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 primary processing of live poultry, manufacturing of prepared and further processed products, use of by-products mainly as pet food, and 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. The Baktalórántháza farm has been certified as a McDonald's Flagship Farm since 2015. In 2020, the group generated sales of about HUF 110bn and EBITDA of roughly HUF 13.9bn. The entity is wholly owned by the Bárány family, which is also involved in its management.

Key metrics

			Scope estimates		
Scope credit ratios	2019	2020	2021E	2022E	2023E
EBITDA/interest expense (x)	40.7x	17.1x	11.9x	10.9x	40.7x
Scope-adjusted debt (SaD)/EBITDA	3.0x	3.6x	3.7x	3.9x	3.0x
Scope-adjusted FFO/SaD	31%	26%	25%	23%	31%
Free operating cash flow (FOCF)/SaD	-27%	-19%	-4%	-37%	-27%

Rating rationale

Scope affirms the BB-/Stable issuer rating for Hungary-based Baromfi-Coop Kft. ahead of its new HUF 23bn senior unsecured green bond issuance. The agency also affirmed the BB- senior unsecured debt rating.

The rating reflects the company's solid EBITDA margin and its position as the biggest chicken-processing company in Hungary, its proven track record of expansion, and its resilience. The rating is constrained by weak diversification.

Following its 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, which includes a blended industry rating for agriculture and consumer goods of BBB+. 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 and the Baktalórántháza farm has been certified as a McDonald's Flagship Farm since 2015.) With an annual production capacity of up to 64m chickens per year, Baromfi-Coop accounts for around 25% of overall Hungarian chicken-meat production. The company is continually looking to increase output and deepen vertical integration. However, it is still rather small compared to European competitors, and this continues to constrain our assessment of the company's market share. Baromfi-Coop's business risk profile is also constrained by weak diversification, despite positive effects following its acquisition of Saga Foods (e.g. higher scale and broader scope). Diversification is limited by: i) a fairly concentrated customer portfolio, which has broadened somewhat in export markets during the pandemic due to the closure of the HORECA sector in Hungary and lower demand from OSI Group (a McDonald's supplier) and ii) a focus on one poultry species (chicken). Baromfi-Coop's profitability (EBITDA margin) continues to be credit-supportive, with reported EBITDA margins averaging around 12% from 2016 to 2019 and coming in at 12.6% in 2020, despite the global economy being hit by Covid-19.

Ratings & Outlook

Corporate rating	BB-/Stable
Senior unsecured rating	BB-

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Related methodology

Corporate Rating Methodology, February 2020

Consumer Products Methodology, September 2020

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Bloomberg: RESP SCOP

The company's financial risk profile is affirmed at BB-. Thanks to business development in export markets resulting in strong performance in 2020, Baromfi-Coop was not meaningfully affected by the Covid-19 pandemic, save for increased inventory levels in chicken breast products. Demand from major retail chains remained unchanged, McDonald's ramped up its delivery and drive-in supply channels, and the HORECA segment restarted in May 2021, albeit with lower guest numbers at first. Based on the company's acquisition of Saga Foods, its first capex programme, and its recently announced second capex programme, we anticipate leverage, as measured by Scope-adjusted debt (SaD)/EBTIDA, of 3.7x at year-end 2021 and 3.9x at 31 December 2022.

Our previous assumptions included a second capex cycle in 2021, although there were no details at that stage. The company's investments will be financed through its own sources, subsidies, and a senior unsecured green bond of HUF 23bn. Furthermore, the owners plan to contribute in-kind the two companies (Steam Cook Kft. and Várda Meat Kft.) in a creditor-friendly fashion into the structure to support further vertical integration at Sága Foods, mainly in the area of frozen convenience food.

We anticipate that free operating cash will not improve until 2023, instead of in 2021/2022 as previously assumed, due to the investments mentioned. 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. Its phased investment programme is divided into several standalone projects over the next three years, which provide room to manage liquidity. 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 the future, based on its previous strategy.

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

Outlook and rating change drivers

Stable Outlook

The Outlook is Stable, reflecting our expectation of continued positive performance thanks to a resilient business model with limited vulnerability to the Covid-19 pandemic. Our rating scenario anticipates SaD/EBITDA ranging from 3.5x to 4.0x in the medium term.

Rating upside

A positive rating action could be warranted by SaD/EBITDA of less than 3.5x on a sustainable basis. This could occur if Baromfi-Coop's capital allocation policy shifts from repeated capex programmes to debt reduction.

Rating downside

A negative rating action could be required if SaD/EBITDA were to rise 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 (2020: 12.6%) – current investments in automation and ramp-up of by-products will offset higher expected labour costs • Successful management of the pandemic at the top line and EBITDA level, replacing HORECA revenues with export channels	• Rather small size compared to European competitors • Weak diversification, characterized 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 a large capex programme started in 2019 and a new investment programme planned to start in 2021

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	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest expense (x)	40.7x	17.1x	11.9x	10.9x	11.5x
Scope-adjusted debt (SaD)/EBITDA	3.0x	3.6x	3.7x	3.9x	3.5x
Scope-adjusted FFO/SaD	31%	26%	25%	23%	26%
Free operating cash flow (FOCF)/SaD	-27%	-19%	-4%	-37%	1%
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	12,155	13,855	14,630	17,914	19,089
Operating lease payments in respective year	-	-	-	-	-
Other items	-	-	-	-	-
Scope-adjusted EBITDA	12,155	13,855	14,630	17,914	19,089
Scope-adjusted funds from operations (FFO) in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	12,155	13,855	14,630	17,914	19,089
less: (net) cash interest as per cash flow statement	-299	-809	-1,233	-1,638	-1,657
less: cash tax paid as per cash flow statement	-67	-56	-203	-247	-244
less: pension interest	-	-	-	-	-
add: depreciation component operating leases	-	-	-	-	-
add: dividends received from equity-accounted entities	-	-	-	-	-
less: disposal gains on fixed assets included in EBITDA	-	-	-	-	-
less: capitalised interest	-	-	-	-	-
Other items	-535	-	-	-	-
Scope-adjusted funds from operations	11,254	12,990	13,194	16,029	17,187
Scope-adjusted debt (SaD) in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	49,749	53,133	67,007	73,071	69,184
Hybrid debt	-	-	-	-	-
less: cash and cash equivalents	-12,897	-3,538	-13,278	-3,300	-2,899
Cash not accessible	32	32	32	32	32
add: pension adjustment	-	-	-	-	-
add: operating lease obligations	-	-	-	-	-
Other items (contingent liabilities)	-	-	-	-	-
Scope-adjusted debt	36,885	49,627	53,761	69,803	66,317

Business risk profile

Blended industry risk profile: BBB+

We have assigned a blended industry risk of BBB+ given the company's activities – procurement and farming of corn, and 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 division.

Purchase of Saga Foods and contribution in kind of Steam Cook and Várda Meat bolsters business risk profile

Irrespective of the key strengths of the now-acquired Saga Foods (see **Baromfi-Coop acquires Hungarian turkey-processing company Saga Foods**), including its ownership of well-known brands like FÜSTLI and FÜSTLIZER, and a customer portfolio of multinational retail chains, this bolt-on acquisition is fairly small compared to Baromfi-Coop. Saga Foods switched its focus from processing turkey to processing chicken produced by the group. Consequently, Baromfi-Coop will continue to be concentrated on chicken processing. Furthermore, the owners' ambition to contribute in kind Steam Cook Kft. and Várda Meat Kft. further increases the group's vertical integration since certain convenience foods from Sága Foods (such as frozen and breaded products) are processed by these companies. Future contribution in kind is considered credit-friendly since the target companies' leverage is similar to the issuer's leverage and no cash is paid out from the structure.

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 annually, 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 the company's 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 processed by Baromfi-Coop.

Diversification is compromised by several aspects

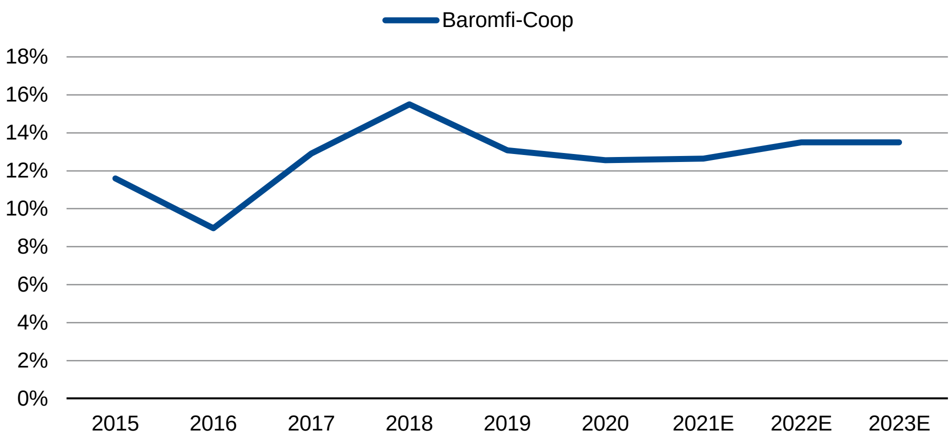
Baromfi-Coop's credit rating continues to be compromised by weak diversification. This is based on: i) a rather concentrated customer portfolio and ii) a focus on processing chicken. In addition, the company's customer portfolio comprises about 250 customers, with its top 10 customers accounting for up to 60% of sales. This rather negative factor is somewhat mitigated by Baromfi-Coop's long-term relationships with customers, along with the fact that its biggest customers are large, well-known retail companies such as Aldi and Tesco and quantities sold by the group cannot be replaced easily by competitors. Given its focus on production of chicken meat, Baromfi-Coop would be highly sensitive to a sharp decline in 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. Sustainability is strengthened by diversification through the use of by-products as pet food, which generates very high margins.

Strong, stable profitability – despite Covid-19

Our view of Baromfi-Coop's profitability continues to be credit-supportive, based on reported EBITDA margins averaging around 12% between 2015 and 2019. Even in 2020, when the global economy was in panic mode, the company achieved an EBITDA margin of 12.6%. This was mainly due to stable demand from major retail chains, as McDonald's ramped up its delivery and drive-in supply channels. Nevertheless, demand from OSI Group (a McDonald's supplier) decreased in 2020. Management successfully boosted export sales channels, which can provide further growth once the HORECA segment fully restarts. The HORECA segment reopened in May 2021, albeit with lower guest numbers at first.

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 rising labour costs; and iv) considerable pricing power, in tandem with positive effects from the Saga Foods acquisition and the contribution in kind of Steam Cook and Várda Meat.

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 2020, credit metrics came in weaker than anticipated 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 that has roughly doubled capacity. The company is therefore purchasing more wheat, corn, and canola, which has driven up inventories. That said, the deterioration in credit metrics is somewhat offset by the initial contribution to EBITDA from Saga Foods, the future contribution in kind of Steam Cook and Várda Meat, and our expectation of solid performance in the remainder of 2021, as Baromfi-Coop successfully navigated a stormy 2020 with low HORECA sector demand.

Second capex cycle in 2021-2023

Management decided to execute a second capex cycle during 2021-2023, with the aim of increasing production capacity, logistics capabilities, animal-feed production, biological water sewage, use of by-products (pet-food production), and energy efficiency.

The proceeds from the new senior unsecured green bond of HUF 23bn to be issued by Baromfi-Coop Kft. with a corporate guarantee from Master Good Kft. in Q3 2021 within the Bond for Growth framework of the MNB for a 10-year tenor, fixed annual coupon payments, and linear amortization of 10% from year 5 with 50% balloon at maturity will be earmarked for investments. The bond documentation, similarly to the previous two bonds maturing in 2026 and 2028 respectively, will cap dividends paid by the issuer at 20% of profit after tax.

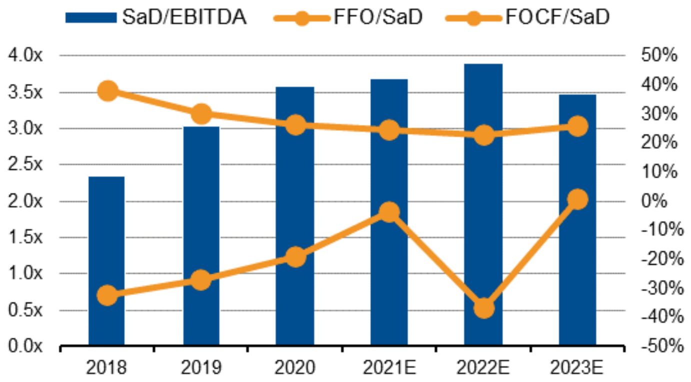
Financial risk profile: BB-

We expect SaD/EBITDA of 3.6x as at 31 December 2020 to loosen to 3.7x at year-end 2021, together with negative free operating cash flow due to the large investments.

Interest cover (EBITDA/interest expense 2021F: 11.9x) will remain very strong – despite a significant rise in interest expenses in absolute terms, following the issuance of the third bond.

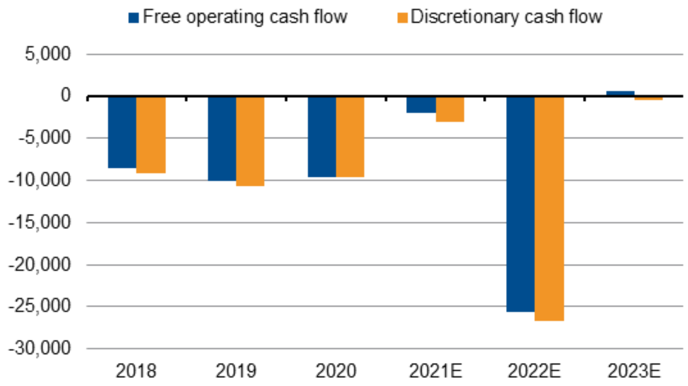
Baromfi-Coop therefore continues to meet our requirements for a BB rated financial risk profile.

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 2023 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 along with ii) our expectation that free operating cash flow will develop positively from 2023 compared to the levels posted in 2018 to 2022. Baromfi-Coop's internal and external liquidity coverage remains weak. The company continues to record considerable amounts of short-term debt, which stood at about HUF 7bn in 2020, and it has access to an additional HUF 3.8bn of unused 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. We deem leverage and liquidity to be controllable by management due to the phased and well divided investment programme and good access to debt-capital markets. We see potential for stronger liquidity coverage on a sustained basis from 2023 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 along with ii) our expectation that free operating cash flow will develop positively in 2021 and 2022 compared to the levels posted from 2018 to 2020. Baromfi-Coop's internal and external liquidity coverage remains weak. The company continues to post considerable amounts of short-term debt, which stood at about HUF 7bn in 2020, and it has no access to an additional HUF 3.8bn of unused 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

In our view, Baromfi-Coop continues to be strongly committed to a neutral financial policy, keeping leverage below 4x as proven by accepting and keeping such financial covenants in its loan agreements. This is combined with insignificant dividend payments during the last few years, which are expected to increase in future to up to 20% of annual profit after tax (to be paid to shareholders).

While the ongoing capex programme has led to higher debt levels, no dividends were paid to shareholders until 2020 and a fairly low payout ratio is planned for the future. The company has taken a disciplined approach to M&A by paying a reasonable price to purchase Sága Foods and by making upcoming contribution in kind plans creditor-friendly.

Moreover, the Bárány family has been running the company proactively for more than 100 years and remains 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. and guaranteed by Master Good Kft. Our recovery assessment is based on a hypothetical default scenario in 2023, including the assumption that bank debt (2023F: HUF 21.5bn) 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.

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