EPKAR Zrt.
Hungary, Construction

SCOPE **BB-** STABLE

Corporate profile

EPKAR Kft. is a leading Hungarian construction company, established in 1981. It is privately owned by its management and employees and generated HUF 24bn of revenues in 2020 EPKAR's heritage and the location of its headquarters is in Budapest. The Hungarian capital accounts for about 50% of EPKAR's construction activities, with the other half in the rest of the country. EPKAR 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	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover (x)	n/a	n/a	12.5x	18.1x
Scope-adjusted debt (SaD)/EBITDA	Net cash	3.0x	1.7x	0.7x
Scope-adjusted funds from operations/SaD	Net cash	33%	51%	117%
Free operating cash flow/SaD	Net cash	45%	47%	98%

Rating rationale

Scope Ratings has affirmed the issuer rating of EPKAR Zrt. at BB-/Stable. The company's senior unsecured debt has been affirmed at BB.

The rating benefits from strong credit metrics, which have also withstood the pandemic. The financial risk profile has been upgraded to BBB since the last yearly review, based on higher cash flows on the back of a stronger-than-expected business environment and an increased order backlog that has improved cash flow visibility.

In terms of leverage, the Scope-adjusted debt/Scope-adjusted EBITDA ratio (SaD/SaEBITDA) peaked at 3.0x at year-end 2020 (adjusting for cash earmarked for property acquisitions) and is expected to reduce to 1.7x at year-end 2021, while funds from operations/SaD is expected at 51% once proceeds from the bond issued in late 2020 are used to acquire an office in central Budapest, as intended in the bond prospectus. Our base case assumes this to happen in Q4 2021. A delay in the intended acquisition while positive cash flows are generated would reduce SaD and strengthen leverage metrics.

We expect interest coverage to remain strong after bond proceeds are deployed, at above 10x. Cash flow cover remains strong due to healthy free operating cash flow. However, the backlog remains concentrated.

The main rating constraint is the business risk profile (assessed at B). The company's small scale in a European construction context lessens its ability to mitigate economic downturns. Weak geographic diversification, segment concentration, and the reliance on government contracts, which increased during the pandemic, are further constraints. The order backlog is also concentrated, though improved over the last 12 months and mitigated by the investment grade counterparties. The book-to-bill ratio is volatile, mitigated by the level remaining above 1x. On the positive side, above-average profitability continues to strengthen the business risk profile. With increased visibility through the prolonged backlog, we foresee profitability to remain above the peer average, at a 13%-15% Scope-adjusted EBITDA.

Ratings & Outlook

Corporate rating	BB-/Stable
Senior unsecured rating	BB

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Related Methodologies

Corporate Rating Methodology: July 2021

Rating Methodology: European Construction Corporates January 2021

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Outlook and rating-change drivers

The Outlook for EPKAR is Stable and incorporates our expectation of healthy cash flow through the construction backlog and the rental income from the office property to be acquired, which shall remain unencumbered. With the prolonged and slightly less concentrated backlog to improve cash flow visibility, we foresee SaD/SaEBITDA to improve to around 1.7x and towards 1x after bond proceeds are deployed.

A positive rating action may be warranted if the business risk profile significantly improved while SaD/SaEBITDA remained at around or below 2x. An improved business risk profile would be evident in a higher market share, larger and more diversified order backlog, improved segment diversification, and higher exposure to private projects.

A negative rating action could occur if SaD/SaEBITDA increased above 3.5x on a sustained basis. This could be triggered by i) an operational development leading to reduced profitability and cash flows; or ii) more debt-funded real estate acquisitions.

Rating drivers

Positive rating drivers	Negative rating drivers
• Historically above-average profitability, somewhat weakened by 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 construction company in a European context with a lack of geographic and segment diversification, somewhat mitigated by top 10 domestic position • Concentrated backlog (top three account for 50%; top 10 for 83%), somewhat mitigated by the investment grade counterparties and a legally enforced payment scheme that covers most of its contracts • High dependency on government contracts • Exposure to cyclical Hungarian construction industry

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Improved business risk profile while SaD/SaEBITDA remains below 2x	• SaD/SaEBITDA sustained above 3.5x

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
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Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	Net cash	3.0x	1.7x	0.7x
Scope-adjusted funds from operations/SaD	Net cash	33%	51%	117%
Free operating cash flow/SaD	Net cash	45%	47%	98%
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	2,764	3,165	3,615	5,042
Operating lease payments in respective year	0	0	0	0
Other (disposal gains)	-878	0	0	0
Scope-adjusted EBITDA	1,886	3,165	3,615	5,042
Scope-adjusted funds from operations in HUF m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	1,886	3,165	3,615	5,042
less: (net) cash interest as per cash flow statement	213	237	-290	-278
less: cash tax paid as per cash flow statement	-289	-261	-288	-372
add: depreciation component, operating leases	0	0	0	0
Scope-adjusted funds from operations	1,810	3,141	3,037	4,392
Scope-adjusted debt in HUF m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	2,972	13,645	13,645	13,645
less: derivatives	0	0	0	0
less: cash and cash equivalents	-7,947	-18,324	-9,153	-11,364
add: cash not accessible	293	11,759	159	159
add: guarantees	2,879	2,568	1,328	1,328
add: pension obligations	0	0	0	0
Scope-adjusted debt	-1,803	9,647	5,978	3,768

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.

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

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

EPKAR is a small construction company in a European context, with HUF 24bn (EUR 71m) of revenues and HUF 3.2bn (EUR 10m) of Scope-adjusted EBITDA in 2020. However, it ranks in the top 10 (lower end) in its home market of Hungary, with a market share of 0.5% (2020) in the overall construction sector and around 3% in its sub-segment of construction. This strong position despite a relatively low market share indicates the highly fragmented and competitive nature of the 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 (including via a joint venture with West Hungaria Bau and the acquisition of Magyar to take part in building Budapest's Puskás Aréna). Thereafter, revenues and EBITDA dipped in 2019 but recovered during 2020 despite the Covid-19 crisis.

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 market position. This position grants it market visibility and moderate access to third-party capital and guarantees, which should help to generate business going forward. This is especially pertinent as the construction sector needs to refocus away from EU-sponsored construction and civil engineering and deal with uncertainties stemming from the upcoming elections in 2022, which have also slowed tendering processes.

Limited geographical diversification exposes EPKAR to Hungary's construction cycle

EPKAR's geographical diversification is limited mostly to Hungary. 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, revenues and margins are likely to come under pressure in a downturn, and EPKAR has no exposure to dampen this effect.

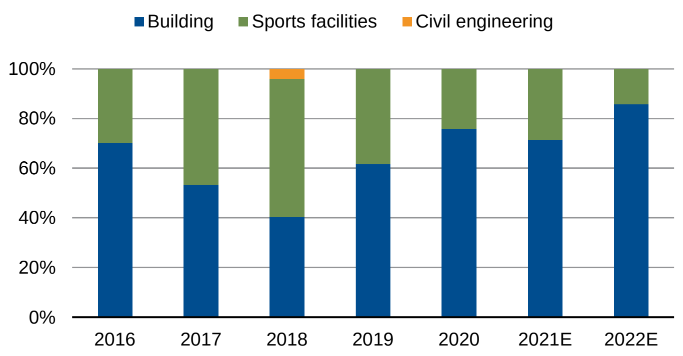
Acquisition of real estate portfolio to mitigate potential downturn

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 an acquisition worth around HUF 12bn, financed by bond proceeds (HUF 11bn) and equity (HUF 1bn). 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 of using acquisition advisors and a professional external management company to run the portfolio.

Limited segment diversification with activities in buildings and sport facilities

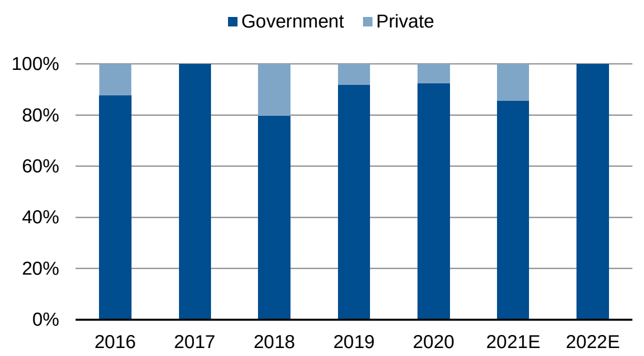
Segment diversification is also limited, as EPKAR is predominantly active in two areas: buildings and sport facilities. The building segment encompasses a vast variety of projects – among them, offices, residences, halls, garages, monuments, hospitals and educational facilities – but do not provide diversification as all properties 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: Scope estimates

Figure 3: Project diversification by customer (%)



Source: 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 depends on government-funded projects, accounting for 99%. During 2016-19, EU funds channelled via the 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 Hungarian National Bank). So far, Hungarian government funds have replaced the decreased EU funds, but the upcoming elections in April 2022 may put this at risk.

We therefore expect a change in EPKAR's customer profile over time. 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 continues to submit tenders for projects. However, it foresees fierce competition, which would drive down margins. We therefore anticipate margin erosion at the end of EPKAR's current backlog.

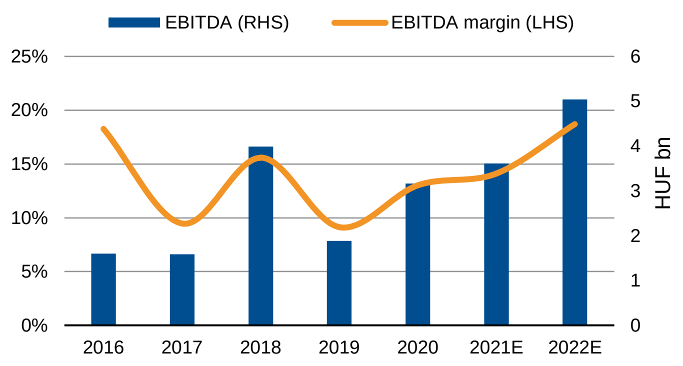
Concentrated backlog mitigated partially by strong counterparties and payment scheme

EPKAR's backlog is concentrated, with the top three projects (a monument restoration, a sports facility and a hospital) representing 50% of the revenue backlog as of Q2 2021 and the top 10 representing 83%. 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 most of the backlog being funded either directly by the 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 (89% of backlog eligible).

Above-average margins to continue through duration of contracted backlog

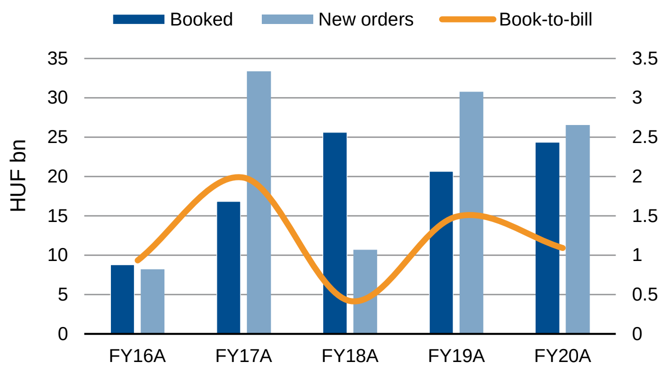
EPKAR's profitability, at around 14% during 2016-20, has been well above the construction industry's range (5%-10%). The level dipped in 2017 and 2019, though this was due to revenue recognition timing. As the backlog covers 100% of revenues expected between 2021 and 2023, we expect these margin levels to be maintained during this period. Thereafter, we assume profitability to be under pressure from the intense competition over market-based projects and inflated labour and material costs. EPKAR's strong profitability will provide a cushion during this time and, in combination with its top 10 market position, will allow it to defend its market share in a price war.

Figure 4: EBITDA and EBITDA margin



Source: Scope estimates

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



Source: Scope

Backlog of 2.5 years; volatile book-to-bill ratio with recent strong order inflow

The current order backlog of HUF 65bn at Q2 2021 covers around 2.5 years of revenues (up from 1.8x at the same time last year). This translates into 100% coverage with contracted orders for revenues expected in 2021, 2022 and most of 2023, 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 in 2019 and 2020, 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 this is due to 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 5.4% in 2021 to HUF 25.6bn, based on the fully covered backlog; revenue growth of 5.3% in 2022 to HUF 27.0bn, based on the fully contracted backlog; thereafter, a small revenue decline, based on only the backlog
- EBITDA margin of 14%-15% for 2021 and 2022, in line with margins in 2018-20 given the contracted backlogs, with manageable margin compression expected thereafter
- Issuance of HUF 11bn (around EUR 30m) bullet bond in November 2020 achieving the planned coupon of 3%; proceeds earmarked for the acquisition of an office worth around HUF 12bn to lease in the long term for steady cash flows (6% net yield targeted); proceeds yet to be used
- Capex of around HUF 12bn in 2021, with most to be used for real estate acquisitions in Q4; HUF 0.4bn for maintenance/general capex thereafter
- Dividend payouts of 50% of net profit yearly in line with management plan (previously only part 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

In the past, the company had little debt. This meant that interest income had exceeded interest expenses, rendering the Scope-adjusted EBITDA interest coverage ratio meaningless. In November 2020, the company issued a HUF 11bn bond with a coupon of 3% and kept its other minor debt positions. Given the short interest period in 2020, EBITDA interest cover became meaningful in 2021, expected at a strong 12.5x, followed by 14.5x in 2022E and 11.3x in 2023E (the latter based on the backlog ending in late 2023).

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 been sufficient to not only cover capex but also increase the net cash position. Going forward, we expect this to continue for the normal course of its construction business.

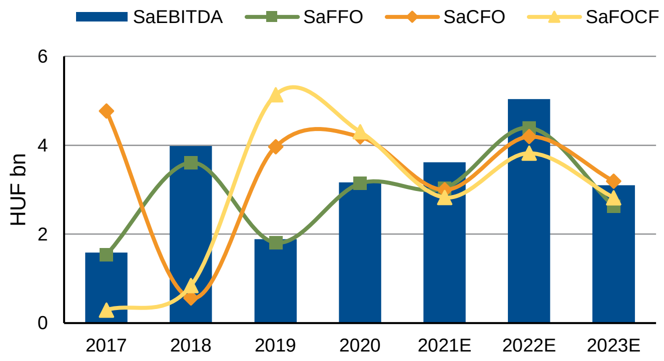
In addition to its core business, the company plans to buy a property portfolio. This will involve:

Large discretionary capex needs to finance Budapest property portfolio

- the use of HUF 11bn of bond proceeds and HUF 1bn-2bn of equity to buy Class A/B offices in Budapest with long-term leases that generate stable cash flows.
- targeted specifications that include an (economic) age of up to 10 years, a good tenant mix with a minimum WAULT of three years, a required net rate of return of at least 6%, and a known property manager to run the portfolio. The newly acquired real estate shall remain unpledged.

Given the non-core nature of these acquisitions, we have classified capex as discretionary. Combined with dividends – assumed at 50% of last year's net profit (HUF 1.5bn-2bn) – the acquisitions will have a significant impact on cash flows in 2021 (figure 7). As mentioned above, these large investments bear price and execution risks. Mitigating these risks are i) the management with good knowledge of structural aspects; ii) the use of acquisition advisors as well as a property management company; and iii) the nature of a performing prime portfolio with decent WAULTs, which bears a manageable risk of covering interest costs through stable rental income.

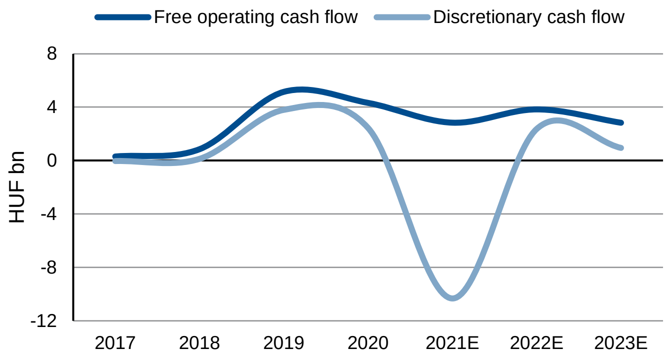
Figure 6: Cash flows[2] (excluding real estate acquisition)



[1]'Sa' = Scope-adjusted

Source: Scope estimates

Figure 7: Discretionary cash flows



Source: Scope

Modest leverage peaking at around 1.7x

EPKAR historically had very little interest-bearing debt, resulting in a net cash position when assessing SaD. The HUF 11bn in bond proceeds received in November 2020 to finance the acquisition of Budapest CRE is yet to be spent, resulting in a reported net cash position continuing in 2020 (we adjust SaD by only considering cash not earmarked for the property transaction, taking SaD/EBITDA to 3x at year end 2020). After the significant discretionary capex expected in late 2021, we assume SaD/SaEBITDA to be at 1.7x and FFO/SaD at around 51%, distorted by delays in the bond issuance and real estate investment. For 2022, we expect SaD/SaEBITDA to normalise to around 1x and FFO/SaD to around 98% due to the foreseeable contract coverage. Thereafter, we anticipate leverage to stabilise throughout 2023 and to potentially increase due to expected margin erosion and revenue contraction after the existing backlog ends. 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)	2021E	2022E
Short-term debt (t-1)	221	221
Unrestricted cash (t-1)	6,565	8,994
Open committed credit lines (t-1)	0	0
Free operating cash flow (t)[3]	2,829	3,678
Coverage	**42x**	**57x**

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 bond.

Long-term and short-term debt instrument ratings

Senior unsecured debt: BB

EPKAR issued a HUF 11bn senior unsecured corporate bond in Q4 2020 under the Bond Funding for Growth Scheme of the Hungarian National Bank. The bond was issued at a 3% fixed annual coupon and a 10-year tenor and will amortise by 10% in the seventh

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

year, 20% in each of the eighth and ninth years, and 50% at maturity in 2030. Bond proceeds were earmarked for financing capex to acquire a performing Class A/B CRE portfolio in Budapest that generates recurring rental income with an intended net yield of 6%, as expected in our initial rating base case. The property portfolio shall remain unencumbered.

We still expect an ‘above average’ recovery for the company’s unsecured debt and affirm the BB rating for this debt class (one notch above the issuer rating).

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