Duna Aszfalt Kft.
Hungary, Construction

SCOPE BB- STABLE

Corporate profile

Founded in 1996 and 100% owned by László Szíjj, Duna Aszfalt Kft. is one of the largest players in Hungarian road construction and renovation. Further business segments include the laying of utility lines, the construction of water and sewage treatment structures and bridge building. Duna Aszfalt has a strategic partnership agreement with Hódút Kft., another Hungarian road construction company. Moreover, Duna Aszfalt provides heavy equipment, and operates asphalt mixing plants, quarries, and emulsion production and laboratory facilities. Duna Aszfalt Kft. has around 480 full-time employees. For the business year 2018, Duna Aszfalt Kft. reported revenues of HUF 129.5bn (approx. EUR 405m) and EBITDA of HUF 22.3bn (approx. EUR 70m).

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	na	na	na	28.4x
Scope-adjusted debt (SaD)/EBITDA	3.6x	2.6x	2.2x	1.9x
Scope-adjusted FFO/SaD	27%	37%	42%	53%
Free operating cash flow (FOCF)/SaD	56%	27%	0%	22%

Rating rationale

Scope Ratings assigns a BB- first-time issuer rating to Duna Aszfalt Kft., with a Stable Outlook. The senior unsecured debt category is rated BB.

Duna Aszfalt's B rated business risk profile is held back by the company's focus on local industrial and civil engineering projects. We rate this construction industry segment B, given its comparatively high cyclicality and low entry barriers. In recent years, Duna Aszfalt has been successful in winning tenders for Hungarian motorway construction projects. The key projects delivered so far include the construction of a 23 km section of the M43 motorway, the Kecskemét northern bypass of national road 445 and the Nyíregyháza bypass of national road 348. This success has resulted in a marked jump in Duna Aszfalt's revenues over the last five years. In 2018, revenues hit a record level of around HUF 130bn and EBITDA of around HUF 21bn. However, Duna Aszfalt is still a relatively small-size construction company in European terms and a specialized player, given its strong focus on motorway construction projects in Hungary (around 60% of revenues in 2018). As a main contractor Duna Aszfalt competes with Strabag (Austria), Colas (France), Swietelsky (Austria) and EuroAszfalt (Hungary). The company's business risk profile is restrained by its limited geographical diversification. At present, Duna Aszfalt generates all of its revenues in Hungary. The company's very concentrated business model further weakens its business risk profile. We note that, with a share of more than 90% in total revenues, construction works dominate business activities. Within construction works, Duna Aszfalt has relatively high exposure to motorway construction, where it generated more than 60% of revenues in 2018.

Ratings & Outlook

Corporate ratings	BB-/Stable
Sen. unsecured rating	BB

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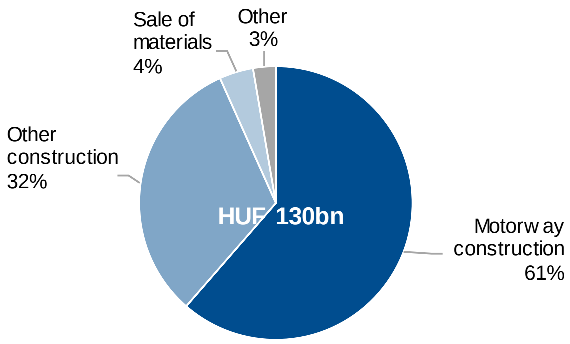
Related methodology

European Construction Corporates Methodology

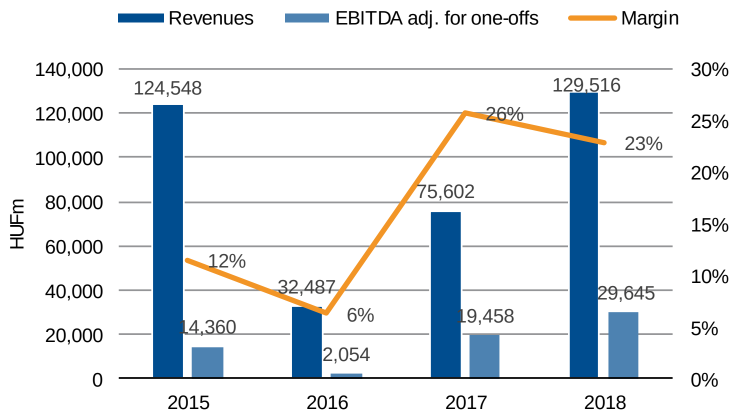
Corporate Rating Methodology

Figure 1: **Breakdown of revenues by segment 2018**



Source: Duna Aszfalt, Scope

Figure 2: **4Y trend in revenues and EBITDA**



Source: Duna Aszfalt, Scope

The company's business risk profile is further restrained by its dependency on state tenders: around 80% of Duna Aszfalt's revenues in 2018 were generated from Hungarian state-owned entities. It is worth mentioning that EU funds make up around 55% of public investments in Hungary. We view negatively the relatively short project length (three years on average), the low backlog-to-sales ratio (2x at year-end 2018) and low predictability for the period following the execution of the current backlog.

Profitability supports the company's business risk profile. Adjusted for the booking and release of provisions, the EBITDA margins in 2016, 2017 and 2018 were 6%, 26% and 23%, respectively. We note that before 2017, Duna Aszfalt's EBITDA margin of around 10% was significantly lower and comparable to sector peers (around 10% on average). Consequently, the sustainability of the current level of profitability is not certain. Having said that, given the order backlog at year-end 2018, which corresponds to 2x the company's revenues in 2018, the current margin level should be maintained for a while.

The outlook for road construction in Hungary is still solid. The Hungarian government plans to strengthen the country's position in logistics by spending HUF 2,500bn on the development of roads between 2016 and 2022, 55% of which will be paid for from the central budget and 45% from European Union funds. Half of this amount was already spent in 2016-2018. Some motorway infrastructure projects are currently in preparation. Given its good track record in winning new tenders, Duna Aszfalt should be able to secure a portion of these projects.

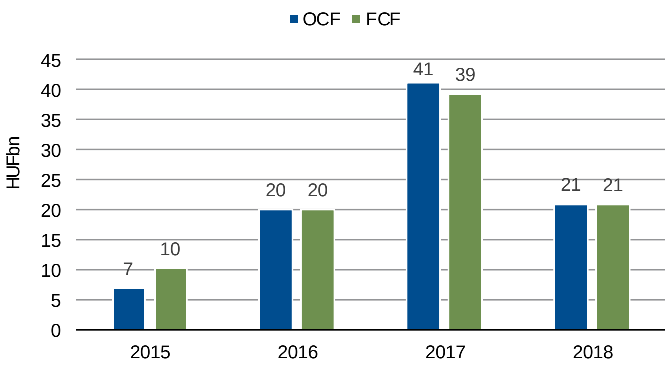
Having said that, given Hungary's dependence on EU funds and the current tensions between Hungary and the European Commission, there may be some doubts regarding the Hungarian government's ability to finance its plans. A dispute between Hungary and the European Commission about some EU-funded projects could delay payments from the EU. Nevertheless, due to the ongoing execution of the current order backlog, we forecast revenues of HUF 182bn and an EBITDA margin of around 22% for 2019F, corresponding to EBITDA of HUF 39bn. These numbers also contain effects from anticipated acquisitions. We expect planned acquisitions to dilute Duna Aszfalt's current EBITDA margin because we believe that the acquired margin will be lower. Having said that, the dilution effect should be relatively minor (around 200 bps) as the deals are expected to be small.

Duna Aszfalt's overall credit risk is strongly supported by its BB+ rated financial risk profile. Due to the considerable jump in EBITDA in 2017 and 2018 following the new state tenders for motorway projects won in 2016, the company's credit metrics improved. At year-end 2018, we calculate Scope-adjusted debt (SaD)/EBITDA of 2.6x (year-end 2017: 3.5x) and funds from operations (FFO)/SaD of 37% (year-end 2017: 27%). Cash flow metrics improved considerably in 2017 and 2018 in line with higher revenues and EBITDA. Operating cash flow in 2016 and 2017 was also positively impacted by large advance payments. The advance payments amounted to around HUF 73bn at year-end 2018, accounting for around 70% of total liabilities. Duna Aszfalt invested the cash in real estate investment fund securities and other assets. The total amount of such assets was HUF 46,4m at year-end 2018. Duna Aszfalt expects customer advances to run-off after the end of the current EU budget period. We have not included future advances in our rating assumptions.

We expect significantly higher FFO for 2019F due to the expected increase in the company's EBITDA. Having said that, we expect free cash flow to be around the zero line for 2019F due to the substantial anticipated reduction in advances.

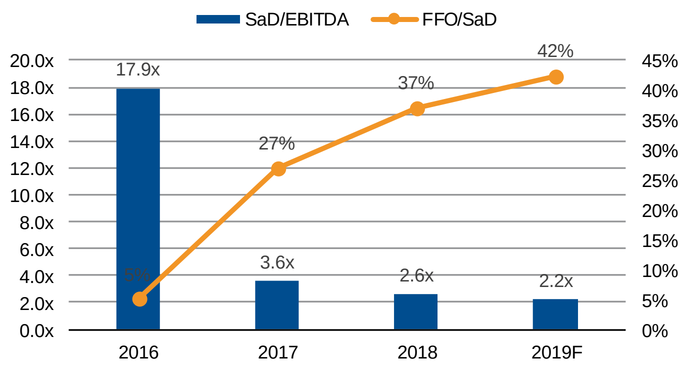
The company had no financial liabilities at year-end 2018. In order to calculate SaD, we made adjustments for: i) guarantees, we added 100% of performance and default guarantees; and ii) advances, given the expected reduction, we considered 100% of liabilities from advance payments. As a result, we calculate SaD of approx. HUF 77bn at end-December 2018. The increase by around HUF 7bn is largely explained by lower cash on balance due to the dividend payment of HUF 12bn in 2018. We expect the company's SaD to increase to around HUF 85bn at year-end 2019F because we believe the positive effects from the substantial anticipated increase in FFO will be outweighed by the negative effects from the expected reduction in advances, M&A and the dividend payment. Given our expectation of higher EBITDA, we expect SaD/EBITDA of around 2.5x at year-end 2019F.

Figure 4: **4Y trend in cash flow**



Source: Duna Aszfalt, Scope

Figure 5: **Key credit metrics 2016 to 2019F**



Source: Duna Aszfalt, Scope

Liquidity

We view Duna Aszfalt's liquidity and financial flexibility as better than adequate in accordance with our methodology to determine the liquidity of corporate issuers. This view is supported by the absence of financial liabilities at year-end 2018.

The company's cash sources at end-December 2018 comprised:

- Cash on balance of HUF 14.8bn. According to Duna Aszfalt, there are no limitations on cash uses
- Marketable securities of HUF 5.4bn. HUF 4.3bn is invested in real estate investment fund notes, while the remaining HUF 1bn is invested in listed Hungarian stocks

We expect proceeds of HUF 7bn from asset sales in 2020F.

We expect the following potential uses of liquidity in 2019F and 2020F:

- Payments for acquisitions of around HUF 30bn in 2019 and around HUF 10bn in 2020
- Expected dividend payments of HUF 13bn in 2019F and HUF 10bn in 2020F

Senior unsecured debt

Duna Aszfalt plans to issue HUF 30bn in unsecured corporate notes with a maturity of 10 years. We understood that the company does not plan to use bank debt any time soon, therefore the planned bond should be the only financial instrument to consider. Our recovery analysis is based on the liquidation value in a potential default scenario. Based on our recovery analysis performed on the year 2020F, we calculate a recovery rate of around 80% for senior unsecured debt. This leads us to rate the senior unsecured debt one notch above the issue rating.

Outlook

The Stable Outlook reflects our expectation that the company will successfully execute its currently profitable order backlog and that SaD/EBITDA will remain in a range of 2-3x.

We may upgrade our rating if Duna Aszfalt manages to diversify its order backlog, thus increasing predictability and lowering dependency on state orders and/or demonstrates its ability to generate SaD/EBITDA in a range of 2-3x with new tenders. A negative rating action could result if SaD/EBITDA moves above 3.5x on a sustained basis, due to less profitable new contracts for example.

Rating drivers

Positive rating drivers	Negative rating drivers
• Very solid profitability: adjusted for provisions, the EBITDA margins in 2017 and 2018 were 26% and 23%, respectively. Having said that, the sustainability of the current level of profitability is not certain. • Marked improvement in credit metrics due to the considerable jump in EBITDA in 2017 and 2018 following the new state tenders for motorway projects won in 2016 • Good recent track record in winning new orders	• Focus on local industrial and civil engineering projects, a construction industry segment with comparatively high cyclicality and low entry barriers • Low diversification: the company generates all of its revenues in Hungary; construction work dominates business activities (over 90% of total revenues); relatively high exposure to motorway construction (over 60% of revenues in 2018) • Dependency on state tenders: around 80% of Duna Aszfalt's revenues in 2018 were generated from Hungarian state-owned entities • Relatively short project length (three years on average), low backlog-to-sales ratio (2x at year-end 2018) and low visibility for the period after the execution of the current backlog • Uncertainty about the company's ability to maintain its current level of profitability and credit metrics with new contracts

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Diversification of order backlog and/or SaD/EBITDA in the range of 2-3x with new tenders	• SaD/EBITDA moving above 3.5x on a sustained basis; possibly due to less profitable new contracts

Financial overview

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	na	na	na	28.4x
SaD/EBITDA	3.6x	2.6x	2.2x	1.9x
Scope-adjusted FFO/SaD	27%	37%	42%	53%
FOCF/SaD	56%	27%	0%	22%
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	19,436	22,295	38,856	39,330
Operating lease payment in respective year	0	0	0	0
Other	22	7,350	0	0
Scope-adjusted EBITDA	19,458	29,645	38,856	34,119
Scope funds from operations in HUF m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	19,458	29,645	38,856	34,119
less: (net) cash interest as per cash flow statement	0	0	0	-1,200
less: pension interest	0	0	0	0
less: cash tax paid as per cash flow statement	-603	-967	-1,830	-2,469
add: depreciation component operating leases	0	0	0	0
Scope funds from operations	18,855	28,679	37,026	30,450
Scope-adjusted debt in HUF m	**2017**	**2018**	**2019F**	**2020F**
Reported gross financial debt	1	0	30,000	30,000
less: cash, cash equivalents	-37,011	-20,179	-8,857	-8,679
Cash not accessible	0	0	0	0
add: advances	81,468	73,364	40,000	20,000
add: guarantees	25,500	24,240	24,240	24,240
Scope-adjusted debt	69,958	77,424	85,383	65,561

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