported the group significantly with equity and owner loans since its inception.

For the Pick Szeged investment, Dr Csányi contributed an equity increase in cash through Bonafarm Group's holding company, Bonitás 2002 Zrt., of HUF 4.4bn in 2020 and HUF 17.25bn in 2019. A previous equity increase in 2016 totalled HUF 28.3bn. These add up to HUF 50bn in five years (EUR 140m).

Senior unsecured debt rating

'Average' recovery rate

Pick Szeged issued senior unsecured debt in 2019 of HUF 27bn. While the company has a strong asset position, we have not provided an uplift for any potential recovery.

We therefore affirm the BB- debt rating on senior unsecured debt issued by Pick Szeged in line with the issuer rating. We expect an 'average' recovery for outstanding senior unsecured debt in a hypothetical default scenario in 2023.

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