D.V.M. Construction Kft.
Hungary, Construction

B STABLE

Corporate profile

D.V.M Construction Kft. (DVM), founded in 2001 and headquartered in Budapest, is the general construction provider of the DVM group, a leading design-and-build service provider in Hungary since 1995. DVM's services include base building and fit-out construction, site supervision and organisation, and coordination of subcontractors, among others.

Key metrics

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019F**	**2020E**	**2021E**
EBITDA interest cover (x)	-328.9x	897.9x	107.6x	5.4x	3.2x
Scope-adjusted debt (SaD)/EBITDA	net cash	0.4x	0.3x	4.8x	4.8x
Scope-adjusted funds from operations/SaD	net cash	210%	310%	15%	13%
Scope-adjusted free operating cash flow/SaD	net cash	-347%	-46%	-92%	-16%

Rating rationale

Scope assigns a first-time issuer rating of B/Stable to D.V.M. Construction Kft.

The B issuer rating is driven by DVM's good domestic network, including established and long-standing relations with its main clients. The rating is further supported by the company's good vertical integration that includes a wide range of services in the different stages of the construction chain (design, project management, contracting, base building, and fit-out services).

The rating is mainly constrained by the company's small scale in both a European and Hungarian context, which weakens its ability to mitigate economic cycles. Weak diversification is a further constraint, namely i) a lack of geographical diversification; ii) a high reliance on one segment (building activities); iii) a strong reliance on some key customers; and iv) limited cash flow visibility, with a concentrated and short-term backlog. A further rating constraint is the anticipated increase in leverage via the company's expansion plans, involving the acquisition of two subcontractors and participation in early-stage development projects.

Outlook and rating-change drivers

The Outlook is Stable and incorporates our view that credit metrics will deteriorate as a consequence of the future negative Scope-adjusted free operating cash flow (SaFOCF), triggered by company's expansion plans, namely the acquisition of two subcontractors and co-development projects for a total of HUF 6bn. Negative SaFOCF is anticipated to be financed with debt, one source being the prospective HUF 8bn bond under the MNB Bond Funding for Growth Scheme (HUF 6bn earmarked for expansion plans, while the remaining HUF 2bn for working capital financing). This will increase leverage, with Scope-adjusted debt (SaD) to Scope-adjusted EBITDA (SaEBITDA) jumping above 4.5x and Scope-adjusted funds from operations (SaFFO) to SaD falling to below 15%, by YE 2020.

Ratings & Outlook

Corporate rating	B/Stable
Senior unsecured rating	B+

Analyst

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Related Methodologies

Corporate Rating Methodology, February 2020

Rating Methodology European Construction Corporates, January 2020

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The Outlook also incorporates our view that DVM will consolidate its two main business lines, base building and fit-out services, starting in 2020. These activities are currently divided and provided by two DVM group companies (DVM Fővállalkozás Kft and DVM construction Kft.). We expect at least all revenues from base buildings projects and fit-out services to be cashed out to the rated issuer, ensuring it can pay obligations on time, such as debt service and operating expenditure. In addition, DVM Fővállalkozás Kft is the second range guarantor in the Unicredit loan used to finance the development of the Szervita Square, while Szervita Square, with a total estimated cost of EUR 70m (asset market value of EUR 38m as of March 2020), is the first range guarantee. The probability that the guarantee will be called upon is remote.

A positive rating action is seen to be remote but may be warranted if the company can keep Scope-adjusted debt (SaD) to EBITDA below 3.5x on a sustained basis.

A negative rating action could occur if projects suffered significant delays or cost overruns, or if liquidity worsened. The latter could happen if, for example, 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
• Market position benefiting from an integrated business, offering a turn-key solution that translates into a time- and cost-efficient model • Adequate debt protection despite the anticipated strong increase in interest-bearing debt	• Small-scale construction company in a European context, with a lack of geographic diversification exposing it to its domestic construction industry, leaving cash flows vulnerable to the expected cooldown • Short and concentrated contracted backlog providing limited visibility on future revenues (top three projects accounting for 60% of backlog revenues; top 10 for 98%) partially mitigated by long-standing relations with main clients • Negative free operating cash flow, which also translates into negative Scope cash flow metrics in the coming years; while this is typical for companies in investment phases, it reflects the continued need for external financing

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Keeping SaD to Scope-adjusted EBITDA below 3.5x on a sustained basis	• Worsening liquidity due to, for example, delayed customer payments or cost overruns • Projects in current pipeline suffering delays or cost overruns

Financial overview

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**	**2021E**
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Scope-adjusted free operating cash flow/SaD	net cash	-347%	-46%	-92%	-16%
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA	992.3	964.0	1,291.3	973.3	1,151.5
less: disposal gains from fixed assets included in EBITDA	0.0	0.0	0.0	0.0	0.0
Other	0.0	-1.5	0.0	0.0	0.0
Scope-adjusted EBITDA	992.3	962.5	1,291.3	973.3	1,151.5
Scope-adjusted funds from operations in HUF m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Scope-adjusted EBITDA	992.3	962.5	1,291.3	973.3	1,151.5
less: cash interest as per cash flow statement	3.0	-1.1	-12.0	-180.0	-360.0
less: interest component, operating leases	0.0	0.0	0.0	0.0	0.0
less: cash tax paid as per cash flow statement	-68.6	-78.0	-112.0	-75.5	-56.0
less: capitalised interest	0.0	0.0	0.0	0.0	0.0
Scope-adjusted funds from operations	926.8	883.5	1,167.3	717.8	735.6
Scope-adjusted debt in HUF m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Interest-bearing debt	77.7	730.3	649.5	8,094.0	8,064.0
Subordinated liabilities	0.0	0.0	0.0	0.0	0.0
Other liabilities	0.0	0.0	0.0	0.0	0.0
Cash	-454.7	-308.7	-272.6	-3,459.4	-2,565.3
Restricted cash	0.0	0.0	0.0	0.0	0.0
Off-balance sheet debt	0.0	0.0	0.0	0.0	0.0
Scope-adjusted debt	-377.0	421.6	377.0	4,634.6	5,498.7

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 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 business can lower a company's exposure to cyclicality, thus reducing industry risk.

Cyclicality: high

Market entry barriers: low

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

Substitution risk: low

Substitution risk is low as it is unlikely that any technology will replace the fundamental role played by construction companies in addressing the need for new commercial and residential buildings as well as in heavy and civil engineering (the construction of railway tracks, bridges, highways, tunnels, airports and other functional capital-intensive ventures). Such construction work will be fueled by population growth, globalisation and urbanisation worldwide.

Figure 1: Industry risk assessment: European construction corporates

Barriers to entry / Cyclicality	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 both in a European context and domestically

DVM is a small construction company both in a European context and in Hungary, a highly fragmented market. It is at the lower end of the top 25 construction companies in Hungary, with HUF 18bn (EUR 52m) in revenues and HUF 1.2bn (EUR 3.7m) in Scope-adjusted EBITDA, as of 2019 (preliminary figures).

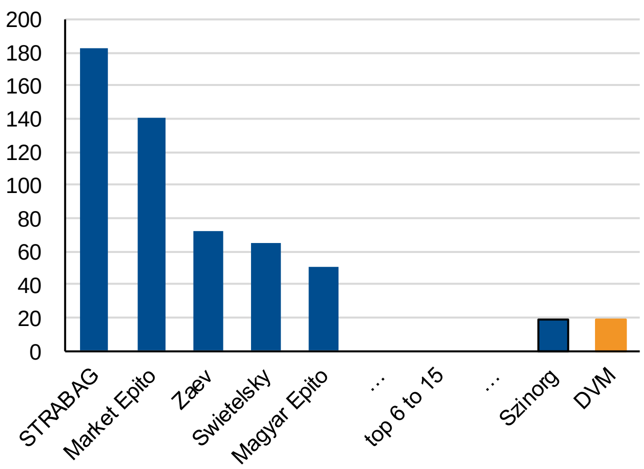
The company is targeting some growth, via HUF 6bn of investments in the next three years, focused on brownfield development (acquiring early-stage development projects and securing the future pipeline for the group), and the acquisition of subcontractors. Despite this, we expect DVM to remain relatively small. Limited size is a negative rating driver because it implies greater sensitivity to unforeseen shocks, greater cash flow volatility and limited economies of scale.

Market position benefits from one-stop-shop model offering both time- and cost-efficiency

The company started activities in early 1995 with a vertically integrated service chain that has continued to develop through the years. DVM's 'one-stop shop' business model offers clients a turn-key solution whereby design and implementation run parallel, generating efficiencies in both the cost and duration of projects. DVM is a leader in high-value-added fit-out constructions. The company's visibility has benefited from its restoration of high-profile buildings, like the Eiffel Palace in the Budapest's central business district, the first office in Central and Eastern Europe awarded a dual environmental certificate. Other important projects include the Millennium Towers II-III (with Morgan Stanley as partner; worth HUF 0.7bn over 2,600 sqm), Danubius Hotel (HUF 1.6bn over 2,949 sqm) and the fit-out of several floors in the GTC-WH building (with BlackRock and Edison Jaguar; worth HUF 3.8bn over 10,162 sqm).

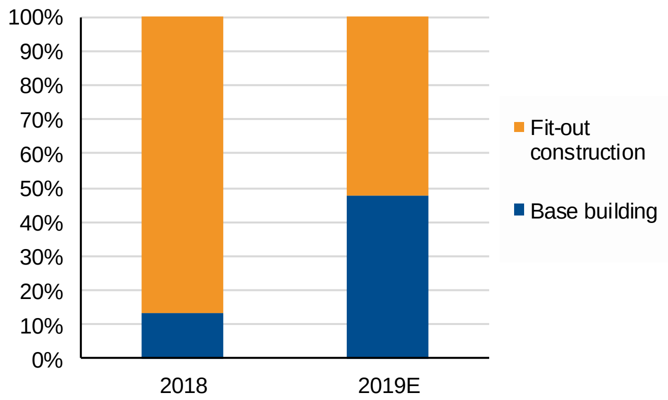
DVM's integrated model makes it a unique servicer with no direct competitors. Its market position is also supported by a good domestic network including longstanding relations with national and international customers. We believe both factors will help to support its business going forward.

Figure 2: Contractors in Hungary by 2018 revenue (HUF bn)



Source: EMIS, Scope

Figure 3: Revenue breakdown by type of asset (%)



Source: DVM, Scope

Exposed to domestic construction industry

Geographical diversification is weak. Despite some international projects, all revenues stem from Hungary, with no intentions to expand abroad in the short term. This strategy is based on the view that specialised services require good market knowledge and an understanding of specific client requirements in other geographies. While this seems prudent given DVM's limited size, it also creates a full exposure to the macroeconomy of one market, compounded by the company's focus on construction, a cyclical industry in which market downturns tend to affect revenues and earnings.

We consider growth in the Hungarian construction market to be unsustainable. The expansion of the contract portfolio stopped at the end of 2018 and has been decreasing since March 2019. According to Danube Capital, this is a sign of an overheated market at its peak, with the other signs being i) price growth exceeding inflation; ii) high capacity utilisation and labour shortages; iii) the significant delays in projects, averaging half a year; and iv) the decline in sector confidence since 2019. Further delays are possible following the general economic slowdown expected for 2020. As such, we believe the issuer's sole exposure to Hungary will lead to slightly declining revenues in 2020, but stable at above HUF 20bn from 2021 on, which result from the expectation that the company will be able to keep its turnover above historical levels.

Model with high vertical integration

DVM's vertically integrated business model offers a wide range of services in the different stages of the construction chain (design, project management, contracting, base building, and fit-out). While all activities relate to just one sub-segment in one industry (building construction), they serve different end-markets (office, retail, industrial, hotel, among others) and thus benefit from the different underlying demand patterns. This will partially dampen the effects from the cooling demand anticipated for the industry.

To further enhance its business model, the company plans to acquire two subcontractors for fit-out services and to participate in the early stages of the projects, e.g. acquiring land plots or upgrading B graded buildings. This opens the opportunity to develop projects using the different services offered by the group.

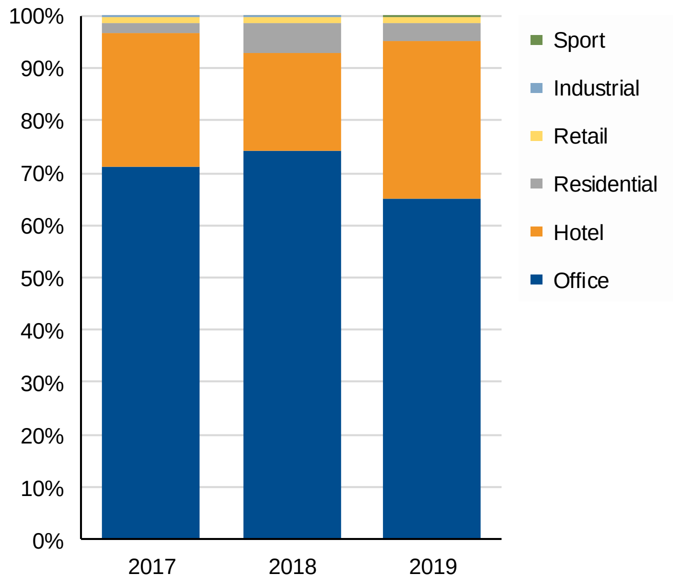
While the expansion could yield benefits, there remains execution risks regarding the merger of acquired companies and the development phase. The company plans to mitigate the first risk by hiring external advisors to facilitate the merger process, which will be combined with DVM's extensive experience with subcontractors to help keep a constant workload and improve the management of acquired companies. For development risks, the company is planning projects for the medium term and in accordance with the cycle and may consider building refurbishments when existing tenants are interested in an upgrade.

Concentrated customer structure, with some long-term customers in the portfolio

DVM's small size results in high customer concentration (Figure 5) and a limit to the number of projects it can execute simultaneously. This means both profitability and cash flow from operations can be affected greatly by the failure of one project. Particularly material are office projects Budagardens and Szervita Square, which respectively represent 29% and 17% of expected revenues between 2020 and 2022. Both projects are commissioned by Horizon Development, one of the largest clients of the DVM group.

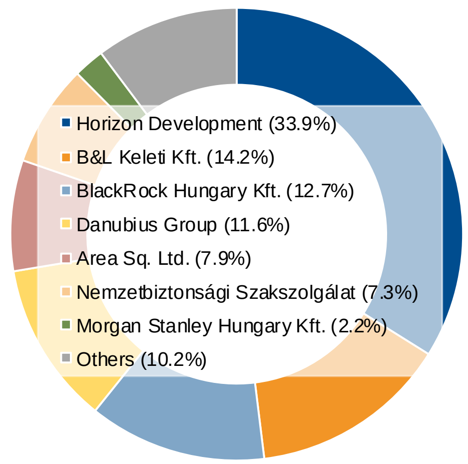
The company benefits from a strong relationship with local and international clients. There are no long-term contracts, but these partnerships have provided recurring mandates. One example is the ongoing partnership with Morgan Stanley, initiated around seven years ago and providing HUF 600m-800m worth of office construction or refurbishment work each year. Danubius Hotels, one of the largest Hungarian hotel chains, is another partnership that started around six years ago and is worth HUF 2.5bn-3bn of work each year. Another key customer is Vodafone, a partnership originating around 10 years ago, with projects including the development of all 21 big retail stores in Hungary during its rebranding phase and its headquarters in the Millennium Tower office building. DVM continues to work with Vodaphone through the reshaping or renewal of its offices. A new local partner is BIF with two projects: the Attila Street residential project and the Városmajor office.

Figure 4: Revenue breakdown type of assets (%)



Source: DVM, Scope

Figure 5: Revenue breakdown by customer (%)



Source: DVM, Scope

Relatively concentrated backlog

DVM's backlog is concentrated, with the top three projects accounting for 60% of future contracted revenues and the top 10 for 98%. This bears the risk of significant cash flow volatility if projects are delayed or customers defer or cancel payments (e.g. due to bankruptcy). The latter is partially mitigated by a payment scheme enforced by law that protects contractors from non-payment or late payments for projects larger than HUF

1.5bn (92% of DVM's backlog). The limited backlog diversification also exposes the company to the slowdown in certain segments, for example, hotels represents 25% of the company's backlog, and hospitality has been one of the hardest-hit segments by the Covid-19 outbreak.

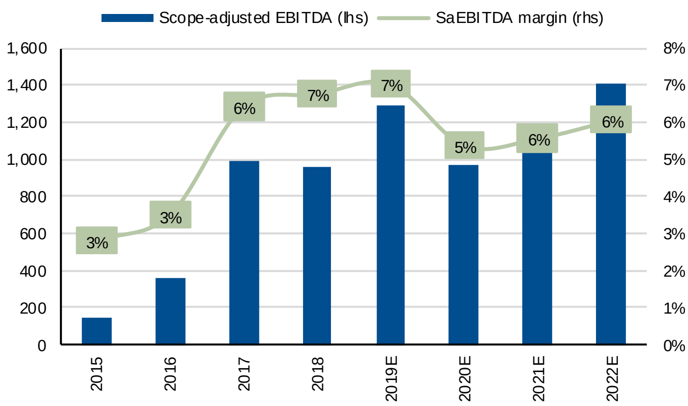
Short-term backlog provides limited visibility on future cash flows

The current pipeline of projects is equates to around HUF 45bn as of April 2020 (including ongoing projects and contracts with a signed letter of engagement). This short-term backlog provides limited visibility on future cash flow.

To partially mitigate this, the company intends to acquire co-developments in early-stage projects (at least 50% participation), thereby also securing business for other group companies. This future pipeline consists of real estate development activities, with HUF 5bn to be invested from 2020 on, to be mainly financed by the MNB bond issuance (HUF 8bn).

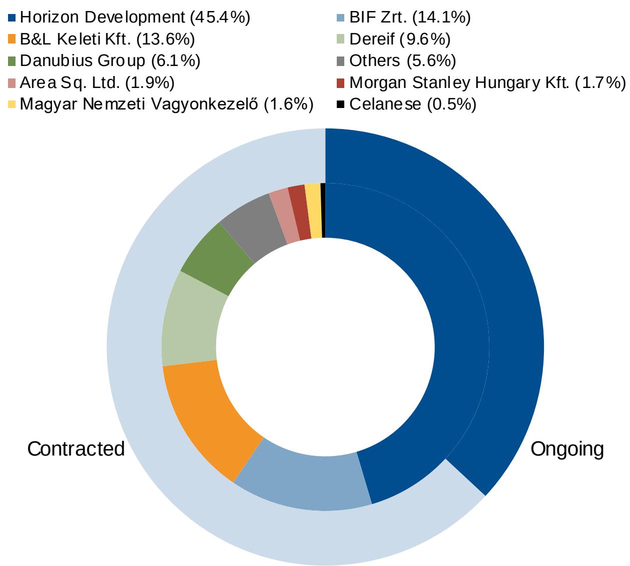
DVM's profitability, as measured by the EBITDA margin, has been stable and similar to those of industry peers (5-10%). However, following our expectations of the upcoming industry contraction, we forecast margins to be under pressure in the coming years, which will come despite the company's relatively flexible cost structure.

Figure 6: EBITDA and EBITDA margin



Source: DVM, Scope estimates, 'Sa' = Scope-adjusted

Figure 7: Backlog by customer and current status



Source: DVM, Scope estimates

Financial risk profile: B

Our rating scenario assumes the following:

- Revenue growth according to the company's backlog as per year-end 2019
- All expenses to grow in line with inflation as forecasted by the European Commission in November 2019
- Issuance of a HUF 8bn bullet bond in H2 2020 under the MNB Bond Funding for Growth Scheme, with an estimated coupon of 3% (fixed and paid annually) and a maturity of 10 years; bond proceeds are intended for capital expenditure and financing working capital
- No dividend payout in the first two business years following the bond issuance; from the third year, payout limited at 20% of the issuer's annual profit after tax
- Szervita Square project to be finalized by the end of 2020
- Pro-forma consolidation of DVM Fővállalkozás Kft and DVM construction Kft

Adequate debt protection although debt increase in 2020

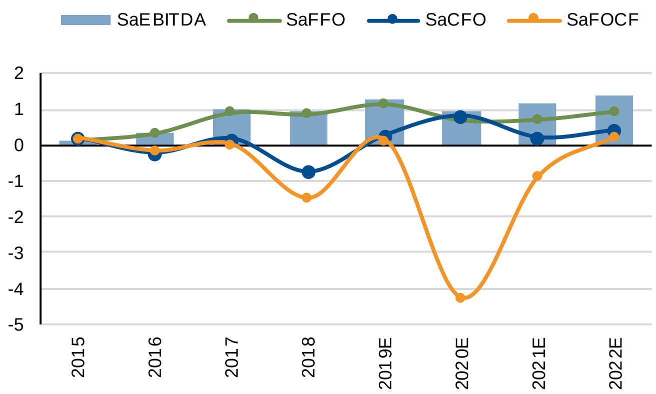
As DVM has had relatively little debt in the past, interest expenses have been low. This has resulted in a strong EBITDA interest coverage ratio in the years prior to 2019. The planned HUF 8bn bond issuance for investment purposes will have a negative impact on debt protection but remain at adequate levels. We expect Scope-adjusted EBITDA interest coverage at around 5x in 2020 and 3x in 2021.

Given this adequate coverage ratio, we believe the company can meet interest payment obligations in the next two years, even with the increase in indebtedness.

Negative free operating cash flows driven by development pipeline from 2020 on

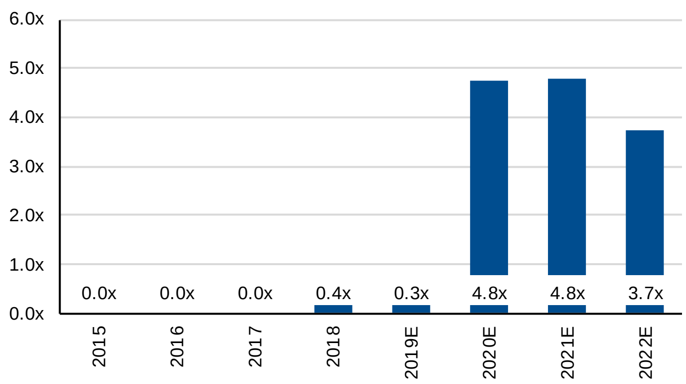
For the next few years, we anticipate relatively stable and positive operational cash flows (Scope-adjusted EBITDA and Scope-adjusted funds from operations and Scope-adjusted cash flow from operations), based on DVM's backlog in 2020 and the expectation that the company can maintain turnover at historical levels or higher. Scope-adjusted free operating cash flow has been more volatile and is expected to remain negative, driven by real estate developments planned from 2020 on.

Figure 8: Cash flows (HUF bn)



Source: DVM, Scope estimates; 'Sa' = Scope-adjusted

Figure 9: Leverage (SaD/SaEBITDA)



Source: DVM, Scope estimates; 'Sa' = Scope-adjusted

Growth strategy at the expense of strong increase in leverage

The company's debt strategy has been conservative, evidenced by the very low debt levels. Currently, debt consists of HUF 500m of bank loans and a HUF 187m shareholder loan (as of FY 2019). DVM plans to redeem both in 2020. However, leverage will soon increase, driven by a significant debt-finance capex programme from 2020.

Regarding contingent liabilities, DVM Fővállalkozás Kft. is the second range guarantor in the Unicredit loan used to finance Szervita Square, while Szervita Square, with a total estimated cost of EUR 70m (asset market value of EUR 38m, as of March 2020, compared to a drawn loan amount of EUR 30.5m as of April 2020), is the first range guarantee. We do consider the probability that the guarantee will be called upon is remote.

Adequate liquidity

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

Figure 9: Liquidity

in HUF m	2019E	2020E
Short-term debt (t)	556	30
Unrestricted cash (t)	273	3,487
Open committed credit lines (t)	0	0
Free operating cash flow (t+1)[1]	770	387
Coverage	1.9x	129.1x

Source: Scope estimates

Liquidity benefits from a back-loaded debt maturity profile, with no significant amount due in the coming years. We anticipate the company's low short-term debt levels to be maintained going forward and to be sufficiently covered by available financing sources. The company has a HUF 500m credit line with Erste Bank, this is fully drawn as of March 2020. Erste Bank has also provided the company with bank guarantees (HUF 4.5bn limit with HUF 1.5bn undrawn as of December 2019), which can be used towards future activities.

Given the long maturity of the prospective MNB bond, upcoming short-term maturities are likely to be manageable for the foreseeable future.

Corporate Governance

Strong market expertise of management

The company is managed by its majority shareholders, who have strong market expertise through years of experience in construction, including the building or restoration of offices, industrial sites and civil engineering. DVM's founder and owners have company tenures of more than 20 years. The company has no independent board that provides oversight functions.

DVM's majority owner, Attila Kovacs, also owns Horizon Development Kft., one of DVM's largest clients, accounting for 34% of revenues in 2019. Horizon Development is likely to be a partner in DVM's planned co-developments.

Outlook and rating-change drivers

Outlook: Stable

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

and Scope-adjusted funds from operations (SaFFO) to SaD falling to below 15%, by YE 2020.

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Long-term and short-term debt instrument ratings

The rated entity plans to issue a HUF 8bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. The planned bond has a 3% coupon with a tenor until 2030. Proceeds from the bond are earmarked for financing the acquisition of subcontractors (HUF 1bn), the acquisition of co-development early-stage projects (HUF 5bn) and working capital (HUF 2bn). The planned bond will be subject to the following covenants: i) no dividend payout in the first two business years following the bond issuance; from the third year, payout limited at 20% of the issuer's annual profit after tax; and ii) Loan-to-value (LTV) ratio will not exceed more than 30% on aggregate for all co-development projects; or more than 50% LTV for each co-development project..

Senior unsecured debt: B+

Our recovery analysis is based on a hypothetical default scenario in 2021 and is based on DVM's liquidation value, considering its planned investment (acquisition of co-development projects and subcontractors in the form of financial investments). For the recovery analysis, we assume all covenants are met and senior-ranked bank loans financing the co-development projects reach only a maximum LTV of 30%.

We expect an 'above average' recovery for DVM's senior unsecured debt (HUF 8bn), allowing a one-notch uplift on the company's issuer rating. We therefore assign a debt class rating of B+.

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