EPKAR Zrt.
Hungary, Construction

Corporate profile

EPKAR Kft. is one of the leading Hungarian construction companies, established in 1981. It is privately owned by its management and employees and generated HUF 26bn of revenues in 2018. EPKAR's heritage and the location of its headquarters is in Budapest, which accounts for about 50% of its activities, with the other half of its construction work from the rest of Hungary. It is predominantly involved in the construction and maintenance of buildings, monuments and sport facilities and aims to build up a real estate portfolio.

Key metrics

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA/interest cover (x)	n/a	n/a	n/a	13.5x	10.7x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	net cash	1.8x	1.7x
Scope-adjusted FFO/SaD	net cash	net cash	net cash	45%	45%
FOCF/SaD	net cash	net cash	net cash	18%	41%

Rating rationale

Scope assigns a first-time issuer rating of BB-/Stable to EPKAR Zrt. and a BB instrument rating for its senior unsecured debt.

The BB- issuer rating is supported by EPKAR's relatively strong credit metrics despite its planned debt-funded acquisition of a prime real estate portfolio. Additionally, its historically above-average profitability, adequate liquidity and long backlog relative to peers benefit the rating. 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 dependency on government contracts. We judge its backlog as concentrated (though somewhat mitigated by its investment grade counterparties) and its book-to-bill ratio as volatile.

Outlook

The Outlook for EPKAR is Stable and incorporates our view of a slowdown in the Hungarian construction industry, which will adversely affect the company's revenue and profitability potential after the current backlog is worked off at year-end 2021. We assume the company will partially balance the decline in construction cash flows with recurring rental income from the planned buy-to-hold portfolio, which will consist of performing Class A/B properties in Budapest.

The Outlook also incorporates the successful placement in H1 2020 of the HUF 10bn bond under the MNB Bond Funding for Growth Scheme. Proceeds are earmarked for capital expenditure to build up the aforementioned real estate portfolio.

Ratings & Outlook

Corporate ratings	BB-
Senior unsecured rating	BB

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Related Methodologies

Corporate Rating Methodology

Rating Methodology European Construction Corporates

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A positive rating action is seen to be remote, but may be warranted if the company can significantly improve its business risk profile – evidenced by a higher market share and a larger and more diversified order backlog – while keeping Scope-adjusted debt to Scope-adjusted EBITDA around 2x on a sustained basis.

A negative rating action could occur if Scope-adjusted debt to Scope-adjusted EBITDA increases above 3.5x on a sustained basis. An increase in leverage could be triggered by either i) an adverse operational development leading to reduced profitability and cash flows; or ii) additional debt-funded real estate acquisitions.

Rating drivers

Positive rating drivers	Negative rating drivers
• Historically above-average profitability, somewhat weakened by the lower margins expected in a downturn cycle • Moderate leverage after the debt-funded acquisition of a real estate portfolio, with relatively strong credit metrics overall • Adequate liquidity, with limited short-term maturities • Domestic market position translating into strong 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 top 10 domestic position • Concentration issues in its backlog (top three account for 58%; top 10 for 98%), somewhat mitigated by the investment grade counterparties and a legally enforced payment scheme that covers most of its contracts • High dependency on government contracts that are expected to diminish and leave a large gap that is difficult to fill • Exposure to cyclical Hungarian construction industry

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significantly improved business risk profile while keeping Scope-adjusted debt to Scope-adjusted EBITDA around 2x on a sustained basis	• Increased leverage, i.e. Scope-adjusted debt to Scope-adjusted EBITDA sustained above 3.5x

Financial overview

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA/interest cover (x)	n/a	n/a	n/a	13.5x	10.7x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	net cash	1.8x	1.7x
Scope-adjusted funds from operations/SaD	net cash	net cash	net cash	45%	45%
Free operating cash flow/SaD	net cash	net cash	net cash	18%	41%
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA	1,588	4,296	3,795	4,392	3,384
Operating lease payments in respective year	0	0	0	0	0
Other	0	-309	-878	0	0
Scope-adjusted EBITDA	1,588	3,987	2,917	4,392	3,384
Scope-adjusted funds from operations in EUR m	**2017**	**2018**	**2019F**	**2020F**	**2021F**
EBITDA	1,588	3,987	2,917	4,392	3,384
less: (net) cash interest as per cash flow statement	24	57	31	-326	-315
less: cash tax paid as per cash flow statement	-72	-434	-360	-418	-408
add: depreciation component, operating leases	0	0	0	0	0
Add: dividends from shareholdings	0	0	0	0	0
Scope-adjusted funds from operations	1,541	3,609	2,588	3,649	2,661
Scope-adjusted debt in EUR m	**2017**	**2018**	**2019F**	**2020F**	**2021F**
Reported gross financial debt	1,423	1,817	2,377	12,542	12,368
less: hybrid bonds	0	0	0	0	0
less: cash and cash equivalents	-3,243	-2,095	-7,578	-4,864	-6,939
add: cash not accessible	313	148	293	293	293
add: guarantees	0	44	150	150	150
add: operating lease obligations	0	0	0	0	0
Other	0	0	0	0	0
Scope-adjusted debt	-1,507	-86	-4,758	8,121	5,872

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; or ii) risks from price fluctuations on materials, labour and energy. We view the overall construction industry's cyclicality to be high. However, a large share of concession-related and service businesses can lower 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

Industry outlook: stable

The European construction sector's credit outlook is stable. The strong order backlog coupled with enduring capacity constraints, mostly related to labour, will outweigh the impact of cooling demand for new projects (Construction Outlook 2020).

Small player in a European context but top 10 in Hungary's fragmented market

EPKAR Zrt. is a small construction company in a European context, with HUF 26bn (EUR 77m) of revenues and HUF 4.3bn (EUR 13m) of Scope-adjusted EBITDA in 2018. However, it ranks in the top 10 (lower end) in its home market of Hungary, with a market share of 1.2% (2018) in a narrow construction sector definition. This strong position despite a relatively low market share indicates the highly fragmented and competitive Hungarian market, with over 56,000 construction companies, according to the European Construction Sector Observatory.

EPKAR grew strongly during 2016-18 – as did Hungary's overall construction market – with revenues and EBITDA tripling based on strong organic growth but also inorganic growth (e.g. via a joint venture with West Hungaria Bau and the acquisition of Magyar to take part in building Budapest's Puskás Aréna). The company's limited size leads to more volatile cash flows and limited economies of scale, though this is somewhat mitigated by its top 10 status, which grants it market visibility and moderate access to third-party capital and guarantees. Both factors should help to generate business going forward, which is especially pertinent given the need of the whole construction sector to refocus away from EU-sponsored construction and civil engineering, with the EU funding period to end soon.

Limited geographical diversification exposes EPKAR to Hungary's construction cycle

EPKAR's geographical diversification is limited, with predominantly domestic activities. Its activities are split in line with the domestic construction industry's revenue potential: 50% within Budapest and 50% from the rest of the country. Given the cyclicality of the industry – whose overheated growth has now peaked, according to market observers – revenues and margins are likely to come under pressure in a downturn, and EPKAR has no exposure to dampen this effect.

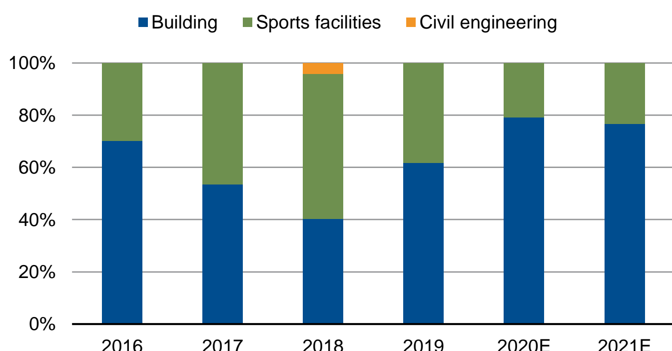
Acquisition of real estate portfolio to mitigate potential downturn

To mitigate this, EPKAR plans to establish a portfolio of prime Budapest commercial real estate (CRE) that can generate recurring rental income. The company is planning acquisitions worth up to HUF 12bn, financed by bond proceeds (HUF 10bn) and equity (HUF 2bn). Price and execution risks are likely as EPKAR has no experience in large-scale CRE acquisitions. However, this is mitigated by i) the company's knowledge in the sector and in Budapest; and ii) its sober approach in using acquisition advisors and a professional external management company to run the portfolio.

Limited segment diversification with activities in buildings and sport facilities

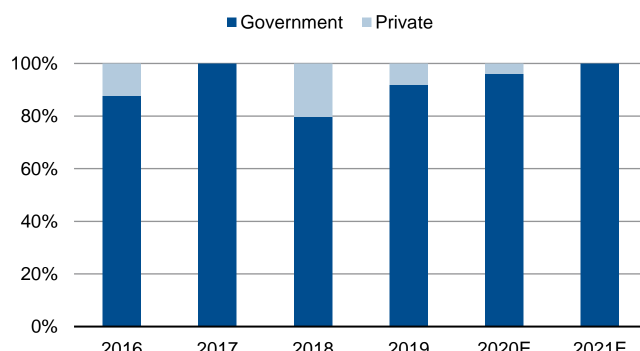
Segment diversification is also limited, as EPKAR is predominantly active in two areas: buildings and sport facilities. The building segment encompasses a vast variety of projects – among them, offices, residences, halls, garages, monuments, hospitals and educational facilities – but do not provide diversification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

Figure 2: Project diversification by segment (%)



Source: EPKAR, Scope estimates

Figure 3: Project diversification by customer (%)



Source: EPKAR, Scope estimates

Customer diversification: high dependency on government contracts

Customer diversification is rather low (figure 3). EPKAR has been relying on contracts from central or local governments during the period analysed and its backlog strongly depends on government-funded projects, accounting for 98%. 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. With the EU funds cycle due to end, this source is projected to decrease by 83% until 2022 (to around EUR 400m, according to the MNB).

We therefore expect a drastic change in EPKAR's customer profile. The gap to be left by government projects must be filled with market-based projects to maintain a stable top line as targeted. Management sees opportunities in sports facilities and buildings for large industrial customers, for which it is currently negotiating and tendering for projects. Some projects provide a viable alternative, but have been delayed due to the overheated construction cycle (driven by government-funded projects) while competition for them is expected to be fierce. We therefore anticipate margin erosion at the end of EPKAR's current backlog.

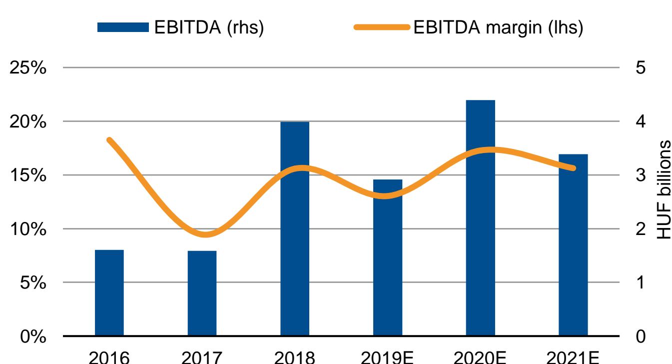
Concentrated backlog, somewhat mitigated by investment grade counterparties and legally enforced payment scheme

EPKAR's backlog is concentrated, with the top three projects (a monument restoration, a sports facility and an office building) representing 58% of the revenue backlog as of YE 2019 and the top 10 representing 98%. This bears the risk of significant cash flow volatility in the event of project delays, cost overruns, or customers deferring payment or being unable to pay (e.g. due to bankruptcy). The latter is somewhat mitigated by 75% of the backlog being funded either directly by central government (Republic of Hungary, rated BBB+ by Scope), or indirectly through Budapest's local government with state support/dependency. In addition, a payment scheme[1] enforced by Hungarian law protects contractors from non-payment or late payments for projects larger than HUF 1.5bn (93% of backlog).

Above-average margins to continue through duration of contracted backlog

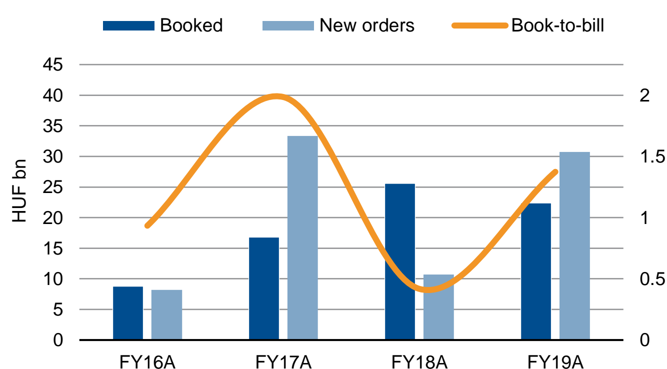
EPKAR's profitability, at 17%-18% during 2016-19, has been well above the construction industry's range (5%-10%). The level dipped in 2017 to 9%, though this was due to revenue recognition timing. As the backlog covers 100% of expected revenues for 2020 and 80% for 2021, we expect these margin levels to be maintained during this period. Thereafter, we assume profitability pressures from intense competition over market-based projects, while labour and material costs are likely to remain inflated. EPKAR's strong profitability will provide a cushion during this time and, in combination with its top 10 status, will allow it to defend its market share in a price war.

Figure 4: EBITDA and EBITDA margin



Source: EPKAR, Scope estimates

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



Source: EPKAR, Scope estimates

Backlog of 1.8 years; volatile book-to-bill ratio with recent strong order inflow

The current order backlog of HUF 40bn at YE 2019 covers around 1.8 years of revenues. This translates into 100% coverage with contracted orders for revenues expected in 2020 and 70% for those expected in 2021, levels which are high among local peers.

EPKAR's book-to-bill ratio is quite volatile and fluctuates between 2x (very strong demand) and less than 1x (insufficient or weak demand). In 2016 and 2017, order intake was strong before dipping in 2018. But order intakes have since recovered, providing some comfort for future revenues and mitigating the risks posed by the huge gap to be filled once current government contracts dry up.

Family-owned; no independent board

EPKAR is owned by the Szeivolt family and 38 employee shareholders (2.5%). 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.

[1] Customers are obliged to pay upfront the costs invoiced by the contractor for the next construction phase on an escrow account to secure timely payment.

Financial risk profile: BBB-

Our rating scenario assumes the following:

- Revenue growth of 14% in 2020 to HUF 25.4bn, based on the fully covered backlog; revenue decline of 15% in 2021 to HUF 21.6bn, based on the contracted backlog plus already tendered projects with high visibility of receiving the contracts; thereafter, a stark revenue decline, based on a limited backlog and low visibility on potential market orders
- EBITDA margin of 17% for 2020 and 16% for 2021, in line with margins in 2018 and 2019 given contracted backlogs, with manageable margin compression expected thereafter
- Issuance of a HUF 10bn (roughly EUR 30m) bond in H1 2020 under the MNB Bond Funds for Growth Scheme, with an expected coupon of 3% and a maturity of 10 years; bond proceeds to be used for diversification into real estate investment(s), specifically offices worth around HUF 12bn (using HUF 2bn equity) to gain long-term leases that generate steady cash flows (6% net yield targeted)
- Capital expenditure of around HUF 12.7bn in 2020, of which roughly HUF 12.0bn to be used for real estate acquisitions; HUF 1.1bn for maintenance/general capex thereafter
- Annual dividend payouts of HUF 1.0bn as per management's plan (in the past only partial amounts of declared dividends were paid, with the rest accumulating on balance sheet as other short- or long-term debt, a practice the company intends to maintain)
- Restricted cash relates to cash pledged as collateral for banks to issue guarantees

Strong interest coverage

As the company has had little debt in the past, interest income historically exceeded its limited interest expenses, rendering the Scope-adjusted EBITDA interest coverage ratio meaningless. Going forward the company plans to issue a HUF 10bn bond with an estimate coupon of around 3% in H1 2020 while keeping its HUF 600m short-term interest-bearing debt (drawn facility). This will translate into a strong EBITDA interest coverage of 40x in 2020 and 31x in 2021.

Given the very high coverage, which is foreseen to continue even assuming an adverse EBITDA development beyond our rating horizon, we believe EPKAR will be able to meet its interest payment obligations.

Good capex coverage on core business

EPKAR's cash flow generation has historically been sufficient to not only cover capital expenditure but also increase the net cash position. Going forward we expect this to continue with comfortable coverage for the normal course of its construction business.

In addition to its core business, the company plans to buy a property portfolio, with:

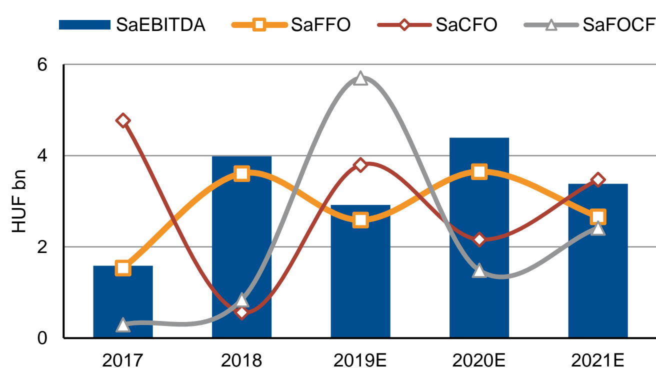
Large discretionary capex needs to fund the Budapest property portfolio

- bond proceeds of HUF 10bn to be used in combination with HUF 2bn of equity to buy Class A/B offices located in central Budapest to procure long-term leases that generate stable cash flows.
- targeted specifications including an (economic) age of up to 10 years, good tenant mix with a minimum WAULT of three years, required net rate of return of at least 6%, and a known property manager to run the portfolio. The new real estate shall remain unpledged.

Given the non-core nature of these acquisitions, we have classified capex as discretionary. Combined with dividends – assumed at HUF 1bn annually – the acquisitions will have a significant impact on cash flows in 2020 (figure 7). These large investments bear price and execution risks as the company has no experience in large

acquisitions. Mitigating these risks are i) management with good knowledge of structural aspects; ii) the use of acquisition advisors as well as a property management company to run the portfolio; and iii) the nature of a performing prime portfolio with decent WAULTs, which bears a manageable risk of at least covering interest costs through stable rental income.

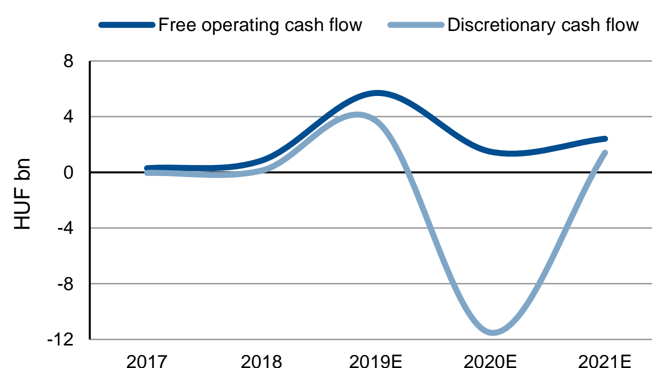
Figure 6: Cash flows[1] (excluding real estate acquisition)



[1]'Sa' = Scope-adjusted

Source: Scope estimates

Figure 7: Discretionary cash flows



Source: Scope estimates

Modest leverage peaking at around 2x

EPKAR historically had very little interest-bearing debt, resulting in a net cash position when assessing SaD. After significant discretionary capex spending in 2020, we assume SaD/EBITDA to be 1.7x and funds from operations (FFO)/SaD at around 45%, with a stable development in 2021 due to foreseeable contract coverage. Thereafter, we anticipate an increase in leverage to slightly above 2x while FFO/SaD decreases below 40% due to expected margin erosion and revenue contraction. Nevertheless, in the absence of further debt-financed acquisitions or an external shock to the business, the leverage ratios bode well for the overall financial risk profile.

Liquidity

Strong liquidity

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

Figure 8: Liquidity

EPKAR (HUF m)	2019E	2020E
Short-term debt (t)	600	542
Unrestricted cash (t)	7,285	4,571
Open committed credit lines (t)	0	0
Free operating cash flow (t+1)[2]	1,485	2,415
Coverage	**14.6x**	**12.9x**

Source: Scope

Unrestricted cash exceeds short-term debt comfortably and upcoming short-term maturities are likely to be manageable for the foreseeable future given the long maturity of the prospective bond.

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

Outlook and rating-change drivers

Outlook: Stable

The Outlook for EPKAR is Stable and incorporates our view of a slowdown in Hungarian construction industry, which will adversely affect the company's revenue and profitability potential after the current backlog is worked off at year-end 2021. We assume the company will partially balance the decline in construction cash flows with recurring rental income from the planned buy-to-hold portfolio of performing class A/B properties in Budapest.

The Outlook also incorporates the successful placement in H1 2020 of the HUF 10bn bond under the MNB Bond Funding for Growth Scheme. Proceeds are earmarked for capital expenditure to build up the planned real estate portfolio of performing class A/B properties in Budapest.

A positive rating action is seen to be remote, but may be warranted if the company can significantly improve its business risk profile – evidenced by a higher market share and a larger and more diversified order backlog – while keeping Scope-adjusted debt to Scope-adjusted EBITDA around 2x on a sustained basis.

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Long-term and short-term debt instrument ratings

Senior unsecured debt: BB

The rated entity plans to issue a HUF 10bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. The planned bond has a 3% coupon and is non-amortising with a tenor until 2030. Bond proceeds are earmarked for financing the capital expenditures to acquire a performing Class A/B commercial real estate portfolio in Budapest that generates recurring rental income. The portfolio shall remain unencumbered.

Our recovery analysis is based on a hypothetical default scenario occurring at year-end 2021, in which we assume outstanding senior unsecured debt of HUF 11.8bn (bond loan and payables) in addition to senior secured bank debt of HUF 1.5bn (loan facility, cash advances guarantee). We expect an 'above average recovery' for the company's unsecured debt, resulting in a BB rating for this debt class (one notch above the issuer rating).

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