1 February 2021 Corporates

West Hungaria Bau Kft.
Hungary, Construction

SCOPE B+ STABLE

Corporate profile

West Hungaria Bau Kft. (WHB) is one of the leading Hungarian construction companies, established in 1997. It is privately owned by its management, employs around 700 people and generated HUF 50bn of revenue in 2018. WHB's heritage and location of its headquarters is Györ, but it performs construction work all over Hungary. It is predominantly involved in the construction and maintenance of buildings, monuments and sport facilities, with minor activities including in-house profile manufacturing and maintenance work at the Paks nuclear plant.

Key metrics

			Scope estimates		
Scope credit ratios	2018	2019	2020F	2021F	2022F
EBITDA/interest cover (x)	n/a	n/a	n/a	28.2x	7.3x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	net cash	0.7x	3.1x
Scope-adjusted funds from operations/SaD	net cash	net cash	net cash	134%	33%
Free operating cash flow/SaD	net cash	net cash	net cash	-125%	-20%

Rating rationale

Scope has affirmed the B+/Stable issuer rating of West Hungaria Bau Kft. and the B+ instrument rating for its senior unsecured debt. The Outlook is Stable.

WHB's business was impacted negatively at the beginning of the Covid-19 crisis in 2020 by material shortages, but those were quickly resolved and the company gained traction on the back of the health crisis. WHB received a contract for a container hospital, boosting revenues above its own expectations. In addition, it signed and fulfilled a large contract to expand prison capacity in Hungary, which was required of the Hungarian state to comply with EU prison regulations and avoid payment sanctions. Apart from minor extraordinary expenses related to protective gear (masks, disinfectants), the company's costs were not affected by the crisis. WHB also did not have to use the credit moratorium or apply for employee wage subsidies. As a result, the company ended 2020 with strong operational performance, with construction-related revenues forecasted at HUF 78bn (versus our expectations of HUF 62bn) and EBITDA at HUF 12.8bn (versus the expected HUF 4bn). WHB, while pleased with the result, cautioned that the achieved margin is unsustainable, distorted by the delayed recognition of revenues from previous years.

During the year, WHB also expanded a maintenance facility at the Paks Industrial Park; previously the company had leased a facility and equipment. This is in light of ongoing maintenance contracts and expected new contracts with Paks2.

The company delayed its plans to fully acquire and control a multifunctional shopping centre and start its refurbishment in 2020, with acquisition now foreseen by mid-2021. Conditional to this purchase is the issuance of a HUF 10bn (roughly EUR 27m) bond in H2 2021 under the Hungarian National Bank's Bond Funding for Growth Scheme, with an expected coupon of 3% and a maturity of 10 years, amortising after five years with equal annual payments. Regarding the acquisition, we foresee a capex need of HUF 6bn for 2021 and HUF 4bn for 2022, which will lead to negative free operating cash flow.

Ratings & Outlook

Corporate ratings	B+/Stable
Senior unsecured rating	B+

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Related Methodologies

Corporate Rating Methodology, February 2020

Rating Methodology European Construction Corporates January 2021

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The capex programme comes at a time when the company faces a short backlog that covers only 2021, during which we estimate revenues of HUF 66bn followed by HUF 45bn in 2022. EBITDA will follow suit with HUF 5bn in 2021 and HUF 2.5bn in 2022.

Outlook and rating-change drivers

The Outlook for WHB is Stable and incorporates our view of the company's high transformation risk in 2021, when its government contracts will be completed and need to be replaced with new contracts not known of as of today. Thus, we anticipate a strong decline in Scope-adjusted EBITDA in 2022 to HUF 2.5bn, leading to weakening credit metrics with a Scope-adjusted debt (SaD)/EBITDA ratio of around 3.1x. Furthermore, the Outlook incorporates a successful placement of a HUF 10bn bond in H2 2021 to finance the acquisition, related costs and the refurbishment of a multifunction complex in western Hungary. The project should benefit recurring EBITDA in the medium term but will result in significant capex and opex in the short term. Additionally, we expect dividend payouts to be in line with current covenants, at a maximum of 50% of net operating income.

A positive rating action is remote but may be warranted if the company can increase visibility on revenues beyond the next 12 months, helping to keep SaD/EBITDA below 2.5x. This could be driven by i) an improving order backlog, benefitting from a higher granularity of customers and more complex projects extending respective execution periods; and ii) a successful revamp of the multifunctional complex that supports cash flow beyond our current expectations.

A negative rating action could occur if SaD/EBITDA increases over 3.5x on a sustained basis or if liquidity worsens. This could be a function of adverse operational developments with reduced profitability and cash flows, or dividend payouts that are higher than company policy. The latter could happen if i) customers delay payments significantly; ii) the company becomes exposed to the non-recoverable cost overruns of its projects, or iii) guarantees are drawn.

Rating drivers

Positive rating drivers	Negative rating drivers
• Historically above-average profitability, somewhat weakened by the lower margins expected in a downturn cycle • Adequate liquidity, with limited short-term maturities • Domestic market position that translates into market visibility and moderate access to third-party capital and guarantees	• Small-scale construction company in European context with lack of geographic and segment diversification, somewhat mitigated by its relatively strong fourth position in the domestic market • Concentration issues in its backlog (top three account for 48%; top 10 for 74%), somewhat mitigated by the investment grade counterparties (Republic of Hungary) • Recent dependency on government contracts that will soon end and leave a large gap that will be difficult to fill • Exposure to overheated Hungarian construction industry • Large upcoming capex programme, which will lead to very negative cash flows

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Increased visibility on revenues beyond the next 12 months, helping to keep SaD to Scope-adjusted EBITDA below 2.5x	• Increased leverage, i.e. SaD to Scope-adjusted EBITDA sustained above 3.5x • Worsening of liquidity due to, for example, delayed customer payments or cost overruns

Financial overview

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA/interest cover (x)	n/a	n/a	n/a	28.2x	7.3x
Scope-adjusted debt (SaD)/EBITDA	Net cash	Net cash	Net cash	0.7x	3.1x
Scope-adjusted funds from operations/SaD	Net cash	Net cash	Net cash	134%	33%
Free operating cash flow/SaD	Net cash	Net cash	Net cash	-125%	-20%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA	7,075	4,029	12,850	5,082	2,543
Operating lease payments in respective year	0	0	0	0	0
Other	0	0	0	0	0
Scope-adjusted EBITDA	7,075	4,029	12,850	5,082	2,543
Scope-adjusted funds from operations in HUF m	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA	7,075	4,029	12,850	5,082	2,543
less: (net) cash interest as per cash flow statement	72	97	97	-165	-332
less: cash tax paid as per cash flow statement	-515	-390	-1,048	-479	-226
add: depreciation component, operating leases	-23	-19	-15	-15	-15
Add: dividends from shareholdings	800	650	350	650	650
Scope-adjusted funds from operations	7,409	4,367	12,233	5,073	2,619
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020F**	**2021F**	**2022F**
Reported gross financial debt	709	2,888	4,115	12,422	12,422
less: hybrid bonds	0	0	0	0	0
less: cash and cash equivalents	-7,473	-14,278	-14,832	-13,434	-9,297
add: cash not accessible	2,771	2,771	4,128	4,128	4,128
add: pension adjustment	0	0	0	0	0
add: operating lease obligations, off-balance-sheet debt	1,524	1,114	660	660	660
Other	0	0	0	0	0
Scope-adjusted debt	-2,469	-7,506	-5,930	3,776	7,913

Business risk profile: B

Industry risk: B

While the construction industry is often associated with cyclical features when compared to industries with inelastic demand patterns, these cycles vary depending on the individual business model. We incorporate exposures to economic trends that affect the downside volatility of cash flows. Downside volatility can arise from either i) volume risks from a high exposure to buildings, industrial construction and a large share of public/government customers; and ii) risks from price fluctuations on materials, labour and energy. We view the overall construction industry's cyclicality to be high. However, with a large share of concession-related and service business, companies could lower their exposure to cyclicality, thus reducing industry risk.

Cyclicality (high)

Market entry barriers (low)

We believe the construction sector has low market entry barriers as initial investments are relatively low and proprietary technologies are not needed to enter local markets. This applies in particular to the building segment.

Substitution risk (high)

Along with entry barriers for potential new competitors, the degree of substitution risks from existing competitors also depends on a constructor's segment exposure. However, substitution risk is generally high as the companies do not need specific technologies for delivering the vast majority of project types. In addition, regulations for government projects in Europe enable competition and allow for substitution.

Figure 1: Industry risk assessment: European construction corporates

Cyclicality \ Barriers to entry	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 player in a European context but top five in Hungary's fragmented market

WHB is a relatively small player in the European construction landscape with HUF 65bn (EUR 200m) of revenues and HUF 4bn (EUR 13m) of Scope-adjusted EBITDA in 2019. Within its home market of Hungary, the company is well-established and reached a market share of 2.3% (2018), which puts it fourth after Market, Zalai and Strabag. Reaching a top five position despite a relatively low market share indicates the highly fragmented and competitive Hungarian construction market, with over 56,000 companies, according to the European Construction Sector Observatory.

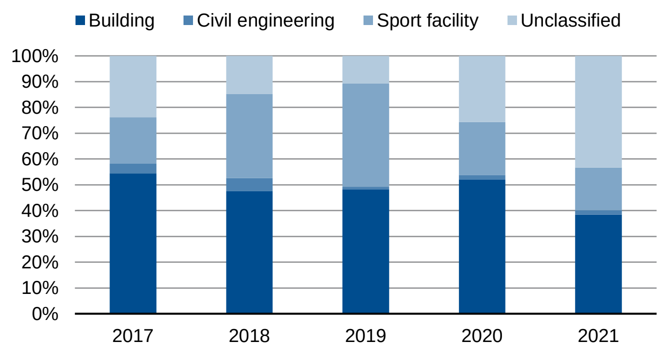
WHB grew strongly during 2016-19 – as did the construction market in Hungary as a whole –, more than doubling revenues and tripling EBITDA based on strong organic but also inorganic growth (e.g. acquiring 50% of Magyar to take part in building the Puskás Aréna in Budapest). WHB's top five status confers it market visibility as well as moderate access to third-party capital and guarantees. Both factors should help to generate business going forward, especially given the need of the whole construction sector to refocus away from EU-sponsored construction and civil engineering.

Limited geographical diversification exposes WHB to Hungary's construction cycle

WHB's geographical diversification is rather limited, with predominantly domestic activities. The recent growth in the Hungarian construction market has been deemed unsustainable by market observers, who cited 29% and 22% of growth for 2017 and 2018, respectively, with contract portfolios having dried up in late 2018 and decreasing in number in 2019. In 2020, the construction industry was highly impacted by Covid-19, but managed to remain open despite building material shortages early in the crisis, and the rest of the year appeared to be business as usual. That year, Hungary announced a programme to stimulate demand in sectors including construction and tourism. The government intends to increase public spending on hospital renovations and road construction – areas also potentially eligible for EU funding. Given the industry's cyclicality, WHB's revenues and margins are likely to come under pressure in a downturn when the stimulus fades out because it lacks an exposure to dampen this effect.

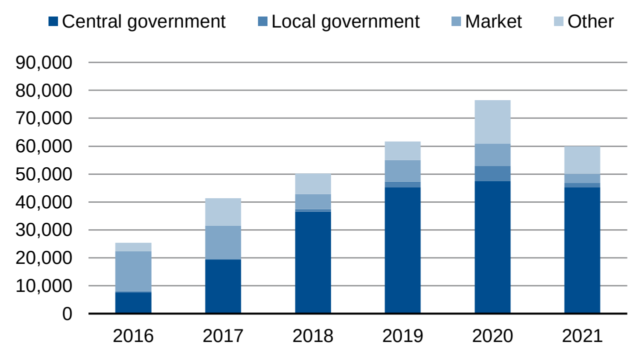
Segment diversification is also rather limited, as WHB is predominantly active in two types of projects: buildings and sport facilities. WHB's building segment encompasses a vast variety – among them, offices, residential, halls, garages, monuments, and educational facilities – but do not provide diversification as all are structurally the same but with different end-uses. The second segment, sport facilities, does provide diversification due to its civil engineering features and requirement for technical skills. The actual civil engineering part is negligible and WHB has no concession work.

Figure 2: Project diversification by segment (%)



Source: WHB, Scope estimates

Figure 3: Project diversification by customer (HUF m)



Source: WHB, Scope estimates

Customer diversification: from free market to government projects and eventually back again

Customer diversification has changed over time. Historically, WHB was exposed mainly to the 'free market' but has recently become almost fully dependent on central government projects. During 2016-19, the use of EU funds channelled via central government into the construction industry almost tripled, from roughly EUR 900m to EUR 2,250m. Due to the end of the EU funds cycle this source of investment is projected to decrease by 83% until 2022 (to around EUR 400m; source: MNB).

In 2019, WHB's exposure of 73% to central and local governments meant its customer profile was up for a drastic change, with completed government contracts having to be replaced with market-based projects to keep the top line stable as targeted. Management saw opportunities to fill the gap with market-based projects that have been delayed due to the overheated construction cycle (driven by government-funded projects). Government contracts again dominated projects in 2020 thanks to stimulus packages, and the dependency on such projects increased even further: current contracted work outside local/central government projects is only 6% of the backlog.

Concentrated backlog, somewhat mitigated by the investment grade counterparties

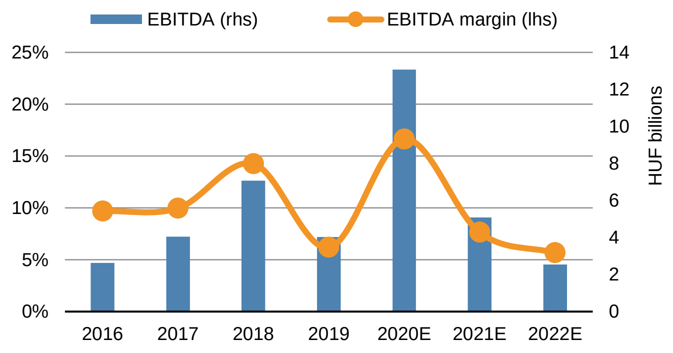
WHB's backlog is rather concentrated, with the top three projects representing 48% of revenue backlog as of January 2021. Two-thirds of the backlog relate to just six projects while the top 10 represent 74% of contracted revenues. Seven of the top 10 projects are funded by central government (Republic of Hungary, rated BBB+ by Scope), which somewhat mitigates the concentration; one is a market project; and two stem from a local government. Notable in this context is the very short backlog, which covers only 2021 and leaves revenue potential of around HUF 4bn thereafter – representing only 10% of Scope's predicted revenue for 2021.

Above-average margins recently; reversion expected in the future

WHB's historical profitability, at 10% or above, has been in the upper range of the construction industry's (5%-10%). The low profitability of 6% in 2019 was compensated for in 2020 with 16.5% – management cited delayed revenue recognition of projects from previous years as the reason, with the true underlying profitability lying somewhere between the two. Going forward, we expect a slightly lower adjusted margin of around 8% and highlight the uncertainty beyond the end of the backlog in late-2021 with government-sponsored contracts set to be completed.

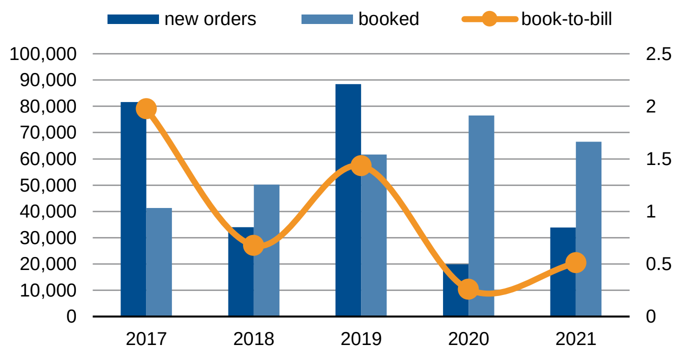
We assume profitability pressure to come from future non-contracted projects as the current stimulus comes to an end and WHB has to fill the gap with market-based orders. While labour and material costs are likely to be sticky at inflated levels, high competition for market-based projects will drive down revenues and, with it, profitability.

Figure 4: EBITDA and EBITDA margin



Source: WHB, Scope estimates

Figure 5: New orders, booked, and book-to-bill ratio



Source: WHB, Scope estimates

Backlog of 1 years; volatile book-to-bill ratio

WHB's current order backlog of HUF 64bn as at January 2021 (HUF 106bn last year) covers around one year of revenues. This translates into almost full coverage with contracted orders for 2021 before the backlog dries up – the 2022 revenue forecast is so far only 10% contracted.

This is also visible in its book-to-bill ratio, which is quite volatile and fluctuates between 2x (very strong demand) and less than 1x (insufficient or weak demand).

Management-owned; no independent board

WHB's four private owners are also its top management, and no independent board provides an oversight function. This is exemplified by the HUF 2bn interest-free loan granted to one owner (partially repaid at year end 2019). While we understand the family-owned nature of the company, an improvement in corporate governance would be positive given its growth in scale. Regulatory and reputational risks are negative ESG factors. We believe that WHB's market position in recent years was gained through state tenders, which were secured thanks to the company's established credentials on projects with state-owned companies. The company is now highly dependent on state tenders, which accounted for around 90% of total revenues in 2020.

Financial risk profile: BB-

Our rating scenario assumes the following:

- Revenue growth of 21% in 2020 to HUF 78.6bn, shrinkage of -15% YoY to HUF 66.6bn in 2021 in line with current contracted backlog for 2021. For 2022 we do not foresee that the company can fill the large contract gap that will be left by current government contracts with market-based orders and estimate a 33% decline in revenues to HUF 44.9bn.
- Issuance of HUF 10bn (roughly EUR 27m) bond in H2 2021 under the Hungarian National Bank's Bond Funding for Growth Scheme, with an expected coupon of 3% and a maturity of 10 years, amortising after five years with equal annual payments. The bond proceeds will be used for the acquisition and refurbishment of a multifunctional shopping centre in western Hungary.

- Capital expenditure of around HUF 6bn in 2021 and HUF 4bn thereafter for the acquisition and refurbishment of the multifunctional shopping centre in addition to HUF 800m annually for WHB's core business.
- Dividend payouts of HUF 1.7bn in 2020, HUF 5bn in 2021 and HUF 2.5bn in 2022 as per company dividend policy and covenant restrictions.
- Restricted cash of currently HUF 4.1bn relating to cash pledged as collateral for banks to issue guarantees.

Strong interest coverage

As the company has little debt and grants inter-company loans to subsidiaries/affiliates, its interest income historically exceeded its limited interest expenses, rendering Scope's EBITDA interest coverage ratio meaningless. The company plans to issue a HUF 10bn bond with an estimated coupon of around 3% in H2 2021 while keeping around HUF 2bn in short-term interest-bearing debt (Scope estimate) and HUF 0.35bn in debt to an associated company. This will translate into a strong EBITDA interest coverage of 28x in 2021 and 7.3x in 2022.

Given the relatively high coverage despite its downward trend, we believe WHB will be able to meet its interest payment obligations in the period considered.

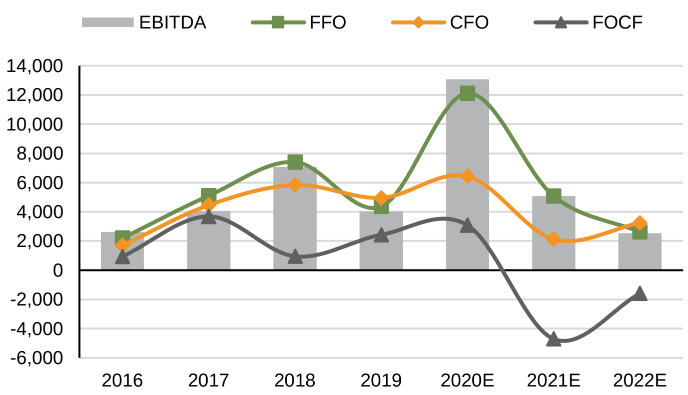
Historically good capex coverage…

WHB's cash flow generation has so far been sufficient to cover capital expenditure in addition to increasing its net cash position. Going forward the company plans to invest in one large project (also the reason for participating in the Bond Funding for Growth Scheme).

…one new project requiring external funding

This new project involves the acquisition, refurbishment and operation of a multifunction complex in western Hungary encompassing a mall, a hotel and a stadium. The project requires significant upfront capital expenditure while attached operating cash flows will be lagging and uncertain. Therefore, free operating cash flow (as shown in figure 6) will turn negative in the near-to-medium term, applying a heavy strain on the company's finances at a time of uncertainty due to the short backlog and the likely cooling of Hungary's construction industry fundamentals once stimulus runs out.

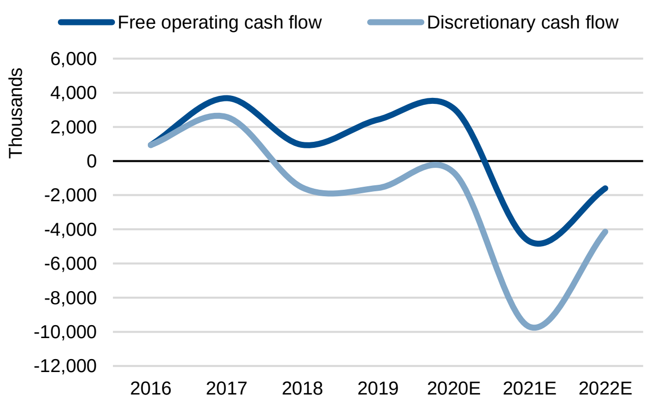
Figure 6: Cash flows[1] (excluding green-field spending)



[1]all are Scope-adjusted figures

Source: Scope estimates

Figure 7: Discretionary cash flows



Source: Scope

We add the planned dividend payments to arrive at discretionary cash flows, resulting in a HUF 9.7bn cash outflow in 2021 and a HUF 4.1bn outflow in 2022.

Heavily negative cash flows constrain the financial risk profile

The highly negative cash flows expected until revenues from this project contribute to operations constrain WHB's financial risk profile.

WHB historically had very little interest-bearing debt, resulting in a net cash position when assessing SaD. After its significant capex programme until YE 2022, we assume a SaD/EBITDA of 3.1x and an FFO/SaD of around 33%, which we foresee to further worsen if WHB cannot contract enough revenues to keep the top line at previous year's level.

Current dividend policy a pre-requisite for rating base case

WHB's dividend policy is currently restricted by bank debt covenants and ensures the smooth operation of the company and the maintenance of a liquidity buffer. An increase in dividends is planned, from HUF 1.7bn in 2020 to HUF 5bn in 2021, in line with covenants; we estimate a reduction to HUF 2.5bn in 2022. Our rating base case expects the continuation of the current dividend policy with the most restrictive covenant of a maximum 50% of net operating income (excluding write-ups and the like), even if bank debt are refinanced or covenants amended. In the upcoming two-year period, the company is engaging in one large debt-funded project that will drive free operating cash flow negative in the short run, rendering dividends to be funded with debt.

Liquidity

We consider WHB's liquidity to be adequate, in detail:

Figure 8: Liquidity

WHB (HUFm)	2019E	2020E
Short-term debt (t-1)	2,493	360
Unrestricted cash (t-1)	11,507	10,704
Open committed credit lines (t-1)	0.0	0.0
Free operating cash flow (t)[1]	3,077	-4,706
Coverage	**5.9x**	**16.7x**

Source: Scope

We judge the company's liquidity to be adequate, with unrestricted cash exceeding short-term debt even if free operating cash flow turns further negative. Given the long maturity of the prospective bond, upcoming short-term maturities are likely manageable for the foreseeable future.

Senior unsecured debt

The rated entity plans to issue a HUF 10bn senior unsecured corporate bond under the Hungarian National Bank's Bond Funding for Growth Scheme. The planned bond has a 3% coupon and is amortising after five years (equal annual payments) with a tenor until 2031. Proceeds from the bond are earmarked for financing the capex to acquire, refurbish and operate a multifunction complex in western Hungary encompassing a mall, a hotel and a stadium.

Senior unsecured debt: B+

Our recovery analysis is based on a hypothetical default scenario occurring at year-end 2022, in which we assume an outstanding senior unsecured bond debt of HUF 10bn in addition to the existing debt positions. We expect an 'average recovery' for the company's unsecured debt, resulting in a B+ rating for this debt class (the same as the issuer rating).

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

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