Duna Aszfalt Zrt.
Hungary, Construction

BB- POSITIVE

Corporate profile

Founded in 1996 and 100% owned by László Szíjj, Duna Aszfalt Zrt. (Duna Aszfalt) is one of the largest players in Hungarian road construction and renovation. Further segments include the laying of utility lines, the construction of water and sewage treatment structures, and bridge building. Duna Aszfalt also provides heavy equipment and operates asphalt-mixing plants, quarries as well as emulsion production and laboratory facilities.

Key metrics

			Scope estimates	
Scope credit ratios	2019	2020	2021E	2022E
EBITDA/interest cover	343.6x	67.9x	69.0x	47.5x
Scope-adjusted debt (SaD)/EBITDA	1.8x	0.8x	1.5x	1.9x
Scope-adjusted FFO/SaD	53%	110%	62%	48%
FOCF/SaD	14%	-14%	48%	54%

Rating rationale

Scope Ratings has affirmed the BB- issuer rating to Duna Aszfalt Zrt. with the Outlook revised to Positive from Stable. Scope has also affirmed the BB rating for the senior unsecured debt category.

The rating affirmation is driven by Duna Aszfalt's resilient performance in 2020. The group generated revenues of HUF 254bn and Scope-adjusted EBITDA of HUF 62.4bn (8% and 41% above our forecast), despite the impact of Covid-19 on the economy. This performance was supported by the group's construction activities, mostly road construction, which held up well during 2020. The group's order backlog of projects has also grown, equating around 2.0x 2020 revenues. In spite of the positive development in some of the group's key metrics, Duna Aszfalt remains a relatively small-sized construction group in the European context and a niche player. Weak diversification remains a constraint, namely: i) a lack of geographical diversification; ii) a high reliance on one construction segment (motorways); and iii) a concentrated customer portfolio and backlog, in a segment where demand is mostly dependent on governmental demand and strategy. Profitability, as measured by the Scope-adjusted EBITDA margin, continues to support the rating.

Duna Aszfalt's financial risk profile benefits from its solid credit metrics. Scope-adjusted debt (SaD)/Scope-adjusted EBITDA was 0.8x as of December 2020, slightly below our expectations. This resulted from higher-than-expected Scope-adjusted EBITDA (41% above our forecast) and lower SaD (15% below), in particular driven by the announced conversion of long-term financial assets into more liquid assets in 2020. We anticipate that SaD/EBITDA will remain below 2x in the next few years but remain cautious about the sustainability of current credit metrics. Firstly, they are heavily influenced by the profitability of contracts in Duna Aszfalt's current order backlog, which will be executed over the next few years. Secondly, Duna Aszfalt's is reducing its long-term financial assets – and increasing its cash balances – to prepare for large projects and future acquisitions. Thus, the cash position at the end of 2020 (HUF 65bn) is not permanent, in our view.

Ratings & Outlook

Corporate rating	BB-/Positive
Senior unsecured rating	BB

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Related Methodology

Corporate Rating Methodology: July 2021

Rating Methodology: European Construction Corporates January 2021

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Outlook and rating-change drivers

The Positive Outlook reflects our expectation that the group will maintain the momentum on its order intake and order backlog, with increasing diversification, providing continued visibility on its solid financial profile.

We may take a positive rating action if Duna Aszfalt's order backlog strengthens, thereby providing greater visibility on future cash flows and lowering dependency on state orders, paired with an unchanged solid financial risk profile.

A negative rating action (such as a reversion of the rating Outlook to Stable) could result if our expectations of an increasingly diversified order intake and backlog paired with an unchanged strong financial risk profile do not materialise. We recognise that Duna has increased its headroom to a negative rating action. However, a downgrade could be required if Duna Aszfalt's leverage – as measured by SaD/EBITDA – significatively deteriorates to above 3.5x on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Very solid profitability, but with uncertain sustainability once backlog dries up • Marked improvement in credit metrics as EBITDA has been boosted by state tenders won since 2016 • Good track record in winning new tenders	• Uncertain ability to maintain current profitability and credit metrics through new tenders • Focus on local industrial and civil engineering projects, a segment with high cyclicality and low entry barriers • Full revenue concentration in Hungary, high concentration in both construction and motorway construction • Dependency on state tenders • Relatively low backlog-to-sales ratio, and low visibility after current backlog executed • Market position relies on the group's well-established credentials for projects with state owned companies, resulting in regulatory and reputational risks [ESG factor]

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Strengthened order backlog, increasing cash flow predictability and lower dependency on state orders, paired with an unchanged solid financial risk profile	• Strengthened order backlog and financial risk profile do not materialise • Leverage (SaD/EBITDA) increases above 3.5x on a sustained basis

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA/Scope-adjusted interest cover (x)	343.6x	67.9x	69.0x	47.5x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA (x)	1.8x	0.8x	1.5x	1.9x
Scope-adjusted funds from operations/SaD (%)	53%	110%	62%	48%
Scope-adjusted free operating cash flow/SaD (%)	14%	-14%	48%	54%
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	54,887	57,613	62,077	42,768
less: disposal gains from fixed assets included in EBITDA	0	0	0	0
Other adjustments	14,652	4,825	0	0
Scope-adjusted EBITDA	69,539	62,438	62,077	42,768
Scope funds from operations in HUF m	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA	69,539	62,438	62,077	42,768
less: cash interest as per cash flow statement	-202	-920	-900	-900
less: cash tax paid as per cash flow statement	-2,870	-4,672	-4,849	-3,186
Scope funds from operations	66,467	56,847	56,328	38,681
Scope-adjusted debt in HUF m	**2019**	**2020**	**2021E**	**2022E**
Interest-bearing debt	31,078	30,000	30,000	30,000
add: Advances	89,260	47,979	55,000	45,000
less: Cash and cash equivalents	-44,458	-81,074	-100,413	-65,377
add: cash not accessible[1,2]	5,500	5,500	48,000	13,000
add: Off-balance sheet debt[3]	44,667	49,451	57,541	57,541
Scope-adjusted debt	126,047	51,856	90,128	80,164

[1] Netting of cash: generally, only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible
[2] Whilst cash balance is high going forward, we assess part of it as earmarked for financing the group's investment plan – mainly business expansion, as well as concessions in non-european and domestic market. Thus, we believe accessible cash as rather around HUF 35bn a level equal to that prior extensively tapping capital markets.
[3] Includes performance and default guarantees.

Business risk profile: B

Industry risk: B

Duna Aszfalt operates as a main constructor. The group has a very concentrated business model, as around 90% of its revenues in the last few years have come from construction works with a strong focus on motorway construction (around 60% of revenues in 2020). Further construction activities include the laying of utility lines, the construction of water and sewage treatment structures and bridge building.

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

Small construction player in a European context, but leader in its niche market

Duna Aszfalt's construction activities have not been interrupted by the impact of Covid 19 on the economy. The group benefited from robust performance in 2020 with revenues totalling HUF 254bn (-6% below the previous year but 8% YoY above our forecast) and Scope-adjusted EBITDA of HUF 62.4bn (41% above our forecast). Nonetheless, Duna Aszfalt remains a small construction player in the European context and a niche player, given its strong focus on motorway construction projects in Hungary. We note, however, that Duna Aszfalt remains one of the largest motorway construction companies in Hungary.

Exposed to domestic construction market – one segment and geography

Diversification across business segments continues to be limited. Although it covers various construction segments (mainly roads, the laying of utility lines, the construction of water and sewage treatment structures and bridge building) the group has a relatively high exposure to motorway construction, where it generated over 60% of revenues in 2020. In addition, Duna Aszfalt's activities are concentrated on its domestic market, resulting in a high exposure to the macroeconomy of one market. This is compounded by the group's focus on construction, a cyclical industry in which market downturns tend to affect revenues and earnings.

In 2020, Duna Aszfalt started operations in the Polish market. Its activities mainly comprise the production of raw materials, mainly steel, to be used in Duna Aszfalt's construction projects in Hungary. Due to the pandemic and uncertainty in the investment market, the group has slightly delayed the planned geographic expansion into other neighbouring countries, which is now expected to be executed from 2022 on. If successful, this could support the rating in the medium to long term.

Concentrated customer structure, strongly exposed to state tenders

A further restraining factor for the group's business risk profile is its high dependency on state tenders. Government-related projects have represented more than 65% of Duna Aszfalt's revenues since 2017. Thus, the group's revenue generation heavily depends on government demand and strategy.

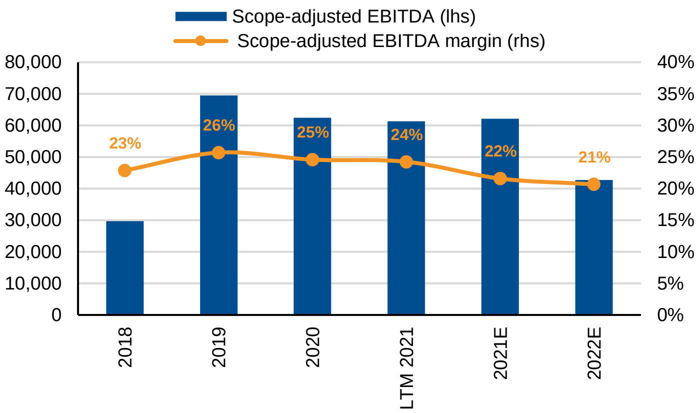
Above-average profitability, but uncertain development once backlog dries up

Profitability continues to be the main supportive factor for the group's business risk profile. Scope-adjusted EBITDA was HUF 62bn, adjusted for net provisions of HUF 4.3bn. According to the group, the provisions were mainly created as a Covid-19 reserve and for new warranty provisions. Profitability, as measured by the Scope-adjusted EBITDA margin, reached 25% in 2020. The margin has remained above the construction industry profitability range (5%-10%) since 2017. In the first half of 2021, Duna Aszfalt achieved revenues of HUF 106bn and Scope-adjusted EBITDA of HUF 22bn. The EBITDA margin remained above 20%.

We attribute the current profitability level to the motorway construction tenders the group has obtained since 2016. We expect margins to remain at around 20% in the next few years. We also acknowledge that Duna Aszfalt has continued sourcing new projects in the last couple of years.

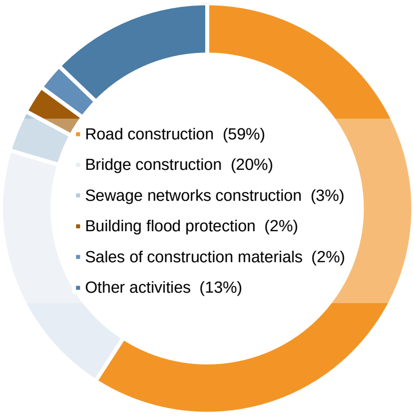
We remain cautious in our view on margins until Duna Aszfalt proves its ability to maintain the current profitability level with newly gained tenders. This is due to low visibility for the period after the execution of the existent order backlog and regarding the sustainability of the current profitability level.

Figure 1: EBITDA (in HUFm) and EBITDA margin



Source: Scope estimates

Figure 2: Revenue breakdown, 2020



Source: Scope estimates

Slightly improved but still concentrated backlog

Duna Aszfalt's order backlog of projects has grown, equating around 2.0x 2020 revenues. The group has recently gained new tenders, including the largest projects in its current backlog, the Kalocsa-Paks motorway and the extension of the M6 Motorway. However, its backlog is still concentrated, with 75% of projects assigned by the one customer and the top ten projects accounting for 66% of future contracted revenues.

Financial risk profile: BBB-

Low leverage, benefiting from high advance payments

Leverage was low in 2020, with SaD/Scope-adjusted EBITDA below 1x and Scope-adjusted funds from operations/SaD of above 60%. Duna Aszfalt's reported financial debt at year-end 2020 was HUF 30bn, only corresponding to the corporate notes issued under the Hungarian Central Bank's Bond for Growth Programme. To calculate Scope adjusted debt (SaD), we adjusted for: i) guarantees, adding 100% of performance and default guarantees; and ii) advances payments. SaD therefore amounted to HUF 52bn at end-December 2020 (HUF 126bn at end-December 2019). The decrease is mainly because of reduced advances (HUF 41bn below the previous year) and a higher cash balance as a result of the planned reduction in long-term financial assets.

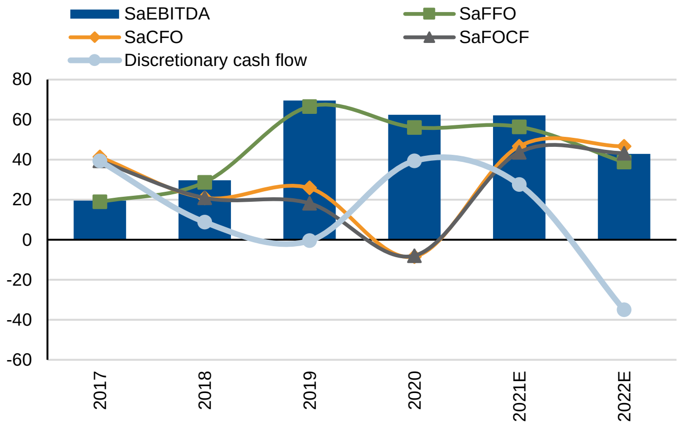
Although Duna Aszfalt expected customer advances to decline after the end of the current EU budget period, the group won a handful of high advance payment intense projects in 2020 and the first half of 2021. We expect these advances to gradually decrease in the next few years.

We do not consider the lower leverage in 2020 to be sustainable as the group plans to use existing cash to finance its business plan. We therefore expect SaD/Scope-adjusted EBITDA to move towards 2x in the next years.

Operating cash flow impacted by reduced advance payments in 2020

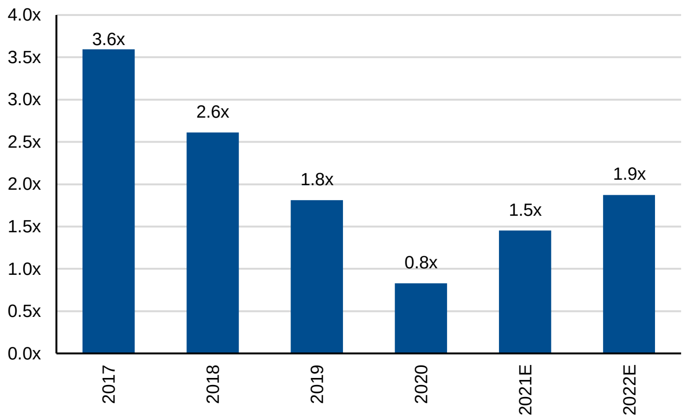
Operating cash flow and free operating cash flow turned negative in 2020, mostly impacted by the reduction in advance payments (HUF 41bn lower than year-end 2019) weighing on group cash flows. The group had capital expenditures of HUF 3.5bn in 2020, mostly counterbalanced by some asset disposals (HUF 3.9bn). The group has distributed dividends of HUF 10.8bn. At the same time, Duna Aszfalt has executed the planned conversion of long-term financial assets (investment units) into short-term assets to prepare for large concession projects and future acquisitions. For 2021, we expect positive operating cash flow, reflecting EBITDA mostly in line with the 2020 figure and positive free operating cash flow – supported by the group's backlog and higher than initially expected advance payments.

Figure 3: Cash flows (HUF bn)



Source: Scope estimates
Sa = Scope-adjusted

Figure 4: Leverage (SaD/EBITDA)



Source: Scope estimates

Adequate liquidity

Liquidity is adequate with cash balances of HUF 65bn available as of December 2020. With no significant amount due in the coming years and a solid cash position, we view Duna Aszfalt's liquidity and financial flexibility as adequate.

Due to the uncertainty in the investment market in 2020, Duna Aszfalt decided to slow its expansion into neighbouring countries and revised its investment plan. The revised investment programme for the 2021-2022 includes business expansion in CEE as well as the build-up of Duna Aszfalt's presence in the concession segment.

ESG factors

We deem regulatory and reputational risks to be a negative ESG factor

We believe that Duna Aszfalt's market position in recent years has been gained by winning state tenders, thanks to the group's well-established credentials regarding projects with state owned companies. State tenders accounted for around 65% of total revenues in 2020, which creates a high dependency.

Long-term debt rating

Senior unsecured debt: BB

In line with the group's plans, we assume that the business plan can be executed without the need for additional bank debt or other senior-ranked financing. Thus, the HUF 30bn unsecured corporate notes issued under the Hungarian National Bank's Bond Funding for Growth Scheme are the only financial instrument to consider. Further, the recovery rate calculation assumes: i) that payables have a higher seniority than the bond; and ii) the same seniority for advances received in comparison to the bond. This view is based on the legal opinion provided by local legal counsel.

Our recovery analysis is based on a liquidation value in a hypothetical default in 2022 of HUF 96bn. This value is based on a haircut of around 60% on assets and reflects liquidation costs for the assets of 10%. An above average recovery is expected for senior unsecured debt. Thus, we affirm the BB rating for the senior unsecured debt class, one notch above the issuer rating. The uplift is limited due to the risk and possibility that senior secured debt will potentially increase in the path to default (volatility of capital structure and share of senior unsecured debt).

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