Szabó Fogaskerékgyártó Kft.
Hungary, Capital Goods

B STABLE

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. The company has a 2,500 sq m production facility in Kaposvár and employs more than 50 people. In 2020, it reported revenues of around HUF 1.78bn (roughly EUR 5m) with an EBITDA margin of 45%.

Key metrics

			Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	106.1x	454.0x	19.8x	5.6x	6.9x
Scope-adjusted debt (SaD)/EBITDA	1.0x	0.7x	1.9x	3.7x	3.1x
Scope-adjusted funds from operations/SaD	100%	129%	48%	21%	27%
Free operating cash flow/SaD	27%	-20%	-43%	-40%	-2%

Rating rationale

Scope Ratings has assigned Szabó Fogaskerékgyártó Kft. a first-time issuer rating of B/Stable. Senior unsecured debt has been rated B+, one notch above the issuer rating.

Szabó Fogaskerékgyártó plans to issue a HUF 1.5bn bond under the Hungarian National Bank's Bond Funding for Growth Scheme. The bond will feature a tenor of 10 years, 10% annual amortisation of the notional value between 2027-31, a 50% bullet repayment in 2032, and a 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 an automated warehouse structure.

The business risk profile, assessed B-, is constrained by the company's size, low product diversification, and high customer and end-market concentration. With sales of around HUF 1.8bn (roughly EUR 5m), Szabó Fogaskerékgyártó is a very small niche player in the European capital goods market. It specialises in gear manufacturing. Profitability is the main support for the business risk profile.

The financial risk profile is assessed BB. We expect Scope-adjusted-debt (SaD) to increase to around HUF 1.03bn at year-end 2021 (HUF 549m at year-end 2020) due to an increase in financial leases during 2021. Assuming a successful bond issue, we expect SaD to increase to around HUF 2.34bn at year-end 2022.

Leverage as measured by SaD/EBITDA is expected at 1.9x in 2021 (0.7x in 2020), reflecting higher SaD and lower expected EBITDA. We expect this ratio to increase after the planned bond issuance to a range of 3.5x-4.0x at year-end 2022. After that, we expect the ratio to improve to around 3.0x at year-end 2023. Based on the company's expansion plans leading to high capex and negative FOCF, we expect cash flow cover as measured by free operating cash flow/SaD to be negative in 2021, 2022 and 2023.

We consider Szabó Fogaskerékgyártó's liquidity and financial flexibility to be 'adequate'. This view is supported by a new HUF 200m loan that the company raised from Erste Bank in 2021 to repay maturities in 2021, the reimbursement of the loan to the company's subsidiary in 2021, and our assumption of a successful HUF 1.5bn bond issue in 2022.

Ratings & Outlook

Corporate rating	B/Stable
Senior unsecured rating	B+

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Related Methodology

Corporate Rating Methodology, July 2021

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Outlook and rating-change drivers

The Stable Outlook incorporates a successful placement of the HUF 1.5bn bond under the Hungarian National Bank's Bond Funding for Growth Scheme. It also includes our expectation that proceeds from the bond will be used for investments and that Szabó Fogaskerékgyártó will retain its main customers and return to growth in 2022 after an expected small dip in growth in 2021. Furthermore, the outlook reflects our expectation that dividends will be limited to HUF 50m during the investment cycle and no further subsidiary loans or shareholder loans will be approved.

We deem a rating upgrade to be remote at this stage but it is possible if the company can grow while achieving deleveraging.

A negative rating action could result from SaD/EBITDA staying at around 4x on a sustained basis, e.g. caused by EBITDA margin pressure from rising material or personnel costs or increased financial debt. It could also result from weaker liquidity, the loss of a major customer, or the use of bond proceeds for purposes other than those announced.

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong operating profitability (EBITDA). The Scope-adjusted EBITDA margin was 44.8% in 2020 and 38.7% in 2019. • Solid revenue development is expected, driven by recent capacity expansion • Long relationships with largest customers	• Very small niche player in the European capital goods market with revenues of HUF 1.8bn (roughly EUR 5m) in 2020 • Low product diversification, very low share of recurring revenues and lack of aftermarket activities, which usually result in lower volatility • High customer concentration: 85% of revenues from two customers • High end-market concentration: around 90% of revenues come from companies in the agricultural machinery sector • Weak FOCF: We project negative FOCF for 2021-23 (reflecting planned investment cycle)

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Remote at this stage but it is possible if the company can grow while achieving deleveraging	• SaD/EBITDA staying at around 4x on a sustained basis • Deterioration in liquidity, use of bond proceeds for other purposes than those announced, loss of a major customer

Financial overview

			Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	106.1x	454.0x	19.8x	5.6x	6.9x
SaD/EBITDA	1.0x	0.7x	1.9x	3.7x	3.1x
Scope-adjusted funds from operations/SaD	100%	129%	48%	21%	27%
FOCF/SaD	27%	-20%	-43%	-40%	-2%
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	626.7	797.6	550.0	625.0	705.6
Other					
Scope-adjusted EBITDA	626.7	797.6	550.0	625.0	705.6
Scope-adjusted funds from operations in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	626.7	797.6	550.0	625.0	705.6
less: (net) cash interest as per cash flow statement	-5.9	-1.8	-27.8	-112.1	-102.3
less: cash tax paid as per cash flow statement	-23.1	-55.5	-24.5	-21.4	-20.9
less: pension interest					
Other					
Scope-adjusted funds from operations	597.7	740.3	497.7	491.5	582.4
SaD in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	571.6	549.3	1,008.9	2,315.3	2,129.8
less: hybrid bonds					
less: cash and cash equivalents					
add: cash not accessible					
add: pension adjustment					
add: lease obligations					
Other	25.0	25.0	25.0	25.0	25.0
SaD	596.6	574.3	1,033.9	2,340.3	2,154.8

Business risk profile

Business risk profile assessed B-

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

Specialised in gear manufacturing

The company specialises in gear manufacturing, production of geared parts, and machining. It has a multitude of gear types (over 1,000 varieties). The main product lines are spur gears, helical gears, worm gears, planetary gears, spline shafts, straight bevel gears and geared axes. The company is involved in R&D, and it produces prototypes as well.

Figure 1: **Examples of products**

Source: Scope

Very small niche player in the European capital goods market

With sales of around HUF 1.8bn (roughly EUR 5m), Szabó Fogaskerékgyártó is a very small niche player in the European capital goods market.

More than 4,000 companies in Hungary are currently active in metalworking. 115 of those have annual sales of HUF 1bn-10bn, and 121 of them have sales of HUF 1bn-50bn.

Most of Hungary's metalworking companies (and most of its suppliers in general) serve the automotive and consumer electronics industries. Both of these industries are characterised by mass production, intense price competition (automotive has a 10% EBITDA margin on average), and a high degree of cyclicality.

Usually produces small to mid-size batches

Unlike companies in the automotive sector, Szabó Fogaskerékgyártó does not produce parts with high level of standardization i.e. high volume. Instead, the company has a multitude of gear types (over 1,000 varieties), which it usually produces in small to mid-size batches (10-500 pieces per order).

EBITDA margin indicates good bargaining power

The market is fairly fragmented overall. Some customers outsource metalworking to suppliers such as Szabó Fogaskerékgyártó. The company's reported EBITDA margin suggests that it has good bargaining power in negotiations. Quality, precision and reliability (just in time) are factors that play a role in when customers select suppliers.

Diversification is main constraint

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 product portfolio can be structured as follows: i) gear and gearbox production (99% of total turnover); and ii) waste management and heat treatment (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 around 85% of total sales. We note positively that relationships with the most significant clients go back 20-30 years. Szabó Fogaskerékgyártó not only produces gears for its clients, it also takes part in the product development and testing phase, which ensures customer retention. Customer retention is also ensured by the fact that Szabó Fogaskerékgyártó does not produce

parts with a high level of standardisation i.e. high volume, but rather small to mid-size batches (10-500 pieces per order) from its portfolio of a multitude of gear types (over 1,000 varieties).

- 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: Export activity accounts for 62% of the company's total net sales revenue, and Germany accounts for 97% of total export sales revenue. All of the company's manufacturing capacity is in Hungary. It relies largely on a natural hedge to manage exchange rate risk as more than 60% of its revenues are denominated in EUR. Its purchases of raw materials, tools etc. are also in EUR.

Profitability supports business risk profile

Profitability is the main support for the business risk profile. The EBITDA margin reached 44.8% in 2020, a significant increase versus 38.7% in 2019 due to a higher gross profit margin.

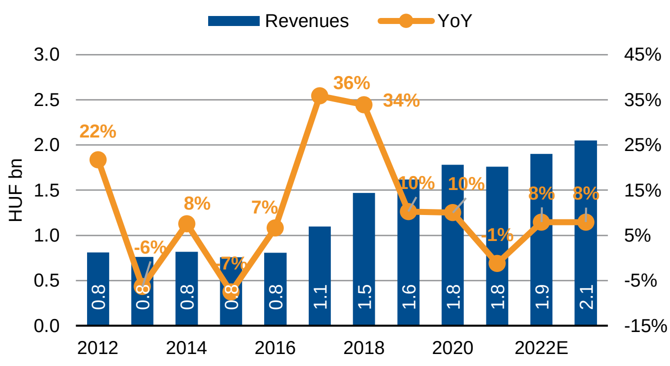
Volatility in EBITDA margin driven by product mix

Szabó Fogaskerékgyártó sources its own raw materials. The company only has project orders, not long-term production contracts. This gives it flexibility to react to changes in raw materials prices. Nevertheless, the gross profit margin proved volatile between 2015-20, affecting the EBITDA margin.

We expect a Scope-adjusted EBITDA margin of around 35% in 2021 and 2022

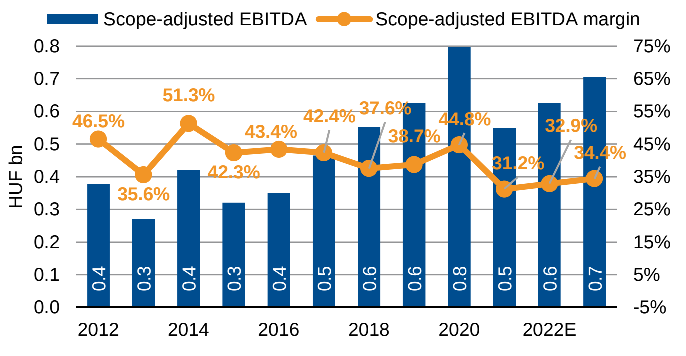
After 9M 2021, the EBITDA margin decreased to 35.1%, reflecting a lower gross profit margin due to higher raw materials prices and steel shortages. Higher personnel expenses due to an increased headcount and higher average wages are also expected to weigh on profitability. Szabó Fogaskerékgyártó's guidance for the full year 2021 puts EBITDA at around HUF 550m (EBITDA margin of around 31%) and attributes the decrease to a large purchase of raw materials at the end of 2021 that was intended to secure margins in 2022. We expect EBITDA margins in the range of 30%-35% in 2022-23.

Figure 2: **Revenues, 2012 to 2023E**



Source: Szabó Fogaskerékgyártó, Scope

Figure 3: **Scope-adjusted EBITDA, Scope-adjusted EBITDA margin, 2012 to 2023E**



Source: Szabó Fogaskerékgyártó, Scope

Significant growth in revenues since 2016

The company's revenues have grown significantly since 2016, driven by a strong increase in export activity, which in turn was driven by strong customer demand. The company met this demand by adding shifts. Domestic revenues remained rather flat with substantial volatility year on year. Generally, domestic sales volumes are driven by trends at Szabó Fogaskerékgyártó's largest Hungarian customer. Flat domestic sales volumes reflect the company's strategy of putting more emphasis on international sales, shifting the order book in that direction.

Low share of recurring revenues is credit-negative

We note negatively the low share of recurring revenues as Szabó Fogaskerékgyártó only has project orders, not long-term production contracts.

Capacity expansion in 2021 and larger order backlog to drive revenues in 2022

In 2020, revenues increased by 10% YoY to HUF 1.78bn, driven by higher domestic sales (up 36% YoY), while export sales were 1.4% lower YoY. After 9M 2021, revenues totaled HUF 1.28bn (down 10.4% YoY). According to Szabó Fogaskerékgyártó, preliminary figures indicate 2021 revenues were around HUF 1.8bn. We expect 2022 revenues to increase by about 8% to HUF 1.9bn, as the new machinery purchased in 2021 will give the company additional production volume (around 30% in extra capacity). The company says the order backlog from its two main customers (which together accounted for 85% of revenue in 2020)[1], stood at around HUF 1.6bn at year-end 2021. In 2023, we expect revenues to increase by around 8% to HUF 2.05bn.

Financial risk profile: BB

Financial risk profile assessed BB

The financial risk profile is assessed BB. Reported debt stood at HUF 549m at year-end 2020 (HUF 1.1bn at end-September 2021).

SaD of HUF 1.03bn expected at year-end 2021

Debt comprises bank loans (HUF 526m, HUF 599m at end-September 2021) and leases (HUF 23m, HUF 475m at end-September 2021). Scope has made an adjustment for an EU investment grant of HUF 25m (part of accrued liabilities), which will terminate in 2025. Based on this adjustment, Scope calculates SaD of HUF 549m at year-end 2020 (HUF 572m at year-end 2019). Scope expects SaD to increase to around HUF 1.03bn at year-end 2021, largely reflecting an increase in financial leases due to new leases of additional machines in 2021.

SaD expected to increase to HUF 2.34bn after bond issuance

Szabó Fogaskerékgyártó plans to issue a HUF 1.5bn in 2022 with a 10-year maturity under the Hungarian National Bank's Bond Funding for Growth Scheme. The proceeds with be used to expand capacity. Assuming a successful bond issue, Scope expects SaD to rise to around HUF 2.34bn at year-end 2022.

No financial covenants

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

Operating cash flow and FOCF turned negative in 2020

Operating cash flow was positive between 2012-19. Negative operating cash flow of HUF 62m in 2020 reflects an increase in other receivables due to loans to subsidiary Szabo Hajtástechnológia Kft. as well as higher shareholder loans. This caused FOCF to turn negative in 2020 (negative HUF 114m) after being in positive territory between 2016-19.

According to the company, loans provided to the subsidiary have been largely reimbursed in 2021 and no further support is planned in the near future. This loan reimbursement will positively impact FOCF by around HUF 290m in 2021.

Higher expected net working capital in 2021 to weigh on cash flow

We expect higher net working capital in 2021 because of the company's strategic decision to make a large purchase of raw materials at the end of 2021 in order to secure profitability in 2022. This weighed on cash flow in 2021.

High capex in 2021-23 due to investment cycle …

… with negative FOCF during that period

Szabó Fogaskerékgyártó has informed us that its preliminary figures indicate its 2021 capex was around HUF 1bn. Based on our revenue and EBITDA margin assessment, we expect capex of around HUF 1.6bn in 2022 and around HUF 550m in 2023. Increased capex compared to previous years reflects planned investments in a new production hall and logistics centre and the development of an automated warehouse structure. In view of this increased capex, we expect FOCF to turn negative, falling to negative HUF 450m, negative HUF 940m, and negative HUF 40m (all approximate) for 2021, 2022 and 2023 respectively.

[1] The text was amended on 31 January 2022 to remove confidential information.

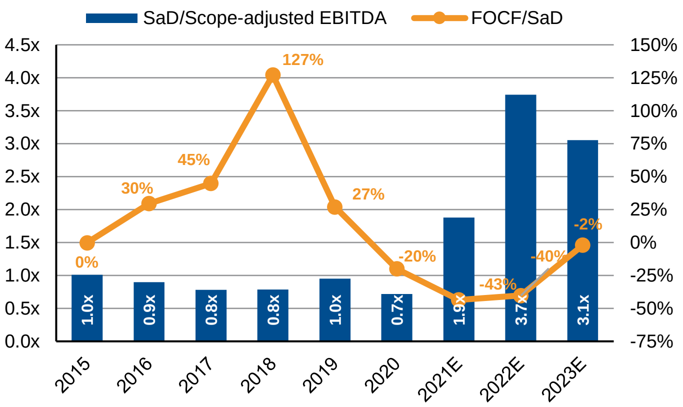
Leverage to increase to more than 3x after bond issuance

Leverage as measured by SaD/EBITDA is expected at 1.9x for 2021. This is an increase from 0.7x due to higher-than-expected SaD and lower expected EBITDA. We anticipate this ratio will increase further after the planned bond issuance, to a range of 3.5x-4.0x at year-end 2022. After that, we expect the ratio to improve to around 3.0x at year-end 2023.

Negative FOCF/SaD driven by the investment cycle

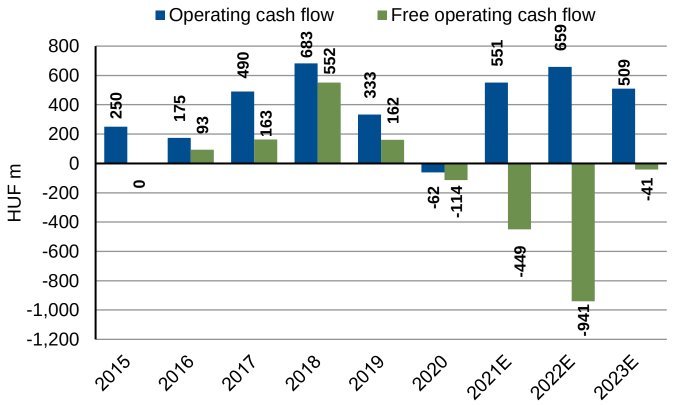
Cash flow cover as measured by FOCF/SaD stood at negative 20% in 2020 (28% in 2019), reflecting negative FOCF due to loans to a subsidiary. In view of the planned investment cycle, we believe cash flow cover will remain negative in 2021, 2022 and 2023.

Figure 4: SaD/Scope-adjusted EBITDA, 2015 to 2023E



Source: Szabó Fogaskerékgyártó, Scope

Figure 5: Cash flow, 2015 to 2023E



Source: Szabó Fogaskerékgyártó, Scope

Adequate liquidity

We consider Szabó Fogaskerékgyártó's liquidity and financial flexibility to be 'adequate'.

Cash sources

Liquidity at end-December 2020 comprised cash on balance sheet of HUF 607m (HUF 27m at end-September 2021) and short-term financial assets (government bonds) of HUF 62m (HUF 62m at end-September 2021). 2021 saw the company raise a new HUF 200m loan from Erste Bank to repay maturities in 2021. In addition, we expect HUF 1.5bn in proceeds during 2022 from the planned bond issue. Furthermore, we expect operating cash flow of around HUF 550m in 2021 (supported by the reimbursement of the subsidiary loan) and around HUF 660m in 2022.

Cash uses

On the other hand, we expect the following cash uses: i) capex of around HUF 1.0bn in 2021, HUF 1.6bn in 2022 and HUF 550m in 2023; ii) dividend payments of around HUF 50m in 2021, 2022 and 2023; and iii) debt repayments of around HUF 165m in 2021 and around HUF 200m in 2022.

Neutral view on financial policy

In recent years Szabó Fogaskerékgyártó has tended to distribute all of its FOCF as shareholder dividends. This had a limited impact on the balance sheet, with SaD/SaEBITDA remaining relatively stable at around 0.8x. Its plans state that it intends to reduce its dividend payment to HUF 50m during the investment cycle. However, it is our understanding that it will not make a contractual commitment to this reduced dividend payment.

Long-term debt rating

B+ senior unsecured debt rating

In view of the 'above average' recovery prospects for bondholders in a simulated event of default, we have assigned a rating of B+ to the senior unsecured debt class, one notch above the issuer rating.

The company currently has credit/leasing facilities of HUF 1.07bn, of which HUF 598m is bank credit and HUF 475m is financial leasing. Bank loans are secured by a pledge on selected machines, trucks and cars.

The company plans to issue a HUF 1.5bn bond under the Hungarian National Bank's Bond Funding for Growth Scheme. The bond will feature a tenor of 10 years, 10% annual amortisation of the notional value between 2027-31, a 50% bullet repayment in 2032, and a 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 (automated warehouse structure).

We assume that Szabó Fogaskerékgyártó will reduce its bank and lease debt by around HUF 385m until year-end 2023 and the business plan and investment programme will be executed as planned with no additional bank debt or other senior-ranking financing ahead of the planned bond.

Our recovery analysis uses a liquidation value of around HUF 2.1bn for a hypothetical default in 2023. This value is based on a haircut on assets and reflects liquidation costs of 10% for assets. We assume that the liquidation value will benefit from the high level of ongoing investments. We also assume that shareholder and subsidiary receivables from the parent would become non-recoverable in the event of payment default.

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