Szinorg Universal Zrt.
Hungary, Construction

SCOPE | B STABLE

Corporate profile

Szinorg Universal Vagyonkezelő Zrt. (Szinorg), headquartered in Debrecen, is one of the largest construction groups in eastern Hungary. Its activities include the construction, development, and property and facility management of real estate assets. The group's three largest subsidiaries by revenues are construction companies Hunép Zrt. and HC Építő Kft., as well as Hajdu-Alu Zrt, which dedicates to the production of curtain walls and doors and windows. The company has nearly 200 employees.

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020P**	**2021E**	**2022E**
Scope-adjusted EBITDA/Scope- adjusted interest cover (x)	120.4x	6.6x	5.9x	4.2x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	net cash	net cash	net cash	4.5x
Scope-adjusted FFO/SaD	net cash	net cash	net cash	17%
Scope-adjusted free operating cash flows FOCF/SaD	net cash	net cash	net cash	-177%

Rating rationale

Scope affirms B/Stable issuer rating of Szinorg Universal Zrt.

Szinorg's construction activities have not been interrupted by the impact of Covid-19 on the economy. However, the crisis has led to delays in public procurements and private tenders, while some contracted work has been rescheduled, which resulted in revenue declines (-16% below the previous year, based on 2020 preliminary figures). Profitability has also been impacted (4.2% in FY 2020 from 6.6% FY in 2019). Nonetheless, we believe Szinorg's plan to establish a real estate portfolio – to generate recurring income and/or sales proceeds – as well as its improved backlog (HUF 31bn) will help the company to protect revenues and cash flow generation in the next few years.

In H1 2020 the company issued a senior unsecured bond for a total of HUF 5bn, to partially finance its own planned developments. It also received financing from the Hungarian state (subsidies of HUF 3.7bn). Szinorg has available liquid resources (including HUF 10.4bn in cash in FY 2020) and we estimate that the company could add further bank loans for up to HUF 4bn for refinancing purposes in the period to 2023.

Szinorg's business risk, affirmed at B, continues to benefit from its market position and regional presence, as this translates into market visibility and affords moderate access to third-party financing. The rating is also supported by the company's customer diversification, with good outreach in terms of public and private customers (each representing 50% of total revenues in 2020). Finally, Szinorg's unrestricted and available liquidity exceeds its limited financial debt, resulting in negative Scope-adjusted debt (SaD) and, ultimately, in adequate credit ratios.

The rating remains constrained by the company's small scale in both a European and Hungarian context, which lessens its ability to mitigate economic cycles. Weak diversification is a further constraint, namely: i) a lack of geographical diversification (predominantly active in eastern Hungary); ii) a high reliance on one segment (building activities); and iii) a concentrated backlog of projects.

Ratings & Outlook

Corporate ratings B

Senior unsecured rating B+

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Related Methodology

Corporate Rating Methodology, February 2020

Rating Methodology European Construction Corporates January 2021

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Outlook and rating-change drivers

The Outlook for Szinorg remains Stable and incorporates our view that the company's revenues will stabilise at a level of at least around HUF 15bn, based on its current backlog and diversified portfolio of real estate developments. We assume Szinorg will be able to partially balance the decline in construction revenues by building up a real estate portfolio that can generate recurring income and/or sales proceeds. This should help keep its top line close to current levels in the medium term.

A positive rating action is remote but may be warranted if Szinorg keeps its backlog at above 2x on a sustained basis, benefiting from a higher granularity of customers and more complex projects, which would extend respective execution periods and help keep SaD/EBITDA below 3.5x on a sustained basis.

A negative rating action could occur if real estate developments suffer from significant delays or cost overruns but also if liquidity worsens. The latter could happen if, for example: i) customers delay payments significantly; or ii) the company becomes exposed to non-recoverable cost overruns on its projects.

Rating drivers

Positive rating drivers	Negative rating drivers
• Good regional market position translating into local market visibility as well as moderate access to third-party finance sources and guarantees • Strong liquidity (HUF 10.4bn in cash in FY 2020) supported by marketable securities of HUF 4.5bn and available undrawn overdrafts totalling HUF 2.8bn as at December 2020 • Healthy debt protection despite sharp anticipated increase in interest-bearing debt	• Small-scale construction company in a European context, with a lack of geographic and segment diversification, somewhat mitigated by the company's strong position within a niche market • Concentrated contracted backlog (top three projects account for 63% of backlog revenues, top 10 for 93%) • Negative free operating cash flow, which also translates into negative Scope cash flow metrics, but this is typical for companies in investment phases

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Maintenance of backlog at above 2x on a sustained basis combined with higher diversification (customers and projects) while keeping SaD/Scope-adjusted EBITDA below 3.5x on a sustained basis	• Worsening liquidity due, for example, to delayed customer payments or cost overruns • Delays or cost overruns for real estate developments

Financial overview

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020P**	**2021F**	**2022F**
Scope-adjusted EBITDA/Scope-adjusted interest cover (x)	164.6x	120.4x	6.6x	5.9x	4.2x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	net cash	net cash	4.5x
Scope-adjusted funds from operations/SaD	net cash	net cash	net cash	net cash	17%
Scope-adjusted free operating cash flow/SaD	net cash	net cash	net cash	net cash	-177%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020P**	**2021E**	**2022E**
Scope-adjusted EBITDA	1,820.5	1,485.2	662.0	925.2	738.3
less: disposals gains from fixed assets included in EBITDA	-9.8	-262.0	0.0	0.0	0.0
Other	174.1	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	1,984.8	1,223.2	662.0	925.2	738.3
Scope-adjusted funds from operations in HUF m	**2018**	**2019**	**2020P**	**2021E**	**2022E**
Scope-adjusted EBITDA	1,984.8	1,223.2	662.0	925.2	738.3
less: (net) cash interest as per cash flow statement	-12.1	-10.2	-100.0	-157.0	-176.5
less: cash tax paid as per cash flow statement	-60.5	-98.7	-40.0	-33.7	-11.2
add: depreciation component, operating leases	0.0	0.0	0.0	0.0	0.0
Scope-adjusted funds from operations	1,912.3	1,114.3	522.0	734.4	550.7
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020P**	**2021E**	**2022E**
Interest-bearing debt	39.0	0.1	5,000.0	5,700.0	6,700.0
Subordinated liabilities	1,277.4	1,277.4	1,280.0	1,280.0	1,280.0
Other liabilities	1,276.2	754.0	756.0	756.0	756.0
Cash	-6,721.8	-9,920.2	-10,392.5	-8,768.7	-5,593.6
Restricted cash	0.0	0.0	145.8	145.8	145.8
Off-balance sheet debt	0.0	0.0	0.0	0.0	0.0
Scope-adjusted debt	-4,129.1	-7,888.7	-3,210.7	-886.9	3,288.2

Business risk profile: B

Industry risk: B

Szinorg's activities include construction, real estate developments as well as the facility management of some group properties (such as hotels and student accommodation). However, construction is the most representative, with Hunép and HC Építő, providing more than 90% of revenues in 2020.

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

Small market player, both in a European context and domestically

Szinorg is a small construction company both in a European context and in Hungary, a highly fragmented market. It is at the lower end of the top 25 construction companies in Hungary, with only HUF 16bn in revenues and HUF 0.6bn in Scope-adjusted EBITDA in 2020 (based on preliminary figures). The company's small size limits its ability to benefit from economies of scale or to offset the impact of economic cycles, as evidenced in 2020.

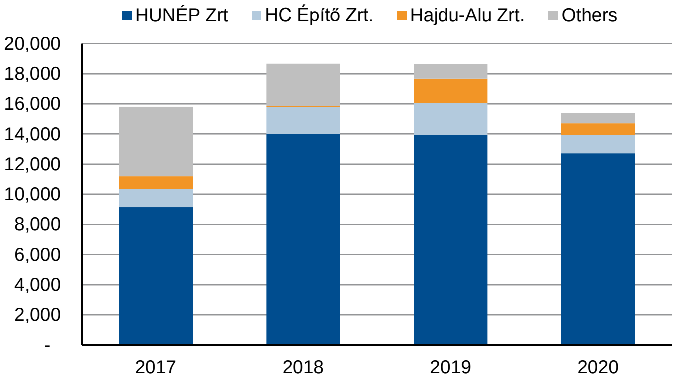
Szinorg's construction activities have not been interrupted by the impact of Covid-19 on the economy. However, the crisis has led to delays in public procurements and private tenders, while some contracted work has been rescheduled, which resulted in revenue declines. In 2020, revenues and Scope-adjusted EBITDA declined by 16% and 55% respectively compared to 2019, based on 2020 preliminary figures.

Nonetheless, we believe that Szinorg's revenue generation will be protected in the next few years by its real estate portfolio development pipeline – which can generate recurring income and/or sales proceeds – as well as an improved backlog (HUF 31bn). Further, Szinorg's activities are focused on a geographic niche market (eastern Hungary), providing the company with a good market visibility in the region. The company is ranked among the top five in its core market. Its solid market positioning is also supported by a strong network in its domestic market, where the company has built or restored over 100 public buildings and institutions.

Weak geographical diversification with portfolio focused on Debrecen

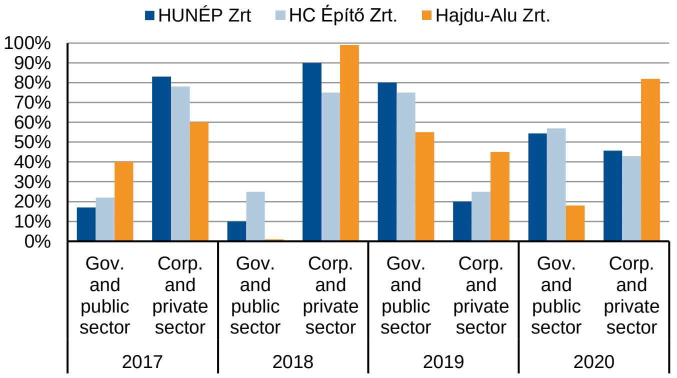
Geographical diversification is limited. Activities are concentrated in eastern Hungary, with more than 80% of revenues from projects in Debrecen and the surrounding areas. The company has a certain presence in Budapest (through HP Építő), but intends to maintain its focus on Debrecen, as it defines itself as a market specialist and prefers to benefit from its good local knowledge and networks. While this seems prudent given Szinorg's small size, it leads to a full exposure to the macroeconomic environment of one region. This is further compounded by its focus on construction, a cyclical industry in which market downturns tend to affect revenues and earnings.

Figure 1: Revenue breakdown by company (HUF m)



Source: Szinorg, Scope

Figure 2: Revenue breakdown by type of customer (%)



Source: Szinorg, Scope

Concentrated but balanced customer mix, including state institutions and municipalities

Szinorg's limited size results in high customer concentration as only a few projects can be executed simultaneously. This means both profitability and cash flow from operations can be greatly affected by the failure of one project. However, the ratio of public to private customers reflects Szinorg's good track record of developing projects privately as well as publicly financed projects. In 2020 the shares were almost equal: 50% of revenues were from private customers and 50% from public customers. This results in a lower dependence on government customers compared to other peers.

Improved backlog, but still concentrated on a limited number of projects

The company's backlog as of February amounts to HUF 31bn (HUF 21bn for 2020), resulting in a backlog-to-sales ratio of 2x. Szinorg's pipeline partly benefits from projects being part of the government's long-term investment plan for the Debrecen region (the 'Debrecen 2030' development programme).

However, Szinorg's backlog is still concentrated, with the top three projects accounting for 63% of future contracted revenues. The largest project, the reconstruction of the Csokonai Theatre in Debrecen, represents 30% of the total backlog while the second largest (the Bajcsy Hotel) represents 27%. The remainder is distributed across 17 other projects. This concentration bears the risk of significant cash flow volatility if projects are delayed or cancelled.

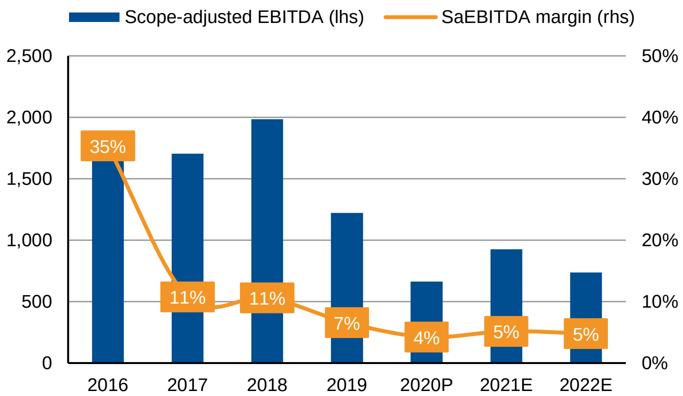
Real estate developments to secure pipeline of projects

To partially mitigate this risk, Szinorg has started to develop a real estate portfolio to generate recurring income and/or sales proceeds. The current pipeline includes projects for approx. HUF 25bn to be invested in the next few years. The development pipeline consists of a portfolio diversified across different asset classes, including a hotel, residential developments, offices and industrial premises. Some of the projects are already ongoing, while others will be started on demand, as the company aims to keep the flexibility to prioritise projects and use available resources more efficiently.

Weaker profitability, expected to recover in the next few years

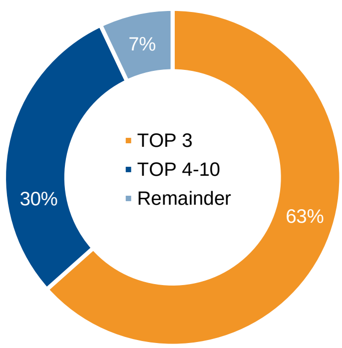
Profitability in 2020, as measured by the Scope-adjusted EBITDA margin, has been impacted by lower revenues combined with fairly stable fixed costs (including staff). It decreased to around 4% from 6% accounted in the previous year. However, the pipeline of projects has improved and provides more visibility regarding future revenues. We therefore expect profitability to recover and stabilise at above 5%.

Figure 3: EBITDA and EBITDA margin



Source: Szinorg, Scope estimates, 'Sa' = Scope-adjusted

Figure 4: Customer concentration in 2020 backlog



Source: Szinorg, Scope estimates

Financial risk profile: B+

Adequate debt protection metrics despite debt increase in 2020

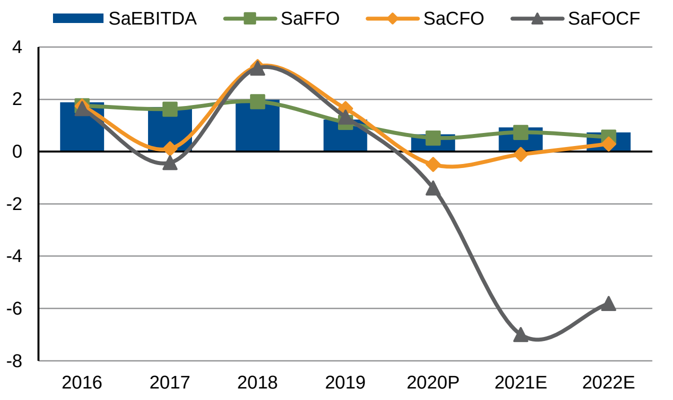
Szinorg has had relatively little financial debt in the past, keeping interest expenses low. This has resulted in a strong Scope-adjusted EBITDA interest coverage ratio in the years prior to 2019. With the HUF 5bn bond issued in 2020 (3% coupon) financial costs have risen. While we expect further increases in financial debt, the company aims to benefit from the low interest rate environment, thus helping to keep Scope-adjusted EBITDA interest coverage at adequate levels in the next few years.

Free operating cash flow impacted by development pipeline

We expect stable and positive funds from operations in the next few years. This is based on Szinorg's backlog and our expectation that the company will be able to maintain turnover of at least HUF 15bn. Free operating cash flow has been more volatile. We expect it to remain negative, driven by the portfolio of real estate developments to be built over the next few years.

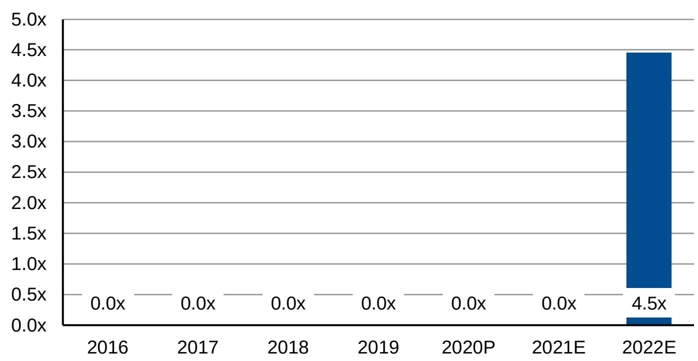
In 2020, the company benefited from two subsidies for a total of HUF 3.7bn (approx. HUF 2bn already disbursed). The subsidies have no preconditions, are not reimbursable, and are only subject to some covenants including: an employment covenant (given employee number to be kept until the property is finished) and operational covenants during the operational period (for the hotel). Szinorg has further resources available to finance its planned developments, with liquid resources of approx. HUF 15bn in FY 2020. While it does not currently depend on the availability of external financing, the company plans to refinance some projects, involving external sources at later stages in the projects.

Figure 5: Cash flows (HUF bn)



Source: Szinorg, Scope estimates; 'Sa' = Scope-adjusted

Figure 6: Leverage (SaD/SaEBITDA)



Source: Szinorg, Scope estimates; 'Sa' = Scope-adjusted

Growth strategy at the expense of increase in leverage

Szinorg's debt strategy has been prudent and conservative, evidenced by its very low levels of debt (net cash as at December 2020). In 2020, the company issued a HUF 5bn senior unsecured bond under the MNB Bond Funding for Growth Scheme to partially finance its significant capex programme. The company will finance the projects by using current available funds, and bank financing will be involved – once needed – to start other remaining projects in the pipeline at a later stage. We estimate that Szinorg could add further bank loans of up to HUF 4bn for refinancing purposes in the period to 2023.

Given the company's targeted increase in its real estate exposure, we have also considered the issuer's loan/value ratio to assess leverage. We forecast that the loan/value ratio will increase to around 30% in the coming years (including the HUF 5.0bn bond and an estimated HUF 4bn in bank loans). Szinorg's low leverage gives it sufficient financial headroom to execute its portfolio expansion plans, even if this entails increased costs.

Strong liquidity

Liquidity is strong, with unrestricted cash balances exceeding HUF 10bn as of December 2020. We anticipate that low short-term debt levels will be maintained going forward and that they will be sufficiently covered by available financing sources. Szinorg also has good relationships with several Hungarian banks. This is reflected in its revolving overdrafts totalling HUF 2.8bn – provided by five different Hungarian banks for over 11 years – as well as HUF 6bn of bank guarantees, which can be used towards future activities.

Figure 7: Liquidity

in HUF m	2020P	2021E
Short-term debt (t-1)	0	0
Unrestricted cash (t-1)[1]	10,076	14,797
Open committed credit lines (t-1)	3,087	2,760
Free operating cash flow (t)[2]	-1,389	-6,992
Coverage	**9.5x**	**2.5x**

Source: Scope estimates

Long-term and short-term debt ratings

Senior unsecured debt: B+

Szinorg issued a HUF 5bn senior unsecured bond (ISIN HU0000359633) in H1 2020 under the Hungarian National Bank's Bond Funding for Growth Scheme. The bond has a 3% coupon and a tenor until 2030.

Our recovery analysis is based on a hypothetical default scenario in 2022, which assumes outstanding senior unsecured debt of HUF 5.0bn in addition to an estimated HUF 1.7bn in bank loans. We expect an 'above average recovery' for the company's unsecured debt. Therefore, we affirm the B+ rating for this debt category (one notch above the issuer rating).

[1] It includes marketable securities (HUF 5bn FY 2020).
[2] We exclude discretionary expansion capex from our liquidity calculation, as such investments are only made if external financing is available.

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