

# Szabó Fogaskerégyártó Kft.

## Hungary, Capital Goods



B

NEGATIVE

### Key metrics

Scope credit ratios	2020	2021	Scope estimates	
			2022E	2023E
Scope-adjusted EBITDA/interest cover	454.0x	97.8x	Net interest positive	7.3x
Scope-adjusted debt/EBITDA	0.7x	1.7x	6.2x	3.9x
Scope-adjusted funds from operations/debt	129%	55%	17%	22%
Scope-adjusted free operating cash flow (FOCF)/debt	45%	-49%	3%	-91%

### Rating rationale

The issuer rating of B for Szabó Fogaskerégyártó Kft. is based on our business risk profile assessment of B- and our financial risk profile assessment of BB-. The business risk profile is constrained by the company's size, low product diversification, and high customer and end-market concentration. Profitability compared to peers is the main support for the business risk profile. Profitability also supports the leverage ratios, which ultimately lead to a financial risk profile assessed as moderate.

### Outlook and rating-change drivers

The Negative Outlook reflects the anticipated deterioration in credit metrics in 2022 due to the expected drop in Scope-adjusted EBITDA, as reflected by the expected Scope-adjusted debt/EBITDA ratio of 6.2x at YE 2022. It also reflects the deteriorating economic environment, which increases the risks to our forecast, especially due to the company's weak diversification, which makes it quite vulnerable to economic shocks. We also note the difficult price negotiations with key customers in 2022, which were only recently concluded and were responsible for the decline in profitability. This raises questions about the company's ability to raise its prices further if needed. It also reflects our expectation that the company's profitability will not return to pre-2022 levels of more than 30% in the foreseeable future due to continued cost pressures.

To return to a stable outlook, Szabó Fogaskerégyártó needs to demonstrate its ability to restore its Scope-adjusted EBITDA margin to above 25% while increasing revenues. We deem a rating upgrade to be remote at this stage, but possible if the company can grow with high margins while deleveraging.

A negative rating action could result from Scope-adjusted debt/EBITDA staying at above 4x on a sustained basis, e.g. caused by lower revenues or EBITDA margin pressure from rising material or personnel costs. It could also result from weaker liquidity or the loss of a major customer. In this context, we note that Szabó Fogaskerégyártó's senior unsecured bond issued under the Hungarian Central Bank's Bond Scheme has an accelerated repayment clause. The clause requires Szabó Fogaskerégyártó to repay the nominal amount (HUF 1.5bn) within 10 business days after the bond rating falls below a B-, which could have a default implication.

### Rating history

Date	Rating action	Issuer rating & Outlook
21 Dec 2022	Outlook change	B/Negative
31 Jan 2022	New	B/Stable

### Ratings & Outlook

Issuer	B/Negative
Senior unsecured debt	B+

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### Related Methodology and Related Research

[Corporate Rating Methodology; July 2022](#)

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Bloomberg: RESP SCOP

#### Positive rating drivers

- Good operating profitability (EBITDA) compared to peers
- Solid liquidity situation after the cash inflows in 2022
- Long relationships with largest customers

#### Negative rating drivers

- Very small niche player in the European capital goods market with revenues of HUF 1.8bn (roughly EUR 5m) in 2021
- Low product diversification, very low share of recurring revenues and lack of aftermarket activities, which usually result in higher volatility
- High customer concentration: more than 90% of revenues from two customers
- High end-market concentration: around 90% of revenues come from companies in the agricultural machinery sector
- Weak FOCF in 2022-23 due to lower EBITDA and planned investments
- Key person risk (ESG factor) as the entire management of the company rests with the current CEO Ferenc Szabo - the 100% sole owner of Szabó Fogaskerékgyártó Kft. - and his son Krisztian Szabo, the executive vice president

#### Positive rating-change drivers

- To return to a stable outlook, sustained recovery in the Scope-adjusted EBITDA margin to above 25% while increasing revenues
- Rating upgrade is remote at this stage, but it is possible if the company can grow while deleveraging

#### Negative rating-change drivers

- Scope-adjusted debt/EBITDA staying above 4x on a sustained basis
- Deterioration in liquidity, use of bond proceeds for other purposes than those announced, loss of a major customer

## Corporate profile

Founded in 1976, Szabó Fogaskerékgyártó Kft. is a gear manufacturer based in Kaposvár, Hungary. It is a family-operated business, and Ferenc Szabó is the 100% owner.

Szabó Fogaskerékgyártó Kft. specializes in gear manufacturing. The company's activities include CNC hobbing, CNC milling, gear shaping, CNC turning, contact surface testing heat treatment, CNC gear grinding, broaching, 3D CNC measuring. The main product lines are spur gears, helical gears, worm gears, planetary gears, spline shafts, straight bevel gears and geared axis.

In 2021, Szabó Fogaskerékgyártó Kft. reported revenues of around HUF 1.77bn (~EUR 5m) with an EBITDA margin of 35%. Szabó Fogaskerékgyártó Kft. has a 3,500 sq m production facility, located in Kaposvár and employs more than 50 people. The site Szabó Fogaskerékgyártó currently operates on is owned by its 100%-owned subsidiary Szabó Hajtástechnológia. Szabó Hajtástechnológia's total revenues in 2021 were HUF 31m, consisting mainly of rental income from the parent company.







## Financial overview

Scope credit ratios	2019	2020	2021	Scope estimates		
				2022E	2023E	2024E
Scope-adjusted EBITDA/interest cover	106.1x	454.0x	97.8x	Net interest positive	7.3x	6.5x
Scope-adjusted debt/EBITDA	1.0x	0.7x	1.7x	6.2x	3.9x	2.8x
Scope-adjusted funds from operations/debt	100%	129%	55%	17%	22%	29%
Scope-adjusted FOCF/debt	27%	45%	-49%	3%	-91%	0%
<b>Scope-adjusted EBITDA in HUF m</b>						
EBITDA	626.7	797.6	611.7	360.0	508.9	610.3
less: capitalised development costs						
add: share-based compensation expense						
<b>Scope-adjusted EBITDA</b>	<b>626.7</b>	<b>797.6</b>	<b>611.7</b>	<b>360.0</b>	<b>508.9</b>	<b>610.3</b>
<b>Funds from operations in HUF m</b>						
EBITDA	626.7	797.6	611.7	360.0	508.9	610.3
less: (net) cash interest paid	-5.9	-1.8	-6.3	39.3	-70.1	-94.1
less: cash tax paid per cash flow statement	-23.1	-55.5	-31.1	-12.1	-12.1	-7.4
less: pension interest						
add: share-based compensation expense						
less: capitalised development costs						
Profit/loss on disposals						
<b>Funds from operations</b>	<b>597.7</b>	<b>740.3</b>	<b>574.3</b>	<b>387.2</b>	<b>426.7</b>	<b>508.8</b>
<b>Free operating cash flow in HUF m</b>						
Operating cash flow	332.9	-61.9	890.5	1,511.0	315.5	283.2
less: capital expenditure (net)	-171.3	-52.4	-1,067.1	-437.6	-2,105.0	-277.0
add/less: special items		373.1	-328.8	-1,000.0		
<b>Free operating cash flow</b>	<b>161.6</b>	<b>258.8</b>	<b>-505.4</b>	<b>73.4</b>	<b>-1,789.5</b>	<b>6.2</b>
<b>Net cash interest paid in HUF m</b>						
Net cash interest per cash flow statement	5.9	1.8	6.3	-39.3	70.1	94.1
add: interest component, pension						
<b>Net cash interest paid</b>	<b>5.9</b>	<b>1.8</b>	<b>6.3</b>	<b>-39.3</b>	<b>70.1</b>	<b>94.1</b>
<b>Scope-adjusted debt in HUF m</b>						
Reported gross financial debt	571.6	549.3	1,016.2	2,210.8	1,944.6	1,710.0
less: cash and cash equivalents						
add: non-accessible cash						
Other	25.0	25.0	25.0	25.0	25.0	25
<b>Scope-adjusted debt</b>	<b>596.6</b>	<b>574.3</b>	<b>1,041.2</b>	<b>2,235.8</b>	<b>1,969.6</b>	<b>1,735.0</b>

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## Environmental, social and governance (ESG) profile<sup>1</sup>

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)

## Key person risk

There is a key person risk (ESG factor) as the entire management of the company rests with the current CEO Ferenc Szabo, the 100% owner of Szabó Fogaskerékgyártó Kft. and his son Krisztian Szabo, the executive vice president. Ferenc Szabo and Krisztian Szabo decided to enter into an official agreement on the joint management of the company in February 2022, whereby Krisztián Szabó became the managing director of the company alongside his father and was given independent signing authority. Ferenc Szabo is responsible for strategic decisions, and these are always prepared in consensus with Krisztian Szabo. Szabo senior also has the representative tasks of the company, prepares the mechanical engineers, and takes an active role in formulating pricing and other policies. Krisztian Szabo is responsible for the operative managerial tasks, taking an active role in production planning either directly or through engineer colleagues and the ERP system. Control of the financial planning along with accounting falls are his responsibility, likewise R&D and the first line of contact with international business partners.

<sup>1</sup> 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-

#### Industry risk profile: BBB

As a manufacturer of gears, Szabó Fogaskerékgyártó is exposed to the capital goods industry. We believe this industry has medium cyclicality, medium barriers to entry and medium substitution risk, and we assess its industry risk at BBB.

#### Business risk profile rated B-

Szabó Fogaskerékgyártó's business risk profile, rated B-, continues to be constrained by the company's size, low product diversification, and high customer and end-market concentration.

#### Very small niche player in the European capital goods market

With sales of around HUF 1.8bn (roughly EUR 5m), Szabó Fogaskerékgyártó is a small niche player in the European capital goods market. The company specialises in gear manufacturing, production of geared parts, and machining. The main product lines are spur gears, helical gears, worm gears, planetary gears, spline shafts, straight bevel gears and geared axes.

**Figure 1: Examples of products**



Source: Scope

Szabó Fogaskerékgyártó does not produce parts with a high degree of standardisation, i.e. no 'mass production', instead, the company has a wide range of gear types (over 1,000 variants), which it usually produces in small to medium-sized batches (10-500 pieces per order). In an overall fragmented market, Szabó Fogaskerékgyártó is an established player. Quality, precision, reliability (just-in-time) are factors that play a role in the supplier selection process of customers. Szabó Fogaskerékgyártó is able to attract new customers, as the recent acquisition of six names, mainly from Germany, shows.

#### Diversification is main constraint

In addition to its relatively weak market positioning, diversification remains another rating restraining factor. The key constraints regarding diversification are:

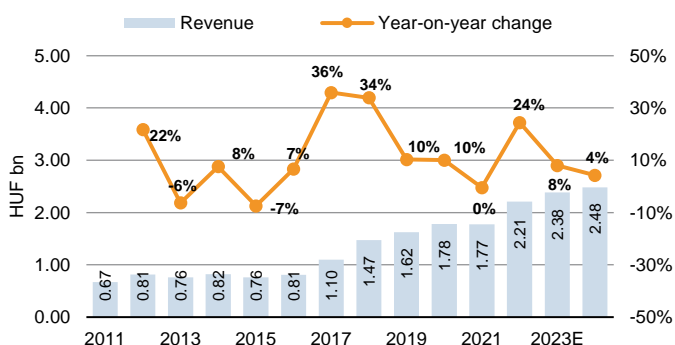
- Limited product range and lack of aftermarket activities (lower volatility and high profitability, recurring in nature): Szabó Fogaskerékgyártó has a highly concentrated product portfolio as indicated by its relatively low revenues (around EUR 5m). The company's turnover is 99% gear and gearbox production, with waste management and heat treatment providing 1% of total turnover.
- Significant customer concentration: There is high dependence on certain 'strategic' customers, as the top two customers (German and Canadian-Hungarian agricultural machinery manufacturers) account for more than 90% of total revenues. We note positively that relationships with those two clients go back 20-30 years. Szabó Fogaskerékgyártó not only manufactures gears for its customers, but is also involved in product development and testing, which promote customer loyalty. Customer loyalty is also promoted by the fact that Szabó Fogaskerékgyártó does not produce high volume parts with a high level of standardisation, but rather small to mid-size batches (10-500 pieces per order) from its portfolio of over 1,000 different gear types. During 2022, Szabó Fogaskerékgyártó Kft. has acquired six new customers which have already placed orders with the company. These additional customers do not change our view of diversification, as the dependence on the two most important customers will remain high, contributing around 80% of revenues after the addition.
- High end-market concentration: While the company has little exposure to highly cyclical end markets like automotive, trucks, and consumer products, around 90% of its revenues are generated from companies in the agricultural machinery sector.

- Low geographical diversification and high currency risk: Export activity accounts for 58% of the company's total net sales revenue, and Germany accounts for 91% of total export sales revenue. Although 42% of revenues are generated in Hungary, the share of EUR-based revenues is much higher at around 95%, as a large part of domestic revenues are also EUR-based. However, as Szabó Fogaskerégyártó's manufacturing capacity is located only in Hungary, more than 30% of the costs, mainly personnel and some material costs, are incurred in HUF. The currency risk is not hedged. Profitability in a peer group context main support for the business risk profile

Despite the declines in 2021-22, profitability compared to peers remains the main support for the business risk profile. Scope-adjusted EBITDA declined to HUF 612m in 2021 compared to HUF 798m in 2020. While revenues stagnated at HUF 1.77bn in 2021 compared to HUF 1.78bn in 2020, as lower export revenues were largely offset by higher domestic revenues, the EBITDA decline was due to the higher materials costs, which reduced the gross profit margin to 51% in 2021 (58% in 2020). In addition to higher material costs, EBITDA was negatively impacted by a 25.5% increase YoY in personnel expenses due to the difficult labour market conditions and inflation (the percentage of staff costs to revenue increased to 12.5% in 2021 compared to 10.1% previously). All this led to a decline in the Scope-adjusted EBITDA margin from 44.8% in 2020 to 34.5% in 2021.

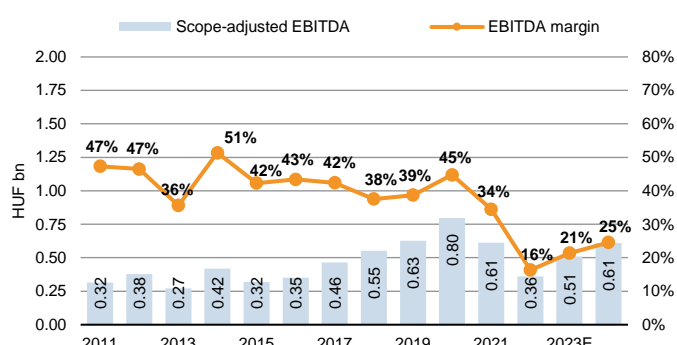
**Higher material costs and personal expenses weighed on profitability in 2021**

**Figure 2: Trend in revenue**



Sources: Szabó Fogaskerégyártó, Scope (estimates)

**Figure 3: Trend in Scope-adjusted EBITDA margin**



Sources: Szabó Fogaskerégyártó, Scope (estimates)

**Dependency on metal prices, moderate impact of energy prices**

Szabó Fogaskerégyártó's gross profit margin is particularly dependent on the development of metal prices (raw material and tool cost was approx. 34% of revenues in 2021). There are no price escalation clauses with its customers, as Szabó Fogaskerégyártó has no long-term production contracts, but mainly project contracts, some on a recurring basis. Each time an order is received, the actual costs for raw materials, tools, energy, etc. are checked and the prices are adjusted accordingly. Nevertheless, the gross profit and EBITDA margins have been volatile. The impact of energy prices on profitability is moderate, as energy costs are only 3-4% of revenues. Electricity prices correlate with the spot market and are settled monthly. Natural gas is bought at a fixed price (currently HUF 1.194/m<sup>3</sup>, from 1 October 2022), fixed for one year.

**Strong growth in 9M 2022 revenues also expected for the full year 2022**

After 9M 2022, revenues of HUF 1.65bn were around 29% higher than in the same period last year (HUF 1.28bn), mainly driven by domestic revenues due to strong orders from the main Hungarian customer. Although export revenues increased by 12.5% YoY, the increase was mainly due to the HUF devaluation. The export business has generally shown weakness, declining by 1.4% in 2020 and 7.4% in 2021.

**Weakness in export business**

For the full year 2022, we expect revenues of HUF 2.2bn (+24% YoY).





Recently negotiated price increases and new customers should drive export revenues in 2023

Szabó Fogaskerégyártó has negotiated an average price increase of 23% in some contracts, which will take effect from November 2022. We have understood that the recent pricing negotiations were quite difficult, which raises questions about the company's ability to further increase its prices if necessary.

Profitability down in 9M 2022 on soaring material costs and further increase in staff costs

Szabó Fogaskerégyártó has also informed us that its most important export customer (around 53% of revenues in 2021) has committed to order the same quantity as in 2022. Combined with the recently negotiated price increases, this should support export revenues in 2023. Export revenues should be also supported by the addition of new customers with a total expected revenue contribution of around HUF 300m. All in all, we expect 2023 revenues to increase by around 8% to HUF 2.4bn. The informative value of the current order book of HUF 1.4bn for revenues in 2023 is limited by the nature of Szabó Fogaskerégyártó's business (project orders) with a relatively short lead time (1-6 months).

Apparently difficult price negotiations with key customers

After 9M 2022, the Scope-adjusted EBITDA margin decreased to 16.7% due to the strong increase in raw material prices. As the company was not able to complete pricing negotiations with its customers during 9M 2022 to pass on higher material prices, the gross profit margin fell to 32% after 9M 2022 compared to 51% in the full year 2021. A further increase in staff costs also weighed on profitability, with staff costs as a percentage of sales increasing to 14.6% after 9M of 2022 compared to 12.5% in 2021 as a whole. We also point to the apparently difficult price negotiations with key customers in 2022, which have only recently been concluded and are responsible for the decline in profitability. This also raises questions about the company's ability to further increase its prices if needed. We expect for the full year 2022 a Scope-adjusted EBITDA margin of 16% and a Scope-adjusted EBITDA of HUF 360m. Given the expected continued cost pressure, we do not expect the company's profitability to return to the pre-2022 level of more than 30% in the foreseeable future. However, the recently concluded price negotiations with an agreed price increase of 23% should have a positive impact on the gross profit margin in 2023 and more than compensate for the expected further increase in personnel costs. We expect a Scope-adjusted EBITDA of HUF 509m (margin: 21%) in 2023.

We expect Scope-adjusted EBITDA margin to remain below 25% in 2023

### Financial risk profile: BB-

Financial risk profile rated BB-

Szabó Fogaskerégyártó's issuer rating benefits from its BB- (previously BB) assessed financial risk profile.

One-notch decrease due to the expected increase in leverage at YE 2022 and increasing economic risks

The one-notch decline reflects the expected increase in the leverage ratio to approximately 6x at YE 2022 (1.7x at YE 2021) due to the expected increase in Scope-adjusted debt to around HUF 2.2bn (HUF 1.0bn at YE 2021) following the issuance of a HUF 1.5bn bond and the significant decrease in Scope-adjusted EBITDA. Although we expect this ratio to improve to below 4.0x by the end of 2023 in our base case scenario, we note the increasing risks to this base case scenario as the economic environment deteriorates and the company is only weakly diversified, making it highly vulnerable to economic shocks.

Reported debt of HUF 1.0bn at YE 2021

Szabó Fogaskerégyártó's reported debt was HUF 1.0bn at YE 2021 vs. HUF 549m at YE 2020. The debt was mainly comprised of bank loans (HUF 691m) and financial leases (HUF 326m).

No financial covenants

According to Szabó Fogaskerégyártó, its bank debt has no financial covenants.

Adjustment for an EU investment grant, HUF 1bn subsidy not considered due to low probability of repayment

We have made an adjustment for an EU investment grant of HUF 25m (part of accrued liabilities), which will terminate in 2025. In 2022 Szabó Fogaskerégyártó received a roughly HUF 1bn subsidy to finance its investments under the Economic Development and Innovation Operational Programme Plus. This subsidy is not included in Scope-

adjusted debt as we deem the probability of repayment to be rather low. Repayment is only required if Szabó Fogaskerégyártó fails to comply with a conditionality scheme consisting of the following three main factors:

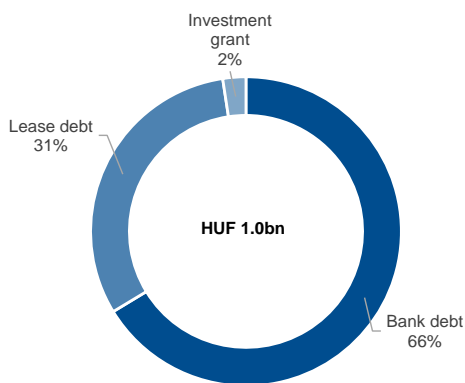
- The growth rate of gross value added compared to GDP growth.
- Growth of the entrepreneurial knowledge base. This can be fulfilled if Szabó Fogaskerégyártó participates in one of the government's enterprise development knowledge programs.
- Effective project fulfilment: On the basis of the subsidy agreement, Szabó Fogaskerégyártó can only request up to three changes to its submitted investment plan.

**Testing for repayment starts in 2024 ...**

... underachievement on the milestones leads to a pro-rated repayment rather than a 'full' repayment

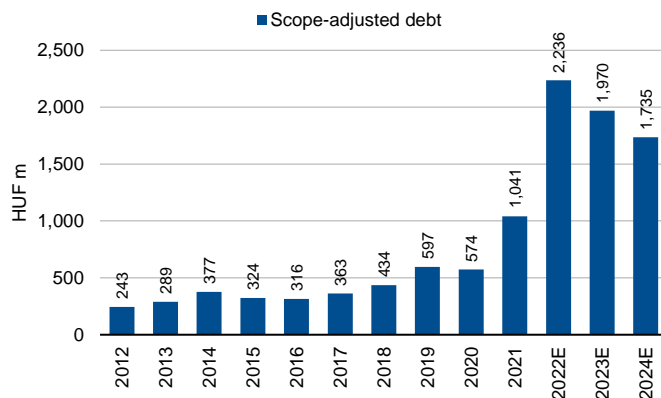
Testing for repayment of subsidies therefore only starts in 2024 – the period when the investment program is scheduled to be completed. The reference year for the monitoring period is year 2019. Underachievement on the milestones leads to a pro-rated repayment of subsidies rather than a 'full' repayment of the subsidies received. It is also important to note that the measurement calculation is only a proposal from the subsidy provider, it will be finalised when the program is completed.

**Figure 4: Funding structure at YE 2021**



Sources: Szabó Fogaskerégyártó, Scope

**Figure 5: Trend in Scope-adjusted debt**



Sources: Szabó Fogaskerégyártó, Scope (estimates)

**Increase in Scope-adjusted debt to HUF 1.0bn at YE 2021**

**Expected increase in Scope-adjusted debt to HUF 2.2bn at YE 2022**

**Company plans to reduce its financial debt by around HUF 950m by the end of 2024**

**Scope-adjusted FOCF to remain weak at least until 2023**

Based on these adjustments, we calculate Scope-adjusted debt of HUF 1.0bn at YE 2021 (HUF 574m at YE 2020). The increase in financial debt is due to the higher leasing obligations for the purchase of machinery as part of the investment programme currently underway. We expect the issuance of the HUF 1.5bn bond under the Bond Fund for Growth Scheme of Hungarian National Bank for investments in capacity expansion in February 2022 to lead Scope-adjusted debt to increase to around HUF 2.2bn at YE 2022. This bond has a maturity of 10 years, an annual redemption of the nominal value by 10% in the period 2027-2031 with a bullet redemption of 50% in 2032 and a fixed interest coupon of 5.5% payable annually. Szabó Fogaskerégyártó plans to reduce its financial debt by around HUF 950m by the end of 2024, as bank debt is due for repayment in 2022-24 and equipment used under finance leases is replaced by machinery purchased in-house. Based on these deleveraging plans, we expect a decrease in Scope-adjusted debt to around HUF 1.7bn by YE 2024.

We expect Scope-adjusted FOCF to remain weak at least until 2023, reflecting the planned investment cycle and lower EBITDA. Despite lower EBITDA, the reported operating cash flow in 2021 increased to HUF 891m vs. minus HUF 62m. The company's loans provided to the subsidiary have been largely reimbursed in 2021 (HUF 44m still on the balance sheet vs. HUF 373m at YE 2020) and no further support is planned in the near future. The reimbursement of the loan had a positive impact of around HUF 329m on the operating cash flow in 2021, an amount adjusted in our Scope-adjusted FOCF calculation as



we consider it non-operational and calculate a negative Scope-adjusted FOCF of around HUF 505m, burdened by the investment programme in production capacity.

**Negative Scope-adjusted FOCF after 9M 2022**

Reported FOCF after 9M 2022 was HUF 835m, mainly due to the state subsidy of around HUF 1bn. Adjusted for this non-operating effect, Scope-adjusted FOCF was negative at around HUF 165m, due to the decline in EBITDA. For the full year 2022, we expect capex of around HUF 440m (HUF 371m after 9M 2022) and a Scope-adjusted FOCF of around HUF 70m. While capex after 9M 2022 was still relatively high due to the ongoing investment programme, it was lower than previously guided due to postponements caused by difficulties in the operating business.

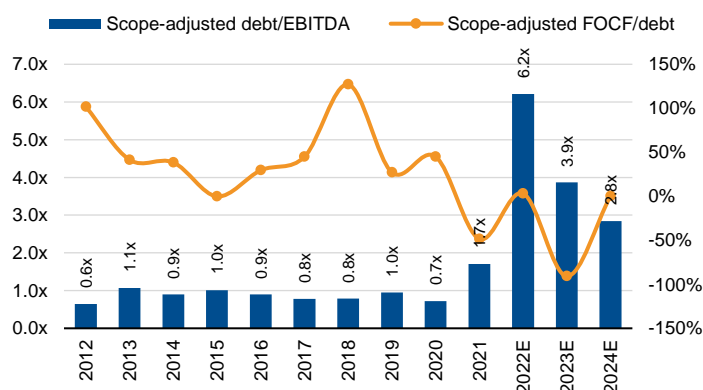
**High capex in 2023 due to planned investments**

The investments postponed in 2022 will be made up in 2023. Therefore, we expect capex to increase to around HUF 2.1bn in 2023 and Scope-adjusted FOCF to turn negative in 2023 at around HUF 1.8bn. Szabó Fogaskerékgyártó plans to build a new 5,000 sq m production hall in the industrial park in Kaposvár, with the completion expected by the end of 2023. The vast majority of the investments should be completed in 2023, therefore we expect lower capex and a return to a positive Scope-adjusted FOCF in 2024.

**Weak Scope-adjusted FOCF/debt in 2021-23 due to investment cycle and lower EBITDA**

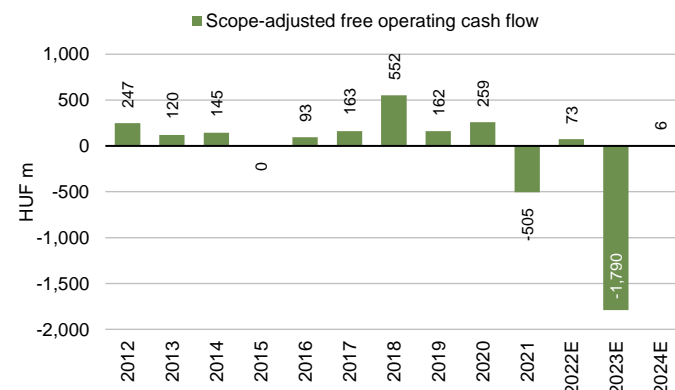
Cash flow cover was a negative 49% in 2021 reflecting the increased capex due to the initiated investment programme. Given the expected decline in EBITDA in 2022 and the high investments in 2023, which will weigh on the Scope-adjusted FOCF, we continue to see the cash flow coverage as weak in 2022 and 2023.

**Figure 6: Key credit metrics, 2014 to 2024E**



Sources: Szabó Fogaskerékgyártó, Scope (estimates)

**Figure 7: Trend in Scope-adjusted free operating cash flow**



Sources: Szabó Fogaskerékgyártó, Scope (estimates)

**Neutral view on financial policy**

In recent years Szabó Fogaskerékgyártó has tended to distribute all FOCF as shareholder dividends. In 2021, Szabó Fogaskerékgyártó Kft. distributed a dividend of HUF 220m. As provided for in the bond prospectus, Szabó Fogaskerékgyártó will reduce the annual dividend to HUF 50m during the investment cycle from 2022 to 2024.

In 2018 Szabó Fogaskerékgyártó Kft. started to provide loans to its shareholder and its subsidiary, run by Krisztian Szabo. Loans provided to the shareholder amounted to HUF 73.8m at YE 2021 compared to HUF 97.3m at YE 2020. Loans provided to the subsidiary were largely reimbursed in 2021 (HUF 44.3m at YE 2021 vs. HUF 411.4m at YE 2020) and no further support is planned in the near future. This, however, cannot be fully excluded as there are no binding contractual obligations.

**Adequate liquidity**

We consider Szabó Fogaskerékgyártó's liquidity and financial flexibility as 'adequate' given the significant cash inflows in 2022, the HUF 1.5bn proceeds from the February 2022 bond issue and the HUF 1bn subsidy, as well as the well-stretched maturity structure.

Balance in HUF m	2021	2022E	2023E
Unrestricted cash (t-1)	178	225	2,443
Open committed credit lines (t-1)			
Free operating cash flow (t)	-505	73	-1,790
Short-term debt (t-1)	237	367	254
<b>Coverage</b>	<b>&lt;-100%</b>	<b>~80%</b>	<b>&gt;200%</b>

#### Cash sources

Szabó Fogaskerékgyártó's liquidity at end-December 2021 comprised:

- Cash on balance sheet of HUF 212m (HUF 1.4bn at end-September 2022)
- Short-term financial assets (short-term bank deposits as well as short-term government bonds) of HUF 13m (HUF 1.1bn at end-September 2022)

Furthermore, we expect operating cash flow of around HUF 510m in 2022 and around HUF 315m in 2023.

#### Cash uses

On the other hand, we expect the following cash uses:

- Capex of around HUF 440m in 2022 and HUF 2.1bn in 2023,
- Annual dividend payment of around HUF 50m in 2022 and 2023,
- Debt repayments in the amount of around HUF 350m in 2022 and around HUF 265m in 2023.

#### Long-term debt rating

#### Senior unsecured debt rating: B+

In line with the affirmed issuer rating, we have affirmed the B+ rating for senior unsecured debt, one notch above the issuer rating, debt based on an 'above average' recovery prospect in a simulated event of default.

In February 2022, Szabó Fogaskerékgyártó issued a HUF 1.5bn bond under the MNB Bond Funding for Growth Scheme with a tenor of 10 years, amortisation of the notional amount by 10% annually over 2027-2031 with a 50% bullet repayment in 2032, and a 5.5% fixed interest rate coupon payable annually. Proceeds from the bond are to be used for investments in a new production hall and logistics centre and to develop the production structure with an automated warehouse structure. The remaining debt comprises bank debt and financial leases. Banking loans are secured by pledge on some selected machines, vehicles trucks and cars.

We assume that Szabó Fogaskerékgyártó will reduce its bank and lease debt by around HUF 950m by YE 2024 in line with its business plan and the investment programme will be executed as planned with no additional bank debt or other senior-ranking financing ahead of the bond.

In 2022 Szabó Fogaskerékgyártó received a HUF 1bn state subsidy to finance its investments. To determine claimholders, we have ranked the repayment obligation for subsidies at the simulated point of default senior to the claims on the prospective bond.

We also assume a significant increase in property, plant and equipment compared to the end of 2021, due to the ongoing investment programme.

Our recovery analysis uses the liquidation value in a hypothetical default in 2024 of HUF 2.4bn. This value is based on a haircut on the assets and reflects liquidation costs of 10%. The haircut also assumes the receivable from the parent used to refinance the acquisition debt would become non-recoverable in the event of payment default.



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