Baromfi-Coop Kft.
Hungary, Consumer Goods

SCOPE BB- STABLE

Corporate profile

Baromfi-Coop, headquartered in Debrecen, Hungary, operates along the whole value chain in the chicken processing industry. While Baromfi-Coop covers the agricultural activities of the group (procurement and corn farming), Master Good focuses on the primary processing of live poultry, the manufacturing of prepared and further processed products, as well as sales. Besides its main farm in Kisvárda, Baromfi-Coop operates a hatchery in Petneháza, as well as feed production plants in Nyírkércs, Balsa and Nyírmada. In 2019, the company generated sales of about HUF 93bn and EBITDA of roughly HUF 12.1bn. The entity is fully owned by the managing Bárány family.

Key metrics

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA/interest expense (x)	38.1x	20.8x	16.5x	17.6x	18.0x
Scope-adjusted debt (SaD)/EBITDA	2.4x	3.0x	4.0x	3.6x	3.4x
Scope-adjusted FFO/SaD	38%	31%	23%	28%	27%
Free operating cash flow (FOCF)/SaD	-33%	-27%	-25%	7%	-2%

Rating rationale

Scope Ratings has today affirmed its BB-/Stable corporate issuer rating to Hungary-based Baromfi-Coop Kft. The agency also affirmed the BB- senior unsecured debt rating.

Following the acquisition of Saga Foods (see: **Baromfi-Coop acquires Hungarian turkey processing company Saga Foods**), Baromfi-Coop's business risk profile has strengthened but continues to be commensurate with a 'BB' rating. The company's long-term relationship with McDonald's is especially positive (up to 15% of all chicken products sold by McDonald's in Europe are supplied by the company). With an annual production capacity of up to 64m chickens per year, Baromfi-Coop accounts for around 25% of overall Hungarian chicken meat production. However, this is still rather small compared to European competitors, and continues to hold back our assessment of the company's market share. Baromfi-Coop's business risk profile is also constrained by weak diversification despite positive effects following the acquisition of Saga Foods, e.g. higher scale and broader scope. Diversification is limited by: i) a fairly concentrated customer portfolio; and ii) the focus on one poultry species (chicken). Baromfi-Coop's profitability (EBITDA margin) continues to be credit supportive, with reported EBITDA margins averaging around 12% (2016 to 2019) and coming in at 14.1% in H1 2020, despite the global economy being hit by Covid-19.

The company's financial risk profile is affirmed at 'BB-'. Thanks to strong performance in H1 2020, Baromfi-Coop was not meaningfully affected by the Covid-19 pandemic. Demand from major retail chains remained unchanged, McDonalds ramped up its delivery and drive-in supply channels, and frozen finished products were temporally stored at Baromfi-Coop and shipped to customers in July 2020, with the corresponding revenues recorded in H1 2020. Based on the acquisition of Saga Foods, higher inventory levels and a continued positive trend in growth and pricing power, we anticipate leverage (Scope-adjusted debt [SaD]/EBTIDA) of 4.0x at year-end 2020 and 3.6x at 31 December 2021.

Ratings & Outlook

Corporate rating	BB-/Stable
Senior unsecured rating	BB-

Analysts

Klaus Kobold
+49 69 6677389 23
k.kobold@scoperatings.com

Related methodology

Corporate Rating Methodology

Scope Ratings GmbH

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

Tel. +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

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

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Besides a higher contribution from Saga Foods, our assumptions for 2021 include a second capex cycle in 2021 and 2020. We anticipate that free operating cash will improve in 2021 and 2022 compared to levels posted in 2018 to 2020. However, Baromfi-Coop's internal and external liquidity coverage remains weak, as the company continues to disclose considerable amounts of short-term debt every year. That said, we have not adjusted Baromfi-Coop's financial risk profile, as the company has successfully entered capital markets as a source of funding and is expected to refinance maturing short-term debt in future, based on its previous strategy.

We have made no adjustment for supplementary rating drivers due to Baromfi-Coop's neutral financial policy.

Outlook

Stable Outlook

The Outlook is Stable, reflecting our expectation of continuing positive performance thanks to a resilient business model, with limited vulnerability to the Covid-19 pandemic. In our rating scenario, we anticipate SaD/EBITDA ranging from 3.5x to 4.0x over a medium-term horizon.

Rating upside

A positive rating action could be warranted by SaD/EBITDA of below 3.5x on a sustainable basis. This could occur if Baromfi-Coop's capital allocation policy shifts towards debt reduction rather than a second capex programme.

Rating downside

A negative rating action could be required if SaD/EBITDA moves above 4.0x on a sustained basis. This could occur if the company orchestrates large M&A or if EBITDA falls short of our projections. Lastly, a rating downgrade could result from continued weak liquidity coverage beyond 2022.

Rating drivers

Positive rating drivers	Negative rating drivers
• Integrated approach covering the whole value chain, including crop production and processing of chicken meat • Biggest chicken processing company in Hungary (around 25% market share) • Up to 15% of all chicken products sold by McDonald's in Europe are supplied by Baromfi-Coop • Long-term relationships with customers • Solid EBITDA margin (2019: 13.1%) – current investments in automation and ramp-up of byproducts will offset higher expected labour costs	• Rather small size compared to European competitors • Weak diversification, characterised by: i) concentrated customer portfolio; and ii) focus on one poultry species (chicken) • Negative free cash flows and weak cash flow cover as a consequence of large capex programme

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA of below 3.5x on a sustained basis	• SaD/EBITDA of above 4.0x on a sustained basis • Continued weak liquidity coverage beyond 2022

Financial overview

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA/interest expense (x)	38.1x	20.8x	16.5x	17.6x	18.0x
Scope-adjusted debt (SaD)/EBITDA	2.4x	3.0x	4.0x	3.6x	3.4x
Scope-adjusted FFO/SaD	38%	31%	23%	28%	27%
Free operating cash flow (FOCF)/SaD	-33%	-27%	-25%	7%	-2%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA	11,222	12,155	13,879	14,690	15,491
Operating lease payments in respective year	-	-	-	-	-
Other items	0	0	0	0	0
Scope-adjusted EBITDA	11,222	12,155	13,879	14,690	15,491
Scope-adjusted funds from operations (FFO) in HUF m	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA	11,222	12,155	13,879	14,690	15,491
less: (net) cash interest as per cash flow statement	-294	-585	-843	-833	-863
less: cash tax paid as per cash flow statement	-169	-67	-171	-180	-183
less: pension interest	-	-	-	-	-
add: depreciation component operating leases	-	-	-	-	-
add: dividends received from equity-accounted entities	0	0	0	0	0
less: disposal gains on fixed assets included in EBITDA	0	0	0	0	0
less: capitalised interest	0	0	0	0	0
Other items	-703	-250	-18	837	-367
Scope-adjusted funds from operations	10,056	11,253	12,847	14,514	14,078
Scope-adjusted debt (SaD) in HUF m	**2018**	**2019**	**2020F**	**2021F**	**2022F**
Reported gross financial debt	26,996	49,749	57,397	53,974	53,263
Hybrid debt	-	-	-	-	-
less: cash and cash equivalents	-640	-12,897	-2,593	-1,616	-643
Cash not accessible	32	32	32	32	32
add: pension adjustment	-	-	-	-	-
add: operating lease obligations	-	-	-	-	-
Other items (contingent liabilities)	-	-	-	-	-
Scope-adjusted debt	26,388	36,884	54,836	52,390	52,652

Business risk profile

Blended industry risk profile: BBB+

We have assigned a blended industry risk of 'BBB+' given the company's activities – the procurement and farming of corn, and the processing of chicken. This is based on our industry risk profiles for non-durable consumer goods (cyclicality: low; market entry barriers: medium; substitution risk: low; industry outlook: stable) and agriculture (cyclicality: high; market entry barriers: high; substitution risk: low; industry outlook: stable) as well as the company's EBITDA breakdown by divisions.

Purchase of Saga Foods bolsters business risk profile

Irrespective of the key strengths of acquired Saga Foods (see: **Baromfi-Coop acquires Hungarian turkey processing company Saga Foods**), including the ownership of well-known brands like FÜSTLI and FÜSTLIZER, and a customer portfolio of multinational retail chains, the size of the bolt-on acquisition is fairly small compared to Baromfi-Coop. In contrast to our previous understanding, Saga Foods will switch its focus from processing turkey to chicken. Consequently, Baromfi-Coop will continue to be concentrated on chicken processing. We have affirmed the company's business risk profile at the current level of 'BB'.

Leading player in the Hungarian chicken processing industry….

… but rather small compared to European competitors

The affirmed rating reflects the company's integrated approach, covering the whole value chain in the poultry processing industry. With an annual production capacity of up to 64m chickens yearly, we estimate that Baromfi-Coop accounts for up to 25% of Hungarian chicken meat production. Given the rather fragmented structure of the Hungarian chicken processing industry, we view the company as the market leader. Baromfi-Coop's relationship with McDonald's is also a positive rating driver. Baromfi-Coop supplies up to 15% of all chicken products sold by McDonald's in Europe and McDonald's has been a company customer for over 15 years. However, Baromfi-Coop's production output is rather low compared to European competitors. For instance, France-based LDC and Plukon Food Group, located in the Netherlands, process more than 400m chickens per year, compared to up to 64m chickens by Baromfi-Coop.

Diversification is compromised by several aspects

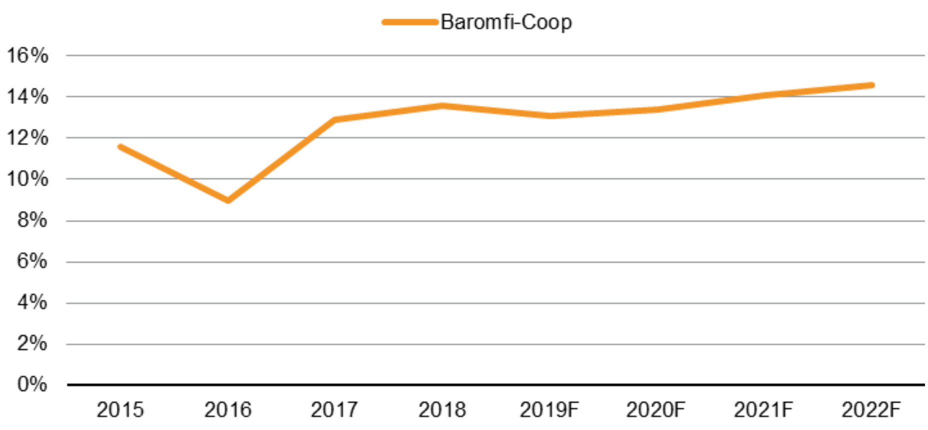
Baromfi-Coop's credit rating continues to be compromised by weak diversification. This is based on: i) a rather concentrated customer portfolio; and ii) the focus on the processing of chicken. In addition, the company's customer portfolio consists of about 250 customers, with its top 10 customers accounting for up to 60% of sales. This negative factor is somewhat mitigated by Baromfi-Coop's long-term relationships with customers, together with the fact that its biggest customers are large, well-known retail companies such as Aldi and Tesco. Given its focus on the production of chicken meat, Baromfi-Coop would be highly sensitive to a sharp decline in the demand for chicken, e.g. due to an unexpected outbreak of avian influenza in Eastern Europe. However, we believe that the company's animal stock is well protected from infection and thus from emergency slaughter in such an event. This assumption is grounded on its stringent hygiene regulations, including farms which operate as self-sufficient systems, including waste water purification.

Strong profitability – despite Covid-19

Our view on Baromfi-Coop's profitability continues to be credit supportive, based on reported EBITDA margins averaging around 12% between 2015 and 2019. Even in H1 2020, when the global economy was in panic mode, the company delivered an EBITDA of 14.1%. This was mainly attributable to demand from major retail chains remaining unchanged, with McDonald's ramping up its delivery and drive-in supply channels. Furthermore, frozen finished products were temporally stored at Baromfi-Coop and shipped to customers in July 2020, with the respective revenues recorded in H1 2020.

Our rating case projects a moderate increase in Baromfi-Coop's EBITDA margin, given: i) its continuing integrated approach, which limits sensitivity to fluctuations in crop prices; ii) efforts to ramp up highly profitable business lines, e.g. the sale of fertilisers and abattoir waste from chicken processing for the pet food industry; iii) capex on automation to counterbalance increasing labour costs; and iv) considerable pricing power, in tandem with positive effects from the Saga Foods acquisition.

Figure 1: Profitability (EBITDA margin)



Source: Baromfi-Coop, Scope

Financial risk profile

Issuance of two bonds in November 2019

In line with our former rating scenario, Baromfi-Coop issued two bonds (ISIN: HU0000359294, HUF 14.0m, 2016; ISIN: HU0000359302, HUF 14.5m, 2028) in November 2019. As the company has moved parts of its capex programme to 2020, key credit ratios entered 2020 stronger than anticipated. In the current year, we anticipate that credit metrics will be weaker due to the continuation of the overall capex programme, the acquisition of Saga Foods and significant investments in working capital. Baromfi-Coop now operates a new feed mixer which roughly doubles capacity. The company is therefore purchasing more wheat, corn and canola, driving inventories upwards. That said, the deterioration in credit metrics will be somewhat offset by the initial EBITDA contribution of Saga Foods and our expectation of solid performance in the remainder of 2020, as Baromfi-Coop successfully navigated stormy H1 2020.

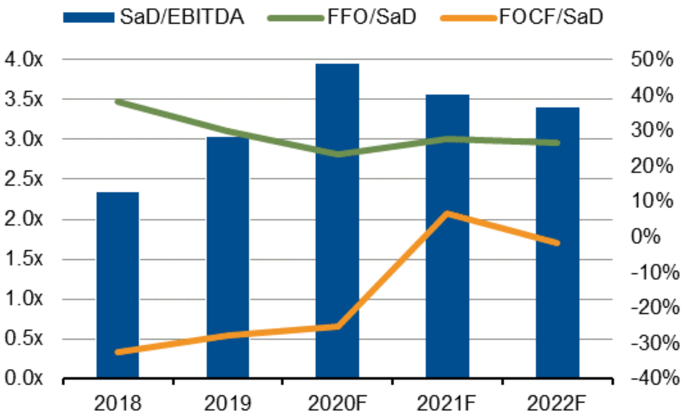
Second capex cycle in 2021 and 2022

Given our understanding that management is currently evaluating a second capex cycle to be executed in 2021 and 2022, we foresee related expenditures of roughly HUF 10m in 2021 and 2022, primarily to increase production capacity at Saga Foods. Based on our view that Baromfi-Coop continues to be strongly committed to a neutral financial policy, combined with insignificant dividend payments in the last few years, we expect no material dividend payments or further bolt-on acquisitions until at least 2022. That said, the covenants of the outstanding bonds allow a maximum of 20% of annual net income to be paid to shareholders.

Financial risk profile: BB-

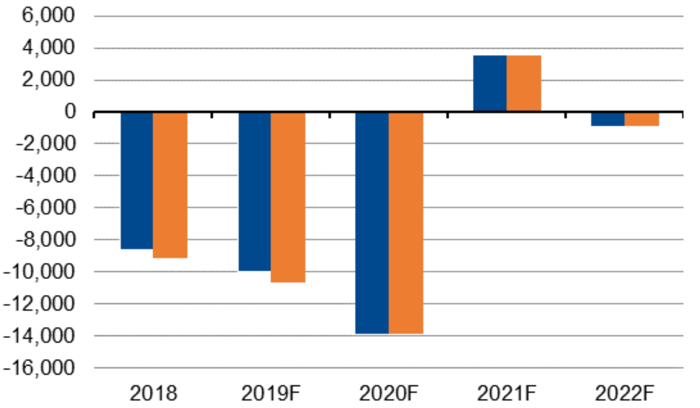
We expect SaD/EBITDA of 4.0x as at 31 December 2020 to strengthen to 3.6x at year-end 2021, together with improving free operating cash flow. Baromfi-Coop therefore continues to meet our requirements for a 'BB-' rated financial risk profile. Interest cover (EBITDA/interest expense 2020F: 16.5x) will remain very strong – despite a significant rise in interest expense in absolute terms, following the issuance of the two bonds.

Figure 2: Credit metrics



Source: Scope

Figure 3: Free operating and discretionary cash flow (HUF m)



Source: Scope

Liquidity: 'adequate'

We see potential for stronger liquidity coverage on a sustained basis from 2021 onwards. This is based on: i) the company's intention to improve its liability transformation profile by reducing short-term debt and increasing long-term debt; together with ii) our expectation that free operating cash flow will develop positively in 2021 and 2022 compared to the levels posted in 2018 to 2020. Baromfi-Coop's internal and external liquidity coverage remains weak. The company continues to record considerable amounts of short-term debt of about HUF 6m in 2020 and roughly HUF 8m in 2021, and has no access to credit facilities. However, we have not adjusted Baromfi-Coop's financial risk profile, as the company successfully entered capital markets as a source of funding and is expected to refinance maturing short-term debt in future, based on its previous strategy.

Supplementary rating drivers

Neutral financial policy

Baromfi-Coop's financial policy is neutral. While the ongoing capex programme has led to higher debt levels, no dividends were paid to shareholders and the company has taken a disciplined approach to M&A, which we expect to continue in the foreseeable future. Moreover, the Bárány family has been running the company proactively for more than 100 years and continues to be strongly committed to its long-term success.

Senior unsecured debt rating

Rating for senior unsecured debt: BB-

All senior unsecured debt has been issued by Baromfi-Coop Kft. Our recovery assessment is based on a hypothetical default scenario in 2022, including the assumption that bank debt (2022F: HUF 24.7m) is ranked senior secured. The outcome of our recovery analysis indicates an 'average recovery' for senior unsecured debt. This expectation translates into a rating of 'BB-' for this debt category.

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

23 Boulevard des Capucines
F-75002 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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