Bonafarm Group
Hungary, Consumer Products

BB- POSITIVE

Corporate profile

Bonafarm Group, which consists of Bonafarm Zrt. and its fully consolidated subsidiaries, is Hungary's largest fresh-food producer, with a broad, diversified product portfolio. The group is vertically integrated, with activities ranging from crop production and large-scale animal husbandry to the production of wholesale food products under both its own brands and private labels. Bonafarm Zrt. is the parent company of eight separate business units (five in agriculture and three in the food industry). Its three main operating groups are called Agriculture, Food Industry, and HQ & Administration (BonOffice Ltd, Bonafarm Zrt.). Agriculture includes Bóly Group (crop and seed production, pig and dairy cattle breeding), Dalmand Co. (crop and seed production, pig breeding), Fiorács Ltd. (crop production, pig breeding), Agroprodukt Group (crop and seed production, pig and dairy cattle breeding), and Bábolna Takarmány Ltd (fodder production). Food Industry includes Pick Szeged Co. (processed meat production), Sole-Mizo Co. (milk processing) and Csányi Pincészet Co. (wine). The group is fully owned by renowned businessman and banker Dr. Sándor Csányi through holding company Bonitás 2002 Zrt.

Key metrics

		Scope estimates		
Scope credit ratios	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	144.5x	Negative	127.4x	32.6x
Scope-adjusted debt (SaD)/EBITDA	2.5x	2.2x	2.1x	2.7x
Scope-adjusted funds from operations/SaD	40%	44%	45%	35%
Free operating cash flow/SaD	Negative	2%	Negative	Negative

Rating rationale

Scope has affirmed the BB- issuer rating of Bonafarm Group along with the BB- senior unsecured debt rating. The Outlook was changed to Positive from Stable.

The Positive Outlook reflects the already improved profitability, which resulted in a lower leverage than previously anticipated. The lower leverage is also due to the delay in contracting the once-in-a-lifetime capex programme for subsidiary Pick Szeged. With construction costs soaring of late, the final budget may change, though this is mitigated by the increased subsidies.

The credit rating mainly reflects the leading positions in Hungary's meat and milk processing industries. This is attributed to: i) two of the group's brands, PICK and Sole-Mizo, being among the most valued in Hungary; ii) its high vertical integration for its agriculture assets (crops, animal feed, livestock, wine); iii) solid profitability (EBITDA margin of 7.5% in 2020); and iv) continuously strong parent support. The rating is held back by the effects of the delayed modernisation of acquired plants across several locations. The low automation in the plants has not only resulted in headcount being double that of main competitors but also made operating expenses and EBITDA more vulnerable to market prices, compounded by the soaring construction costs that will affect the budget of the delayed modernisation works (financed by the 2019 bond issuance).

Ratings & Outlook

Corporate rating	BB-/Positive
Senior unsecured rating	BB-

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Related Methodologies

Corporate Rating Methodology, July 2021

Consumer Products Methodology, September 2020

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Bloomberg: RESP SCOP

The business risk profile is rated BB+ overall. Bonafarm Group's industry rating remains at A-, with a portfolio consisting one-third of agribusiness and two-thirds of non-durable consumer products. Bonafarm Group is Hungary's largest fresh-food producer and has a controlled vertical integration model. Its market leadership in meat and milk processing gives it pricing power in Hungary. However, our assessment of market share is held back by the group's production output, which is much lower than European competitors', although the medium-term target of expanding its regional presence may lead to an improvement.

Customer diversification is broad. Meat and milk products are present in all Hungarian retail chains. In addition, export markets, mainly to Germany and Romania, made up more than 20% of group revenues (with HUF 59bn) in 2020. Third-party suppliers are well diversified. Strategic partnerships are strong with the group owner's other assets such as MCS Slaughterhouse, one of largest such establishments in the region. However, the product offering, while improving, remains limited. Processed meats focus on salami (around 50% of Pick Szeged's revenues), with a low share of high-protein products such as premium ham. The milk processing segment mainly relates to milk-fat-based products and lacks the protein-based (whey/added milk protein) and plant-based milk products offered by competitors.

The financial risk profile is rated B+ based on the reasonable leverage metrics, with a Scope-adjusted debt (SaD)/EBITDA ratio projected below 3x despite the ongoing capex and potential for M&A. The good projected leverage is supported by prior deleveraging to 2.5x as of 2020, by way of the 62% EBITDA increase since 2017 (to HUF 18.4bn from HUF 11.3bn) due to increases in sales by 25% and in the EBITDA margin to 7.5% from 5.7%. EBITDA/interest cover has always been strong. Funds from operations/SaD has been well above 30% since 2019 due to the improving EBITDA margin and good working capital management.

The main rating constraint, however, is free operating cash flow/SaD, which has been as low as -50% in 2017 due to large investments in processing plants. We expect very negative values once the brownfield investment for the Pick Szeged processed meat products kicks in.

The issuer rating also reflects a one-notch upgrade for parent support, reinforced by the recent equity increase for Pick Szeged's capital expenditure.

Outlook and rating-change drivers

The Outlook was changed to Positive from Stable reflecting the already improved profitability, which resulted in a lower leverage than previously anticipated. We may expect better future metrics subject to uncertain investment budget.

A positive rating action is possible upon i) a free operating cash flow/SaD sustained at more than 5% as a result of the executed investment strategy and production ramp-up; and/or ii) the contracting of Pick Szeged's investments within budget despite the soaring construction costs.

A negative rating action could be warranted by i) a funds from operations/SaD sustained below 15%; and/or ii) a SaD/EBITDA sustained above 4x. The latter could be caused by more debt taken on due to: i) higher construction costs; ii) a slow production ramp-up; iii) a significant change in market input prices; and/or iv) weaker pricing power in main segments due to further delays in modernisation that result in shrinking market shares and/or mergers and acquisitions.

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong position in Hungarian consumer products (processed meat and milk products) and agriculture, enabling pricing power • Vertical integration covering the full process chain: agriculture including animal feed and livestock, pork meat and milk processing and wines • Ownership of two of the most valuable consumer product brands in Hungary: PICK and Sole-Mizo • Strong parent support exemplified by equity increases totaling HUF 50bn in 2016-20	• EBITDA vulnerability to market prices, especially the recently increasing animal feed price, the fluctuating ZMP index, milk price and labour costs • Delayed execution to modernise plants in the context of soaring construction prices, mitigated by a higher-than-expected subsidy and owner's equity contribution • High production-related headcount compared to peers in both milk and meat processing as a consequence of delayed investments, low automation and production sites situated in multiple locations • Lack of transparency and discrepancies in past and forecasted financial disclosures • Possible high fluctuations in metrics due to large capital expenditures and M&A activity

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Free operating cash flow/SaD returning to more than 5% on a sustained basis due to executed investments and production ramp-up • Contracting of Pick Szeged's investments within budget	• SaD/EBITDA sustained above 4x • Funds from operations/SaD sustained below 15%

Financial overview

		Scope estimates		
Scope credit ratios	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	144.5x	neg.	127.4x	32.6x
Scope-adjusted debt (SaD)/EBITDA	2.5x	2.2x	2.1x	2.7x
Scope-adjusted funds from operations/SaD	40%	44%	45%	35%
Free operating cash flow/SaD	Negative	2%	Negative	Negative
Scope-adjusted EBITDA in HUF '000s	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	18,441,664	19,895,000	20,149,000	21,157,000
Operating lease payments in respective year				
Other				
Scope-adjusted EBITDA	18,441,664	19,895,000	20,149,000	21,157,000
Scope-adjusted funds from operations in HUF '000s	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	18,441,664	19,895,000	20,149,000	21,157,000
less: (net) cash interest as per cash flow statement	-127,604	233,597	-158,104	-649,604
less: cash tax paid as per cash flow statement	-160,293	-265,000	-362,000	-394,000
add: depreciation component, operating leases				
Scope-adjusted funds from operations	18,285,231	19,512,877	19,323,897	20,118,397
Scope-adjusted debt in HUF '000s	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	58,154,615	52,237,000	49,173,000	59,701,000
less: hybrid debt and bonds	-2,324,905			
less: cash and cash equivalents	-20,638,852	-17,557,167	-15,501,170	-1,663,491
add: cash not accessible	10,000,000	10,000,000	9,000,000	
add: pension adjustment				
add: operating lease obligations				
Other				
Scope-adjusted debt	45,190,858	44,679,833	42,671,830	58,037,509

Business risk profile: BB+

Industry risk profile: A-

As a vertically integrated agribusiness and commodity foods manufacturer, Bonafarm Group primarily generates revenues from the sourcing and distribution of crops, food, animals and their products as well as their inputs, and the processing, distribution and marketing of commodity food products. We used a blended approach to assign the industry risk profile, with roughly two-thirds of total sales and EBITDA relating to fast-moving (processed meat and milk products) consumer goods (A industry risk) and the remainder from agribusiness (BBB). With low substitution risk (food is non-discretionary), the overall industry risk profile is A-.

High cyclicality

Non-discretionary products normally have low cyclicality. However, the strong supply swings for agribusiness and commodity food products introduce significant volatility to both costs and prices, resulting in volatile revenues and EBITDA. Both expected (crop forecasts) and unexpected events (bad weather, diseases and government import restrictions) can lead to volatility, with supply shortages (increasing prices) and supply gluts (decreasing prices) leading to price volatility well in excess of more general price changes. For these reasons, we consider industry cyclicality to be high.

High entry barriers

Barriers to entry are high. This reflects the need to purchase appropriate land, construct specialised infrastructure and hire qualified personnel. Animal husbandry also involves significant temporal lags between breeding livestock and processing the resulting milk and meat products, as well as capital costs to establish adequate processing capacity. Costs for generating specialised infrastructure and changing products to align with demand are also substantial. Unemployment continues to be low among farmers and animal breeders in Hungary, making it difficult to find qualified personnel. Additional market barriers are intellectual property rights (trademarks, proprietary recipes for milk and meat products) and genetics (specialised, proprietary and high-productivity breeds).

Low substitution risk

Substitution risks are low, although agricultural commodity products can be easily substituted (either via imports or alternative domestic sources). Since Bonafarm Group is the largest vertically integrated (plot to plate) agribusiness and commodity food manufacturer in Hungary, other suppliers cannot offer the same scale and product coverage. Hence, vertical integration and the resulting control over final products (processed meat and milk products) limit substitution risks, as consumers are unlikely to accept differences in price, taste and consistency. The group also provides the necessary value chain certification for non-GMO products that cannot be easily reproduced with alternative inputs.

Stable outlook on core market of Hungary despite negative Covid-19 effect

Bonafarm's main market is Hungary. The country's economic growth, despite the negative effects of the Covid-19 pandemic, remains relatively robust, but is challenged by an ageing workforce. Productivity growth to meet this challenge has been strong. The Hungarian economy is open and medium-sized, with cyclical behaviour matching that of the eurozone in general. Robust wage growth, aided by productivity increases, has helped consumer demand grow strongly in recent years. Access to EU markets and a sound infrastructure support the robust outlook.

Our public finance rating for Hungary is BBB+/Stable, reflecting the country's track record of public debt reduction, robust capital inflows of foreign direct investment and EU funds supporting growth potential, and increased resilience against external shocks. Following years of above-trend growth, Hungary's highly open economy, with a large exposure to cyclical industries, has been severely affected by the Covid-19 pandemic and associated mitigation measures. A large and effective set of monetary and fiscal intervention was implemented to support the healthcare sector, businesses and households, cushioning the economy from the pandemic's impact. These factors, combined with the unprecedented EU-wide monetary and fiscal stimulus in response to the crisis, underpin our view that the country is well positioned to weather the Covid-19 crisis and will return to robust growth from 2021 onward.

Consumer product companies with strong brands benefit from pandemic

Market development continues to reflect slow changes in consumer preferences. The pandemic has increased food consumption at home rather than in restaurants. At the same time, the government has supported local production with subsidies and grants and, if needed, loans and financial guarantees from state-owned banks. Bonafarm Group has profited greatly from this due to its market leadership in processed milk and meat products in Hungary and its strong brands.

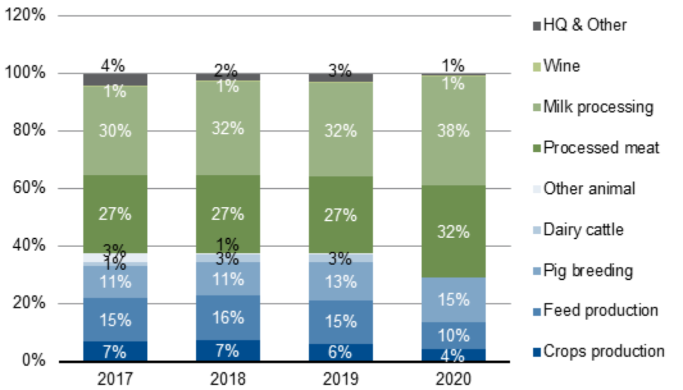
Strong vertical integration enhances diversification

Concentration on Hungarian market

Bonafarm Group profits from strong vertical integration. Access to key markets (China, Japan) is still an issue because certain parts of pork are sold frozen due to African Swine Fever. The effect is seen on the results of pig slaughterhouse MCS Vágóhíd, a strategic partner owned by Dr Sándor Csányi but not part of Bonafarm Group. For an agribusiness, the company is well diversified. Geographical diversification is concentrated on Hungary and export sales are moderate at less than a quarter of total revenues (mainly to Germany and Romania). We note that agriculture generates around HUF 75bn of revenues, typically domestically.

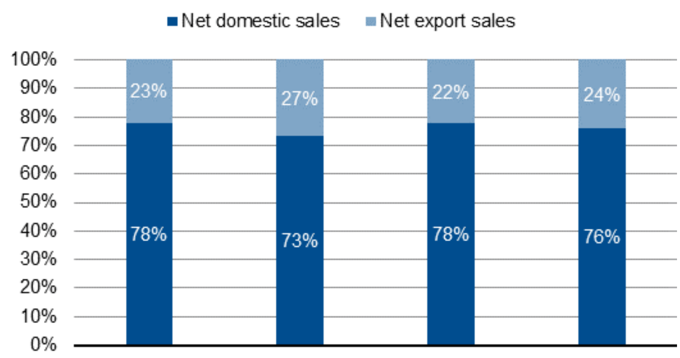
Product diversification (Figure 1) in 2020 was dominated by processed meat and milk production, at around 70% of total revenues. This increased from 60% in 2019 after revenues rose in consumer products and decreased in agriculture. Market diversification (Figure 2) shows the relatively moderate international position of revenues (consolidated) with relatively stable development.

Figure 1: Product diversification (sales, % of total)



Source: Bonafarm

Figure 2: Market diversification (sales, % of total)



Source: Bonafarm

Customer diversification

Bonafarm Group's customer base is highly diversified for a consumer product company, including all relevant retail chains in Hungary. Sales are balanced among retailers as its brands are in high demand in Hungary. Hence, there is limited concentration risk. Overall, Bonafarm Group is a price-taker, unable to fully recover cost increases in raw materials or, if so, with a delay. Bonafarm Group plans to expand distribution channels for future growth, especially for dairy. Export markets are increasing in importance, and Bonafarm Group is concentrating on key growth markets within Europe.

Improving profitability in line with other consumer product companies during Covid-19

EBITDA margins are moderate, at 5%-6% during 2015-18 and above 7% afterwards. Planned investments will move this towards 8% in the long term but not beyond. EBITDA is fairly volatile, mainly due to cost changes outside of the company's control such as increasing labour costs and input costs.

Slow execution of investments allow competition to gain market share and better profitability

Bonafarm Group is one of the largest employers in Hungary, with a headcount of more than 5,600. The ratio of revenue to headcount is half that of its main competitors in processed meat and milk. The seemingly low efficiency is mostly due to the old technology used in its production facilities, whose modernisation has been delayed, facilities being situated in multiple locations, and the nature of the production of its products (salami). In agriculture the group uses state of the art technologies with high efficiency, especially in crop production and livestock breeding.

The main domestic competitor of Bonafarm Group's milk processing subsidiary, Sole-Mizo, is Alföldi Tej, which in 2020 caught up to Sole-Mizo's domestic revenue with around HUF 55bn and outperformed its EBITDA margin with 4.9% against Sole-Mizo's 4.6%. This is due to Alföldi Tej's better efficiency and wider product portfolio. Bonafarm Group focuses on fat-based milk and meat products, while the competition also offers a wide range of premium protein-based products, which have superior EBITDA margins. Further delays in investments in the meat segment may see competition continuing to catch up.

Strong brands enable pricing power in Hungary

In Hungary, both PICK and Sole-Mizo brands have high consumer awareness and are known for high quality. This leading position enables premium pricing for salami and certain milk products despite lower operating efficiencies compared to competitors, which the group is using well in negotiations with retailers. We see the sustained market leadership by both sales and brand as key to keeping this pricing power.

Financial risk profile: B+

Financial risk assumptions

We overweighed the financial risk profile rating as the large capex budget is subject to change and the group could benefit from a tighter financial policy.

Our key financial assumptions are: i) no major restructuring of the company or subsidiaries; ii) mergers or acquisitions of up to HUF 8bn, resulting in SaD/EBITDA staying below 3.5x in line with group financial policy; iii) continuity of management; iv) top-line sales growing organically by up to 5% yearly; v) return to market growth, low unemployment and strong wage growth in Hungary, combined with the central bank continuing to keep interest rates within targets and exchange rates stable; vi) no major agribusiness-related event (e.g. drought, disease); vii) investment plans executed as presented with no meaningful operational or financial risks; and viii) continuity of financial policy, especially in terms of no dividends and no new large debt issuances, while SaD/EBITDA stays below 3.5x.

Improving leverage ahead of large brownfield investment

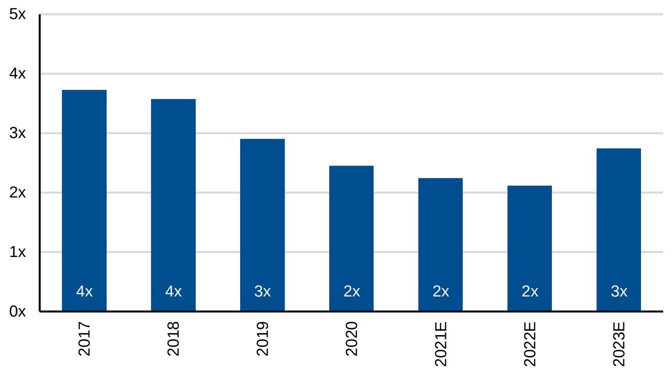
The consortial secured financing provided by CIB Bank Zrt (member of Intesa Group) and Raiffeisen Bank Zrt of HUF 44.7bn (EUR 139.8m) is jointly, severally, irrevocably and unconditionally guaranteed by Bonafarm Group. The covenants of the consortium credit line are i) an equity ratio of at least 30%; ii) maximum indebtedness of 4x; iii) two-year average net operating cash flows of at least HUF 9bn; iv) annual debt service coverage ratio of at least 1.05x; and v) total assets to shareholder equity of at least 45%. According to the 2020 compliance certificate, all covenants were fulfilled with good headroom. Ongoing capex will negatively affect credit metrics.

Leverage has been decreasing since 2017, from 3.7x to 2.5x in 2020 as measured by SaD/EBITDA. The reason is the increases in sales by 25%, in the EBITDA margin to 7.5% from 5.7%, and in EBITDA to EUR 18.4bn from HUF 11.3bn (+62%).

Gross debt increased to HUF 58bn in 2020 from HUF 43bn in 2017 (+34%), though this related to the upcoming PICK facility – hence, the EBITDA effect will come from 2025 onwards. Nevertheless, the EBITDA increase during the years has been double the increase for debt, resulting in deleveraging. This may rise back to around 3.5x due to investments (organic and M&A).

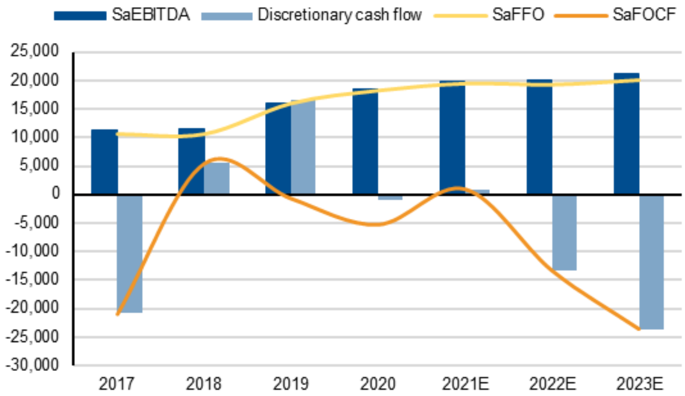
Funds from operations/SaD has been well above 30% since 2019 due to the improving EBITDA margin and good working capital management.

Figure 3: Leverage over time as measured by SaD/EBITDA[1]



Source: Bonafarm, Scope estimates

Figure 4: Cash flow overview showing large investments



Source: Bonafarm, Scope estimates

Strong interest cover coupled with improving cash flow headroom

EBITDA/interest cover has always been strong at Bonafarm Group. The low interest rate regime of the central bank combined with state-subsidised financing opportunities has allowed Bonafarm Group to contract debt with an average interest burden of 1.24%, calculated for 2020 on the drawn exposure. 80% of committed financing facilities have fixed interest rates. Hence, we expect the increasing base rate in Hungary to have no major impact.

Bonafarm Group also receives interest from affiliates and related parties to the extent that interest received may exceed interest payable in 2021.

The financing structure includes low amortisation and high balloon or bullet facilities, which allow a good debt service coverage ratio. The issued HUF 27bn bond is repayable only at maturity in 2029, which provides great cash flow headroom.

Soaring construction costs are mitigated by higher-than-expected state subsidy

With the acquisition of large production sites in need of modernisation as well as and efficiency and capacity expansion, free operating cash flow/SaD fell to -50% in 2017. We expect to see very negative values once the Pick Szeged investment kicks in.

Since the plans for the Pick Szeged facility were made and the related bond was issued in 2019, construction costs in Hungary have soared. The Hungarian Investment Promotion Agency recently granted a HUF 10.6bn non-refundable investment subsidy to the HUF 39bn investment budget; the previous plan calculated conservatively only a HUF 2bn subsidy, leaving room for cost overruns.

Adequate liquidity

Liquidity is improving due to the small chunks of short-term debt and increasing cash flow. The company has a HUF 7.3bn overdraft facility, which is currently mainly unused, and a small factoring facility at Sole-Mizo (fully consolidated subsidiary), also unused. However, due to the short tenor of these facilities, we have excluded them from the liquidity calculation.

[1] Small analytical changes have been performed on 2017-19 Scope-adjusted debt figures from slightly above 4x to slightly below 4x.

Supplementary rating drivers

Neutral financial policy, coupled with discrepancies in disclosures

Bonafarm Group's financial policy continues to have the aims of a strong expansion of core businesses (primarily Pick Szeged) and organic growth overall. The Pick Szeged investment focuses on strategic modernisation and expansion and the replacement of a production plant built in the 1970s. Bonafarm Group carries all group debt. We view financial policy as largely prudent as management is committed to keeping leverage at a maximum of 3.5x. Loan covenants allow up to 4x. We also have moderate expectations for top-line growth. The group has implemented IT system SAP for reporting and controlling production costs. Even so, financial planning, financial reporting and detailed notes for audit disclosures still have room for improvement. We did not adjust the rating for financial policy or governance.

Parent support: one-notch uplift for investing HUF 50bn in five years

Dr Sándor Csányi was for a long time Hungary's richest individual; currently he is second. Forbes magazine estimated his wealth in 2021 at HUF 420bn (around EUR 1.2 bn). Dr Csányi has several other interests not consolidated in Bonafarm Group. These include MCS Vágóhíd, one of the region's largest pig slaughterhouses; KITE, which trades agricultural goods and machinery; and Hungerit, one of Hungary's largest chicken processing and production companies. Dr Csányi fully owns Bonafarm Group through Bonitás 2002 Zrt. and has supported the group significantly with equity and owner loans since its inception.

For the Pick Szeged investment, Dr Csányi contributed an equity increase in cash through Bonafarm Group's holding company, Bonitás 2002 Zrt., of HUF 4.4bn in 2020 and HUF 17.25bn in 2019. A previous equity increase in 2016 totalled HUF 28.3bn. These add up to HUF 50bn in five years (EUR 140m).

Therefore, we maintain the one-notch uplift for parent support, reinforced by the recent equity increases.

Senior unsecured debt rating

Average recovery

Wholly owned subsidiary Pick Szeged issued senior unsecured debt in 2019 of HUF 27bn. While the company has a strong asset position, we have not provided an uplift for any potential recovery.

We therefore affirm the BB- rating on senior unsecured debt issued by Bonafarm Group, which is in line with the issuer rating. The debt category rating reflects the ranking of debt issued by Pick Szeged, which is below the HUF 32bn senior secured bank debt and unfunded commitments of HUF 8.3bn of Bonafarm Group. We expect an 'average' recovery for outstanding senior unsecured debt in a hypothetical default scenario in 2023.

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