Vasútvill Kft.
Hungary, Construction

SCOPE BB- STABLE

Corporate profile

Vasútvill Kft., headquartered in Budapest, is the largest company in Hungary's railway overhead lines construction segment. Its core business includes the construction, reconstruction, maintenance and transformation of railway electrical overhead lines, covering the whole business chain in the railway segment. With nearly 200 employees, the company has been involved in most of the major railway electrification projects in Hungary and, together with its legal predecessors, has been present in the Hungarian market for over 70 years.

Key metrics

			Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/Scope-adjusted interest cover (x)	729.8x	121.9x	15.1x	12.2x	6.7x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	Net cash	Net cash	Net cash	Net cash	3.1x
Scope-adjusted FFO/SaD	Net cash	Net cash	Net cash	Net cash	27%
Scope-adjusted free operating cash flows FOCF/SaD	Net cash	Net cash	Net cash	Net cash	6%

Rating rationale

Scope Ratings GmbH (Scope) has today affirmed its BB-/Stable issuer rating on Vasútvill Kft.

While Vasútvill's operational construction activities have not been interrupted by the impact of Covid-19 on the economy, the company's revenues decreased by 12.4% in 2020 compared to the previous year. The crisis has impacted the construction industry as it has led to delays in public procurements and private tenders. This resulted in a weaker backlog of projects, totalling HUF 22bn as of May 2021 and equating 1.8x revenues (HUF 32bn in May 2020). Profitability, as measured by the Scope-adjusted EBITDA margin, was also below the previous year's margins and below our forecast (down to 16% in FY 2020 from 19% in FY 2019). We expect profitability to deteriorate as the company has signed projects together with its strategic partners, Homlok Zrt. and R-Kord Kft., in which it will have the role of subcontractor. This role will reduce Vasútvill's achievable profit margin for the next few years. We foresee profitability remaining slightly below 10%. This negatively impacts the company's profitability score and translates into a weaker business risk profile.

Vasútvill's financial risk profile benefits from a conservative debt strategy, as evidenced by its very low debt levels up to 2020. In 2020, the company announced the issuance of a HUF 8bn bond. At the end of 2020, however, it reviewed its business plan and decided to reduce the issuance to a HUF 3bn senior unsecured bond to finance net working capital requirements. Although financial debt rose after the bond emission, the increase was less than expected. Vasútvill's unrestricted cash and cash equivalents currently exceed its limited financial debt, which results in negative Scope-adjusted debt and, ultimately, in strong credit ratios for the next few years. However, as potential expansion remains part of Vasútvill's business plan – likely to be financed via a new bond issuance – the company's present net cash position is of a temporary nature in our view.

Ratings & Outlook

Corporate ratings	BB-/Stable
Senior unsecured rating	BB-

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Related Methodology

Corporate Rating Methodology: July 2021

Rating Methodology European Construction Corporates January 2021

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In addition, we note the large dividend payments in the three last years (HUF 2.2bn in FY 2020), which the company forecasts will continue. Although these are not implemented as an established policy, we see the practice as an aggressive financial policy because it erodes cash flow generation and will not be supportive if profitability declines.

Outlook and rating change drivers

The Outlook for Vasútvill remains Stable despite the expected decrease in profitability, as measured by the Scope-adjusted EBITDA margin. We continue to expect the company's present net cash position to be temporary – as management returns to its initial aim of making acquisitions in the medium term. However, our base case still assumes that leverage will not exceed 3.5x in this event.

A positive rating action is unlikely but could be warranted if the company achieves substantial growth, affording better geographical and customer diversification, with the Scope-adjusted EBITDA margin recovering to significantly above 10% on a sustained basis, as a potential consequence of new orders, all combined with a more supportive dividend policy.

A negative rating action could occur if Vasútvill's leverage exceeds 3.5x on a sustained basis or its market position weakens, leading to lower revenues and profitability margins than projected in our rating case scenario i.e. significantly below 10%. The latter could occur if no additional projects are won or the company maintains an aggressive dividend policy.

Rating drivers

Positive rating drivers	Negative rating drivers
• Leader in its domestic niche market, having participated in 85% of the railway electrification projects in Hungary • Market position benefits from a business model that covers the whole business chain in the railway construction segment • 70 year track record and good network in domestic market • Low leverage consisting mainly of financial leasing, used to finance machinery acquisitions	• Small-scale construction company in a European context, with a lack of geographic and segment diversification, somewhat mitigated by the company's strong position in a niche market • Concentrated customer portfolio and dependence on public sector tenders • Weak diversification across geographies, with activities focused on Hungary • Relatively short and concentrated contracted backlog provides limited visibility on future revenues (top three projects account for 71% of backlog revenues) • Working capital under pressure following the completion of contracted work and reduction of advanced payments from clients

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Substantial growth affording better diversification (geographies and customers) while recovering profitability above 10%, combined with a more supportive dividend policy	• Leverage exceeding 3.5x on a sustained basis or weaker market position, leading to lower profitability margins (significantly below 10%) and weaker cash flow generation, due to no additional projects won and aggressive dividend policy

Financial overview

			Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Scope-adjusted EBITDA/Scope-adjusted interest cover (x)	729.8x	121.9x	15.1x	12.2x	6.7x
Scope-adjusted debt (SaD)/SaEBITDA (x)	Net cash	Net cash	Net cash	Net cash	3.1x
Scope-adjusted funds from operations/SaD (%)	Net cash	Net cash	Net cash	Net cash	27%
Scope-adjusted free operating cash flow/SaD (%)	Net cash	Net cash	Net cash	Net cash	6%
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	2,708.1	2,017.4	1,561.2	1,237.2	680.7
less: disposal gains from fixed assets included in EBITDA	0.4	-24.5	0.0	0.0	0.0
Others	0.0	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	2,708.5	1,992.9	1,561.2	1,237.2	680.7
Scope funds from operations in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Scope-adjusted EBITDA	2,708.5	1,992.9	1,561.2	1,237.2	680.7
less: cash interest as per cash flow statement	-3.7	-16.4	-103.6	-101.4	-101.6
less: cash tax paid as per cash flow statement	-331.5	-200.0	-99.4	-64.8	-10.9
Scope funds from operations	2,373.3	1,776.5	1,358.1	1,071.1	568.2
Scope-adjusted debt in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Interest-bearing debt	119.8	890.2	3,681.0	3,569.0	3,629.0
Subordinated liabilities	0.0	0.0	0.0	0.0	0.0
Cash equivalent	-5,271.8	-3,734.5	-3,000.0	-3,000.0	-1,000.0
Cash	-1,556.1	-311.7	-2,263.7	-770.7	-598.7
Off-balance sheet debt	86.0	73.0	73.0	73.0	73.0
Scope-adjusted debt	-6,622.1	-3,083.0	-1,509.7	-128.7	2,103.3

Business risk profile: B+

Industry risk: BB

Vasútvill's activities are concentrated in the civil engineering segment, including the construction, renovation and reconstruction of 25 kV, 50 Hz single-phase electrical overhead lines. This is a field in which the company has an extensive professional track record. Its activities also include the maintenance and renovation of railway tracks, thus covering the full spectrum of services in this niche market.

We consider the construction industry to be highly cyclical overall, with medium barriers to entry and low/medium substitution risk.

Small market player both in a European context and domestically

With only HUF 12.4bn in revenues and HUF 2.0bn in Scope-adjusted EBITDA in 2020, Vasútvill is a small construction company both in a European context and in Hungary. Limited size is a negative rating driver because it implies greater sensitivity to unforeseen shocks, greater cash flow volatility and limited economies of scale.

Vasútvill's revenues were 12.4% lower in 2020 than in the previous year and were also slightly below our forecast (- 5%). Nonetheless, the company managed to continue its operational construction activities uninterrupted, despite the impact of Covid-19 on the economy. Revenue generation in the year was mainly supported by Vasútvill's core project, the electrification of the 55 km line section between Szabadbattyán and Balatonfüred, which was completed on time in spite of the pandemic.

We believe that Vasútvill's revenue generation will be protected in the next couple of years by its backlog and focus on a niche market. Vasútvill benefits from its specialisation in one specific market, railway electrical overhead line construction, in which it has a long track record of over 70 years. The company and its legal predecessors have participated in practically all major electrification and renovation projects for the Hungarian railway network. Working as a contractor or subcontractor, the company has built more than 2,500 km of railway overhead lines of Hungary's approx. 3,100 km of electrified railway lines. This contribution has provided Vasútvill with an estimated market share of 75%. This niche market has significant potential as only 41% of the total railway network in Hungary is electrified, below the European Union average of 53.7%. The Hungarian national goal is to have 3,400 km electrified by 2025 (45% of the total network). Some other international initiatives, like the Budapest-Belgrade railway, could also provide a market for Vasútvill.

Weak diversification across geographies with a portfolio focused on Hungary

Geographical diversification is limited, with a strong foothold in Hungary. While this focus has supported the company's positioning on its domestic market, it also creates full exposure to the macroeconomic environment of one region. This is compounded by Vasútvill's focus on the construction segment, a cyclical industry in which market downturns tend to affect revenues and earnings.

Activities focused on one segment

Vasútvill's diversification across business segments is limited. Although it covers the full spectrum of activities in the segment, including the design, construction, maintenance, renovation and transformation of railway electrical overhead lines, all of this activity is fully related to one end-market: railway line construction.

Concentrated customer structure, with some long-term customers in the portfolio

Vasútvill's limited size results in high customer concentration as only very few projects can be executed simultaneously (13 projects in 2020). This means both profitability and cash flow from operations can be greatly affected by the failure of one project. Further, as Vasútvill's activities are concentrated in one niche market, the company is reliant on the development of this one segment, which is mostly dependent on government demand and strategy.

The company has a strong relationship with the Nemzeti Infrastruktúra Fejlesztő Zrt. (National Infrastructure Development in Hungary), the Magyar Államvasutak Zrt

(Hungarian State Railways) and the Györ-Sopron-Ebenfurth Railway (Hungarian-Austrian railway company), the main entities related to the development of transport projects and the principal railway operators in Hungary.

Relatively concentrated backlog

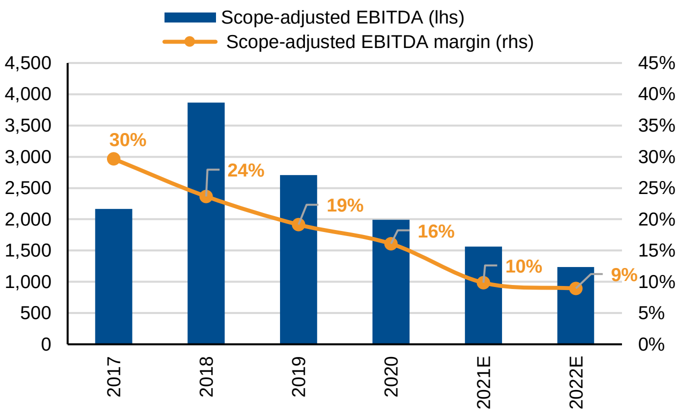
Vasútvill's backlog is concentrated, with the top three projects accounting for 71% of future contracted revenues. The largest project in the pipeline (28%) is the upgrade of the North Balaton railway. Six other projects account for 68% of the backlog, while smaller projects make up the remainder. This concentration bears the risk of significant cash flow volatility if projects are delayed or there are cost overruns.

Shorter backlog, still concentrated on a limited number of projects

The crisis has impacted the construction industry as it has led to delays in public procurements and private tenders. This has resulted in a weaker backlog of projects, totalling HUF 22bn[1] as of May 2021 compared to HUF 32bn in May 2020 and equating 1.8x 2020 revenues (2.2x in the previous year). This short-term backlog provides only limited visibility on future cash flows.

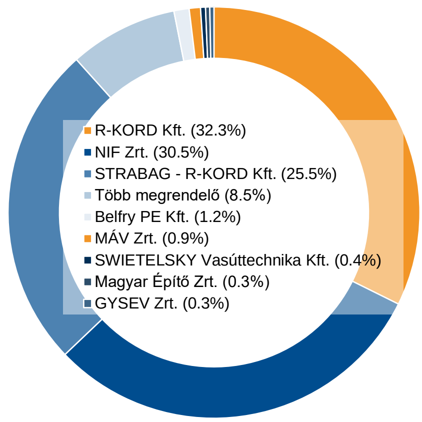
Nevertheless, Vasútvill may be able to obtain further projects in coming tender processes, as only 41% of the railway lines in Hungary are electrified. However, this is subject to the EU funding programme and government prioritisation of the goal of electrifying 45%-50% of the railway network by 2025.

Figure 1: EBTIDA and EBITDA margin



Source: Scope estimates

Figure 2: Backlog by customer



Source: Scope estimates

Profitability is weaker but still above industry average

Profitability, as measured by the Scope-adjusted EBITDA margin, was below the previous year's margins and below our forecast (down to 16% in FY 2020 from 19% in FY 2019).

We expect profitability to deteriorate as the company has signed projects (about 70% of the contracted pipeline) together with its strategic partner, Homlok Zrt., in which it will have the role of subcontractor. This role will reduce Vasútvill's achievable profit margin for the next few years. We foresee profitability remaining slightly below 10% going forward. This is above that of other construction peers but will leave Vasútvill less room to compete if other players enter the market. The company's profitability score is impacted by the medium-term trend of deteriorating margins, which translates into a weaker business risk profile.

Financial risk profile: BB

Moderate debt protection metrics despite debt increase in 2021

Vasútvill has had relatively little financial debt in the past, keeping interest expenses low. This has resulted in a strong Scope-adjusted EBITDA interest coverage ratio in the years prior to 2020. Financial costs will rise following the HUF 3bn bond issued in 2021 (3%

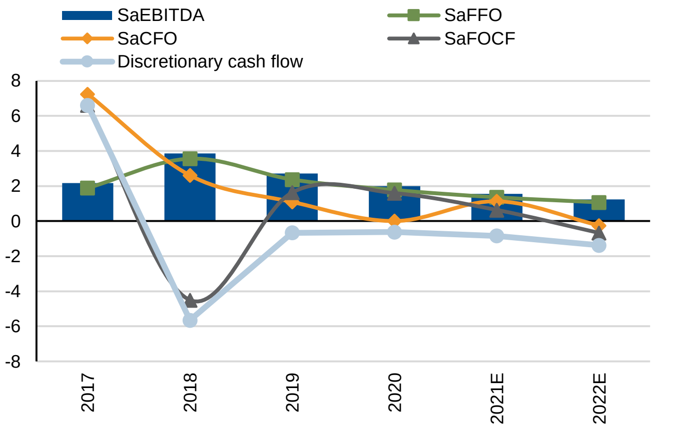
[1] Signed projects. Including other expected projects Backlog amounts HUF24.7bn.

coupon), but we expect debt protection to remain strong, based on the company's backlog up to 2022. There will be some uncertainty in 2023 once the backlog dries up.

Weakening free operating cash flows from 2020 on

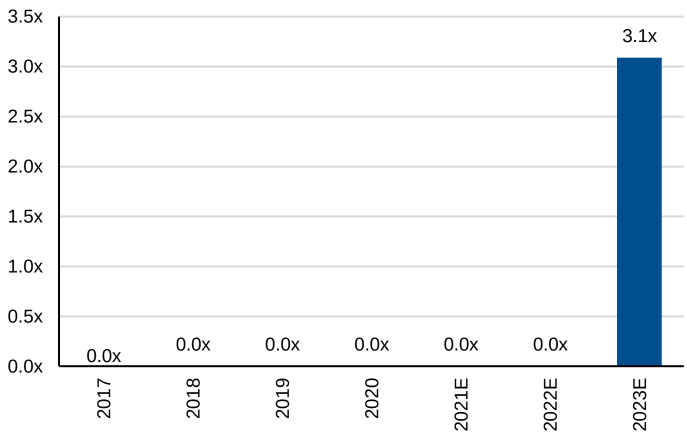
We expect stable and positive funds from operations in the next few years, based on Vasútvill's backlog. For the next few years, operational cash flows will be under pressure due to a strong expected increase in working capital requirements, driving Scope-adjusted cash flow from operations into negative territory. In the past, infrastructure development projects were implemented in a very favourable financing context, as the main contractor was entitled to a 50% advance immediately after signing the construction contract, with appropriate advance repayment guarantees. However, it is not certain that these conditions will be maintained for Vasútvill's future projects. A significant part of the advances received by the company were related to projects in which Vasútvill was the main contractor in a consortium. For newly signed projects, the company will participate as a subcontractor and will have less opportunity to obtain advances through the main contractors. To counterbalance this, Vasútvill plans to use HUF 3bn as reserves to cover any potential working capital requirements. In addition, we expect discretionary cash flow, mainly dividends, to squeeze the company's cash flow.

Figure 3: Cash flows (HUF bn)



Source: Scope estimates
Sa = Scope-adjusted

Figure 4: Leverage (SaD/EBITDA)



Source: Scope

Potential growth at the expense of increase in leverage

Vasútvill's debt strategy has been prudent, evidenced by its very low debt levels (net cash as at December 2020). In Q1 2021, the company issued a HUF 3bn senior unsecured bond under the MNB Bond Funding for Growth Scheme. Other than that, debt is mainly composed of financial leasing used to finance the acquisitions of production machines (HUF 780m by the end of 2020). The company intends to add further machinery in the next three years under a similar structure.

In the summer of 2020, the company announced the issuance of a HUF 8bn bond to finance its expansion plans via the acquisition of smaller players (HUF 5bn) and also to finance net working capital (HUF 3bn), which was incorporated into our rating case. By the end of 2020, Vasútvill had reviewed its business plan and decided to reduce the issuance to a HUF 3bn senior unsecured bond to finance net working capital requirements. Although financial debt rose after the HUF 3bn bond emission, the increase was less than expected. Vasútvill's unrestricted cash and cash equivalents currently exceed its limited financial debt, which results in negative Scope-adjusted debt and, ultimately, in strong credit ratios for the next few years. However, as potential expansion remains part of Vasútvill's business plan – likely to be financed via a new bond issuance – the company's present net cash position is of a temporary nature in our view.

Adequate liquidity

Liquidity is adequate and benefits from the company's conservative, back-loaded debt maturity profile, with no significant amount due in the coming years. The company has financial leases implying a yearly amortisation of approx. HUF 409m in 2021 and HUF 40m from 2022 on. Given the long maturity of the prospective MNB bond, upcoming short-term maturities are likely to be manageable for the foreseeable future. We anticipate that Vasútvill's low short-term debt levels will be maintained going forward, however, the agency does not see as sustainable the company's net cash position in the medium term.

Figure 5: Liquidity

in HUF m	2020	2021E
Short-term debt (t-1)	0	0.0
Unrestricted cash (t-1)	312	2,263.7
Open committed credit lines (t-1)	0	0.0
Free operating cash flow (t)[2]	631	-675.7
Coverage	No short-term debt	3.4x

Source: Scope estimates

Corporate governance

Management expects the shareholders to set the dividend distribution on a year-by-year basis, according to the company's results and needs.

We note the large dividend payments in the three last years (HUF 2.2bn in FY 2020), which the company forecasts will continue. While they are not implemented as an established policy, we see this practice as an aggressive financial policy as it erodes cash flow generation and will not be supportive if profitability declines.

Long-term and short-term debt ratings

Senior unsecured debt: BB-

Vasútvill issued a HUF 3bn senior unsecured corporate bond (ISIN HU0000360151) in Q1 2021, to partially finance future working capital requirements. The bond terms include amortisation of 20% yearly from 2026 until maturity, a fixed annual coupon and a 10-year tenor.

Our recovery analysis is based on a hypothetical default scenario in 2022, factoring in Vasútvill's liquidation value and assuming outstanding senior unsecured debt of HUF 3bn. We expect an above-average recovery for Vasútvill's senior unsecured debt, and therefore affirm the debt class rating of BB- in line with the issuer rating.

[2] We exclude discretionary expansion capex from our liquidity calculation, as such investments are only made if external financing is available.

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