2 March 2023 Corporates

Zalaco Sütőipari Zrt.
Hungary, Consumer Products

SCOPE B+ POSITIVE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022[1]**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	7.4x	15.1x	10.1x	11.4x
Scope-adjusted debt/EBITDA	4.6x	3.4x	3.0x	2.7x
Scope-adjusted funds from operations (FFO)/debt	18%	27%	29%	32%
Scope-adjusted free operating cash flow (FOCF)/debt	1%	-8%	3%	17%

Rating rationale

The issuer rating benefits from low underlying industry risk, solid profitability and low leverage. It is constrained by limited scale, high customer concentration and negative free operating cash flow. Zalaco's credit metrics might already justify a higher financial risk profile and/or issuer standalone rating, but we acknowledge the challenges that the company is facing from rising input prices and increasing utility costs, which could impact its operating performance. These challenges could potentially lead to volatility in the company's financials. Taking into consideration the operating environment and limited visibility, we have taken a conservative approach.

Outlook and rating-change drivers

The Positive Outlook reflects our expectation that Zalaco's Scope-adjusted debt to EBITDA ratio will remain below 3.5x and Scope-adjusted funds from operations/debt will stay above 20%. The Outlook assumes that the company can tackle inflation and keep its margins. We do not expect any M&A activity or a significant capex programme. The Positive rating outlook also reflects the successful transition towards a frozen products automated production line.

An Upgrade could be warranted if Scope-adjusted funds from operations/debt exceeds 20% on a sustained basis and Scope-adjusted debt/EBITDA consistently trends below 3.5x. A decrease in leverage may be achieved by an increase in profitability following the successful implementation of the company's operating optimisation strategy. An Upgrade will incorporate that company will be able to manage higher electricity and gas prices effectively and maintain its operations without any significant negative impact.

A negative rating action (i.e an Outlook change back to Stable from Positive) could be triggered by a failure to keep Scope-adjusted debt/EBITDA below 3.5x and Scope-adjusted funds from operations/debt above 20%. The further downside is deemed to be remote but could result from a deterioration in credit metrics, as indicated by Scope-adjusted funds from operations/debt of below 10% and Scope-adjusted debt/EBITDA of above 5.0x on a sustained basis. An increase in leverage could be triggered by an adverse operational development, leading to reduced profitability or the need for additional external financing for capital expenditure, M&A

Rating history

Date	Rating action	Issuer rating & Outlook
2 Mar 2023	Outlook change	B+/Positive
7 Mar 2022	Outlook change	B+/Stable
08 Apr 2021	Outlook change	B+/Positive

[1] Preliminary results - unaudited

Ratings & Outlook

Issuer	B+/Positive
Senior unsecured debt	BB-

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Related Methodologies and Related Research

General Corporate Rating Methodology; July 2022

Consumer Products Rating Methodology; November 2022

Sovereign and Public Sector rating report on Hungary; February 2023

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Bloomberg: RESP SCOP

Positive rating drivers	Negative rating drivers
• Operational sustainability following decades of partnerships with international value chains • Vertically integrated value chain and business operations • Relatively high profitability margins	• Cash flow cover remains under pressure due to significant capex spending and lease repayments • Limited diversification of the group outside Hungary • The inventory shrinkage and obsolete inventory costs remain at around 2% of sales (ESG factor: credit negative) • Highly concentrated customer base, mainly exposed to Lidl • Small scale compared to international peers

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted debt/EBITDA below 3.5x on a sustained basis • Scope-adjusted funds from operations/debt above 20% on a sustained basis	• Scope-adjusted debt/EBITDA above 5x on a sustained basis • Scope-adjusted funds from operations/debt below 10% on sustained basis

Corporate profile

Zalaco Sütőipari Zrt.'s core business is the production of bread and fresh bakery products. The Hungarian company has expanded its sales and production capacity and increased its product portfolio. It currently distributes nearly 400 bakery and confectionery products, with production plants established in Zalaegerszeg, Ajka and Sopron between 2014 and 2017. In addition, Zalaco operates around 50 of its own bakeries.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022[2]**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	9.0x	7.4x	15.1x	10.1x	11.4x	12.1x
Scope-adjusted debt/EBITDA	4.7x	4.6x	3.4x	3.0x	2.7x	2.6x
Scope-adjusted FFO/debt	19%	18%	27%	29%	32%	35%
Scope-adjusted FOCF/debt	-2%	1%	-8%	3%	17%	19%
Scope-adjusted EBITDA in HUF m						
EBITDA	1,080	1,354	1,875	2,047	2,303	2,487
Other items	157	155	178	195	205	205
Scope-adjusted EBITDA	**1,237**	**1,509**	**2,053**	**2,242**	**2,508**	**2,692**
FFO in HUF m						
EBITDA	1,080	1,354	1,875	2,047	2,303	2,487
less: (net) cash interest paid	-106	-170	-99	-181	-176	-176
less: cash tax paid per cash flow statement	-23	-28	-36	-55	-65	-76
add: depreciation component op leases	125	122	142	154	161	159
FFO	**1,076**	**1,278**	**1,882**	**1,965**	**2,224**	**2,394**
FOCF in HUF m						
Funds from operations	1,076	1,278	1,882	1,965	2,224	2,394
Change in working capital	-63	72	328	-357	-306	-334
Non-operating cash flow	198	134	254	220	220	220
less: capital expenditure (net)	-1,215	-1,294	-2,878	-1,500	-800	-800
less: operating lease payments	-125	-122	-142	-154	-161	-159
FOCF	**-128**	**69**	**-556**	**174**	**1,176**	**1,321**
Net cash interest paid in HUF m						
Net cash interest per cash flow statement	106	170	99	181	176	176
Change in other items	32	33	36	41	44	46
Net cash interest paid	**138**	**203**	**136**	**222**	**220**	**222**
Scope-adjusted debt in HUF m						
Reported gross financial debt	6,327	5,437	5,260	4,960	4,960	4,960
less: cash and cash equivalents	-2,000	0	0	0	0	0
Leasing adjustment	654	668	791	848	899	951
Guarantees	835	835	1,003	1,003	1,003	1,003
Scope-adjusted debt	**5,816**	**6,940**	**7,054**	**6,810**	**6,861**	**6,914**

[2] Preliminary results - unaudited

Table of Content

Environmental, social and governance (ESG) profile[3]

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)	
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)	
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)	
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	

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

Efficiencies

The cost of inventory shrinkage continues to be 2% of sales, leading to a 200-basis point reduction in gross margins. Additionally, the company heavily relies on electricity and gas suppliers, but this dependence may be alleviated with the introduction of a solar panel project that will provide an alternative source of electricity.

[3] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e. those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.

Business risk profile: B+

Credit-supportive industry risk profile: A

Zalaco's industry risk profile (assessed at A) continues to benefit from stable demand in the underlying non-durable consumer products industry, which has low cyclicality, medium barriers to entry and low substitution risk.

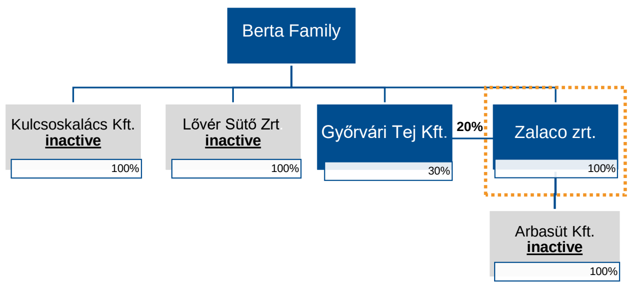
Leading player in Hungarian bakery market and

Zalaco's competitive positioning continues to benefit from its standing as a key national player in the bakery industry.

Limited size

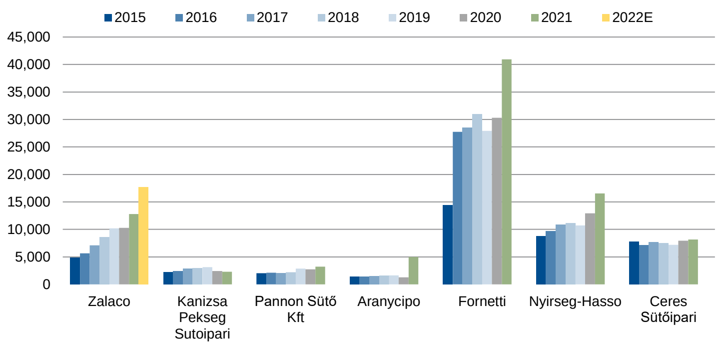
The group's market share is constrained by its small size (HUF 17.7bn in revenue for FY 2022). Although Zalaco's size is significant within Hungary, size remains one of the negative rating drivers of the group's business risk profile.

Figure 1: Organisational structure (as of December 2022)



Sources: Zalaco, Scope

Figure 2: Top-line development of Zalaco's local competitors (HUF m)



Sources: Zalaco, Scope

Regulatory environment

We do not expect quick changes in the regulatory environment for bakery companies and we believe the effect of regulatory action will likely consolidate Zalaco's market share as it will weaken the smaller players.

Geographical diversification remains weak

While diversification benefits from a vertically integrated group structure, geographical diversification remains the weak element of the group's business risk profile as it remains heavily dependent on the Hungarian market (macroeconomic vulnerability, see below) in determining input costs.

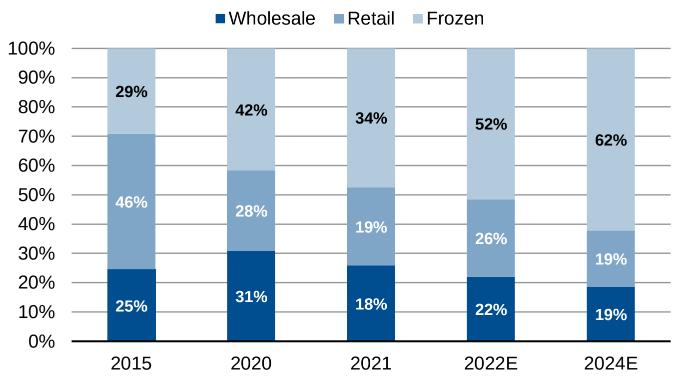
Country growth outlook and inflation

Zalaco is active solely in Hungary and its lack of geographical diversification is a negative rating driver since it leads to vulnerability to macroeconomic risks. Hungary is among the most exposed countries to the fallout from the Ukraine conflict, in view of its high reliance on Russian energy amplified by an economic structure dominated by energy-intensive businesses with complex value chains. Prolonged supply chain disruptions, further inflationary pressures and currency weakness are weighing on the country's growth prospects.

Uninterrupted operations despite the closure of two plants

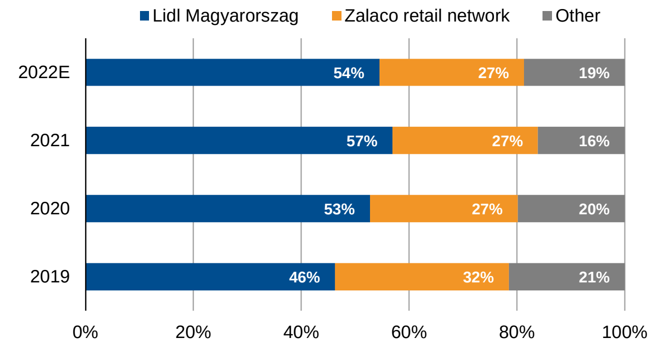
Although the company faced workforce shortages and rising production costs, resulting in the closure of its plants in Mindszent and Sopron, it was able to avoid potential supply disruptions by redistributing production capacity from other plants. The closure of the two plants is viewed as an exceptional circumstance, and we do not anticipate any significant operating challenges from the workforce shortage.

Figure 3: Zalaco's revenue by segment



Sources: Zalaco, Scope estimates

Figure 4: Customer concentration



Sources: Zalaco, Scope estimates

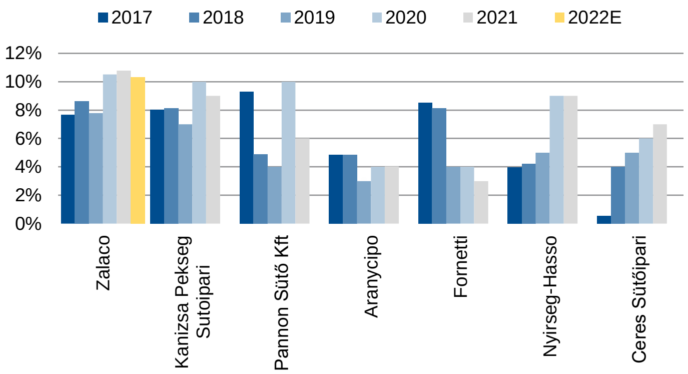
High concentration on Lidl

We regard positively the company's successful transition towards an automated production line which minimises the dependence on the physical workforce and is expected to reduce inventory shrinkage. However, the company's sales remain heavily concentrated on the international retail chain Lidl, which accounted for approximately 54% of its FY 2022 sales (compared to 57% in FY 2021) and is expected to increase further in the medium term as its main customer/partner for frozen product sales. However, the risk of significant sales exposure to Lidl is partially mitigated by Zalaco's ability as a small-cap company to deliver quality-oriented products and maintain sustainable business operations.

Limited export potential

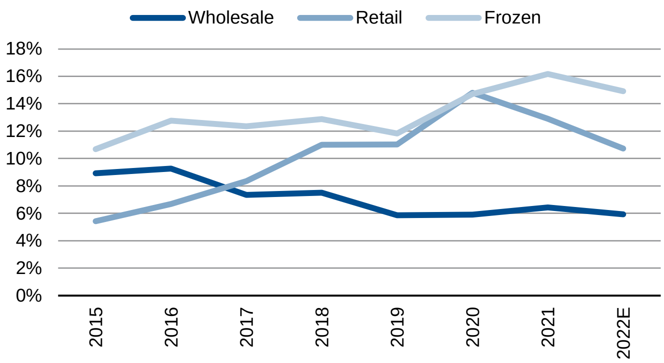
Contrary to our expectations, export sales of frozen products have been delayed. This situation is expected to continue in short to medium term, as international retail chains have postponed commercial negotiations.

Figure 5: Profitability margins compared to domestic and regional peers



Source: Zalaco, Scope estimates

Figure 6: Zalaco's EBITDA by division



Source: Zalaco, Scope estimates

Stable operating profitability margins

While the company's profitability is another major factor that supports the rating (as indicated by relatively high and stable EBITDA margins compared to local competitors), the increase in raw material and utility costs during FY 2022 had a considerable adverse impact on overall profitability and required selling price adjustments (retail 20%, frozen 6% and wholesale 16% on average in 2022).

Ability to pass on increased cost base to customers

The company has confirmed additional price increase on various products in January 2023 which is expected to help mitigate the gross margin pressure caused by the elevated cost base and maintain profitability at current levels. Furthermore, while consumers may become more price conscious as inflation pressures increase, we do not expect any 'sticker shock' effect for Zalaco customers as its main product portfolio consists of non-discretionary products. The inventory shrinkage and obsolete inventory costs remain at around 2% of sales, which decreases gross margins by 200 bp (ESG factor: credit negative). The profitability is additionally supported by the expected full utilisation of the high-margin automated production line for frozen products (14.7% volume increase in 2022 compared to 2021) starting in May 2023.

Financial risk profile: BB-

Adjustments and assumptions

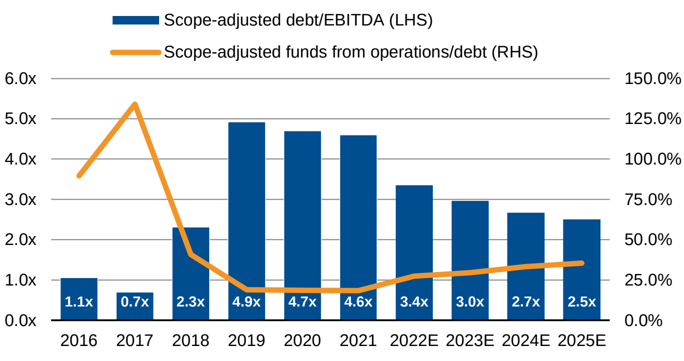
Our adjustments include the following key elements:

- Double-digit percentage top-line growth going forward.
- Stable EBITDA margin despite the assumed fully ramped-up, new automated production line and higher expected margins from export sales, which will be more visible from 2024.
- Expected capex of around HUF 1.5 bn in 2023 for finalising solar panel project
- Adding-back operating leases for 50 retail stores, which are off-balance sheet debt according to Hungarian GAAP
- Netting of 80% of available cash and cash equivalents for fiscal year 2020 (this amount excluded from 2021)
- Dividend payouts at roughly 25% of last year's net profit, in line with company guidance
- Scope-adjusted EBITDA excludes other income items

Improved leverage

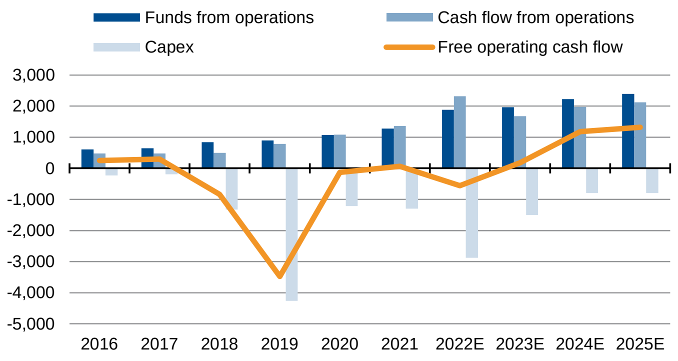
Zalaco's financial risk profile is supported by a sound cash conversion cycle, as reflected by substantial cash generation. Lower-than-expected leverage in 2022 is the result of the solid EBITDA development coupled with the repayment of financial lease liabilities, which decreased overall reported debt by HUF 177m. Scope-adjusted debt/EBITDA stood at 3.4x at YE 2022 (down 1.2x YoY). We expect gradual deleveraging at a slower pace after FY 2022.

Figure 7: Leverage



Sources: Zalaco, Scope estimates

Figure 8: Cash flow (HUF m)



Sources: Zalaco, Scope estimates

Capex phase

The capital expenditures required for the new production line have been completed in FY 2022 which resulted in negative free operating cash flow. We don't expect the heavy capex phase to remain after YE 2022, but enough demand for frozen products from international retail chains might allow the company to increase production capacity with a further expansion.

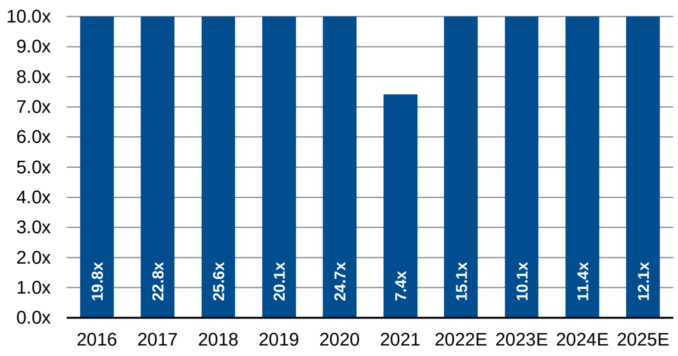
M&A strategy

Alternatively, Zalaco is diligently monitoring potential acquisition targets and remains in the screening phase. However, as of now, no suitable acquisition opportunity has been identified.

Comfortable cost of debt driven by fixed rate on bond

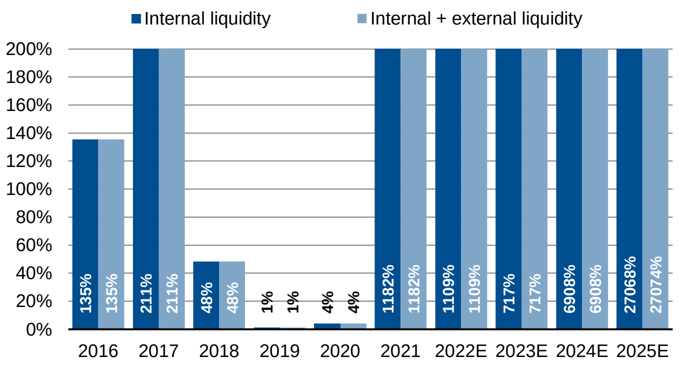
Interest cover is expected to remain at a strong level of above 10x in 2023-25 (Figure 7) supported by the fixed interest rate on the issued bond which compromises the majority of interest-bearing debt.

Figure 9: Interest Cover



Sources: Zalaco, Scope estimates

Figure 10: Liquidity



Sources: Zalaco, Scope estimates

Adequate liquidity

Zalaco's liquidity profile is adequate. Despite a lack of committed credit lines, the liquidity profile benefits from the debt structure after all short-term working capital loans (HUF 1.2bn) were refinanced from bond proceeds in FY 2020. The positive expected free operating cash flows starting from YE 2023, and available cash minimises the short-term refinancing risks of company.

Balance in HUF mm	2023 E	2024 E	2025 E
Unrestricted cash (t-1)	2,290	1,863	2,739
Open committed credit lines (t-1)	0	0	0
FOCF	174	1,176	1,321
Short-term debt (t-1)	344	44	15
Coverage	**7.1x**	**6.9x**	**270x**

Supplementary rating drivers: +/- 0 notches

Credit-neutral supplementary rating drivers

No explicit adjustment for supplementary rating drivers.

Long-term debt rating

Senior unsecured debt rating: BB-

We have affirmed senior unsecured debt at BB-, reflecting our expectation of an average recovery for senior unsecured debt. Our recovery expectations are based on an estimated liquidation value in a hypothetical default scenario in 2025.

Operating leases are excluded from debt waterfall

The debt waterfall includes senior secured loans and guarantees ranked prior to the senior unsecured debt category. The senior unsecured debt of HUF 4.4bn and payables ranked pari passu. As of YE 2022, the loans are constituted of close to 20% of leases, which might stop within short notice time should the situation require it. Our debt waterfall does not take into consideration the recovery of operating leases.

Appendix: Peer comparison (as at last reporting date)

	Zalaco Sütőipari Zrt.	Bonafarm Group	Nikora Trade JSC	Nikora JSC	Naturtex kft.
	B+/Positive	BB-/Stable	B+/Stable	BB-/Stable	B+/Stable
Last reporting date	02 March 2023	23 August 2022	01 September 2022	01 September 2022	19 April 2022
Business risk profile	B+	BB+	BB-	BB-	B+
Market share	~6%	n.a	18%	19%	n.a
Scope-adjusted EBITDA	HUF 1.9bn	HUF 19.9bn	GEL 60.2m	GEL 80.5m	HUF 1.3bn
Operating profitability	10%	9%	9%	11%	11%
Geographical diversification	Hungary	Hungary	Georgia	Georgia	Hungary
Financial risk profile*	BB-	B+	B+	BB-	BB-
Scope-adjusted EBITDA/interest cover	12.2x	124.7	3.6x	3.4x	8.7x
Scope-adjusted debt/EBITDA	3.1x	2.3	2.8x	2.9x	4.1x
Scope-adjusted FFO/debt	0.3x	43%	25%	24%	21%
Scope-adjusted FOCF/debt	0.0x	-23%	0%	-3%	-8%
Liquidity	Adequate	Adequate	Inadequate	Inadequate	Adequate

* Financial risk profile metrics are presented as average of projections

Sources: Public information, Scope

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