Market Építő Zrt
Hungary, Construction

SCOPE BB- NEGATIVE

Corporate profile

Market Építő Zrt. (Market), founded in 1996, is a leading construction company with operations based exclusively in Hungary. The group employs about 1,000 people and generated HUF 199bn in turnover in 2019. Its headquarters are located in Budapest. Market is owned by GARHART Zrt (51%, an investment holding company wholly owned by Istvan Garancsi) and Sandor Scheer (49%, CEO and founder of Market). Market is involved in the construction of buildings, industrial facilities and sport facilities. Building projects encompass offices, public facilities, residential buildings and hotels. The increase in the construction segment over the past few years has been driven by high demand for offices and public facilities. Market's industrial projects include logistics centres, car-making and tyre plants, and electric battery factories.

Key metrics

			Scope estimates	
Scope credit ratios	2018	2019	2020F	2021F
EBITDA/interest cover (x)	116.6x	51.5x	10.6x	4.4x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	0.8x	2.6x
Scope-adjusted FFO/SaD	net cash	net cash	110%	29%
Free operating cash flow (FOCF)/SaD	net cash	net cash	91%	17%

Rating rationale

Scope Ratings changes the Outlook on the BB- issuer rating of Market Epito Zrt from Stable to Negative. At the same time, the BB- issuer rating is affirmed, and senior unsecured debt is downgraded from BB to BB-.

The Outlook change reflects the risk of further pressure on leverage and free operating cash flow generation due to the company's more ambitious investment plan. Following the issuance of its first HUF 20bn bond under the Bond Funding for Growth Scheme of the Hungarian National Bank (MNB) in 2019, Market has decided to expand its growth strategy by increasing investments to HUF 53bn for the next three years. In 2020 and 2021, the company's financial risk profile is expected to come under pressure in terms of our negative rating drivers. We anticipate that key credit metrics will deteriorate in the next 12 to 18 months. The company's financial risk profile has been adjusted to reflect the fact that it no longer has a net cash position, which is the main reason for the current pressure on the issuer rating.

The updated investment plan, which is largely debt financed via a mix of bank loans and a second seven-year HUF 20bn bond under the MNB scheme, is expected to maintain the company's currently good operating performance. This growth strategy focusses on investing in various real estate projects where the group will operate as the main contractor in order to fully maximise its operating capacity. Market's results in 2019 were strong, including double-digit EBITDA growth while consistently winning large-scale projects, even during the Covid-19 lockdown.

Operating cash flows are expected to decrease gradually in 2020 and 2021 on the back of lower EBITDA and a more neutral impact from working capital. Based on the increasing need to finance the investment plan externally, we anticipate that leverage as measured by Scope-adjusted debt (SaD)/Scope-adjusted EBITDA will increase to above 2x on a sustained basis over the next few years.

Ratings & Outlook

Corporate ratings	BB-/Negative
Senior unsecured debt	BB-

Analysts

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Related Methodologies

Corporate Rating Methodology, February 2020

European Construction Methodology, January 2020

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The issuer rating is still supported by Market's leading position in the Hungarian construction sector, strong liquidity and a stable operating margin. On the other hand, the rating remains constrained by Market's limited overall size, low profitability, non-existent geographical diversification, and concentration issues regarding its backlog and business operations, making the company highly sensitive to business cycles.

Finally, in the short term, we expect Covid-19 to have a negative impact on the company backlog as fewer tenders are available on the market, which could lead to a material drop in revenues in the medium term. The HUF 40bn European Union economic recovery package to stimulate investment in infrastructure and sport facilities could help offset this downturn.

Outlook and rating-change drivers

The Negative Outlook on Market's rating reflects the anticipated weakening of credit metrics in the short to medium term as a result of debt-funded investments in real estate assets. Our base case indicates that key credit metrics, including leverage as measured by SaD/Scope-adjusted EBITDA reaching above 2.0x, could deteriorate in 2020 and 2021 if no other cash inflow measures are taken.

A positive rating action, including a change of Outlook, could occur if the company manages to increase its cash inflow in order to reduce the debt-funded part of its upcoming investments, leading to SaD/Scope-adjusted EBITDA remaining below 2.0x on a sustained basis.

A negative rating action could be required if investments in various real estate projects weigh on leverage, resulting in SaD/Scope-adjusted EBITDA moving towards 4.0x.

Long-term debt rating

We have revised our expectation for senior unsecured debt from an 'above-average recovery' to an 'average recovery'. The downgrade for the senior unsecured debt was driven by the introduction of first-ranked secured debt to finance the issuer's real estate development activities. We believe this will limit recovery expectations for senior unsecured debtholders. We have therefore downgraded the BB rating for the senior unsecured debt category to BB-, in line with the issuer rating.

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong leading position in the Hungarian construction market • Net cash position combined with a conservative approach should help weather forecasted slowdown in the Hungarian economy in 2020 • Significant capex plan to reduce supply/demand uncertainty and diversify activities to improve integration • Good credit metrics supported by low gross debt levels and strong liquidity	• Small European contractor with a lack of geographical diversification limiting ability to offset business cycles • Concentration issues regarding backlog (top five projects account for 67%, mitigated by investment grade counterparties) and business segment (mainly buildings) • Low profitability hampered by material increase in prices and wages, mitigated by low to medium volatility in operating margins

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA remaining below 2x on a sustained basis	• SaD/Scope-adjusted EBITDA moving towards 4x

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	116.6x	51.5x	10.6x	4.4x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	0.8x	2.6x
Scope-adjusted FFO/SaD (%)	net cash	net cash	110%	29%
FOCF/SaD	net cash	net cash	91%	17%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	6,663.2	9,926.0	9,113.0	7,949.8
Operating lease payments in respective year	0	0	0	0
Other items	-99.0	-10.0	0	0
Scope-adjusted EBITDA	6,762.1	9,936.0	9,113.0	7,949.8
Scope-adjusted funds from operations in HUF m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	6,762.1	9,936.0	9,113.0	7,949.8
less: (net) cash interest as per cash flow statement	-58.0	-193.0	-861.7	-1,808.7
less: cash tax paid as per cash flow statement	-236.9	-373.0	-597.9	-344.9
Change in provisions	88.0	202.0	0	0
add: depreciation component, operating leases	0	0	0	0
Scope-adjusted funds from operations	6,555.2	9,572.0	7,653.3	5,796.3
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020F**	**2021F**
Reported gross financial debt	1,866.0	22,805.0	45,761.6	69,504.9
Hybrid bond	0	0	0	0
less: cash and cash equivalents	-14,361.0	-37,918.0	-42,311.7	-52,667.9
add: cash not accessible	2,732.0	3,136.0	3,484.5	3,484.5
add: pension adjustment	0	0	0	0
add: operating lease obligations	0	0	0	0
Other items	0	0	0	0
Scope-adjusted debt	-9,763.0	-11,977.0	6,934.4	20,321.5

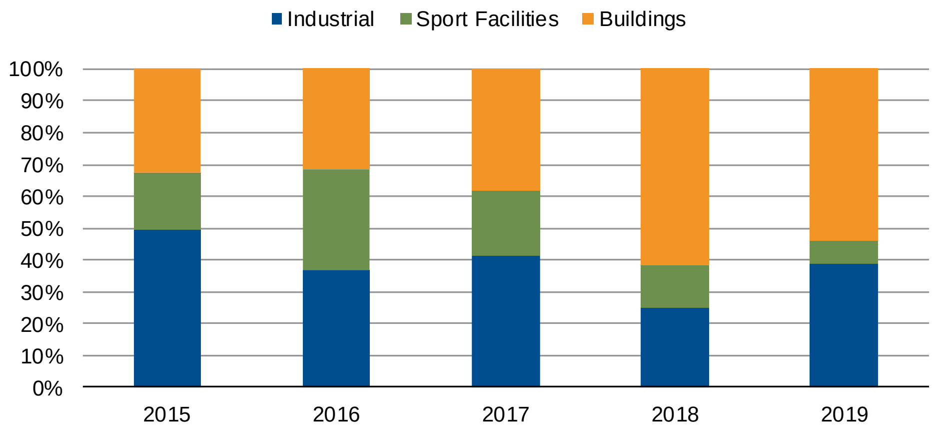
Business risk profile

Company involved in a highly cyclical sector

Market is involved in the construction of buildings, industrial facilities and sport facilities.

The group's building projects encompass offices, public facilities, residential buildings and hotels. This wide range, however, does not provide the required diversification as the projects belong to the same operating sub-segment according to our methodology (the structures are built on a similar basis; only the end-users differ). This segment's growth in recent years has been driven by high demand for offices and public facilities. Industrial projects deal with logistics centres, car-making and tyre plants and electric battery factories. The construction of sport facilities has civil engineering features that require different technical skills. These three types of operations and lack of risk mitigants (concession types provide recurring revenues) make the group highly exposed to cyclicality.

Figure 1: Revenues by types of projects Market – 2015 to 2019



Source: Market, Scope

Low barriers to entry with low to medium substitution risk

In line with its strategy, the group does not bid for civil engineering projects (bridge, roads, railways) because of their complexity. Its industrial projects in terms of logistics centres are not considered complicated. Therefore, construction companies from Eastern Europe or Austria can easily participate in tenders. Nevertheless, some large-scale structures are challenging in terms of the construction method and time constraints (e.g. for the stadium and dome for the Budapest zoo). Indeed, Market has won some contracts thanks to its ability to deliver projects quickly.

Industry Risk Assessment: European Construction Corporates

Barriers to entry / Cyclicality	Low	Medium	High
High	CCC/B	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Source: Scope

Small tier-3 European construction company…

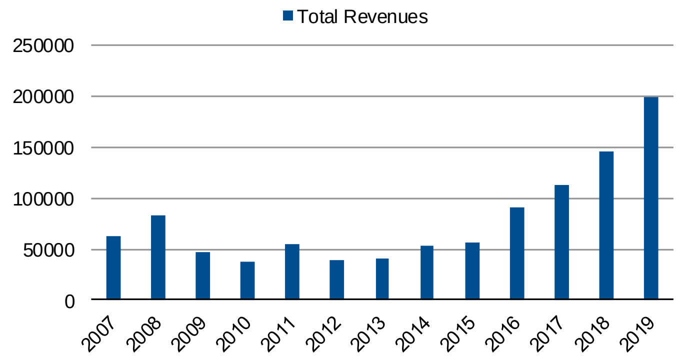
The group is small in terms of revenues and EBITDA. This is due to its core and unique market of Hungary, which remains limited in terms of size. Nevertheless, the group ranks first domestically with an 8% market share (14% if considering only the building sub-segment). This is thanks to its strong track record and well-established position in the highly fragmented Hungarian construction sector (56,095 companies in 2016 according to the European Construction Sector Observatory). Market's strategy focuses only on

Hungarian large-scale and visible projects. The group runs between 50 and 60 projects a year with the main ones accounting for up to 50% of Market's FY revenues.

…but leading position in Hungary benefiting from growing domestic market

Market is Hungary's leading construction company by far with a turnover of HUF199bn or EUR 622m, more than twice that of its direct competitor. This is the payoff of a well-rounded strategy focusing on the buildings segment. In Hungary, this sub-segment is larger than the civil engineering segment and has also been more dynamic (+66% since 2009 vs +4% for civil engineering). Market has a strong footprint in central Hungary – the Budapest region, accounting for almost half of the construction sector – where it derives a large share of its revenues thanks to a sizeable pool of large-scale projects.

Figure 2: Total Revenues (HUFm) – 2007 to 2019



Source: Market, Scope

Figure 3: Top 4 Construction companies in Hungary

	2019 Revenues (EUR m)	Rank
Market Építő Zrt.	622 237	1
Mészáros és Mészáros Kft.	264 377	2
ZÁÉV Építőipari*	219 270	3
Strabag Általános	208 459	4

*2018 Results

Source: Market, Scope

Weak geographical diversification with no intention to expand abroad; limited diversification by segment…

Market's only regional exposure since its founding has been its domestic market of Hungary, allowing the group to take advantage of the local sector's strong growth between 2000 and 2008 (+106%, according to KSH). Due to the 2008 financial crisis combined with the mild recession in 2012, construction output in Hungary declined by 21% during that period, leading to a drop of Market's turnover (see figure 2). The company could not offset the decline due to its lack of diversification, needing eight years to regain the turnover levels during 2008. Although present in most of Hungary's regions, we view Market's footprint as very concentrated. The building segment accounts for 67% of group EBITDA while industrial sites represent 33%.

… but slight improvement expected thanks to future side businesses

We view as positive the intent to further diversify into real estate projects including six different investments into office buildings, hotels, residential buildings and logistic center. This large growth plan, expanded versus last year, is expected to be funded by a mix of an upcoming second bond (HUF 20bn) under the MNB program and secure bank loans. These projects are implemented in-house to support Market's contracting business. Nevertheless, the overall impact on the group's diversification remains limited as they account for around 10% of Market's revenues over the construction period.

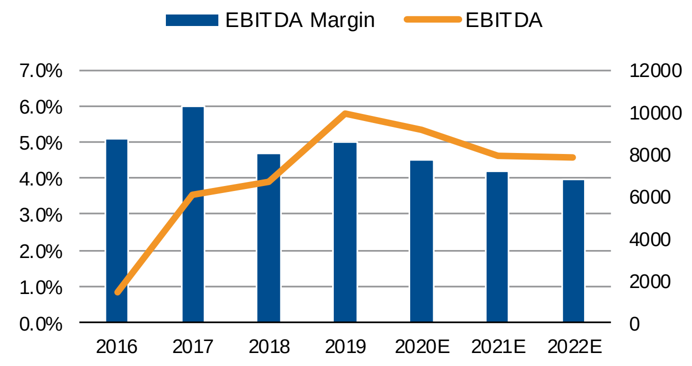
Concentrated backlog mitigated by client quality

We judge diversification of the backlog (a rough indication of future revenue diversification) to be constrained, with the top five accounting for 67% of the total backlog at YE 2019. This concentration, consistent with its strategy to focus on large-scale projects, implies an overreliance on a limited number of projects that could materially impair revenue and EBITDA in the event issues arise for one of them. However, the credit quality of the respective clients (three out of five are investment grade credit quality) mitigates associated risks to a certain extent.

Low but stable profitability constrained by increases in raw material prices and wages

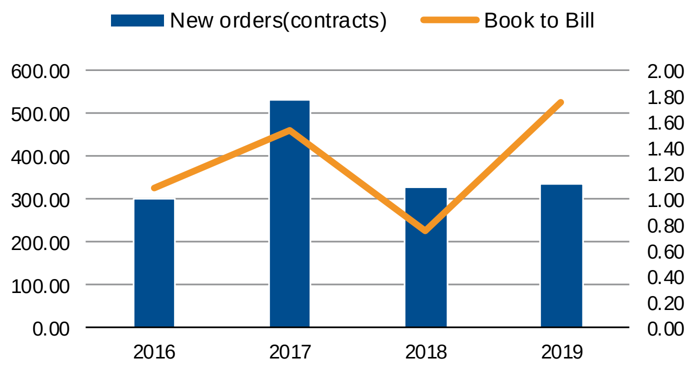
Apart from the overperformance observed in 2016, the group has maintained an EBITDA margin of between 4% and 5%, which is at the lower end of the construction industry range (5%-10%). This low operating margin arises from i) its business mix, which prioritises large, visible projects over profitability criteria; and ii) the booming Hungarian construction sector, which has led to shortages in both raw materials and qualified staff. The lack of domestic material production (for example, concrete in the case of Market) has forced contractors to import goods, driving prices up. In addition, wage costs have increased in a bid to lure back Hungarian construction staff currently working in European countries with better pay conditions.

Figure 4: EBITDA margin and EBITDA (HUF m) – 2016 to 2022E



Source: Market, Scope

Figure 5: Backlog & book-to-bill ratio – 2016 to 2019



Source: Market, Scope

Strong visibility of revenues until 2022 with large order backlog

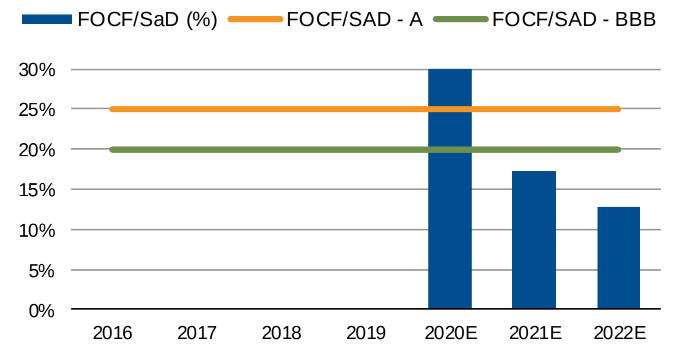
In our view, the current order backlog of HUF 675bn as at YE 2019 provides some revenue visibility for the next few years. The backlog represents 3.4x of 2019 group revenues.

Financial risk profile

Main assumptions for our projections:

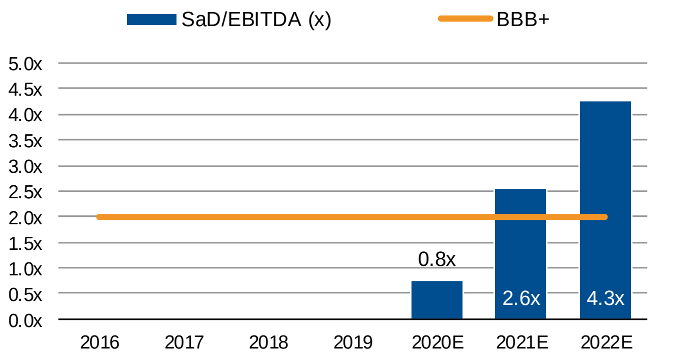
- Revenue growth for 2020, 2021 and 2022 in line with the company's projections and the backlog.
- Decreasing margin in 2020 due to the surge of expenses for raw materials and workforce and fewer tender to compete on, therefore pressuring prices.
- HUF1.7bn maintenance capex.
- Net capex set up at HUF24bn, 14bn and 14bn between 2020-2022 in line with the new investment plan.
- Gross debt increased in 2020 and 2021 by the second HUF20bn MNB bond and 3 bank loans used to fund partly real estate investments.
- Dividend payout of 75%. Company's policy sets maximum payout at 75%
- No change in provisions, no pensions and no operating leases.
- Restricted cash relates to the cash pledged as collateral for banks to issue guarantees.

Figure 6: FOCF/SaD – 2016 to 2022E



Source: Market, Scope

Figure 7: SaD/EBITDA – 2016 to 2022E



Source: Market, Scope

High EBITDA interest expense cover expected to decrease 7x in 2021

EBITDA interest expense cover, while very volatile, has been high at above 20x during 2015-18, including positive interest income in 2016. The volatility of debt protection arises from the very low level of gross interest costs, with an average cost of debt of 3% and historically low gross debt levels. We anticipate debt protection to drop below 7x from 2021 onwards, due to a significant change in future debt levels from the issuance of the second HUF20bn bond in 2020 and HUF26.7bn bank loans.

No net debt at group level thanks to a conservative approach and good cash flow

Since 2016, the company's consolidated leverage, measured by SaD/EBITDA and funds from operations (FFO)/SaD, has been negative due to the consistently low level of gross debt in line with the company's conservative approach – an asset-light strategy combined with small bolt-on acquisitions – helped by recurring positive free cash flow. We forecast the company to become leveraged on a net basis by 2020 due the increase in gross debt, combined with large investments into real estate projects estimated at around HUF53bn for the period 2020-2022.

Adequate liquidity supported by headroom provided by ample unrestricted cash balance and undrawn credit facilities

We view Market's liquidity as strong. This is based on our expectation that liquidity sources will exceed their uses more than 100% in the next 12 months following consistently high liquidity in the past.

Figure 9: Market: Liquidity

Liquidity (HUF m.)	2017	2018	2019	2020E	2021E
Unrestricted cash position	6,072	15,073	11,629	34,782	38,827
Undrawn committed lines	8,020	8,020	6,850	4,950	4,950
Short-term maturities	2,347	803	501	1,006	1,006
Free cash flow	12,845	3,009	8,326	6,296	3,502
Short-term debt coverage	**11.5**	**32.5**	**53.5**	**45.8**	**47.0**

Source: Market, Scope

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