West Hungaria Bau Kft.
Hungary, Construction

B+ STABLE

Corporate profile

West Hungaria Bau Kft. (WHB) is one of the leading Hungarian construction companies, established in 1997. It is privately owned by its management, employs together with its associated companies around 700 people and generated HUF 50bn of revenue in 2018. WHB's heritage and location of its headquarters is Győr, but it performs construction work all over Hungary. It is predominantly involved in the construction and maintenance of buildings, monuments and sport facilities, with minor activities including in-house profile manufacturing and maintenance work at the PAKS nuclear plant.

Key metrics

			Scope estimates		
Scope credit ratios	2017	2018	2019F	2020F	2021F
EBITDA/interest cover (x)	n/a	n/a	n/a	7.7x	5.2x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	net cash	0.9x	3.0x
Scope-adjusted FFO/SaD	net cash	net cash	net cash	76%	30%
FOCF/SaD	net cash	net cash	net cash	-19%	15%

Rating rationale

Scope assigns a first-time issuer rating of B+ to West Hungaria Bau Kft. and a B+ instrument rating for its senior unsecured debt. The Outlook is Stable.

The B+ issuer rating is supported by WHB's historically proven above-average profitability and adequate liquidity. Its domestic market position translates into market visibility and gives moderate access to third-party capital and guarantees.

The rating is mainly constrained by the company's small overall scale in a European construction context, which lessens its ability to mitigate economic cycles. It is further constrained by its weak diversification, namely a lack of geographical diversification (predominantly active in Hungary), segment concentration and its current dependency on government contracts. We judge its backlog as short and concentrated (though somewhat mitigated by its investment grade counterparties) and its book-to-bill ratio as volatile.

Outlook

The Outlook for WHB is Stable and incorporates our view of the high transformation risk that the company is exposed to in 2020 when government contracts are executed and should be replaced by market contracts not known of as of today. Thus, we anticipate a strong decline in Scope-adjusted EBITDA in 2021 to HUF 2.7bn, leading to weakening credit metrics with Scope-adjusted debt (SaD) to EBITDA of around 3x. Furthermore, the Outlook incorporates a successful placement of a HUF 15bn bond in H1 2020 to finance investments into two projects, namely the acquisition and refurbishment of a multifunction complex as well as the development of a green-field logistics facility, both in western Hungary. Both projects should benefit WHB's recurring EBITDA in the medium term. Additionally, we expect dividend payouts to be in line with the current covenant of a maximum 50% of operational net income.

Ratings & Outlook

Corporate ratings B+/Stable

Senior unsecured rating B+

Analyst

Thomas Faeh
+47 21 62 31 40
t.faeh@scoperatings.com

Related Methodologies

Corporate Rating Methodology

Rating Methodology European Construction Corporates

Scope Ratings GmbH

Haakon VII´s gate 6
N-0161 Oslo

Phone +47 21 623142

Headquarters

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

A positive rating action is remote in our view but may be warranted if the company can increase visibility on revenues beyond 2020, helping to keep SaD to Scope-adjusted EBITDA below 2.5x on a sustained basis. This could be driven by, for example, i) an improving order backlog, benefitting from a higher granularity of customers and more complex projects extending the respective execution periods; or ii) a successful revamp of the multifunctional complex that supports cash flow beyond our current expectations.

A negative rating action could occur if SaD to Scope-adjusted EBITDA increases to above 3.5x on a sustained basis or liquidity were to worsen. An increase in leverage could be triggered by either i) an adverse operational development with reduced profitability and cash flows; or ii) more aggressive dividend payouts than currently allowed given the issuer's loan covenants. Liquidity could worsen if, e.g. i) customers delay payments significantly; or ii) the company becomes exposed to the non-recoverable cost overruns of its projects.

Rating drivers

Positive rating drivers	Negative rating drivers
• Historically above-average profitability, somewhat weakened by the lower margins expected in a downturn cycle • Adequate liquidity, with limited short-term maturities • Domestic market position that translates into market visibility as well as moderate access to third-party capital and guarantees	• Small-scale construction company in European context with a lack of geographic and segment diversification, somewhat mitigated by its relatively strong fourth position in the domestic market • Concentration issues in its backlog (top three account for 45%; top 10 for 80%), somewhat mitigated by the investment grade counterparties (Republic of Hungary) • Recent dependency on government contracts that are expected to end and leave a large gap that is difficult to fill • Exposure to overheated Hungarian construction industry • Large upcoming capex programme, which will lead to very negative cash flows

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Increased visibility on revenues beyond 2020, helping to keep SaD to Scope-adjusted EBITDA below 2.5x on a sustained basis	• Increased leverage, i.e. SaD to Scope-adjusted EBITDA sustained above 3.5x • Worsening of liquidity due to, for example, delayed customer payments or cost overruns

West Hungaria Bau Kft.

Hungary, Construction

Financial overview

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA/interest cover (x)	n/a	n/a	177.6	7.7	5.2
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	net cash	0.9	3.0
Scope-adjusted funds from operations/SaD	net cash	net cash	net cash	76%	30%
Free operating cash flow/SaD	net cash	net cash	net cash	-19%	15%
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA	4,049	7,075	6,892	16,556	2,663
Operating lease payments in respective year	0	0	0	0	0
Other	0	0	0	-12,600	0
Scope-adjusted EBITDA	4,049	7,075	6,892	3,956	2,663
Scope-adjusted funds from operations in HUF m	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA	4,049	7,075	6,892	3,956	2,663
less: (net) cash interest as per cash flow statement	63	72	-20	-498	-498
less: cash tax paid as per cash flow statement	-191	-515	-673	-1,439	-163
add: depreciation component, operating leases	-22	-23	-19	-19	-19
Add: dividends from shareholdings	1,200	800	800	600	400
Scope-adjusted funds from operations	5,098	7,409	6,980	2,600	2,383
Scope-adjusted debt in HUF m	**2017**	**2018**	**2019F**	**2020F**	**2021F**
Reported gross financial debt	1,645	709	2,033	17,033	17,033
less: hybrid bonds	0	0	0	0	0
less: cash and cash equivalents	-8,526	-7,473	-8,302	-16,762	-11,380
add: cash not accessible	2,492	2,771	2,771	2,754	1,854
add: pension adjustment	0	0	0	0	0
add: operating lease obligations	437	457	376	376	376
Other	0	0	0	0	0
Scope-adjusted debt	-3,952	-3,536	-3,122	3,401	7,883

Business risk profile: B

Industry risk: B

While the construction industry is often associated with cyclical features when compared to industries with inelastic demand patterns, these cycles vary depending on the individual business model. We incorporate exposures to economic trends that affect the downside volatility of cash flows. Downside volatility can arise from either i) volume risks from a high exposure to buildings, industrial construction and a large share of public/government customers; and ii) risks from price fluctuations on materials, labour and energy. We view the overall construction industry's cyclicality to be high. However, with a large share of concession-related and service business, companies could lower their exposure to cyclicality, thus reducing industry risk.

Cyclicality (high)

Market entry barriers (low)

We believe the construction sector has low market entry barriers as initial investments are relatively low and proprietary technologies are not needed to enter local markets. This applies in particular to the building segment.

Substitution risk (high)

Along with entry barriers for potential new competitors, the degree of substitution risks from existing competitors also depends on a constructor's segment exposure. However, substitution risk is generally high as the companies do not need specific technologies for delivering the vast majority of project types. In addition, regulations for government projects in Europe enable competition and allow for substitution.

Figure 1: industry risk assessment: European construction corporates

Cyclicality \ Barriers to entry	Low	Medium	High
High	CCC/**B**	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Source : Scope

Small player in a European context but top five in Hungary's fragmented market

WHB is a relatively small player in the European construction landscape with HUF 50bn (EUR 155m) of revenues and HUF 7bn (EUR 22m) of Scope-adjusted EBITDA in 2018. Within its home market of Hungary, the company is well-established and reaches a market share of 2.3% (2018), which puts it fourth after Market, Zalai and Strabag. Reaching a top five position despite a relatively low market share indicates the highly fragmented and competitive Hungarian construction market, with over 56,000 companies, according to the European Construction Sector Observatory.

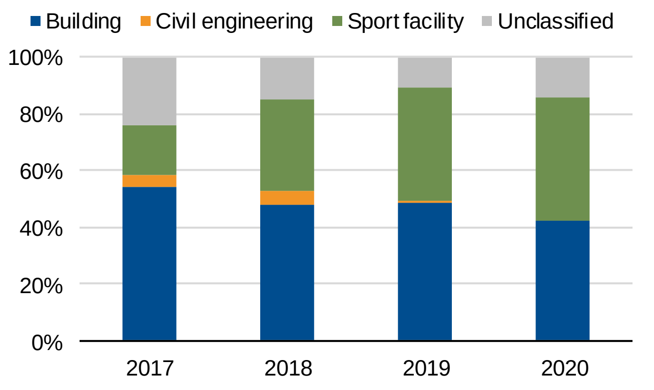
WHB grew strongly during 2016-18 – as did the construction market in Hungary as a whole –, doubling revenues and tripling EBITDA based on strong organic but also inorganic growth (e.g. acquiring 50% of Magyar to take part in building the Puskás Aréna in Budapest). WHB's top five status confers it market visibility as well as moderate access to third-party capital and guarantees. Both factors should help to generate business going forward, especially given the need of the whole construction sector to refocus away from EU-sponsored construction and civil engineering.

Limited geographical diversification exposes WHB to Hungary's construction cycle

WHB's geographical diversification is rather limited, with predominantly domestic activities. The recent growth in the Hungarian construction market has been deemed unsustainable by market observers, citing 29% and 22% growth in the two recent years, respectively, with contract portfolios having dried up in late 2018 and showing decreasing trends since. Given the industry's cyclicality, revenues and margins are likely to come under pressure in a downturn and WHB has no exposure to dampen this effect.

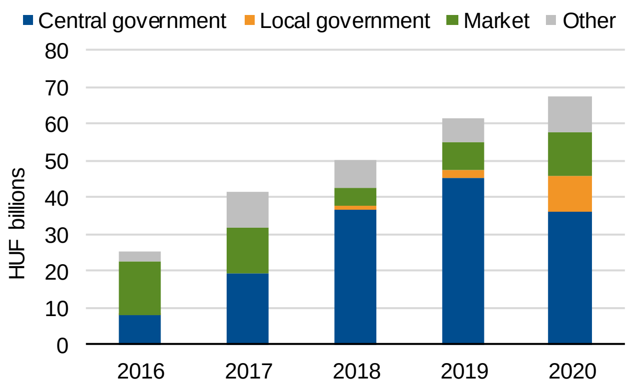
Segment diversification is also rather limited, as WHB is predominantly active in two types of projects: buildings and sport facilities. WHB's building segment encompasses a vast variety – among them, offices, residential, halls, garages, monuments, and educational facilities – but do not provide diversification as all are structurally the same but with different end-uses. The second segment, sport facilities, does provide diversification due to its civil engineering features and requirement for technical skills. The actual civil engineering part is negligible and WHB is not involved in any concession work.

Figure 2: Project diversification by segment (%)



Source: WHB, Scope estimates

Figure 3: Project diversification by customer



Source: WHB, Scope estimates

Customer diversification: from free market to government projects and back again

Customer diversification has changed over time. Historically, WHB was exposed mainly to the 'free market' but has recently become almost fully dependent on central government projects. During 2016-19, the use of EU funds channelled via central government into the construction industry almost tripled, from roughly EUR 900m to EUR 2,250m. Due to the end of the EU funds cycle this source of investment is projected to decrease by 83% until 2022 (to around EUR 400m; source: MNB).

Given WHB's current exposure of 73% to central and local governments, the company's customer profile is up for a drastic change, with the disappearance of government contracts having to be replaced with market-based projects to keep the top line stable as targeted. Management sees opportunities to fill the gap with market-based projects that have been delayed due to the overheated construction cycle (driven by government-funded projects) – which we judge to be difficult, given the currently very limited backlog beyond YE 2020 that so far does not include market-based orders.

Concentrated backlog, somewhat mitigated by the investment grade counterparties

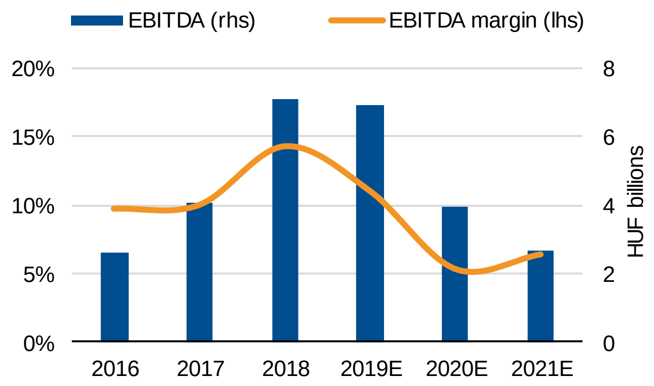
WHB's backlog is rather concentrated, with the top three projects representing 43% of revenue backlog as of Q3 2019. Two-thirds of the backlog relate to just six projects while the top 10 represent 80% of contracted revenues. Seven of the top 10 projects are funded by central government (Republic of Hungary, rated BBB+ by Scope), which somewhat mitigates the concentration; two are market projects; and one stems from a local government. Notable in this context is the very short backlog, which covers only 2020 fully and leaves revenue potential of around HUF 20bn thereafter – representing only 47% of Scope's predicted revenue for 2021.

Above-average margins recently; reversion expected in the future

WHB's profitability, at 10% or above, has been in the upper range of the construction industry (5-10%). Going forward we expect a slightly lower adjusted margin of around 6% and highlight the uncertainty beyond the end of the backlog in early 2021, with government-sponsored projects to dry up and the overheated market to cool down.

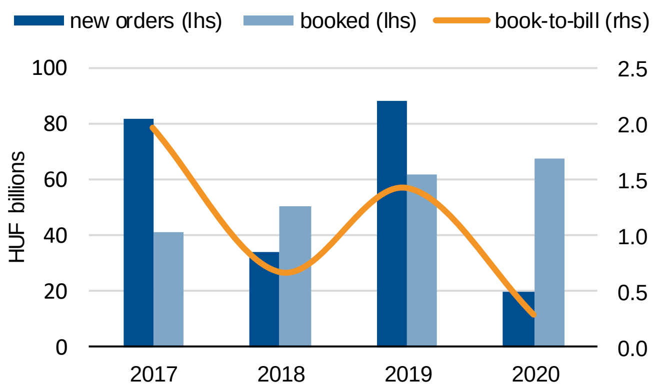
We assume profitability pressure to come from future non-contracted projects as the EU funding cycle comes to an end and WHB has to fill the gap with market-based orders. While labour and material costs are likely to be sticky at inflated levels, high competition for market-based projects will drive down revenues and, with it, profitability.

Figure 4: EBITDA and EBITDA margin



Source: Scope estimates

Figure 5: New orders, booked, Book-to-bill ratio



Source: WHB, Scope estimates

Backlog of 1.5 years; volatile book-to-bill ratio

The current order backlog of HUF 106bn at Q3 2019 covers around 1.5 years of revenues for WHB. This translates into almost full coverage with contracted orders for 2020 before the backlog dries up – the 2021 revenue forecast is so far only 47% contracted.

This is also visible in its book-to-bill ratio, which is quite volatile and fluctuates between 2x (very strong demand) and less than 1x (insufficient or weak demand).

Management-owned; no independent board

WHB's four private owners are also its top management, and no independent board provides an oversight function. While we understand the family-owned nature of the company, an improvement in corporate governance would be positive given its growth in scale.

Financial risk profile: BB-

Our rating scenario assumes the following:

- Revenue growth of 26% in 2019 to HUF 62.5bn, shrinkage of -1% YoY to HUF 62.1bn, excluding a one-off write-up (19.5% including) in 2020 in line with current contracted backlog for 2019 and 2020. For 2021 we do not foresee the company to be able to fill the large upcoming contract gap (after the disappearance of government contracts) with market-based orders and estimate a 33% decline in revenues to HUF 41.9bn.
- Issuance of HUF 15bn (roughly EUR 45m) bond in Q1 2020 under the MNB Bond Funding for Growth scheme, with an expected coupon of 3% and a maturity of 10 years, amortising after five years. Half of the bond proceeds will be used for the acquisition and refurbishment of the multifunctional shopping centre and the other half for a green-field logistics development project in western Hungary.
- Capital expenditure of around HUF 4.4bn in 2019 and HUF 4.1bn in both 2020 and 2021 for the acquisition and refurbishment of the multifunctional shopping centre and WHB's core business (the latter will purely be financed through operating cash flows, not bond proceeds). In addition, we factored in a discretionary HUF 2bn in 2020 and HUF 5bn in 2021 related to the green-field logistics centre.
- Dividend payouts of HUF 3.5bn in 2019, HUF 3.4bn in 2020 and HUF 1.5bn in 2021 as per the company's dividend policy and covenant restrictions.
- Restricted cash relates to the cash pledged as collateral for banks to issue guarantees.

Strong interest coverage

As the company has little debt and gives inter-company loans to subsidiaries/affiliates, its interest income historically exceeded its limited interest expenses, rendering Scope's EBITDA interest coverage ratio meaningless. Going forward the company plans to issue a HUF 15bn bond with an estimate coupon of around 3% in early 2020 while keeping its HUF 1.3bn short-term interest-bearing debt (floating-rate, derivative credit agreement and drawn overdraft facility) and 0.7bn debt to an associated company. This will translate into a strong EBITDA interest coverage of 7.7x in 2020 and 5.2x in 2021.

Given the relatively high coverage, which is foreseen to continue, we believe WHB will be able to meet its interest payment obligations in the period considered.

Historically good capex coverage…

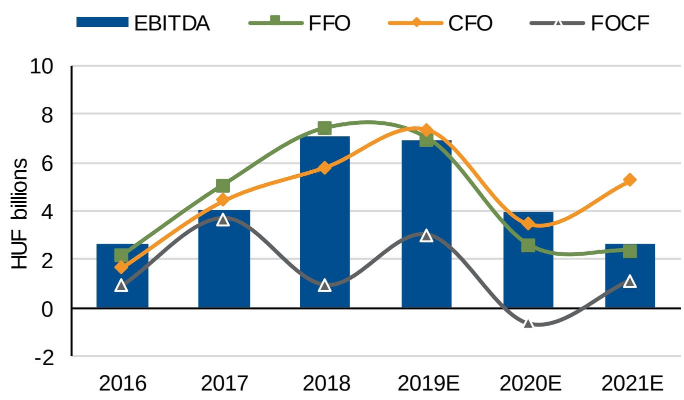
WHB's cash flow generation has so far been sufficient to cover capital expenditure in addition to increasing its net cash position. Going forward the company plans to invest in two larger projects (also the reason for participating in the Hungarian central bank's Bond Funding for Growth scheme):

…two new projects requiring external funding

- The acquisition, refurbishment and operation of a multifunction complex in western Hungary encompassing a mall, a hotel and a stadium.
- The construction and operation of a green-field logistics complex in western Hungary.

These two projects require significant upfront capital expenditure while attached operating cash flows will be lagging and uncertain. Therefore, free operating cash flow (as shown in figure 6) will turn negative in the near-to-medium term, applying a heavy strain on the company's finances at a time of uncertainty due to its relatively short backlog and a likely cooling of Hungary's construction industry fundamentals.

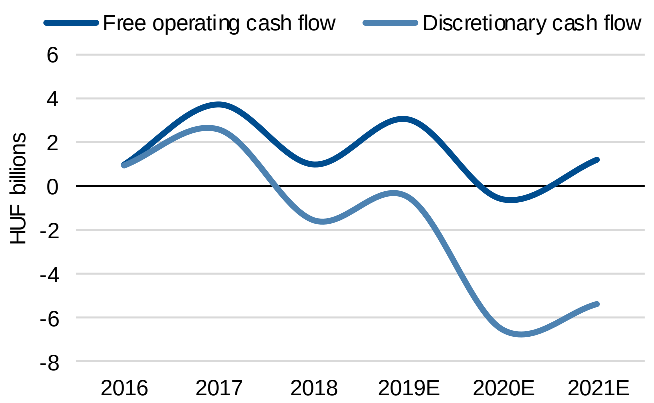
Figure 6: Cash flows[1] (excluding green-field spending)



[1] all are Scope-adjusted figures

Source: Scope estimates

Figure 7: Discretionary spending



Source: Scope estimates

Taking into account the spending of half of the planned bond into its green-field project – which we so far treat as discretionary given the uncertainties around planning, approvals and timing – cash flows will further deteriorate. We add the planned dividend payments to arrive at discretionary cash flows, resulting in a HUF 6.5bn cash outflow in 2020 and HUF 5.4bn outflow in 2021.

Heavily negative cash flows constrain the financial risk profile

The highly negative cash flows expected until revenues from these projects contribute to operations constrain WHB's financial risk profile.

WHB historically had very little interest-bearing debt, resulting in a net cash position when assessing Scope-adjusted debt (SaD). After its significant capex programme until YE 2021, we assume SaD/EBITDA to be at 3x and FFO/SaD at around 30%, which we view as the run-rate going forward.

Current dividend policy a pre-requisite for rating base case

WHB's dividend policy is currently restricted by bank debt covenants and ensures the smooth operation of the company and the maintenance of a liquidity buffer. An increase in dividends is planned, from HUF 2.5bn in 2018 to HUF 3.5bn in 2019, in line with covenants; we estimate a reduction to HUF 3.4bn in 2020 and HUF 1.5bn in 2021. Our rating base case expects the continuation of the current dividend policy, with the most restrictive covenant of a maximum 50% of operational net income (excluding write-ups or the like) being kept in the future, even if bank debt were to be refinanced or covenants amended. In the upcoming two-year period, the company is engaging in two large debt-funded projects that will drive free operating cash flow negative in the short run, rendering dividends to be funded with debt.

Liquidity: adequate

We consider WHB's liquidity to be adequate, in detail:

Figure 8: Liquidity

WHB	2019E	2020E
Short-term debt (t)	1,333,000	1,333,000
Unrestricted cash (t)	5,531,834	14,008,304
Open committed credit lines (t)	0	0
Free operating cash flow (t+1)[1]	-636,151	1,161,466
Coverage	**3.7x**	**11.4x**

Source: Scope

We judge the company's liquidity to be adequate, with unrestricted cash exceeding short-term debt, even if free operating cash flow turns further negative. Given the long maturity of the prospective bond, upcoming short-term maturities are likely to be manageable for the foreseeable future.

Outlook

Outlook: Stable

The Outlook for WHB is Stable and incorporates our view of the high transformation risk that the company is exposed to in 2020 when government contracts are executed and should be replaced by market contracts not known of as of today. Thus, we anticipate a strong decline in Scope-adjusted EBITDA in 2021 to HUF 2.7bn, leading to weakening credit metrics with SaD to Scope-adjusted EBITDA of around 3x. Furthermore, the Outlook incorporates a successful placement of a HUF 15bn bond in H1 2020 to finance investments into two projects, namely the acquisition and refurbishment of a multifunction complex as well as the development of a green-field logistics facility, both in western Hungary. Both projects should benefit WHB's recurring EBITDA in the medium term. Additionally, we expect dividend payouts to be in line with the current covenant of a maximum 50% of operational net income.

A positive rating action is remote in our view but may be warranted if the company can increase visibility on revenues beyond 2020, helping to keep SaD to Scope-adjusted EBITDA below 2.5x on a sustained basis. This could be driven by, for example, i) an improving order backlog, benefitting from a higher granularity of customers and more complex projects extending the respective execution periods; or ii) a successful revamp of the multifunctional complex that supports cash flow beyond our current expectations.

A negative rating action could occur if SaD to Scope-adjusted EBITDA increases to above 3.5x on a sustained basis or liquidity were to worsen. An increase in leverage could be triggered by either i) an adverse operational development with reduced profitability and cash flows; or ii) more aggressive dividend payouts than currently allowed

[1] We exclude discretionary expansion capex from the liquidity calculation, as such investments are made only if external financing is available.

given the issuer's loan covenants. Liquidity could worsen if, e.g. i) customers delay payments significantly; or ii) the company becomes exposed to the non-recoverable cost overruns of its projects.

Long-term and short-term debt instrument ratings

Senior unsecured debt: B+

The rated entity plans to issue a HUF 15bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. The planned bond has a 3.0% coupon and is amortising after 5 years with a tenor until 2030. Proceeds from the bond are earmarked for the acquisition and refurbishment of a multifunctional shopping centre and for a green-field logistics development project in western Hungary.

Our recovery analysis is based on a hypothetical default scenario occurring at year-end 2021, in which we assume an outstanding senior unsecured bond debt of HUF 15bn in addition to the existing debt positions. We expect an 'average recovery' for the company's unsecured debt, resulting in a B+ rating for this debt class (the same as the issuer rating).

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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