Hungary's corporate credit outlook: challenges intensify after decade of favourable conditions

Hungary's corporate sector is headed for a further deterioration in credit quality as soaring inflation, rising interest rates, exchange-rate volatility and uncertainty about EU funds take their toll on private and public-sector demand. The MNB's recent decision to increase short-term rates even further to 18% to stabilise the currency adds further pressure to Hungarian corporate credit risk.

Many Hungarian companies benefit from long-term fixed-rate bonds, while debt amortisation poses no immediate refinancing risk. Cash-rich corporates will most easily finance their supply chains while market leaders will try to squeeze suppliers. The government is offering subsidised SME lending for amounts up to EUR 1m, but this is becoming costly to fund.

Other pressures are mounting across the corporate landscape. Falling demand, notably for consumer products, complicates management's efforts to pass on costs to customers by raising prices. Uncertainty about state spending and disbursement of EU funds adds doubt about orders and future revenues. The construction sector is vulnerable. Many public sector projects face delays if not cancellation if EU funds are not restored by early next year.

Meanwhile, companies' capital expenditure plans are also under pressure. Budgets are in danger of overshooting due to the higher cost of technology and other imports as the Hungarian forint has lost value against the euro.

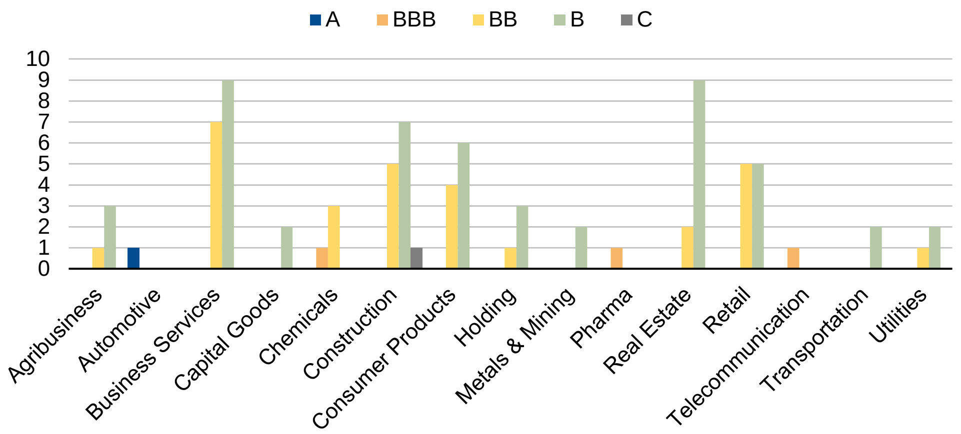
For raw material dependent companies, costlier commodity imports such as oil, aluminium among others, all mainly billed in dollars, will also inflate operating costs and pinch profit margins given the US currency has strengthened against the forint even more than against the euro.

Firms put a brake on investment spending

Faced with high domestic rates and falling bank liquidity, Hungarian firms are more likely to keep cash on deposit than invest, a trend more visible since August. Companies are also turned to cheaper euro financing, variable interest rates, and shorter tenors, pointing to more risky financing structures.

On the upside, exporters benefit from higher margins in domestic currency, as do some commercial real estate firms with revenues denominated in euro. Some producers have started linking their prices to the euro despite government incentives for local firms to keep faith in forint. Some multinational firms are linking wages to the euro, a practice which may spread, particularly as wage inflation is accelerating, up 15% in July 2022 compared with the previous year. There were further increases in September and more are expected in January, according to the companies we follow.

Figure 1: Rating distribution of Scope's Hungarian corporate issuer ratings
Number of rated companies (lhs)



Source: Scope

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Marked deterioration of growth prospects due to external risks

High reliance on Russian energy

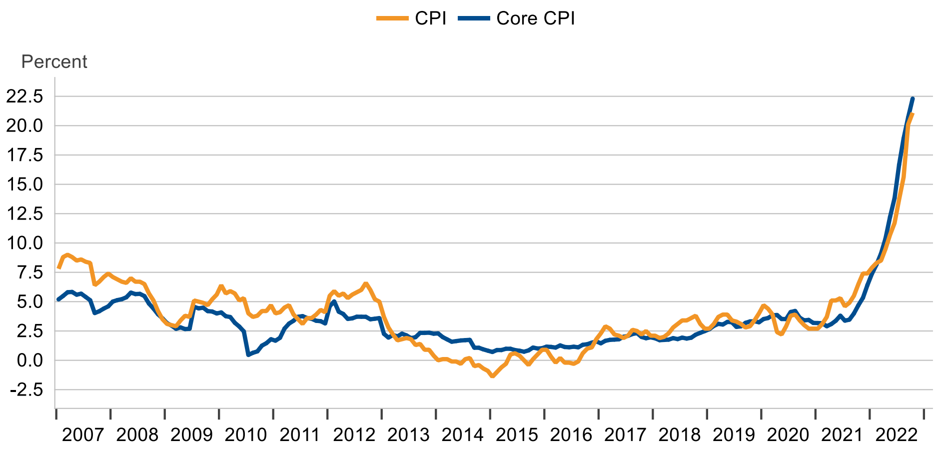
The Hungarian economy has slowed down sharply in H2 2022, reflecting the impact of Russia's war in Ukraine. The country's reliance on Russian energy amplified by an economic structure dominated by energy-intensive businesses with complex value chains, coupled with weaker export demand, makes Hungary one of the most exposed countries to the repercussions of international sanctions on Russia and the Kremlin's weaponisation of its energy exports.

Annual inflation has risen markedly in recent months, running at 20.1% in September, among the highest rates in Central and Eastern Europe. The current account deficit has widened due to rising energy prices and global supply chain disruptions, crimping the performance of some key export industries. The widening energy deficit is also putting pressure on already low foreign exchange (FX) reserves after the MNB announced that it would support imports, a programme worth up to EUR 1.5bn a month.

Inflationary pressures aggravated by weaker forint

The weakening of the forint adds pressure to domestic price dynamics. In response, the National Bank of Hungary rapidly tightened monetary policy, increasing its benchmark interest rate to 13% in September and widened its overnight deposit rate corridor to 25% in October to drain liquidity from the banking system and support the forint.

Figure 2: Inflation surges in Hungary



Source: MNB, HCSO, Macrobond

Growing risks to Hungary's competitiveness

Skills shortages are long-term drag on economic growth

From 2024, Hungary's growth should return towards the medium-term potential of 2.5%-3.0% a year, supported by its share of EU funds from the Recovery and Resilience Facility, currently on hold. However, even in this scenario, we anticipate lower growth rates than before the pandemic, which reflects Hungary's tight labour market and skills shortages, which remain severe by EU standards, reflecting a rapidly ageing population and a shrinking number of people of working age.

Growing domestic control of key economic sectors

The current government's strategy of extending state control over a growing number of sectors of the economy – including energy, media and the banking sector (with three banks being merged into a state-linked Hungarian Bank Holding) – risks compromising the efficient allocation of capital and limiting the country's long-term growth prospects.

Soaring interest rates to reduce demand and raise financing cost

Double digit interest rates hinder new investments

The steep increase in interest rates in 2022 puts pressure on final demand and on companies' financing costs. Since the beginning of the year the Hungarian central bank has raised its policy rate by more than 900bps to 13.00% and overnight deposit rates surged to 18% this month after the MNB widened its deposit rate corridor to 25% to drain liquidity from the banking system. While the Hungarian yield curve is heavily inverted, the 10-year yield, nevertheless, doubled in response to the steep rise in inflation.

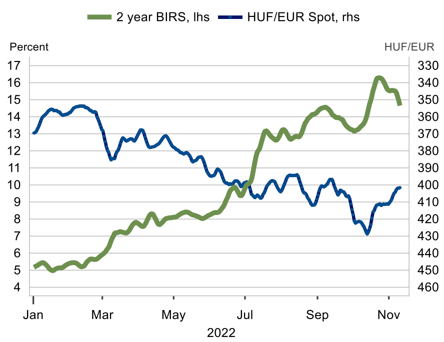
Double digit interest rates for working capital fuel inflation

The increase in interest rates put direct pressure on Hungarian corporates' working capital as this debt is typically denominated in local currency at a variable interest rate. Since 2021, short-term lending rates have increased to 13-15% from 1-2% due to tighter monetary policy conditions. The increase of the base rate this year will sharply raise the cost of corporate borrowing.

Interest-rate pressure on Hungarian debt issuers

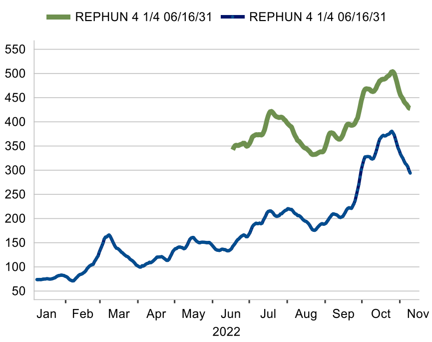
Most Hungarian debt issuers have an EBITDA margin ranging between 3-15%, so highly leveraged companies among them cannot withstand higher interest rates for long. Firms will need to pass on some of the interest cost to customers through higher prices to protect their margins, putting further upward pressure on inflation – or reduce output and impair their credit metrics.

Figure 3: Central Bank (MNB) base rate; Budapest interest rate swaps (BIRS)



Source: Macrobond, Scope

Figure 4: Hungary EUR bond pricing



Source: Bloomberg, Scope

Inflation weighs on consumer demand

High interest costs will be passed on to consumers at a time when food prices are rising by close to 35% YoY. We expect this to cause demand shocks and changes in consumer behaviour: more frugal shopping, preference for cheaper alternatives to more expensive imported or branded goods, all with an adverse impact on the top line and margins of Hungarian debt issuers.

Turning towards euro denominated debt is an option for corporates and households, which has been widely used in the past. However, foreign currency borrowing costs have also increased in line with higher bond yields in the euro area and widening bond spreads for the Hungarian government.

Firms turn to euro-denominated funding

Currency mismatch poses an additional challenge for companies with domestic sales given the forint's volatility and depreciation against the euro.

Currency depreciation has made the rise in commodity prices worse, leading to steep increases across a variety of imported products such as energy, packaging, fertiliser, wood and paper, cement etc.

There is a longer-term impact too as imported inflation crimps investment demand because projects that rely on machinery purchased abroad become more expensive. Construction costs have surged since 2020 as soaring energy prices have fed through to building materials prices, putting pressure on investment returns. Many energy and other commodity supplier contracts reset in December, which will add to further input cost across the supply chain and push inflation higher.

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The era of cheap debt and high public investment is over

Until 2022, the state supported investment with low fixed-rate loans and long-term bonds.

Private, public investment delays crimp competitiveness

New investments now face a double-digit interest rate hurdle, which will delay projects and put pressure on competitiveness when labour costs are increasing. Fixed-rate debt issuers can now arbitrage between high current deposit rates vs low long-term lending rates of recent years, likely delaying investment decisions. Labour-market bottlenecks remain significant constraints on investment spending.

Many public infrastructure investments are experiencing delays due to rising costs and delays of disbursements of EU funds. The government announced new fiscal consolidation package in June, targeting spending cuts of 2.3% of GDP, mainly in public investment, plus tax increases equivalent to 1.4% of GDP. Windfall taxes on corporates add further pressure on profitability and investment sentiment in the affected sectors.

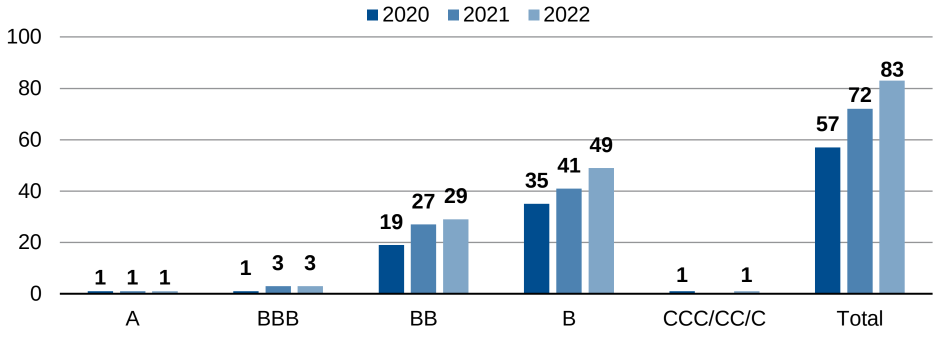
Scope’s rating universe in Hungary

Scope rates 83 Hungarian corporate issuers that issued one or more bonds mainly under the Bond for Growth framework of the MNB. Up to 70% of the issuance was purchased by the central bank and the remainder mainly by local banks. The bonds are fixed coupon in a range from 2% to 4%, which is credit positive considering the much higher market rates, today.

Low rates locked in on EUR 5bn in bonds issuance

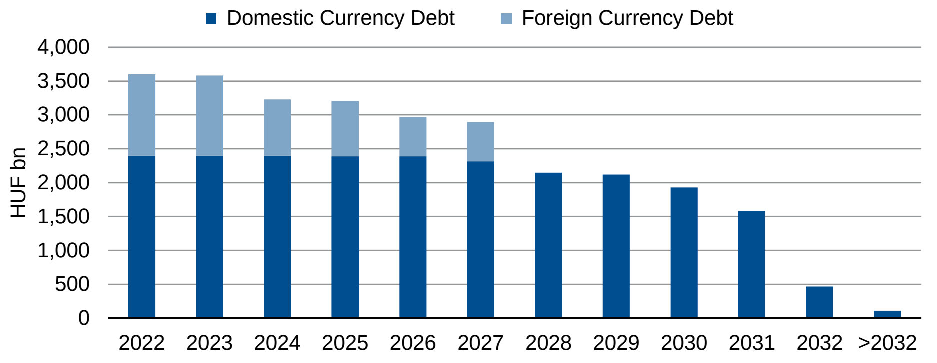
The total debt issuance related to the programme is around EUR 5bn. The maturity schedule is concentrated for 2029-2032 as most of the bonds have a 10-year tenor with a balloon or bullet structure. This provides companies with long-term cheap financing and protects issuers from the soaring rates. However, there is no more cheap funding available to finance working capital and new investments.

Figure 5: Rating distribution 2020-22



Source: Scope

Figure 6: Corporate bond maturities in Hungary (HUF bn)



Source: Bloomberg

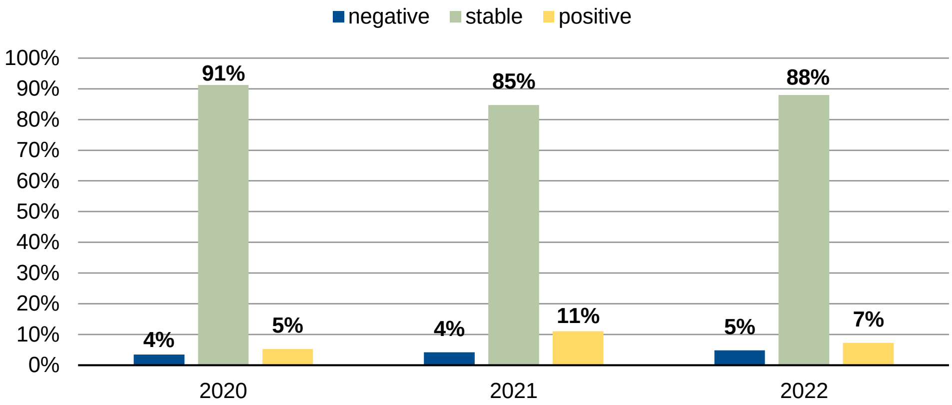
Companies rated on average well below sovereign rating

Scope's ratings for Hungarian corporates range from A to C but are mainly in the B and BB categories, which is well below our sovereign credit rating for Hungary. Scope affirmed Hungary's local- and foreign-currency issuer ratings at BBB+ and revised the Outlook to Negative from Stable on 5 September 2022.

In 2022, the share of BB ratings declined by three percentage points to 35% while the share of B ratings increased by 2 percentage points to 59%. This change is mainly because lower credit quality issuers entered the bond programme towards its end. There is only one C category rating which is a governance related use of funds related issue in the construction sector.

The sector breakdown shows that the higher rated companies are in the business services and retail sectors, followed by construction and consumer products.

Figure 7: Outlook for Hungarian corporate credit ratings



Source: Scope

The higher concentration of firms in the B category has multiple reasons: (i) a strong debt funded investment phase put pressure on ratings, (ii) a deteriorating market environment decreased the credit quality of the issuer, (iii) smaller companies and those with lower credit quality used the central bank's Bond for Growth programme before it expired.

Higher rated entities tend to benefit from international links. The A category contains the subsidiary of a multinational automotive company. The BBB category includes Magyar Telekom Nyrt, a subsidiary of Deutsche Telekom. Domestic companies in the BBB category include MOL Oil & Gas PLC and pharmaceuticals company Richter Gedeon Nyrt.

Outlook for Hungarian corporate credit ratings

An outlook change in the sovereign rating would not immediately mean a deterioration of the corporate issuer rating, which is based on a bottom-up assessment.

Nevertheless, positive outlooks declined by 4 percentage points to 7% of the ratings universe during 2022 while negative outlooks increased slightly from 4% to 5%. The deteriorating market conditions are not yet impacting our sample of Hungarian companies significantly at this stage.

Mixed picture across universe

Our Hungarian rated corporate universe includes utilities and renewable-energy firms, two strongly positioned sectors. In contrast, others such as real estate and mobility services are vulnerable to high energy prices.

Hungarian corporates are exposed to multiple shocks from soaring energy prices, higher interest rates, a weak currency and lower state funding due budget consolidation and delayed EU funds. At the same time, price caps and windfall taxes are making planning unpredictable and weigh on investment sentiment. Smaller companies have additional vulnerabilities due to their size and lack of diversification.

Consumer Goods / Agriculture

More discerning consumer spending emerges in H2

Consumer goods and agriculture companies produce many non-discretionary products, for which demand is rather stable, which allowed producers to pass on steep price increases in the first half of the year. However, in the second half of the year we expect that demand for expensive premium products and discretionary items will fall as consumers buy less and switch to cheaper alternatives.

Slaughterhouses are somewhat affected already. Processed-meat producers have been able to raise prices until now. Since start of 2022, prices at the production facilities have risen by 30-50%, though the governments caps on retail prices have partially offset this impact on consumers. The cap, putting a ceiling on prices on where they were in October 2021, applies to a basket of products including UHT milk, chicken breast, pork leg, sunflower oil, sugar, flour among other goods. High animal feed, energy and aluminium cost will squeeze profitability respectively of KOMETA 99 Zrt (rated B+/Stable), Vajda-Papír Kft (rated B+/Stable), HELL Energy Magyarország Kft (rated B+/Stable).

Vertical integration can help keep input prices low. Using by-products can help improve margins. Therefore, we see higher profitability at food manufacturers such as Pick Szeged Zrt (member of Bonafarm Group, rated BB-/Stable) and Baromfi Coop Kft (rated BB-/Stable) in the short term, but challenged ahead of winter by steep increases in wages, energy costs and other inputs.

Drought in summer has weighed on agriculture

On the supply side, Hungarian agriculture experience a particularly severe drought in Q2 2022 resulting in 35% decrease in production compared with 2021. Costs rose steeply too, from fertiliser to the energy needed for greenhouses. Passing on those still elevated costs to customers has feed food-price inflation in H2.

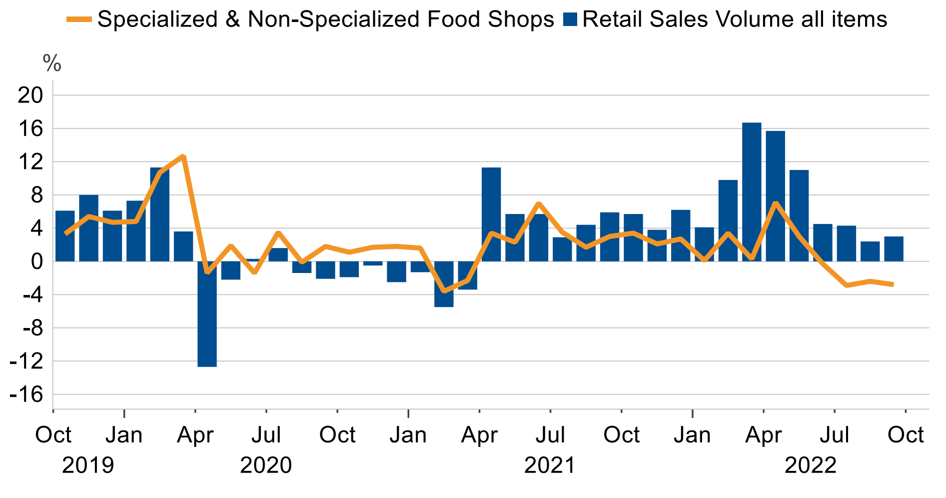
The sector's Scope-adjusted EBITDA margin ranges between 5-16% which puts Hungarian companies at the lower end of this profitability scale at risk.

Retailers

Retail sales growth decelerates

Until July, retail sales rose by 9.3% compared to the previous year. However, volume growth slowed to 2.4% in August as specialised and non-specialised food retailing fell by 2.4%. This trend points towards changes in consumer behaviour favouring non-discretionary consumer products.

Figure 8: Hungary retail sales, monthly change (%), Oct 2019-Sept 2022



Source: HCSO, Macrobond

The sector's Scope-adjusted EBITDA margin ranges between 2.5-15.7% (before windfall tax) which puts these corporates at risk. Electronics retailers may suffer with their discretionary product portfolio – excluding energy-saving products – efficiencies which might be somewhat offset by higher share of services provided such as at Vöröskő Kft (operating under Euronics brand, rated BB/Stable). Daniella Kft could benefit from (rated B+/Stable) customers looking for products to make energy savings.

Car parts retailers benefit from industry bottlenecks

Car parts retailers such as UNIX Autó Kft (rated BB-/Positive) are doing well, as original equipment manufacturers (OEM) experience the lingering effect of supply-change shortages, limiting the supply of new vehicles. In addition, latest data on new car sales (declining) and vehicle parts and accessories (rising) suggest consumers are preferring to keep their current cars on the road rather than buy new ones.

Construction

Dispute with EU, high input prices hamper industry

The backlogs of Hungary's construction industry are likely to decline as there are fewer tenders for firms to compete for as inflation takes its toll on investment decisions. Government tenders are subject to agreement with the EU and all investments are reviewed by the government on a case-by-case basis. With the economic uncertainty and questions over Hungary's access to EU Funds, the credit outlook is negative for construction companies involved in building discretionary public infrastructure or involved with long fixed-priced procurement tenders. Existing fixed price contracts may crimp profitability as construction costs have risen significantly.

On the upside, energy efficiency related investments are running run at high pace, which offsets. One potential beneficiary is Masterplast Nyrt (rated BB-/Stable). Others such as Vasútvill Kft (rated BB-/Negative) less so, as investment in rail infrastructure is subject to disbursement of EU funds. General contractors may see steep cost increases which they not be able to pass on fully on their customers. Projects on the books of international firms and in the hands of vertically integrated construction companies such as MARKET Építő Zrt (rated BB-/Stable) look more resilient.

The sector's Scope-adjusted EBITDA margin ranges between 0-14% (before windfall tax) which puts these corporates at the lower end of the profitability scale at risk.

Services

Above-average services margins make sector more resilient

The topline of business services correlates with GDP growth, set slow in 2023. Margins are typically higher than for consumer goods and retail, which make services more resilient to shocks. Nevertheless, higher energy costs will result in price increases as companies seek to pass them on to customers.

Sector Scope-adjusted EBITDA margin ranges between 5-40% (before windfall tax) which may result in higher resilience than other parts of the Hungarian economy.

Issuers close to the food sector are experiencing steep increases in input costs such as Progress Étteremhálózat Kft (rated BB/Stable) – development licensee of McDonald's restaurants in Hungary -- GVC George's Venture Capital Zrt rated (BB-/Stable) and Aranynektár Kft (B/Stable). They typically passed on price increases to customers in H1 2022, likely tougher to do in H2 and next year as consumers tighten their belts.

Oil & Gas, Chemicals

High political risk in the sector

In the oil and gas sector, companies are benefiting from higher commodity prices but face a squeeze on earnings from windfall taxation, most notably MOL Oil&Gas Plc.In the chemicals sector, supply shocks are unpredictable at this stage, while supply risk remains high. We rate two entities with a Scope-adjusted EBITDA margin of 10% (Envien Magyarország Kft, rated BB/Stable) and 31% respectively (Pannonia Bio Zrt, rated BB+/Stable).

Utilities

Strong recurring revenues provide credit support

The sector is typically resilient due to its healthy profitability, with sector Scope-adjusted EBITDA of 20-33% and strong recurring cashflows. Companies such as ALTEO Nyrt (rated BB+/Stable) have benefited from increasing energy prices.

Real Estate

Strong recurring revenues in property sector

Real estate firms have benefited from long period of low interest rates ending last year, but then benefited in early 2022 from green housing-financing programmes that provided cheap fixed long-term retail mortgages at a rate of 2.5%. Recurring lease revenues are protected by long-term rental agreements with high quality tenants and the pass-through of service charges, including energy. However, we expect a strong demand shock for developers in H2 2022 as retail mortgage rates have risen to double digits. Pre-sale rates are falling at most of developers, posing problems for those without recurring revenues such as CORDIA International Zrt (rated BB/Negative) and SunDell Estate Nyrt (rated B/Stable).

With the sector’s Scope-adjusted EBITDA margin ranging from 27% to 88%, customary high margins for the sector which means there is a considerable profit buffer.

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