Market Építő Zrt
Hungary, Construction

SCOPE BB- STABLE

Corporate profile

Market Építő Zrt. (Market), founded in 1996, is Hungary's leading construction company, with exclusively domestic operations. The group employs about 1,000 people and generated HUF 189bn in turnover in 2020. Its headquarters are in Budapest. Market is owned by GARHART Zrt. (51%, an investment holding company wholly owned by Istvan Garancsi) and Sandor Scheer (49%, CEO and founder of Market). Market is involved in the construction of buildings, industrial facilities and sport facilities. Building projects encompass offices, public facilities, residential buildings and hotels. The increase in the construction segment over the past few years has been driven by high demand for offices and public facilities. Market's industrial projects include logistics centres, auto and tyre production plants and electric battery factories.

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover (x)	51.5x	25.3x	9.9x	9.2x
Scope-adjusted debt (SaD)/EBITDA	Net cash	Net cash	2.0x	2.1x
Scope-adjusted funds from operations/SaD	Net cash	Net cash	41%	40%
Free operating cash flow/SaD	Net cash	Net cash	Negative	Negative

Rating rationale

Scope Ratings GmbH (Scope) has affirmed the BB- issuer rating of Market Építő Zrt. with the Outlook revised to Stable from Negative. The senior unsecured debt rating was affirmed at BB-.

The Outlook change reflects the lower-than-anticipated pressures on leverage and free operating cash flow in the context of the ambitious investment plan started in 2020. Market expanded its growth strategy to invest in real estate projects and in its concrete plant PreBeton (HUF 83bn in capex in the next three years). For 2021 and 2022, we expect a similar financial risk profile as in previous years as cash can cover outstanding gross debt in full. As part of last year's rating action, we anticipated key credit metrics to deteriorate in the subsequent 12-18 months due to large investments mainly funded by debt, which includes bank loans and Market's second bond under the Hungarian National Bank (MNB) scheme (seven-year tenor; HUF 22 bn), issued in November 2020. Our revised forecast now sees leverage as measured by Scope-adjusted debt to Scope-adjusted EBITDA around 2.0x in 2021 and 2022, driven by a stronger EBITDA. This is the main reason for the improved rating Outlook.

The issuer rating is still supported by Market's leading position in the Hungarian construction sector and strong liquidity. On the other hand, the rating remains constrained by Market's limited overall size, non-existent geographical diversification, and the concentrated backlog and business operations that result in a high sensitivity to business cycles.

Outlook and rating-change drivers

The Outlook is Stable and incorporates our expectation of Scope-adjusted debt to Scope-adjusted EBITDA around 2.0x. We expect the company to retain its strong liquidity position. The rating Outlook is based on total capex (including organic expansion and acquisition capex) of around HUF 83bn for period between 2021-23 and a stable Scope-adjusted EBITDA of around HUF 21bn.

Ratings & Outlook

Corporate ratings	BB-/Stable
Senior unsecured debt	BB-

Analyst

Thomas Langlet
+33 1 82882-355
t.langlet@scoperatings.com

Related Methodologies

Corporate Rating Methodology, 6 July 2021

European Construction Methodology, 15 January 2021

Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Tel. +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

A positive rating action is likely if Market's business risk profile improved materially through, for example, improved segment or geographic diversification while credit metrics remain in line with our expectations. However, we do not foresee such improvement in the short to medium term.

A negative rating action could be required if investments under the new business plan and in real estate projects weighed on leverage, resulting in a Scope-adjusted debt to Scope-adjusted EBITDA moving towards 4.0x.

Rating drivers

Positive rating drivers	Negative rating drivers
• Leader in Hungarian construction • Net cash position combined with a conservative approach, which should help weather a potential slowdown in the Hungarian economy. • Significant capex plan to reduce supply/demand uncertainty and diversify activities to improve integration. • Good credit metrics supported by low gross debt and strong liquidity	• Small European contractor with a lack of geographical diversification, limiting ability to offset business cycles • Concentration issues regarding backlog (top five projects account for 60%, mitigated by investment grade counterparties) and business segment (mainly buildings) • Low to average profitability hampered by material increase in prices and wages, mitigated by low to medium volatility in operating margins

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Improved business risk profile through significant geographical expansion and development of new segments while credit metrics remain in line with our expectations.	• Scope-adjusted debt to Scope-adjusted EBITDA moving towards 4.0x

Financial overview

			Scope estimates	
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Scope-adjusted funds from operations/SaD (%)	Net cash	Net cash	41%	40%
Free operating cash flow/SaD	Net cash	Net cash	Negative	Negative
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	9,926.0	22,239.0	21,091.1	21,382.5
Operating lease payments in respective year	0.0	240.6	240.6	240.6
Other items	-10.0	0.0	0.0	0.0
Scope-adjusted EBITDA	**9,936.0**	**22,479.6**	**21,331.7**	**21,623.1**
Scope-adjusted funds from operations in HUF m	**2019**	**2020**	**2021E**	**2022e**
EBITDA	9,926.0	22,239.0	21,091.1	21,382.5
less: (net) cash interest as per cash flow statement	-193.0	-878.0	-2,132.1	-2,334.4
less: cash tax paid as per cash flow statement	-373.0	-811.0	-1,421.4	-1,248.5
Change in provisions	212.0	154.0	0.0	0.0
add: depreciation component, operating leases	0.0	229.1	217.5	217.5
Scope-adjusted funds from operations	**9,572.0**	**20,933.1**	**17,755.1**	**18,017.1**
Scope-adjusted debt in HUF m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	22,805.0	54,321.0	62,097.3	47,182.0
less: cash and cash equivalents	-37,918.0	-74,348.0	-62,097.0	-57,219.7
add: cash not accessible[1,2]	3,136.0	4,690.0	45,097.3	30,182.0
add: pension adjustment	0.0	0.0	0.0	0.0
add: operating lease obligations	0.0	462.2	462.2	462.2
Scope-adjusted debt	**-11,977.0**	**-14,874.8**	**43,587.8**	**44,704.8**

[1] Netting of cash: generally, only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible.
[2] Cash balance is high going forward but might be used to cover for cash needs related to MAM (Market Asset Management) and to fund additional growth, both organic and external, as the issuer declared itself to act opportunistic with this regard. Thus, we believe accessible cash as rather around HUF 17bn a level equal to that prior extensively tapping capital markets.

Business risk profile: B+

Highly cyclical sector; real estate activities still minor

Market is involved in the construction of buildings, industrial facilities and sport facilities. The group's building projects encompass offices, public facilities, residential buildings and hotels. This wide range, however, does not provide the required diversification as the projects belong to the same operating sub-segment, according to our methodology (the structures are built on a similar basis; only the end-users differ). This segment's growth in recent years has been driven by high demand for offices and public facilities. Industrial projects deal with logistics centres, auto and tyre production plants and electric battery factories. The construction of sport facilities has civil engineering features that require different technical skills. These three types of operations and lack of risk mitigants (concession types provide recurring revenues) make the group highly exposed to cyclicality.

Despite the recent investment plan, which includes real estate projects, the industry risk profile remains unchanged and is only related to the construction sector. Real estate activities will generate between HUF 60bn and HUF 62bn of revenues for 2021-24, a minor share of Market's operations (7% of total revenues in the last four years). Market is the main contractor for all these projects, thereby increasing its building capacity.

Low barriers to entry with low to medium substitution risk

In line with its strategy, the group does not bid for civil engineering projects (bridge, roads, railways). Its industrial projects in terms of logistics centres are not complicated. Therefore, construction companies from Eastern Europe or Austria can easily participate in tenders. Nevertheless, large structures can be challenging in terms of the construction method and time constraints (e.g. for the stadium and dome of the Budapest Zoo). Indeed, Market has won some contracts thanks to its ability to deliver projects quickly.

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

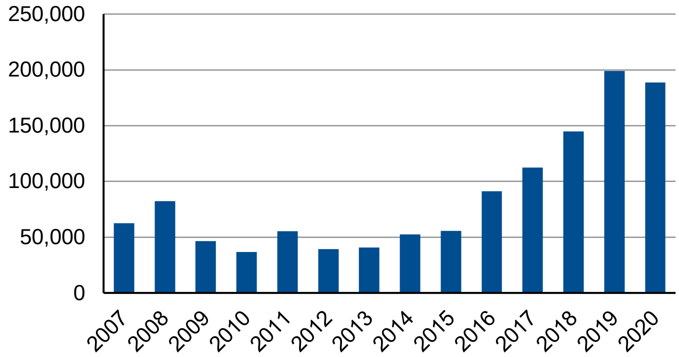
Small tier-3 European construction company…

The group is small in terms of revenues and EBITDA. This is due to its core and only market of Hungary, which remains limited in terms of size. Nevertheless, the group ranks first domestically with a market share of 5%-8% (14% considering only the building sub-segment). This is thanks to its strong track record and well-established position in the highly fragmented Hungarian construction sector (26,812 companies in 2020). Market's strategy focuses only on large and visible projects. The group runs between 50 and 60 projects a year, with the main ones accounting for up to 50% of Market's full-year revenues.

…but leading position in Hungary benefiting from growing domestic market

Market is Hungary's leading construction company by far with a turnover of HUF 189bn (EUR 0.5bn) in 2020, significantly more than that of its direct competitors. This is the payoff of a well-rounded strategy focusing on the sub-segment of buildings, which in Hungary is larger than the civil engineering segment and has also been more dynamic (+32% between 2017 and 2020 vs +21% for civil engineering). Market accounts for almost half of the construction sector in central Hungary (Budapest region), where it derives a large share of its revenues thanks to a sizeable pool of large projects.

Figure 1: Total revenues (HUF m) – 2007 to 2020



Source: Market, Scope

Figure 2: Top four Hungarian construction companies

Company in ranking order	2020 revenues (HUF m)
Market Építő Zrt.	188,727
Mészáros és Mészáros Kft.	116,153
West Hungária Bau Kft.	79,315
KÉSZ Építő- és szerelő Zrt.	64,278

Source: Market, Scope

Weak geographical diversification with no intention to expand abroad; limited diversification by segment…

Market's only regional exposure since its founding has been Hungary, allowing the group to take advantage of the local sector's strong growth between 2000 and 2008 (+106%, according to KSH). Due to the 2008 financial crisis combined with the mild recession in 2012, construction output in Hungary declined by 21% during that period, leading to a drop of Market's turnover (see figure 1). The company could not offset the decline due to its lack of diversification and needed eight years to regain the turnover levels of 2008. Although present in most of Hungary's regions, we view Market's footprint as very concentrated. The building segment accounts for 65.5% of group EBITDA in 2020 while industrial sites represent 34.5%.

… but slight improvement expected thanks to future side businesses

We view as positive the current process to diversify into real estate projects, six of which involving office buildings, hotels, residential buildings, a film studio and a logistics centre. This large growth plan is funded by a mix of Market's second bond (HUF 22bn) under the MNB programme and secured bank loans. These projects are implemented in-house to support Market's contracting business. Nevertheless, the overall impact on the group's diversification remains limited as they account for around 10% of Market's revenues over the construction period.

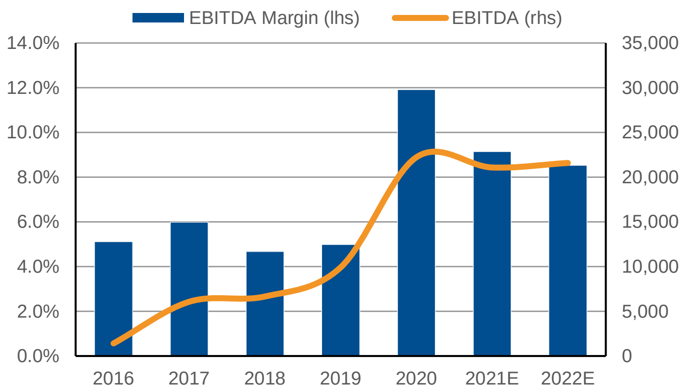
Strong but concentrated backlog mitigated by client quality

We judge diversification of the backlog (a rough indication of future revenue diversification) to be constrained, with the top five accounting for 60% of the total backlog at YE 2020. This concentration, consistent with its strategy to focus on large projects, could lead to a material impairment of revenue and EBITDA if even just one project runs into issues. However, the credit quality of the respective clients (three out of five are investment grade) mitigates associated risks to a certain extent.

Profitability doubled in 2020 despite price inflation for raw material prices and wages

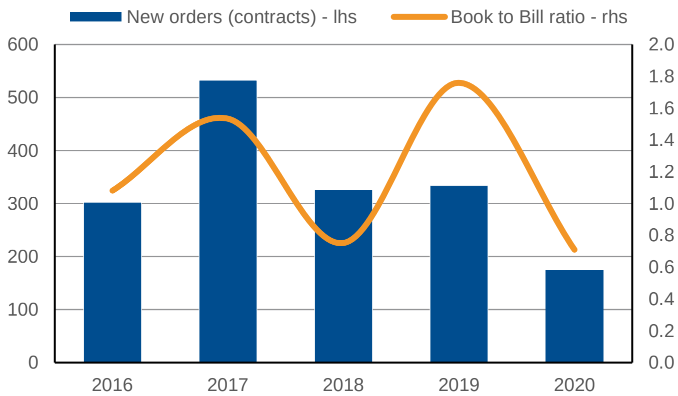
Apart from underperformance in 2016, the EBITDA margin has remained between 4% and 5%, which was at the lower end of the construction industry range until 2019. This low operating margin is due to i) its business mix, which prioritises large, visible projects over profitability; and ii) the booming Hungarian construction sector, which has led to shortages in both raw materials and qualified staff. Although business conditions remain overheated, Market managed to lower costs in 2020 by implementing better sourcing of raw materials, renegotiating contracts with suppliers, reducing intermediaries and improving its in-house material supply with the launch of its concrete manufacturing plant. Market plans to double the plant's capacity through around HUF 18bn in investment for 2021-22. Therefore, EBITDA margin reached an all-time high of 11.9% and is expected to remain stronger than pre-2020 levels of above 8%. The lack of materials production (for example, concrete in the case of Market) in Hungary has forced contractors to import goods, driving prices up. Market has improved its bargaining power with sub-contractors through its strategy of owning subsidiaries that perform a large array of services for the group such as for earthworks, electrical fittings and engineering.

Figure 3: EBITDA margin and EBITDA (HUF m) – 2016 to 2023E



Source: Market, Scope

Figure 4: Backlog and book-to-bill ratio – 2016 to 2020



Source: Market, Scope

Strong visibility of revenues until 2023 with large order backlog

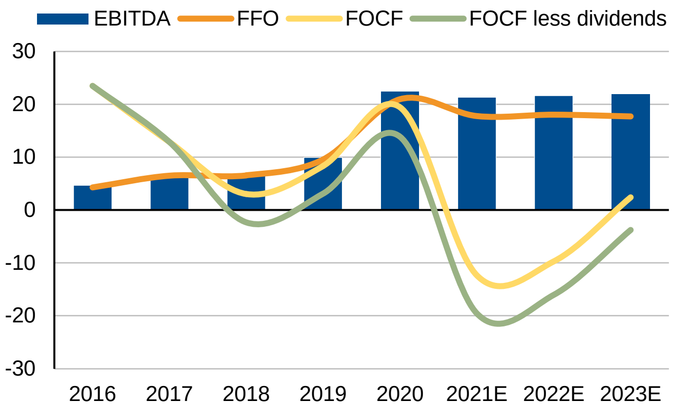
We consider the order backlog of HUF 511bn as at YE 2020 to provide some revenue visibility for the next few years. The backlog represents 2.7x of 2020 group revenues. This supports our view that the recently improved profitability is likely sustainable.

Financial risk profile: BBB+

Main assumptions for our projections:

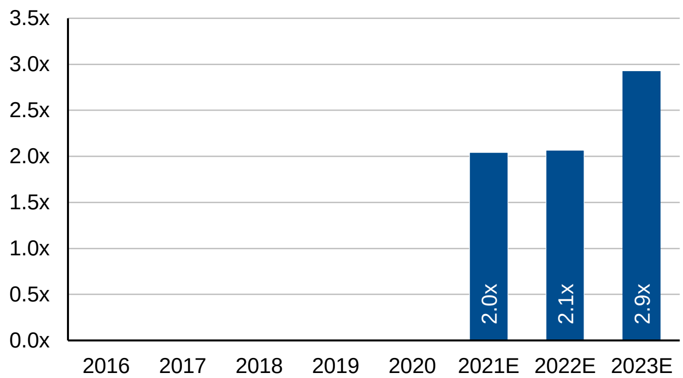
- Revenue growth for 2021, 2022 and 2021 in line with the company's projections, discounted for 5%, and the backlog
- Decreasing margin in 2021 onwards; profitability to remain above historical average (5%) due to sustainable improvement in cost base, partially offset by continuous price pressure on raw materials and wages
- HUF1.7bn of maintenance capex
- Gross capex of HUF 25bn, HUF 36bn and HUF 22bn in 2021-23 in line with the new investment plan
- Gross debt increases in 2022 and 2023 through drawings of bank loans to help finance real estate investments.
- Dividend payout of 50% (company policy sets maximum payout at 75%)
- No change in provisions or pensions

Figure 5: Cash flows – 2016 to 2023E (HUF bn)



Source: Market, Scope

Figure 6: Scope-adjusted debt/EBITDA – 2016 to 2023E



Source: Market, Scope

Reduced debt protection going forward but sufficient to serve interest payments

EBITDA interest expense cover, while very volatile, has been high at above 20x during 2015-20. The volatility of debt protection arises from the very low gross interest costs, averaging 3%, as well as the historically low gross debt. We anticipate debt protection to drop below 10x from 2021 onwards, due to a significant change in debt expected after the issuance of the second HUF 22bn bond in 2020 as well as the increase in bank loans (to HUF 36bn in 2023) to finance MAM's project.

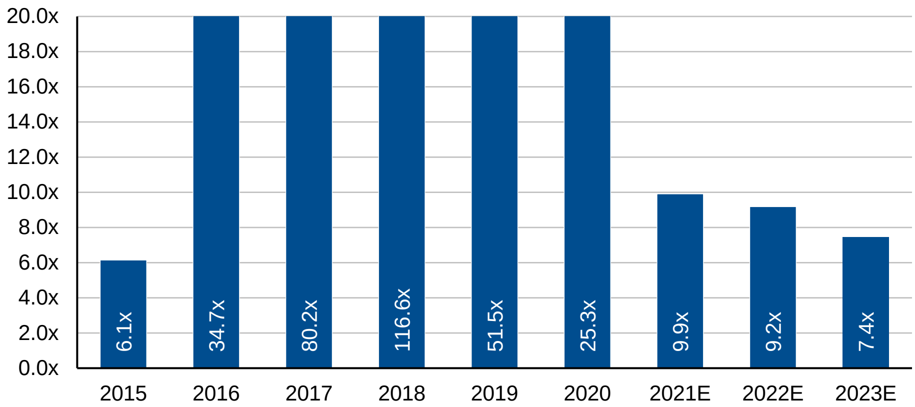
This will impair debt protection to a forecasted 9x-10x going forward. However, the issuer will still be able to serve interest payments and even have headroom for any cash flow volatility driven by the high customer concentration.

Risk posed by negative Scope-adjusted free operating cash flow mitigated by the low net debt

Historically, the very volatile operational cash flow, measured by Scope-adjusted free operating cash flow, has been driven by working capital swings and the gradual increase of capex. The positive impact from working capital almost covers capex in 2019 and 2020. The issuer is likely to continue to show negative Scope-adjusted free operating cash flow, driven by building capex in 2021 and 2022, including for the ramp-up of the real estate investments. Capex is targeted for the expansion of Market's concrete production facility, the BEM palace, the film studio and the Durer Garden project. All these projects are aimed at maximising Market's capacity as a contractor. Working capital is expected to contributing negatively to operating cash flow in 2021 as the revenues will increase by 23.7% (-HUF 5bn in 2021 vs +HUF 20bn on 2020).

In 2022, the bulk of investments (HUF 36bn) does not give a true picture of free operating cash flow, showing that working capital could have even a positive impact.

Figure 7: Debt protection (EBITDA interest cover) – 2016 to 2023E



Source: Market, Scope

Slight increase in leverage caused by strong growth of own development projects

Since 2016, consolidated leverage, measured by Scope-adjusted debt/EBITDA and funds from operations/Scope-adjusted debt, has been negative due to the consistently low gross debt. This is in line with the company's conservative approach – an asset-light strategy combined with small bolt-on acquisitions – helped by positive recurring free cash flow. This strategy has slightly changed with the development of real estate. We forecast higher net leverage by 2021 due the increase in gross debt, combined with large investments estimated at around HUF 82bn for 2021-23.

Scope-adjusted debt/EBITDA is expected to reach 2.0x in 2021, which is still manageable. Because Market remains opportunistic regarding its real estate projects and could take on more in the near future, we assess that the major part of cash balance in 2021-2023 will be spent and we adjust this part as restricted cash.

Adequate liquidity supported by headroom provided by ample unrestricted cash balance and undrawn credit facilities

We view Market's liquidity as strong. This is based on our expectation that liquidity sources (see figure 8) will exceed their uses more than 100% in the next 12 months following consistently high liquidity in the past.

Figure 8: Market's liquidity

Liquidity (HUF m)	2018	2019	2020	2021E	2022E
Unrestricted cash position (t-1)	15,073	11,629	34,782	69,658	17,000
Undrawn committed lines (t-1)	8,020	6,850	7,741	7,741	7,741
Short-term maturities (t-1)	803	501	1,006	7,998	14,016
Free cash flow (t)	3,009	8,326	19,403	-12,369	-9,721
Short-term debt coverage	**32.5**	**53.5**	**61.6**	**8.1**	**1.1**

Source: Market, Scope

Long-term debt rating

Senior unsecured debt: BB-

We expect an 'average recovery' for current and future senior unsecured debt. This translates into a BB- rating for the senior unsecured category (in line with the issuer rating). The recovery expectations are based on a distressed enterprise value under the assumption of a going concern of around HUF 37.5bn in 2023, including a 10% reduction for administrative claims in a liquidation.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

111 Buckingham Palace Road
London SW1W 0SR

Phone +44 020 7340 6347

info@scoperatings.com
www.scoperatings.com

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