# Vasútvill Kft.
# Hungary, Construction

SCOPE BB- NEGATIVE

## Key metrics

| | | | Scope estimates | | |
|---|---|---|---|---|---|
| **Scope credit ratios** | **2020** | **2021** | **2022E** | **2023E** | **2024E** |
| Scope-adjusted EBITDA/interest cover | 122.8x | 9.6x | 6.1x | 3.4x | 8.9x |
| Scope-adjusted debt (SaD)/Scope-adjusted EBITDA | Net cash | 0.4x | 1.8x | 5.5x | 2.3x |
| Funds from operations/SaD | Net cash | 123% | -43% | 15% | 39% |
| Free operating cash flow/SaD | Net cash | 58% | -64% | -42% | -10% |

## Rating rationale

The Outlook change reflects the significant reduction in orders added to Vasútvill's backlog amid the uncertainty regarding future supply of EU-funded public infrastructure projects, which the company's business relies on. A smaller backlog could weaken cash flows and the financial credit profile and could ultimately affect the issuer rating. The Hungarian government's intention to freeze or postpone HUF 1,150bn of public investment in 2022 and 2023 adds to this uncertainty.

After years of fiscal stimulus linked to EU funds and local governmental policies, tenders have become scarcer in Vasútvill's niche market while competition has increased, leading to lower volumes and thinner margins (backlog of HUF 8.2bn in May 2022 compared to HUF 22bn in the previous year). A recovery in future spending in infrastructure projects, also in line with the goal to reduce carbon emissions until 2030, would lead to an increase in stimulus-related orders, but when this will happen is uncertain. We expect the top line and cash flow to remain weak in 2022 before the backlog gradually recovers. This is based on the company's robust market positioning, accounting for around 65% of staff and machinery in Hungary's overhead line construction segment.

## Outlook and rating-change drivers

The Negative Outlook reflects the risk of the backlog remaining low (backlog to revenues of less than 1x) and profitability remaining weak (Scope-adjusted EBITDA margin of less than 10%). Our base case still foresees credit metrics to weaken from 2022, which factors in the lower visibility on business fundamentals, including a weaker economic environment and inflationary pressures, but also the expectation of a gradual recovery in top-line metrics once public procurements recover.

A positive rating action, with a return to a Stable Outlook, is possible if the company's order backlog recovered quickly, improving operational visibility. The possibility of a rating upgrade is remote at the moment.

A negative rating action, i.e. a downgrade, might result from an inability to achieve a fast recovery in business conditions and/or liquidity concerns. This could be triggered by a deterioration in market conditions while no projects are added to the backlog and/or dividend payouts increase.

## Rating history

| Date | Rating action/monitoring review | Issuer rating & Outlook |
|---|---|---|
| 14 June 2022 | Outlook change | BB-/Negative |
| 12 July 2021 | Affirmation | BB-/Stable |
| 7 July 2020 | Initial | BB-/Stable |

### Ratings & Outlook

| | |
|---|---|
| Issuer | BB-/Negative |
| Senior unsecured debt | BB- |

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### Related Methodologies and Related Research

Corporate Rating Methodology; July 2021

Construction and Construction Materials Rating Methodology; January 2022

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Bloomberg: RESP SCOP

| Positive rating drivers | Negative rating drivers |
|---|---|
| • Leadership in domestic niche, having participated in 85% of railway electrification projects in Hungary<br>• Market position that benefits from a business model that covers the whole railway construction chain<br>• 70-year record and good domestic network<br>• Low leverage consisting mainly of a HUF 3bn bond issued in 2021 | • Small construction company in a European context, with a lack of geographic and segment diversification, somewhat mitigated by the strong niche position<br>• Concentrated customer portfolio and dependence on public sector tenders<br>• Geographical concentration on Hungary<br>• Short, concentrated contracted backlog providing limited visibility on revenues |

| Positive rating-change drivers | Negative rating-change drivers |
|---|---|
| • Return to a Stable Outlook could be warranted by fast recovery in the order backlog. | • Downgrade might be warranted by the inability to achieve a recovery in business conditions and/or liquidity concerns arising. |

## Corporate profile

Vasútvill Kft., headquartered in Budapest, is Hungary's largest builder of railway overhead lines. Its core business includes the construction, reconstruction, maintenance and transformation of electrical overhead rail lines, covering the whole business chain in the segment. The company has been involved in most of Hungary's major railway electrification projects and, together with its legal predecessors, has been present in the Hungarian market for over 70 years.

## Financial overview

| Scope credit ratios | 2020 | 2021 | 2022E | 2023E | 2024E |
|---|---|---|---|---|---|
| | | | Scope estimates | | |
| Scope-adjusted EBITDA/interest cover | 122.8x | 9.6x | 6.1x | 3.4x | 8.9x |
| SaD/Scope-adjusted EBITDA | Net cash | 0.4x | 1.8x | 5.5x | 2.3x |
| Funds from operations/SaD | Net cash | 123% | -43% | 15% | 39% |
| Free operating cash flow/SaD | Net cash | 58% | -64% | -42% | -10% |
| **Scope-adjusted EBITDA in EUR m** | | | | | |
| EBITDA | 2,032.0 | 949.9 | 635.6 | 359.8 | 968.2 |
| less: disposal gains from fixed assets included in EBITDA | -24.5 | -0.6 | 0.0 | 0.0 | 0.0 |
| Other items | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Scope-adjusted EBITDA** | 2,007.5 | 949.3 | 635.6 | 359.8 | 968.2 |
| **Funds from operations in EUR m** | | | | | |
| Scope-adjusted EBITDA | 2,007.5 | 949.3 | 635.6 | 359.8 | 968.2 |
| less: (net) cash interest paid | -16.4 | -99.4 | -104.8 | -105.7 | -108.4 |
| less: cash tax paid per cash flow statement | -200.0 | -123.4 | -15.7 | 11.4 | -38.7 |
| Change in other items | 342.4 | -229.7 | -1,000.0 | 30.0 | 30.0 |
| **Funds from operations** | 2,133.6 | 496.9 | -485.0 | 295.5 | 851.2 |
| **Free operating cash flow in EUR m** | | | | | |
| Funds from operations | 2,133.6 | 496.9 | -485.0 | 295.5 | 851.2 |
| Change in working capital | -2,814.6 | -316.6 | 80.4 | -772.7 | -730.2 |
| less: capital expenditure (net) | 236.0 | 54.2 | -327.0 | -352.1 | -349.2 |
| **Free operating cash flow** | -445.0 | 234.5 | -731.6 | -829.2 | -228.3 |
| **Net cash interest paid in EUR m** | | | | | |
| Net cash interest per cash flow statement | -16.4 | -99.4 | -104.8 | -105.7 | -108.4 |
| Change in other items | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Net cash interest paid** | -16.4 | -99.4 | -104.8 | -105.7 | -108.4 |
| **Scope-adjusted debt in EUR m** | | | | | |
| Reported gross financial debt | 890.4 | 3,869.1 | 3,774.2 | 3,722.2 | 3,670.2 |
| add: derivative financial instruments | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| less: securities | -3,734.5 | -1,137.5 | -1,000.0 | -1,000.0 | -1,000.0 |
| less: cash | -311.7 | -2,354.9 | -1,665.9 | -784.7 | -504.4 |
| Other items* | 73.0 | 26.6 | 26.6 | 26.6 | 26.6 |
| **Scope-adjusted debt** | -3,082.8 | 403.3 | 1,134.9 | 1,964.2 | 2,192.4 |

* Given guarantees

### Table of Content



## Environmental, social and governance (ESG) profile[1]

| 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)

### ESG considerations

The construction industry has a massive environmental impact. Industry efforts have focused on reducing energy use and associated emissions. However, the recent disruption in supply chains has forced contractors to quickly find alternative suppliers or pay higher materials prices, a situation that is unlikely to alleviate in the near term. New Covid-related regulations regarding cleanliness and safety have also drastically affected operations at construction sites. Increased union influence could also lead to increased costs and timelines on projects.

The following ESG risks are the most relevant for construction companies: i) rising costs and sustainable building materials; ii) efficient technologies; iii) employee health and safety; and iv) litigation and bribery.

[1] 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: BB-**

Vasútvill's activities are concentrated in the civil engineering segment, including the construction, renovation and reconstruction of 25 kV, 50 Hz single-phase electrical overhead lines. The company has extensive experience in this field. Its activities also include the maintenance and renovation of railway tracks, thus covering the full spectrum of services in this niche market.

We consider the overall construction industry to be highly cyclical, with medium barriers to entry and low-to-medium substitution risk.

**Small player both in a European context and domestically**

With revenues of HUF 14.3bn in 2021, the company remains a small construction company both in a European context and in Hungary. This limited size is a negative rating driver because it implies greater sensitivity to unforeseen shocks, greater cash flow volatility and limited economies of scale.

Vasútvill's construction activities had a mixed performance in 2021. Revenues increased on 15% above the previous year's level but EBITDA stood at a low HUF 1bn (decrease of 53% YoY), mainly due to a sharp rise in construction materials costs. General market uncertainly has also affected the construction segment. Profit margins are being squeezed, while inflationary pressures, supply chain disruptions and increasing interest rates weigh on the cost side.

**Niche specialisation benefits market position**

Vasútvill benefits from its specialisation in one market, railway electrical overhead line construction, in which it has been active for over 70 years. Working as a contractor or subcontractor, the company has built more than 2,500km of Hungary's approx. 3,100km of electrified railway lines. This niche market has significant potential as only 41% of Hungary's rail network is electrified, below the European Union average of 53.7%. Hungary's goal is to have 3,400km electrified by 2025 (45% of the network). Vasútvill could also benefit from other international initiatives like the Budapest-Belgrade railway.

Vasútvill is negotiating two key projects in Hungary (both totalling about HUF 14bn) and plans to participate in at least eight projects, as confirmed by management. Given the normal delay between a new order being secured and its execution, we expect the top line and cash flow to remain weak in 2022 followed by a gradual recovery in the backlog. Our view is based on the company's robust market position, accounting for around 65% of staff and machinery in Hungary's overhead line construction segment.

**Limited diversification by geography, segment and customer**

Geographical diversification remains limited, concentrated in Hungary. While this focus has supported the company's domestic position, it also creates a full exposure to the macroeconomic environment of one region. This is compounded by Vasútvill's focus on construction, a cyclical industry in which market downturns tend to affect revenues and earnings. Moreover, all Vasútvill's construction activities, while covering the entire business chain, relate to one end-market: railway line construction.

Vasútvill's limited size results in high customer concentration as very few projects can be executed simultaneously. This means both profitability and cash flow from operations can be greatly affected by one project. Further, Vasútvill's niche segment is strongly dependent on government strategy and demand for (EU funded) infrastructure projects.

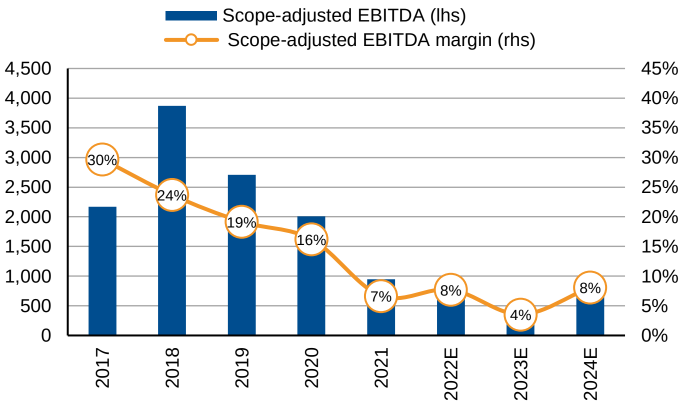
**Shrinking backlog due to increasing scarcity of tenders and more competition**

After years of fiscal stimulus – linked to EU funding priorities and specific local governmental policies – boosted Vasútvill's niche market, tenders have become scarcer while competition has increased, leading to lower volumes and thinner margins. Vasútvill's backlog totals HUF 8.2bn in May 2022 (compared to HUF 22bn in previous year), equating to 0.6x of 2021 revenues. This backlog provides only limited long-term visibility on cash flows and could weaken credit profile and, ultimately, its issuer rating.

Public procurements have also slowed due to the current electoral year in Hungary and the Hungarian government's intention to freeze or postpone HUF 1,150bn of public investment in 2022 and 2023 adds to this uncertainty.

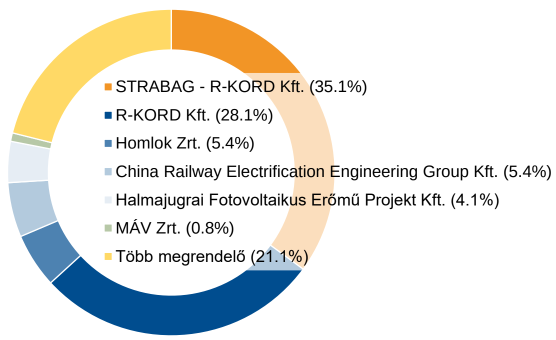
A recovery in the future spending in infrastructure projects, also in line with the goal to reduce carbon emissions until 2030, would support a recovery in stimulus-related orders, but when this will happen is uncertain. We expect the backlog to remain weak in 2022 followed by a gradual recovery supported by the company's robust market positioning.

**Figure 1: EBITDA and EBITDA margin**




Source: Vasútvill, Scope (estimates)

**Figure 2: Backlog by customer**




Source: Vasútvill, Scope

**Weaker profitability impacted by increasing raw materials prices**

Profitability, as measured by the Scope-adjusted EBITDA margin, also weakened to 7% in 2021 from 16% in 2020. To dampen the effect of rising raw materials prices, Vasútvill has entered into a strategic alliance with the Austrian Kirchdorfer Fertigteilholding GmbH, acquired 49% of MABA Hungaria Kft, a manufacturer of concrete construction products, especially sleepers for railway tracks. However, this will be insufficient to offset the full impact on projects of rising construction materials prices and supply chain disruptions. Therefore, we expect profitability to continue to weaken and the buffer against cost overruns before a project becomes loss-making to reduce. Further financial investments – Vasútvill acquired 49% participation in real estate developments – are expected to generate dividend income once projects are completed and sold – but only in the medium term. As such, we foresee profitability to remain below 10% in the next few years.

## Financial risk profile: BB

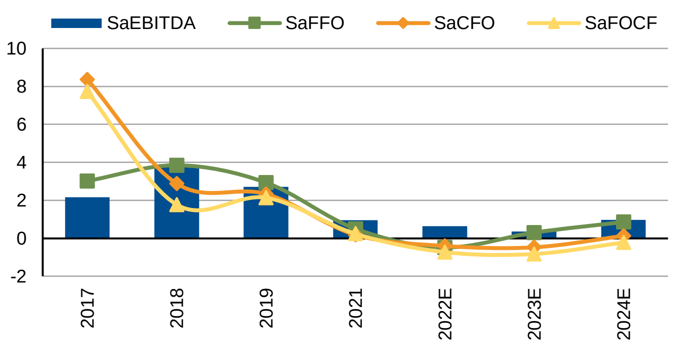
**Moderate debt protection despite debt increase in 2021**

Vasútvill has had relatively little financial debt in the past, keeping interest expenses low. This has resulted in a strong Scope-adjusted EBITDA interest coverage ratio in the years before 2020. Financial costs have risen since the HUF 3bn bond was issued in 2021 (3% coupon), but we expect debt protection to remain strong, based on the low interest expenses. There will be some uncertainty in 2023 once projects in the current backlog are completed.

**Weaker free operating cash flows**

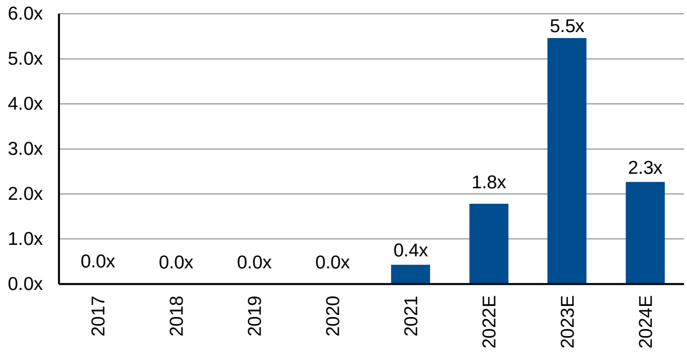
As a result of the very short backlog, we foresee cash flow to weaken. Whilst no significant capex is foreseen in the next few years, working capital requirements could also impact cash flow as the significant advance payments from customers become less likely in the future. In the past, infrastructure projects entitled the main contractor to a 50% advance payment upon signing the construction contract, with appropriate advance repayment guarantees. Whether this practice will continue is uncertain.

**Figure 3: Cash flows (HUF bn)**




Source: Vasútvill Scope (estimates)
Sa = Scope-adjusted

**Figure 4: Leverage (SaD/EBITDA)**




Source: Vasútvill, Scope (estimates)

**Leverage still benefits from robust cash position, but expected to increase**

The company's financial risk profile reflects robust credit metrics as indicated by the Scope-adjusted debt/Scope-adjusted EBITDA ratio of 0.4x at December 2021. Credit metrics benefit from a conservative debt strategy, evidenced by the very low debt balance – comprising mostly the HUF 3bn bond issued and about HUF 700m of financing leases – against the significant balance of unrestricted cash and cash equivalents (HUF 3.5bn at December 2021). We foresee leverage to increase from 2022 due to weaker-than-expected EBITDA followed by a gradual return to previous levels once public procurements recover.

**Adequate liquidity**

Liquidity is adequate and benefits from the company's conservative, back-loaded debt maturity profile, with no significant amount due in the next few years. Financial obligations in 2022 include HUF 40m of investment loans and HUF 454m of financing leases. Given the long maturity of the HUF 3bn bond, upcoming short-term maturities will be manageable. We also expect the company to maintain its low short-term debt levels and ensure these are covered by available liquidity.

| Balance in HUF m | 2021 | 2022E | 2023E |
|---|---|---|---|
| Unrestricted cash (t-1)* | 4,046 | 3,492 | 2,666 |
| Open committed credit lines (t-1) | 0 | 0 | 0 |
| Free operating cash flow | 234 | -732 | -829 |
| Short-term debt (t-1) | 0 | 40 | 40 |
| **Coverage** | **>200%** | **>200%** | **>200%** |

* includes cash and cash equivalents

## Corporate governance

Shareholders set the dividend distribution every year according to the company's results and needs. We note the large dividend payments in the three last years (HUF 1.6bn in FY 2021); however, management has decided to suspend distributions for the next few years in light of the weaker cash flows.

## Long-term and short-term debt ratings

**Senior unsecured debt: BB-**

Vasútvill issued a HUF 3bn senior unsecured corporate bond (ISIN HU0000360151) in Q1 2021 to partially finance future working capital requirements. The bond terms include amortisation of 20% yearly from 2026 until maturity, a fixed annual coupon and a 10-year tenor.

Our recovery analysis is based on a hypothetical default scenario in 2022, factoring in Vasútvill's liquidation value, and assumed outstanding senior unsecured debt of HUF 3bn. We expect an 'above-average' recovery for Vasútvill's senior unsecured debt. However, due to the increased market uncertainty, we have affirmed the debt class rating of BB- in line with the issuer rating and have not applied up-notching.

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