Pick Szeged Zrt.
Hungary, Consumer Products

SCOPE BB- STABLE

Rating rationale

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

The affirmed BB- rating and changed Outlook mirror the rating actions on Pick Szeged's parent, Bonafarm Zrt., based on the parent's unconditional and irrevocable guarantee on group debt. The Outlook change is mainly driven by the flexible financial policy and the M&A policy of Bonafarm Group despite improving credit metrics. The improvement in credit metrics is due to low agricultural input prices (as of 2021) sold with a superior end product margin in 2022 and the slow deployment of capex in the new brownfield meat processing plant at Pick Szeged resulting in lower-than-planned leverage and higher free operating cash flow. Most of the investment budget is still not fixed although construction costs have been soaring since the bond issuance in 2019. We expect metrics to deteriorate moderately once capex is deployed.

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 input prices, inflationary pressure, wage increases and limited diversification temper the rating. Pick Szeged is tackling inflation with a strong pricing response and by discontinuing some of its low-margin processed products.

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 its pork meat are purchased from MCS Slaughterhouse at market price. MCS Slaughterhouse closed the year with a profit after initial loss-making years since production started in 2016. At the same time, 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. At the same time, the strong cash flow generation of Pick Szeged and its low-cost fixed-rate debt can be used up to a limited amount by Bonafarm Group and its strategic partners such as MCS Slaughterhouse from 2022, which can result in higher group leverage extended for the cash use of strategic partners.

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-.

Outlook and rating-change drivers

The Outlook for Pick Szeged has been changed to Stable from Positive, 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 history

Date	Rating action/monitoring review	Issuer rating & Outlook
23.08.2022	Outlook change	BB-/Stable
17.09.2021	Outlook change	BB-/Positive
21.09.2020	Affirmation	BB-/Stable
06.09.2019	Initial Rating	BB-/Stable

Ratings & Outlook

Issuer	BB-/Stable
Senior unsecured debt	BB-

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Related Methodologies

Corporate Rating Methodology, July 2022

Consumer Products Methodology, September 2021

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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 • Slow execution of investments 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 • Discrepancies in past and forecasted financial disclosures

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

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 99.99% 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 three subsidiaries in Hungary (local handball team PICK Kézilabda Zrt. and some smaller subsidiaries), one in Germany (PICK Deutschland GmbH), one in Slovakia (PICK SLOVAKIA s.r.o.) and one in Romania (PICK ARAD S.R.L.) 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.

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Environmental, social and governance (ESG) profile

Environment	Social	Governance	
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)	Labour management	Management and supervision (supervisory boards and key person risk)	Grey leaf
Efficiencies (e.g. in production)	Health and safety (e.g. staff and customers)	Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)	Grey leaf
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)	Clients and supply chain (geographical/product diversification)	Corporate structure (complexity)	Grey leaf
Physical risks (e.g. business/asset vulnerability, diversification)	Regulatory and reputational risks	Stakeholder management (shareholder payouts and respect for creditor interests)	Grey leaf

Legend
Green leaf (ESG factor: credit positive)
Red leaf (ESG factor: credit negative)
Grey leaf (ESG factor: credit neutral)

Circular economy in focus

Bonafarm is the largest Hungarian vertically integrated consumer products and agricultural company with substantial investments in farming and livestock. The production is from crops to processed food, which contributes to the circular economy. The group entities have started developing and implementing ESG principles, with the results visible in their environmental footprints. The agricultural and livestock leg is rather modern (save for further investments needed in crop irrigation) while the processed food plants of Pick Szeged are old and need significant investments, which have been under planning for several years. Therefore, the real change will come from the new and more efficient plant.

The ESG profile of Pick Szeged must be viewed together with its parent's to capture its high vertical integration, common management and ownership.

Decisions driven by family owners

The Csányi family keeps a hands-on approach to strategic decisions.

Pick Szeged was one of the first issuers in the Hungarian Bond for Growth programme after issuing a HUF 27bn bond with a 2% yearly fixed coupon in 2019. The proceeds are meant for building a new integrated meat processing plant on a new plot since the current plant dates to the 1970s. The issuance was done very early, when the greenfield investment was in the planning phase. Pick's management has somewhat changed since then.

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 and superior. 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 and for export) mitigates this risk. Bonafarm Group also provides the necessary value chain certification for non-GMO products that cannot be easily reproduced with alternative inputs.

Core market of Hungary hit by inflation, volatile FX and twin deficit

Pick Szeged's home market is Hungary, where PICK winter salami has been granted 'Hungaricum' status as a commodity representing the local heritage.

Our public finance rating for Hungary is BBB+/Stable (to be reviewed in late August 2022).

The country's economic growth after the pandemic is challenged by record-high inflation (projected to reach up to 17% in 2022[1] while inflation in the food sector was 20%-35% in the H1 2022, one of the worst in the EU), a weakening local currency, the delay in receiving certain EU funds and labour shortages due to the ageing workforce and wage pressure. Before the elections in Q2 2022, the population received fiscal stimulus in the form of wage increases and tax returns, which is fuelling consumption. Hungary's trade deficit turned negative at the end of 2021, which resulted in a twin deficit. This affected the county's ability to further support investments with state grants and develop governmental infrastructure.

The low input prices of 2021 and high sales prices of 2022 will have a positive impact on Bonafarm Group's profitability in 2022. The weakening Hungarian forint will help on the export margin. Most of the investment subsidies have been secured and investments can also be delayed or funded with EU agricultural subsidies; hence, we expect a moderate effect on Bonafarm Group. Increasing wages, however, negatively affect Bonafarm Group, especially Pick Szeged, which is one of Hungary's largest employers. Further, automation is moderate in production.

Consumer product companies with strong brands benefit from pandemic

Market development continues to reflect changes in consumer preferences. The shift during the pandemic towards eating at home rather than in restaurants is likely to continue amid the soaring inflation. During the pandemic, the government supported local production with subsidies and grants and, when needed, loans and financial guarantees from state-owned banks – this is not the case in 2022.

[1] Hungarian Central Bank's report on inflation, June 2022

Bonafarm Group and Pick Szeged have profited greatly from this due to their market leadership in processed milk and meat products in Hungary and strong brands. This was visible on the 2021 improved metrics.

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 the African Swine Fever. The effect was seen in the results of pig slaughterhouse MCS Vágóhíd, a strategic partner owned by Dr Sándor Csányi but not part of Bonafarm Group. The profitability of the slaughterhouse stabilised in 2021.

Domestic market leader and strong export focus towards Germany

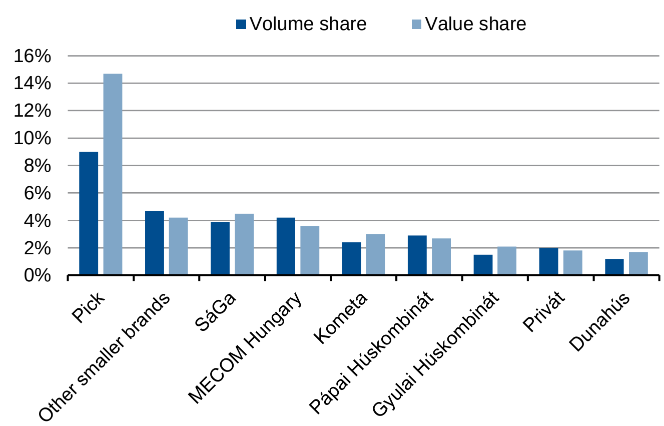
Pick Szeged continues to dominate its market, though its capacity development plans are rather moderate compared to those of competitors.

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 the first five months of 2022, volumes in Hungary's processed meat market decreased by 3% (against -0.8% in H1 2021) and their value increased by 6.8% (against 0.5% in H1 2021). Therefore, inflation is visible both in the lower demand and strongly rising prices.

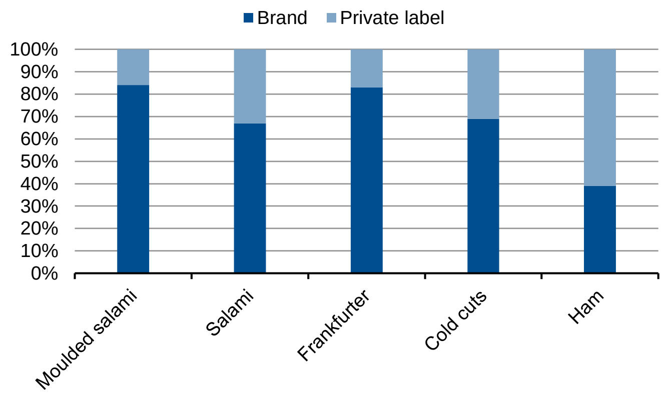
Pick Szeged's share of the private label market remains concentrated on ham and cold cuts as moulded salami is a strong branded product. Volume shares remain similar to those in 2021 at around 9%, while value shares remain at 14.5%-15.5%, which shows strong price acceptance among consumers for the brand and its products. The difference is because Pick Szeged's ownership of Hungary's top processed meat brand allows it to outperform competitors for profitability, 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 has a strong export focus, while the cold cuts and mid-priced ham are for domestic consumption and do not have a large-volume premium product offering compared to regional peers.

Figure 1: Market share of Pick Szeged, H2 2022



Source: Bonafarm/Pick

Figure 2: Pick Szeged's share of branded and private label sales by turnover, H2 2022



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 and to 16% in 2021. EBITDA is volatile, mainly reflecting cost changes outside the company's control such as increasing labour costs and input costs offset by strong price increases. A large portion of sow 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 became profitable in 2021. A combined margin of the slaughtering and meat processing business would be around 10%, which is strong for the Hungarian food production sector.

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 set to double 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 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) strategic capex (above depreciation) of HUF 61bn net of subsidies iii) continuity of management; iv) organic growth in top-line sales below food inflation rate (20% in 2022 and 7.5% p.a. afterwards); v) wage growth in Hungary close to inflation; vi) no major agribusiness-related event (e.g. drought, disease)[2]; 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 SaD/EBITDA stays below 3.5x.

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 2021 compliance certificate, all covenants were fulfilled with good headroom. Ongoing capex will negatively affect credit metrics.

We keep 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 of the central bank combined with state-subsidised financing opportunities has allowed Bonafarm Group to contract debt with an average interest burden of 1.3%, calculated for 2021 on the drawn exposure. 80% of committed financing facilities have fixed interest rates. Hence, we expect the increasing base rate in

[2] As per management information the draughts of 2022 in Hungary should have limited effect on crops production of Bonafarm Group

Hungary to have no major impact and the group interest rate to remain below 2%, which provides excellent debt protection.

Pick Szeged's 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 construction 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 help finance the HUF 39bn investment on the meat processing plant.

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.

Cash pooling is in place across Bonafarm Zrt. and its subsidiaries. MCS Slaughterhouse (not a group entity) was granted limited access to the cash pool in 2022. Therefore, Pick Szeged is a contributor to the cash pool, which may lower its liquidity moderately though not significantly.

Supplementary rating drivers

Neutral financial policy, coupled with discrepancies in disclosures

Group financial policy continues to aim for a strong expansion of core businesses (primarily Pick Szeged) and organic growth overall. The Pick Szeged investment focuses on strategic modernisation and the 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).

Long-term debt ratings

Senior unsecured debt rating: BB-

Pick Szeged Zrt. 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- rating on senior unsecured debt issued by Bonafarm Group, which is in line with the issuer rating. The debt category rating reflects the ranking of debt issued by Pick Szeged, which is below the HUF 32bn senior secured bank debt of Bonafarm Group. We expect an 'average' recovery for outstanding senior unsecured debt in a hypothetical default scenario in 2024.

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