Vasútvill Kft.
Hungary, Construction

SCOPE BB- STABLE

Corporate profile

Vasútvill Kft., headquartered in Budapest, is the largest company in Hungary's railway overhead lines construction segment. Its core business includes the construction, reconstruction, maintenance and transformation of railway electrical overhead lines, covering the whole business chain in the railway segment. With nearly 200 employees, the company has been involved in most of the major railway electrification projects in Hungary and, together with its legal predecessors, has been present in the Hungarian market for more than 70 years.

Key metrics

		Scope estimates		
Scope credit ratios	**2019**	**2020F**	**2021F**	**2022F**
EBITDA/interest cover (x)	878.4x	64.0x	7.0x	4.3x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	net cash	3.4x
Scope-adjusted FFO/SaD	net cash	net cash	net cash	21%
FOCF/SaD	net cash	net cash	net cash	3%

Rating rationale

Scope Ratings has today assigned a first-time issuer rating of BB-/Stable to Vasútvill Kft and a first-time rating of BB- to its senior unsecured debt.

The company's business risk profile benefits from its position as the leader in its domestic niche market, railway overhead line construction. With a presence of over 70 years in the market, Vasútvill is well established in the segment, having participated in practically all major railway electrification projects in Hungary (more than 2,500km of Hungary's 3,100km electrified railway network). The company's profitability (as measured by its Scope adjusted EBITDA) has remained over 20% in the last three years and is higher than that of other construction peers. This would further support Vasútvill's position if other players entered the market. The company also benefits from a business model that covers the whole business chain in the railway construction segment, as well as its longstanding relationships with its main clients.

The rating is mainly constrained by Vasútvill'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 end-market; and iii) a concentrated customer portfolio and backlog, in a segment where demand is mostly dependent on governmental demand and strategy. The rating is also limited by an anticipated increase in leverage driven by the company's planned expansion, and a potential rise in working capital requirements.

Outlook

The Outlook is Stable and incorporates our view that the impact of Covid-19 on Vasútvill's activities will be limited. The Outlook also incorporates the successful placement in 2021 of a HUF 8bn bond under the MNB Bond Funding for Growth Scheme. Of the total proceeds, HUF 5bn are earmarked for expansion plans, while the remaining HUF 3bn will be used to finance working capital. This will increase leverage, but we anticipate that the Scope-adjusted debt (SaD)/Scope-adjusted EBITDA (SaEBITDA) will not rise above 3.5x and that Scope-adjusted funds from operations (SaFFO)/SaD will fall to below 25% by YE 2022.

Ratings & Outlook

Corporate ratings	BB-
Senior unsecured rating	BB-

Analyst

Rigel Scheller
+49 30 27891 319
r.scheller@scoperatings.com

Related Methodology

Corporate Rating Methodology, February 2020

Rating Methodology European Construction Corporates January 2020

Scope Ratings GmbH

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

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

A positive rating action is unlikely but could be warranted if the company achieves substantial growth, affording better diversification of geographies and customers, while SaD/EBITDA advancing towards 3.0x on a sustained basis, as a potential consequence of new orders and a supportive dividend policy.

A negative rating action could occur if Vasútvill's leverage exceeds 4x on a sustained basis or its market position weakens, leading to lower revenues and profitability margins than projected in our base case scenario. The latter could occur if no additional projects are won or the company maintains an aggressive dividend policy.

Rating drivers

Positive rating drivers	Negative rating drivers
• Leader in its domestic niche market, having participated in 85% of the railway electrification projects in Hungary • Market position benefits from a business model that covers the whole business chain in the railway construction segment • 70-year track record and good network in its domestic market • Low leverage that consists mainly of financial leasing, used to finance machinery acquisitions	• Small-scale construction company in a European context, with a lack of geographic and segment diversification, somewhat mitigated by the company's strong position within a niche market • Concentrated customer portfolio and dependent on public sector tenders • Weak diversification across geographies, with activities focused on Hungary • Relatively short and concentrated contracted backlog providing limited visibility on future revenues (top three projects account for 76% of backlog revenues) • Working capital under pressure, following the completion of contracted work and reduction of advance payments from clients • Negative free operating cash flow, which also translates into negative Scope cash flow metrics

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Substantial growth affording better diversification (geographies and customers) while SaD/Scope-adjusted EBITDA advancing towards 3.0x on a sustained basis accompanied by a supportive dividend policy	• Leverage exceeds 4x on a sustained basis or its market position weakens, leading to lower revenues and profitability margins, combined with an aggressive dividend policy

Financial overview

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**	**2022E**
SaEBITDA/interest cover (x)	1,759.9x	878.4x	64.0x	7.0x	4.3x
SaD/SaEBITDA (x)	net cash	net cash	net cash	net cash	3.4x
Scope-adjusted FFO/SaD (%)	net cash	net cash	net cash	net cash	21%
Scope-adjusted FOCF/SaD (%)	net cash	net cash	net cash	net cash	3%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EBITDA	3,866.1	2,708.1	2,356.6	2,206.2	1,351.3
less: disposal gains from fixed assets included in EBITDA	0.4	0.4	0.0	0.0	0.0
Others	274.5	551.4	0.0	0.0	0.0
Scope-adjusted EBITDA	4,141.0	3,259.8	2,356.6	2,206.2	1,351.3
Scope funds from operations in HUF m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Scope-adjusted EBITDA	4,141.0	3,259.8	2,356.6	2,206.2	1,351.3
less: cash interest as per cashflow statement	-2.4	-3.7	-36.8	-314.5	-313.8
less: interest component operating leases	0.0	0.0	0.0	0.0	0.0
less: cash tax paid as per cashflow statement	-300.0	-331.5	-180.3	-132.1	-49.3
less: capitalised interest	0.0	0.0	0.0	0.0	0.0
Scope funds from operations	3,838.6	2,924.6	2,139.5	1,759.6	988.1
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Interest-bearing debt	93.9	119.8	1,818.7	9,726.9	9,692.1
Subordinated liabilities	0.0	0.0	0.0	0.0	0.0
Cash equivalent	-6,000.0	-5,271.8	-2,000.0	-8,000.0	-3,000.0
Cash	-1,687.8	-1,556.1	-3,418.7	-2,834.80	-2,123.1
Off-balance sheet debt*	86.0	86.0	86.0	86.0	86.0
Scope-adjusted debt	-7,507.8	-6,622.1	-3,514.0	-1,021.8	4,655.0

Business risk profile: BB-

Industry risk: BB

Vasútvill's activities are concentrated in the civil engineering segment, including the construction, renovation and reconstruction of 25 kV, 50 Hz single-phase electrical overhead lines. This is a field in which the company has an extensive professional track record. Its activities also include the maintenance and renovation of railway tracks, thus covering the full spectrum of services in this niche market.

Cyclicality: high

While the construction industry is often associated with cyclical features when compared to industries with inelastic demand patterns, these vary depending on the individual business model. Our analysis incorporates exposure 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; and ii) risks from price fluctuations for materials, labour and energy. In contrast to other industrial sectors, construction corporates have large exposures to government customers, making them more vulnerable to changes in fiscal policy. However, given the public need for civil engineering/infrastructure, we observe that the financial crisis affected European construction output much less than building construction due to the public construction spending and fiscal policies used to stimulate civil engineering. In general, we assess the industry's cyclicality as high.

Market entry barriers: medium

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. Civil engineering is generally more capital intensive and often requires letters of credit. Therefore, we view market entry barriers as medium. Only sizeable companies with good access to third-party capital can participate in these predominantly large-scale projects. High entry barriers also exist for large-scale industrial projects, like power plants, oil platforms or refineries, as these projects often require specialised proprietary technologies.

Substitution risk: low

Substitution risk is low. We do not see any technology replacing the fundamental role construction companies play in addressing the need for new commercial and residential buildings or heavy and civil engineering (the construction of railway tracks, bridges, highways, tunnels, airport and other functional, capital-intensive ventures). Such construction work will be fuelled 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

Small market player in a European and domestic context

Vasútvill is a small construction company both in a European context and in Hungary, with HUF 14bn in revenues as of December 2019 and HUF 3bn in SaEBITDA. Limited size is a negative rating driver because it implies greater sensitivity to unforeseen shocks, greater cash flow volatility and limited economies of scale.

The company is targeting some growth in the coming years via HUF 5bn of investments. It intends to expand its business considering two possible directions: i) geographically, through the strategic acquisition of smaller players in neighbouring countries with markets in which Vasútvill may be able to leverage its broad experience in the railway segment; or ii) entry into the construction and maintenance of high-voltage networks and the construction of related transformer substations, for which the technology used is very similar to overhead line construction and railway traction substations. For the latter, the company aims to acquire smaller domestic companies or business lines and benefit from the synergies. Despite this, we expect Vasútvill to remain relatively small and exposed to construction industry cyclicality.

Market position benefits from focus and market shares in its niche market

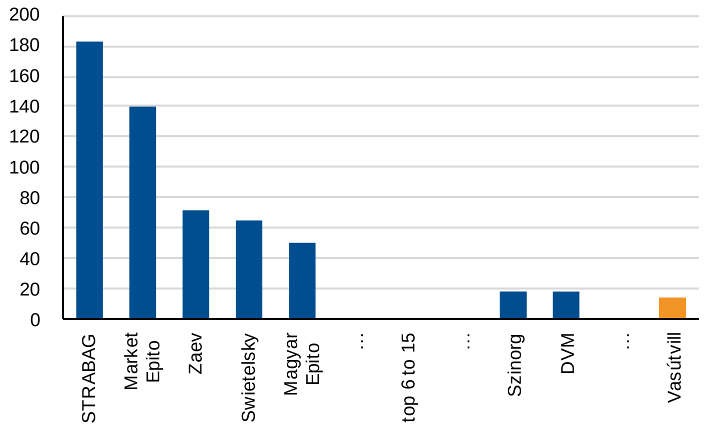
Whilst small, Vasútvill benefits from its specialisation in one specific market, railway electrical overhead line construction, in which the company has a long track record of over 70 years. The company and its legal predecessors have participated in practically all major electrification and renovation projects for the Hungarian railway network. Working as a contractor or subcontractor, the company has built more than 2,500km of railway overhead lines of Hungary's approx. 3,100km of electrified railway lines. This contribution has provided Vasútvill with an estimated market share of 75%.

Vasútvill's most important projects include the Mezőzombor – Sátoraljaújhely railway line (69.35km, delivery 2019) and the Rákosrendező-Esztergom railway line (58.3km, completed in 2019). It is currently involved in upgrading the North Balaton railway (77km, to be delivered in 2021) and the Gödöllő-Hatvan felsővezeték építés (62.8km, to be delivered by the end of 2020).

This niche market has significant potential as only 41% of the total railway network in Hungary is electrified, below the European Union average of 53.7%. The Hungarian national goal is to have 3,400km electrified by 2025 (45% of the total network). Some other international initiatives, like the Budapest-Belgrade railway, could also provide a market for Vasútvill.

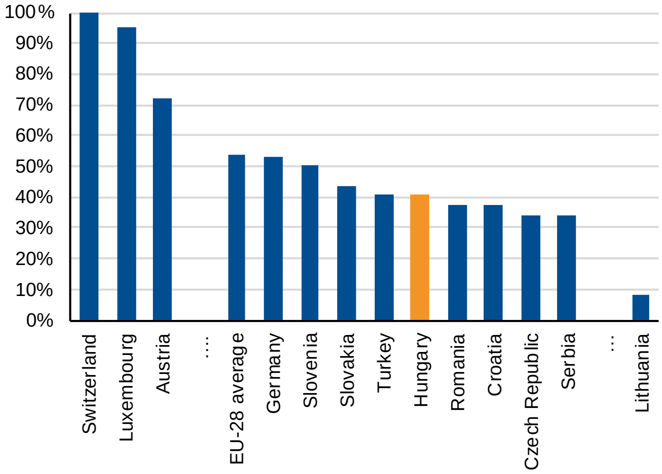
Vasútvill's track record and size (staff and machinery) mean it has no direct competitors in the market, as other participants in the segment are smaller. Further, the company will add HUF 2bn of machineries in the coming years to keep its technology up to date, including amphibious assembly vehicles, machinery equipment and the extension of the track control chain (DGS). Its market position is also supported by a good domestic network including longstanding relationships with its main customers. We believe both factors will help to support its business going forward.

Figure 2: Construction companies in Hungary by revenue (HUF bn)



Source: EMIS, Scope

Figure 3: Electrified railway lines – EU countries 2017 (%)



Source: Statista, Scope

Weak diversification across geographies with a portfolio focused on Hungary

Geographical diversification is limited, with a strong foothold in Hungary. While this focus has supported the company's positioning on its domestic market, it also creates full exposure to the macroeconomic environment of one region, compounded by Vasútvill's focus on the construction segment, a cyclical industry in which market downturns tend to affect revenues and earnings.

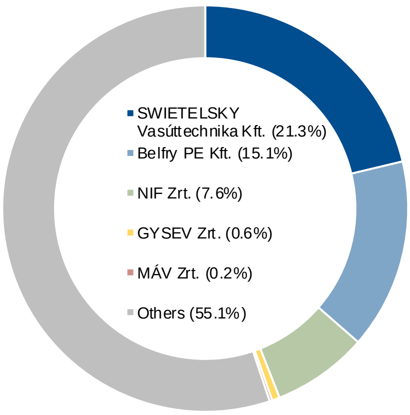
To mitigate this risk, the company intends to broaden its focus by expanding its activities in other Central and Eastern European countries, where European Union funds will further support the development and modernisation of the transport infrastructure. This strategy includes HUF 5bn of investments, focused on the acquisition of local companies in the target countries. Vasútvill's broad experience in the railway segment, combined with acquired local expertise, somewhat mitigates the execution risk related to expansion into neighbouring countries. At the same time, success is closely linked to EU funding priorities and specific local governmental policies. We therefore deem this risk medium.

Activities focused on one segment

Vasútvill's diversification across business segments is limited. Although it covers the full spectrum of activities in the segment, including the design, construction, maintenance, renovation and transformation of railway electrical overhead lines, all of this activity is fully related to one end-market: railway line construction.

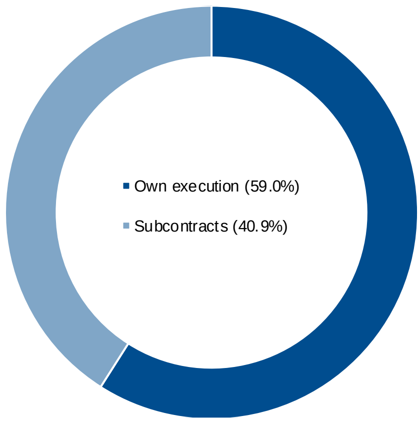
To mitigate this risk, Vasútvill intends to expand its field of activities and enter into the construction and maintenance of high-voltage networks segment, where the technology used is very similar to overhead line construction and railway traction substations. To this end, Vasútvill intends to acquire a smaller Hungarian domestic player or business line, in connection with high-, medium- and low-voltage networks.

Figure 4: Revenue breakdown by customer, 2019 (%)



Source: Vasútvill, Scope

Figure 5: Revenue breakdown by type of contract, 2019 (%)



Source: Vasútvill, Scope

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

Vasútvill's limited size results in high customer concentration as only very few projects can be executed simultaneously. This means both profitability and cash flow from operations can be affected greatly by the failure of one project. Further, as Vasútvill's activities are concentrated in one niche market, the company is reliant on the development of this one segment, which is mostly dependent on government demand and strategy.

The company has a strong relationship with the Nemzeti Infrastruktúra Fejlesztő Zrt.(NIF, National Infrastructure Development in Hungary), the Magyar Államvasutak Zrt (MÁV, Hungarian State Railways) and the Györ-Sopron-Ebenfurth Railway (GySEV, Hungarian-

Austrian railway company), the main entities related to the development of projects in the transport area and the principal railway operators in Hungary.

The 2014-2020 EU funding cycle, under the Integrated Transport Development Operational Programme in Hungary, has boosted new transport projects in the country including railway electrification projects. The next EU funding cycle (2021-2027) is currently in the preparation phase. While this could secure future order intake for Vasútvill, it also exposes the company to this specific funding source.

Concentrated backlog

Vasútvill's backlog is concentrated, with the top three projects accounting for 76% of future contracted revenues. The largest project in the pipeline (47%) is the upgrade of the North Balaton railway, which includes changing railway lines, the design and construction of a 50 Hz 2 × 25 kV AC overhead power line network, and the expansion and reconstruction of some existing substations along the railway line. Six other projects account for 47% of the backlog, with the remainder made up of smaller projects. This concentration bears the risk of significant cash flow volatility if projects are delayed or there are cost overruns.

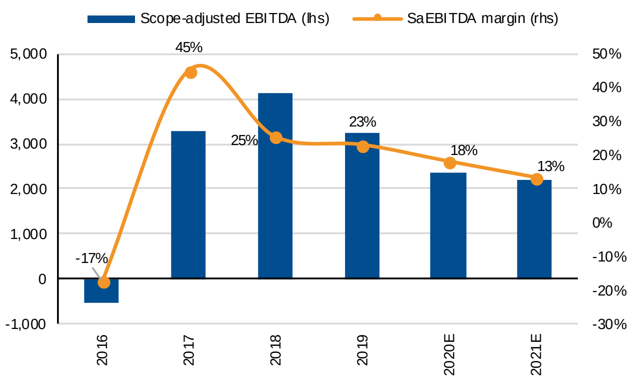
Short-term backlog provides limited visibility on future cash flows

The current project pipeline is around HUF 32bn[1] as of June 2020, resulting in a backlog ratio of 2.25x. This short-term backlog provides only limited visibility on future cash flows. There is potential to obtain further projects in coming tender processes, as only 41% of the railway lines in Hungary are electrified. However, this is subject to the EU funding programme and government prioritisation of the goal of electrifying 45%-50% of the railway network by 2025.

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

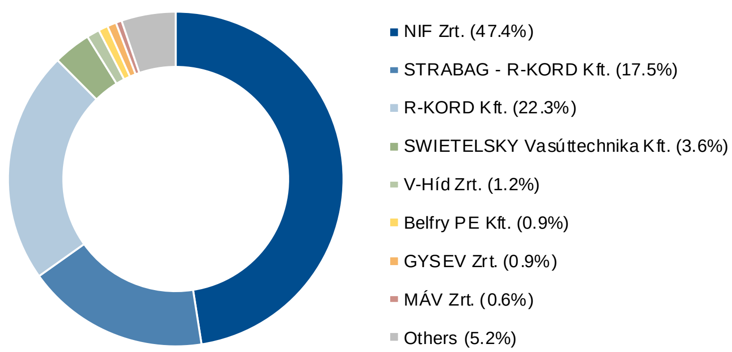
Vasútvill's profitability, as measured by its SaEBITDA margin, has been above the construction industry profitability range (5%-10%) with some extraordinary margin booked in 2017 pushing it above average. While traditional construction companies in Hungary have had higher margins in recent boom years, we believe these will become unsustainable once the economy cools (as expected). Vasútvill has a flexible cost structure with HUF 1bn of yearly fixed costs, allowing it to adjust the company size in accordance with the required capacities and ongoing projects. We forecast that sustainable margins will be at lower levels but still above 10% going forward.

Figure 6: EBITDA and EBITDA margin



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

Figure 7: Backlog by customer



Source: Vasútvill, Scope estimates

[1] Including projects that are in final phases and closer to be signed.

Financial risk profile: BB-

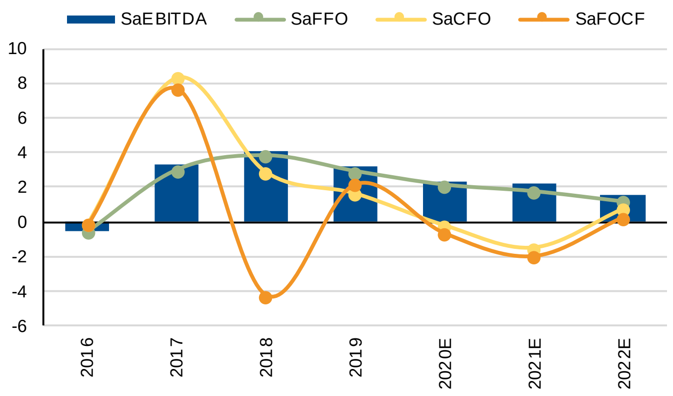
Our rating scenario assumes the following:

- Revenue growth based on the company's backlog, including some stress in 2021 and 2022
- Acquisition of further machinery (approx. HUF 2bn) in the next three years, mainly funded via financial leasing
- Advance payments will be significantly lower in the coming years, after the completion of main projects
- HUF 8bn bond issuance in 2021 under the MNB Bond Funding for Growth Scheme, with an estimated coupon of 3% and a maturity of 10 years
- Bond proceeds initially maintained in temporarily risk-free securities[2], subsequent use to finance working capital (HUF 3bn) and acquire smaller players in the domestic market or abroad (HUF 5bn)

Moderate debt protection metrics although debt will increase in 2021

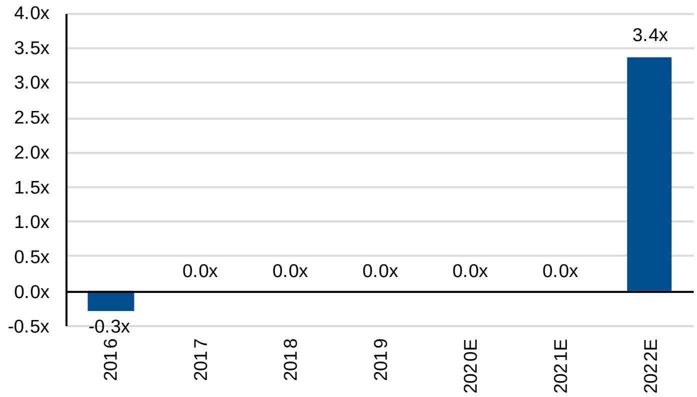
As Vasútvill has had relatively little debt in the past, interest expenses have been low. This has resulted in a strong SaEBITDA interest coverage ratio in the years prior to 2019. The planned HUF 8bn bond issuance in 2021 for investment purposes and working capital financing will have a negative impact on debt protection, which will, however, remain at adequate levels. We expect Scope-adjusted EBITDA interest coverage of above 4x from 2021 on.

Figure 8: Cash flows (HUF bn)



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

Figure 9: Leverage (SaD/SaEBITDA)



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

Negative free operating cash flows driven by cash flow weakening from 2020 on

For the next few years, we anticipate that operational cash flows will be under pressure due to a strong expected increase in working capital requirements, driving Scope-adjusted cash flow from operations into negative territory. In the past, infrastructure development projects were implemented in a very favourable financing context, as the main contractor was entitled to a 50% advance immediately after signing the construction contract, with appropriate advance repayment guarantees. However, it is uncertain if these conditions will be maintained for Vasútvill's future projects. A significant part of the advances received by the company were related to projects in which Vasútvill was the main contractor in a consortium. If, in the future, the company participates as a subcontractor there may be less opportunities to obtain advances through the main contractors. To counterbalance this, Vasútvill plans to use HUF 3bn as reserves to cover any potential working capital requirements.

[2] This sentence was amended on 02 December 2020 after the initial publication.

Growth strategy at the expense of strong increase in leverage

The company's debt strategy has been conservative, evidenced by its very low debt levels. Towards the end of 2019, debt was mainly composed of the financial leasing of 33 cars used for Vasútvill's operations. In 2020 the company has proceeded with a sale and lease back of three Plasser machines, increasing gross debt to HUF 800m by the end of 2020. It intends to add further machinery in the next three years using a similar structure. Moreover, in order to finance its working capital requirements and expansion plans Vasútvill intends to issue a HUF 8bn bond, increasing leverage in 2021. Regarding contingent liabilities, Vasútvill is the guarantor for car leasing transactions used by Homlok Zrt. for a total of HUF 86.3m.

Adequate liquidity

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

Figure 9: Liquidity

in HUF m	2020E	2021E
Short-term debt (t-1)	0	0
Unrestricted cash and cash equivalents (t--1)	1,556	3,419
Open committed credit lines (t-1)	0	0
Free operating cash flow (t)[3]	-643	-1,246
Coverage	**2.4x**	**2.7x**

Source: Scope estimates

Liquidity is adequate and benefits from the company's conservative, back-loaded debt maturity profile, with no significant amount due in the coming years. We anticipate that the company's low short-term debt levels will be maintained going forward and that they will be sufficiently covered by available financing sources. The company has financial leases implying a yearly amortisation of approx. HUF 40m and will repay HUF 200m corresponding to the leaseback transaction for the three Plasser machines before the end of 2020. Vasútvill has bank guarantees available for HUF 16.4bn (HUF 6.0bn undrawn as of March 2020), which can be used for future activities. Given the long maturity of the prospective MNB bond, upcoming short-term maturities are likely to be manageable for the foreseeable future.

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

Outlook and rating-change drivers

Outlook: Stable

The Outlook is Stable and incorporates Scope's view that the impact of Covid-19 on Vasútvill's activities will be limited. The Outlook also incorporates the successful placement in 2021 of a HUF 8bn bond under the MNB Bond Funding for Growth Scheme. Of the total proceeds, HUF 5bn are earmarked for expansion plans, while the remaining HUF 3bn will be used to finance working capital. This will increase leverage, but we anticipate that Scope-adjusted debt/Scope-adjusted EBITDA will not rise above 3.5x and that Scope-adjusted funds from operations/Scope-adjusted debt will fall to below 25% by YE 2022.

A positive rating action is unlikely but could be warranted if the company achieves substantial growth, affording better diversification of geographies and customers, with Scope-adjusted debt/EBITDA advancing towards 3.0x on a sustained basis, as a potential consequence of new orders and a supportive dividend policy.

A negative rating action could occur if Vasútvill's leverage exceeds 4x on a sustained basis or its market position weakens, leading to lower revenues and profitability margins than projected in Scope's base case scenario. The latter could occur if no additional projects are won or the company maintains an aggressive dividend policy.

Long-term and short-term debt instrument ratings

Vasútvill 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 2031. Proceeds from the bond are earmarked for the financing of expansion plans via acquisitions of smaller players (HUF 5bn) and net working capital (HUF 3bn).

Senior unsecured debt: BB-

Our recovery analysis is based on a hypothetical default scenario in 2022, factoring in Vasútvill's liquidation value, considering its planned investment, and assumed outstanding senior unsecured debt of HUF 8bn. We expect an average recovery for Vasútvill's senior unsecured debt, and therefore assign a debt class rating of BB- in line with the issuer rating.

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

1 Cour du Havre
75008 Paris

Phone +33 1 8288 5557

London

3rd Floor
111 Buckingham Palace Road
UK-London SW1W 0SR

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

Disclaimer