15 February 2024 Corporates

Szinorg Universal Zrt.
Hungary, Construction

SCOPE B STABLE

Key metrics

		Scope estimates		
Scope credit ratios	**2022**	**2023P**	**2024E**	**2025E**
Scope-adjusted EBITDA interest cover	Net Cash	Net Cash	Net Cash	5.2x
Scope-adjusted debt/EBITDA	3.7x	3.1x	6.8x	9.5x
Scope-adjusted funds from operations/debt	30%	43%	15%	8%
Scope-adjusted free operating cash flow/debt	-109%	56%	-29%	-34%

Rating rationale

The issuer rating is supported by Szinorg's strong liquidity, healthy debt protection, and regional market visibility in Debrecen, a region with robust foreign direct investments and private demand for construction. The higher EBITDA contribution from the group's real estate portfolio from 2023 on, alongside an expected stabilization of Scope-adjusted EBITDA margin at above 5% are credit-positive.

The rating is constrained by the group's small size in a European context, which limits diversification – with activities concentrated in Hungary and cluster risk, with one contract representing more than 50% of the contracted backlog – and weakens its ability to mitigate economic cycles and to benefit from economies of scale.

Outlook and rating-change drivers

The Stable Outlook reflects the improved share of contribution of real estate assets in the group's EBITDA, which strengthens the company's recurring income base and partially mitigates the volatility related to the construction business. The real estate assets deliver higher profitability margins, which should also counterbalance the margin of construction activities that remains under pressure. The Outlook also incorporates the commencing of five real estate projects in the first half of 2024 and successful completion of current construction backlog. It also assumes ongoing adequate access to external financing to fund the company's business plan.

A positive rating action is remote but could be justified if the group's business risk profile improved, with a significantly larger development pipeline including a backlog of more than one year and improved diversification (by customer and project), while Scope-adjusted debt/EBITDA remained at around 4x, enabled by a higher-than-anticipated recurring EBITDA contribution from the issuer's investment properties.

A negative rating action could occur if the backlog deteriorates to below 1x. It could also occur if liquidity worsened, for example, through significant delays in customer payments or non-recoverable cost overruns in projects.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
1 Feb 2024	Outlook change	B/Stable
1 Feb 2023	Outlook change	B/Negative
1 Feb 2022	Affirmation	B/Stable

Ratings & Outlook

Issuer	B/Stable
Senior unsecured debt	B+

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Related Methodologies and Related Research

General Corporate Rating Methodology; October 2023

Construction and Construction Materials Rating Methodology, January 2024

European Real Estate Rating Methodology; January 2023

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Good regional position translating into local visibility and moderate access to third-party financing sources and guarantees • Strong liquidity with about HUF 13bn in cash, supported by available undrawn overdrafts totalling HUF 2.3bn as at December 2023 • Healthy debt protection despite sharp anticipated increase in interest-bearing debt	• Small construction group in Europe and lack of geographic and segment diversification, somewhat mitigated by the strong position in a niche market • Concentrated contracted backlog, partially mitigated by the delivery of a few real estate properties that provide recurring income • Negative free operating cash flow, which translates into increased indebtness due to Szinorg's investment phase

Positive rating-change drivers	Negative rating-change drivers
• Business risk profile improved, with a larger backlog of above 1x and better diversification (by customer and project) while Scope-adjusted debt/EBITDA remained at around 4x.	• Backlog deteriorated to below 1x • Liquidity worsened due to, for example, delayed customer payments or cost overruns in projects

Corporate profile

Szinorg Universal 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 largest subsidiaries by revenues were Hunép Zrt. and HC Építő Kft. (construction companies) and Hajdu-Alu Zrt. (producer of curtains walls, doors and windows). Szinorg intends to merge both construction companies, a process to be completed by the end of Q1 2024, leaving Hunép Zrt. as the main constructor. In 2023, the contribution of other business lines, mainly accommodation and letting of industrial assets have generated around 25% of the group's EBIDTA.

Financial overview

			Scope estimates		
Scope credit ratios	**2021**	**2022**	**2023P**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	Net Cash	Net Cash	Net Cash	Net Cash	5.2x
Scope-adjusted debt/EBITDA	2.7x	3.7x	3.1x	6.8x	9.5x
Scope-adjusted funds from operations/debt	33%	30%	43%	15%	8%
Scope-adjusted free operating cash flow/debt	-23%	-109%	56%	-29%	-34%
Scope-adjusted EBITDA in HUF m					
EBITDA	1,983	1,675	2,320	1,198	1,478
less: disposal gains from fixed assets included in EBITDA	0	0	0	0	0
Scope-adjusted EBITDA	**1,983**	**1,675**	**2,320**	**1,198**	**1,478**
Scope funds from operations in HUF m					
Scope-adjusted EBITDA	1,983	1,675	2,320	1,198	1,478
less: cash interest as per cash flow statement	5	387	1,205	69	-282
less: cash tax paid as per cash flow statement	-222	-165	-410	-44	-39
Funds from operations (FFO)	**1,767**	**1,897**	**3,115**	**1,223**	**1,157**
Free operating cash flow in HUF m					
Funds from operations	1,767	1,897	3,115	1,223	1,157
Change in working capital	259	-1,433	-2,991	-1,064	-2,928
less: capital expenditure (net)	-3,268	-9,798	-1,539	-2,565	-3,064
Other adjustments[1]	0	2,532	5,453	0	0
Free operating cash flow (FOCF)	**-1,242**	**-6,801**	**4,038**	**-2,406**	**-4,834**
Net cash interest paid in HUF m					
Net cash interest per cash flow statement	5	387	1,205	69	-282
Net cash interest paid	**5**	**387**	**1,205**	**69**	**-282**
Scope-adjusted debt in HUF m					
Reported gross financial debt	5,304	6,247	7,220	8,190	14,065
add: subordinated liabilities	0	0	0	0	0
Scope-adjusted debt (SaD)	**5,304**	**6,247**	**7,220**	**8,190**	**14,065**
Cash balance in HUF m					
Cash balance[2]	11,078	7,669	13,457	9,602	8,223

[1] Change in accruals (deferred revenues and subsidies)
[2] Netting of cash: generally, only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible.

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Environmental, social and governance (ESG) profile[3]

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

ESG factors remain neutral for the rating. We acknowledge, however, the group's implemented sustainability measures. These include: i) strengthening sustainability efforts regarding the Mercure Hotel, via "Accor Planet 21" program; ii) the signature of a subsidy agreement for the energetic development of Hajdu-Alu Zrt.; and iii) the continued participation in the Sustainable Debrecen Program.

[3] 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: B+

Szinorg's activities remain primarily exposed to construction, real estate development and the facility management of some group properties. Construction accounts for most of the business: Hunép and HC Építő (main construction companies) contributed more than 90% of revenues in 2023.

It is worth noting is that, as expected in previous years, revenue and EBITDA from the real estate business – negligible until 2022 – started to contribute in 2023. In 2023, the EBITDA contribution from hotel operations and rental income from warehouses represented around 25% of the group's EBITDA.

We applied weights based on the EBITDA contribution of each business line (see Figure 1). The result was a group-weighted average industry risk of B+.

Figure 1: Expected EBITDA split by business line

Business line	Activities	Estimated average EBITDA contribution (2023-2025)	Industry risk
Construction	Buildings	65%	B
Real Estate	Development – Residential units	1%	BB
	Commercial activities	13%	BB
Leisure and Entertainment	Hotel operations	21%	BB
Weighted average industry risk			**B+**

Sources: Szinorg, Scope estimates

Positive performance in 2023

Based on preliminary figures, revenues in 2023 stood at around HUF 25bn (up 29% YoY), outperforming our rating case by 19% and Scope-adjusted EBITDA is forecasted to increase by 39% YoY up to HUF 2.3bn. This growth was mainly driven by a single project – the construction work of a high bay Warehouse for the Hungarian affiliate of an international company. In recent years, the group's core market of Debrecen has benefitted from strong foreign direct investment[4], which has provided some compensation for the delayed EU-funded government projects and government tenders, which have been postponed until mid-2024 at the earliest.

Szinorg's business plan to build up a real estate portfolio has also made good progress, with around 30% of planned investment of HUF 55bn having been completed as of December 2023. The group has finished two warehouses, encompassing 23,000 sq m of gross lettable area (Szinorg owns 50% of these properties) and a hotel with over 150 rooms in Debrecen's city centre.

… but still small player in both a European context and domestically

However, Szinorg's market share in Debrecen's real estate market is negligible. Since the group's small portfolio is split across multiple asset classes, it does not have significant market power or visibility in the markets in which it operates. The group is targeting some further growth, including various residential projects, one of which is located in the Balaton Lake region. Targeted growth does not materially affect our assessment of Szinorg's market positioning or market shares, as this pipeline remains subject to heightened risks, including lower demand for residential developments and potential delays in project execution and handover. Small size is a negative rating driver as it limits the group's ability to benefit from economies of scale and to offset the impact of economic cycles.

[4] Hungary has attracted EUR 20bn in foreign investment over the past five years, concentrated in the city of Debrecen.

Recurring income to partially mitigate cyclicality from the construction sector

After a period of investment, the group's plan to generate recurring income through the development of real estate assets has started to bear fruit. The group's EBITDA in 2023 has benefitted from the full year operation of the hotel property which has doubled the initial forecast, and rental income from the group's small portfolio of industrial assets which generated around 25% of the group's EBITDA. The contribution from both businesses is expected to increase to above 40% by 2025. Recurring income will partially mitigate the cyclicality risk from activities in the construction sector.

Limited diversification

Geographical diversification remains limited. Activities are concentrated in eastern Hungary, with more than 80% of revenues from projects in Debrecen and the surrounding areas. Szinorg intends to maintain this focus as it defines itself as a specialist and prefers to benefit from its good local knowledge and networks. While this seems prudent given its small size, it fully exposes the group to the macroeconomy of one region.

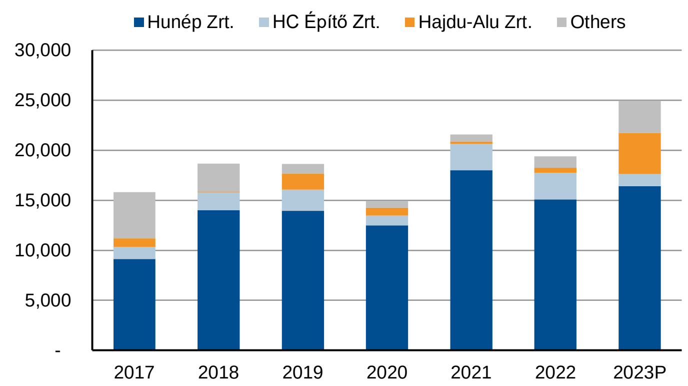
Concentrated but balanced customer mix

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. In the past few years, the company benefitted from a balanced ratio of public to private customers, reflecting Szinorg's good record of developing private and public projects. In 2023, the group's strategy to protect its revenue – from a potential slowdown in the government demand – by developing a real estate portfolio increased the share of private sector clients to more than 80% of revenues.

Real estate activities slightly improving diversification

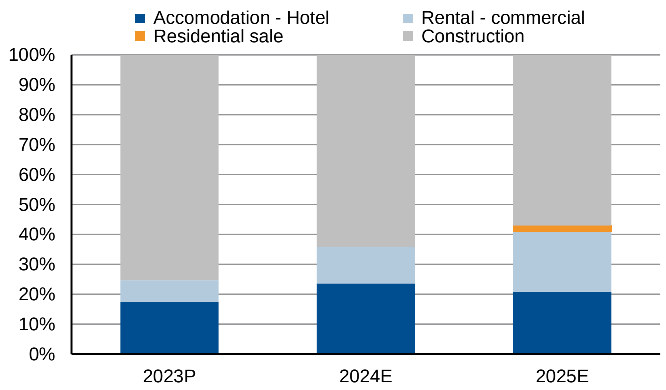
We recognise some improvement in diversification, following the delivery of three real estate properties (two industrial assets and one hotel) that provide recurring income. However, the limited size of the portfolio results in a high tenant concentration (single-tenant assets). The industrial assets are 100% let and have long-term leases (weighted average unexpired lease term of 10 years as of December 2023). In the hotel segment, the Mercure Hotel enjoys from a prime location with no direct competition in its business segment, as well as increasing demand. This has been reflected in a full occupancy on working days, with some vacancies at weekends due to the low number of tourist flights to the region. All in all, the average occupancy rate stood at 63% in 2023 and the group expects to improve this to just over 65% in the next few years.

Figure 2: Revenue breakdown by company (HUF m)



Sources: Szinorg, Scope Ratings

Figure 3: EBITDA breakdown by activities (%)



Sources: Szinorg, Scope Ratings

Backlog still concentrated

The backlog, however, remains concentrated, with the top three and ten projects accounting for 50% and 93% of future contracted revenues, respectively. There is a persistent cluster risk in the order backlog, as a significant project signed in early 2023 continues to be the largest in the group's project pipeline. Such concentration carries the risk of considerable cash flow volatility if projects are delayed or cancelled.

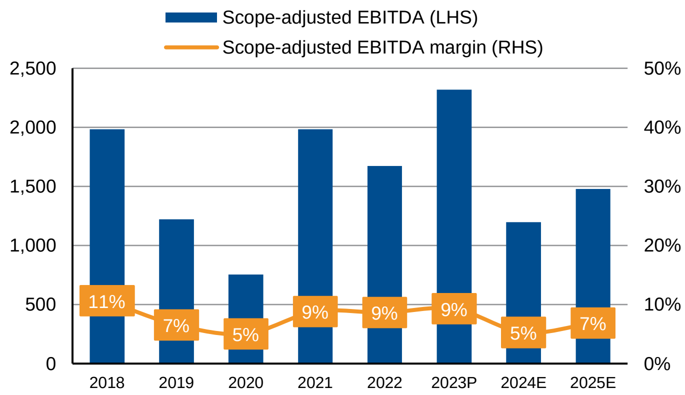
The backlog as of January 2024 amounts to HUF 25bn (including signed construction and real estate projects, as well as close to be signed real estate projects developments), resulting in a backlog of 1.3x, providing top line visibility only until the beginning of 2025.

Stabilized profitability supported by high margins activities

Profitability as measured by the Scope-adjusted EBITDA margin is expected to reach 9.3% for FY 2023 (3.6pp above our forecast). This increase can be attributed to the higher margins in construction works, largely a result of better contract negotiations, despite an increase in project cost, such as labour. Additionally, the group's EBITDA benefitted from the full year operation of the hotel property, which doubled its EBITDA compared to the initial forecast. Conversely, the profitability margin in 2023 was negatively impacted by the higher-than-anticipated personnel costs, largely driven by changes in the corporate incentive programme. However, this impact will be somewhat offset by Szinorg's plan to optimise the group's structure including the merger of two large construction subsidiaries in Q1 2024, which is expected to generate annual payroll cost savings of around HUF 200m.

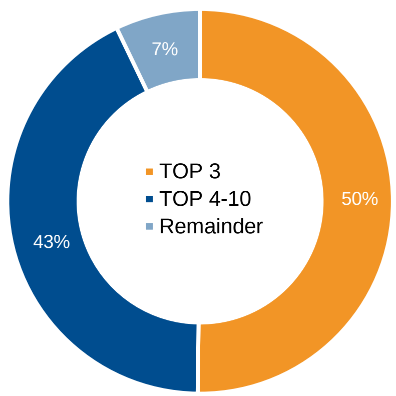
We expect Szinorg's profitability margin to decline, but to stabilise at a moderate level of above 5%. This margin will reflect the company's business profile: (i) constrained by its construction business, which is facing increased competition and typically lower margins ranging 5% to 10%; (ii) but supported by higher margins from hotel operations (averaging around 20%) and letting activities (with margins exceeding 80%). The latter also provides some visibility on future cash flows, which are backed by long-term leases.

Figure 4: Scope-adjusted EBITDA (HUF m) and Scope-adjusted EBITDA margin



Sources: Szinorg, Scope Ratings

Figure 5: Top projects in the construction backlog, 2024



Sources: Szinorg, Scope Ratings

Financial risk profile: B+

Growth strategy at the expense of increased leverage

The financial risk profile (revised to B+ from B) is constrained by our expectation of higher leverage and negative free operating cash flow. This is attributed to increased working capital needs and the substantial investment in the real estate portfolio. We expect that while the real estate portfolio, along with the construction backlog, will continue to strengthen revenues and cash flow, credit metrics will come under pressure over the next few years.

Increasing financial debt to finance real estate development

Szinorg has issued a HUF 5bn senior unsecured bond under the Hungarian National Bank's Bond Funding for Growth Scheme to finance part of its significant capex programme, with the rest to be financed with additional bank loans. As of December 2023, the bank loans amounted to HUF 1.8bn and the group plans to add additional loans totalling approximately HUF 6.8bn by 2025. Regarding Szinorg's financial obligations (including bank loans and bond), 80% are subject to fixed interest rates. As at end-2023, cash reserves were higher than financial debt, yet we anticipate an increase in leverage to above 9x by the end of 2025. This projected increase in leverage is due to upcoming real estate developments and its deferred contribution to Scope-adjusted EBITDA.

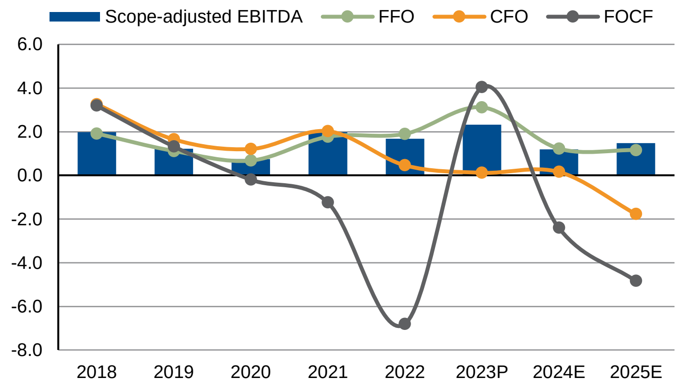
Adequate debt protection metrics despite debt increase in 2020

The interest result was positive in 2023, supported by income from investments in securities and low debt expenses, as the HUF 5bn bond carries a fixed rate of 3%. We anticipate that the interest result for 2024 will remain positive, given the company's high cash balances that will offset expected higher interest expenses due to increased leverage. However, the interest cover is expected to weaken from 2025 onwards because of the planned increase in bank loans to finance further real estate developments. Additionally, floating rates on 20% of the interest-bearing debt leave the group vulnerable to potential fluctuations in the Euribor rate.

Free operating cash flow impacted by development pipeline

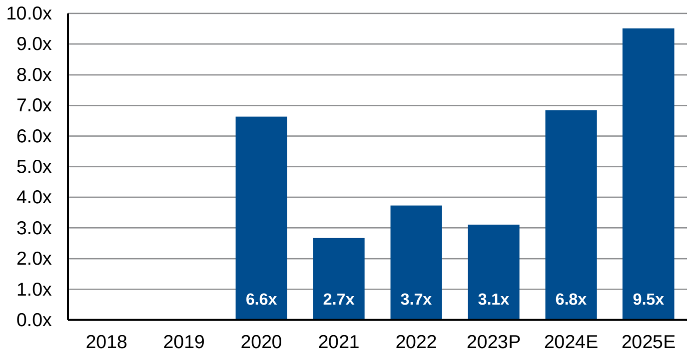
We expect stable and positive FFO in the next few years. This is based on Szinorg's backlog and our expectation that turnover will remain at the historical average. However, FOCF will remain negative over the next years, driven by the build-up of the real estate development portfolio. Projects will be financed using current available funds (liquidity of above HUF 13bn as of December 2023) and potential customer advances.

Figure 6: Cash flows (HUF bn)



Sources: Szinorg, Scope estimates

Figure 7: Leverage (Scope-adjusted debt/EBITDA)



Sources: Szinorg, Scope estimates

Adequate liquidity

Liquidity remains adequate, with over HUF 13bn of cash and equivalents as of December 2023, alongside available overdrafts totalling HUF 2.3bn. The debt maturity profile is back loaded, featuring a HUF 5bn bond maturing only in 2030, with no significant repayments required prior to that date. Nonetheless, external liquidity will be necessary to finance capex and working capital requirements.

Figure 8: Liquidity

in HUF m	2024E	2025E
Short-term debt (t-1)	410	160
Unrestricted cash (t-1) [5]	13,459	9,604
Open committed credit lines (t-1) [6]	0	0
FOCF (t)	-2,406	-4,834
Coverage	**> 200%**	**199%**

Source: Scope estimates

[5] Considers cash and available money market instruments.
[6] Available overdrafts are excluded from our liquidity calculation as those are yearly rolling facilities. However, we acknowledge Szinorg long-term relationship with various financial institutions.

We highlight that Szinorg's senior unsecured bond issued under the Hungarian National Bank's Bond Funding for Growth Scheme has a covenant requiring the accelerated repayment of the outstanding nominal debt amount (HUF 5bn) if the debt rating of the bond stays below B+ for more than two years (grace period) or drops below B- (accelerated repayment within 30 days). Such a development could adversely affect the company's liquidity profile. The rating headroom to entering the grace period is 0 notches.

Given the limited rating headroom, the company must at least maintain its current credit profile to avoid triggering the rating-related covenant.

Long-term debt rating

Senior unsecured debt: B+

The rated entity has issued a HUF 5bn senior unsecured corporate bond (ISIN HU0000359633) in H1 2020 under the Hungarian National Bank's Bond Funding for Growth Scheme. The amortisation schedule of the 10-year, fixed-interest instrument assumes 10% repayment at the eighth anniversary, 20% at ninth anniversary and 70% balloon payment at maturity.

Our recovery analysis is based on a hypothetical default scenario in 2025, which assumes outstanding senior unsecured debt of HUF 5.0bn, additional bank loans of HUF 9.0bn and drawn overdrafts of HUF 2.3bn (assuming the group draws all available lines). We expect an 'above-average' recovery for senior unsecured debt and has therefore affirmed the B+ rating for this debt category (one notch above the issuer rating).

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