24 April 2020

Corporates

Zalaco Sütőipari Zrt.
Hungary, Consumer Goods

B+ STABLE

Zalaco Sütőipari Zrt. (Zalaco) primarily produces bread and fresh bakery products. The company currently distributes almost 400 bakery and confectionery products. In 2014-2017, it established production plants in Zalaegerszeg, Ajka and Sopron. Zalaco has expanded its sales and production capacity and increased the range of its product portfolio. In addition, Zalaco operates around 50 of its own bakeries.

Key metrics

		Scope estimates		
Scope credit ratios	**2018**	**2019F**	**2020F**	**2021F**
EBITDA/interest cover (x)	28.9x	22.0x	8.1x	8.6x
Scope-adjusted debt (SaD)/EBITDA	2.6x	4.1x	4.0x	3.3x
Scope-adjusted funds from operations/SaD	37%	23%	21%	25%
Free operating cash flow/SaD	-25%	-50%	-7%	15%

Rating rationale

Scope Ratings has today assigned an issuer rating of B+/Stable to Hungary-based Zalaco Sütőipari Zrt. A rating of B+ is assigned to the future senior unsecured debt category.

The issuer rating of B+ reflects Zalaco's robust profitability and well-established business operations in western Hungary. The rating is constrained by Zalaco's small scale, limited geographical diversification, high customer concentration and high leverage.

Zalaco's business risk profile (rated B+) benefits from the company's prominent presence in western Hungary, despite only mid-single-digit market shares in the national market. In recent years, Zalaco has become the leader of Transdanubia's bakery market, with its retail chain supplying an extensive range of fresh products daily. It has also gradually increased its production and sales capacities for frozen products. The company has a proven track record of annual top-line growth averaging 20% over the last three years, mainly driven by a solid partnership with Lidl and its potential to grow. We expect Zalaco to increase (at least double from 6%) its market shares on the domestic market in the medium term. This should be achieved by ramping up already-finalised greenfield investment to boost production capacity and outreach in western Hungary and by gaining a foothold in Budapest or other cities through acquisitions.

Geographical diversification is the main constraint on Zalaco's business risk profile, as it is concentrated on one country (further limited by exposure to one specific region) and one industry. Zalaco has high customer concentration in its international retail chains: Lidl accounted for 54% of 2019 sales, while smaller domestic chains and public institutions accounted for only about 5%. At the same time, effective cooperation and a positive track record with international retail chains supports the ability of small-cap companies to deliver quality-oriented products and maintain sustainable business operations.

Although Zalaco does not compare well with its European consumer goods peers, due to its smaller scale, it has relatively high and stable profitability margins in a local context, thanks to its: i) vertically integrated business model; and ii) well-established sales channels. In the short to medium term, Zalaco's profitability would be positively affected by an automated production facility mitigating labour force shortages and reducing scrap percentages. We expect a gradual increase in EBITDA margins, reaching 14% in 2022, following fully ramped-up automated

Ratings & Outlook

Corporate ratings	B+/Stable
Senior unsecured rating	B+

Analysts

Olaf Tölke
+49 69 6677389 11
o.toelke@scoperatings.com

Zurab Zedelashvili
+49 69 667738 947
z.zedelashvili@scoperatings.com

Related Methodology

Corporate Rating Methodology

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Tel. + 49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

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

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

production lines and ongoing greenfield investment, providing the advantage of scale in the region in which Zalaco operates.

Zalaco's **financial risk profile** (rated B+) is supported by our expectation of strong revenue growth, as already confirmed by previous years, which showed above 15% annual growth. This should also lead to a parallel increase in operating profits, resulting in a stable underlying EBITDA margin of about 12%, which is likely to have enabled significant operating cash flow generation in 2019. Considerable growth capital expenditure of about HUF 1.3bn and HUF 4.4bn in 2018 and 2019 respectively, resulted in negative free operating cash flow. Despite the healthy 30% EBITDA increase, leverage, as expressed by Scope-adjusted debt (SaD)/ adjusted EBITDA, rose to over 4x in 2019, mainly driven by the new investment loan of HUF 2.3bn. We expect gradual deleveraging after 2021, assuming: i) the ramping-up of two automatic production lines, which will increase annual production capacity; and ii) potential acquisitions, diversifying Zalaco's sales exposure to additional regions of the domestic market. We expect funds from operations (FFO)/SaD and SaD/EBITDA to reach 30% and 3x respectively in 2022.

Zalaco's liquidity profile deteriorated in 2018-2019, mainly affected by negative free operating cash flow. Despite a lack of committed credit lines, we believe that Zalaco's liquidity has a high likelihood of becoming adequate in the medium term. This is based on a comfortable operating profitability reflected to substantial free cash generation used to re/finance short-term debt maturities.

Outlook and rating-change drivers

The Stable Outlook reflects our expectation that Zalaco's expansion strategy, and increasing demand for its product portfolio, will improve FFO/SaD to around 20% without significantly exceeding a SaD/EBITDA ratio of 4x.

A positive rating action could be warranted if FFO/SaD exceeds 20% on a sustained basis and SaD/Scope-adjusted EBITDA consistently trends below 3.5x. A decrease in leverage may be achieved by an increase in profitability following the successful implementation of the company's expansion strategy.

A negative rating action could result from a deterioration in credit metrics, as indicated by FFO/SaD of below 10% and SaD/EBITDA of above 5.0x on a sustained basis. An increase in leverage could be triggered by an adverse operational development, leading to reduced profitability or the need for additional external financing for capital expenditure, M&A or unplanned intercompany loans.

Long-term and short-term debt ratings

Zalaco plans to issue a HUF 4.0bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. The planned bond with a bullet loan structure has a 3.5% coupon and 10 years' maturity. Proceeds from the bond are allocated for refinancing, expansion and M&A.

Rating drivers

Positive rating drivers	Negative rating drivers
• Relatively high profitability margins • Vertically integrated value chain and business operations • Operational sustainability supported by decades of partnership with international value chains	• High capex requirements turning free operating cash flow negative • Workforce shortages • Small scale compared to international peers • High customer concentration risk

Rating-change drivers

Positive rating drivers	Negative rating drivers
• FFO/SaD above 20% • SaD/EBITDA below 3.5x	• FFO/SaD below 10% • SaD/EBITDA above 5x

Financial overview

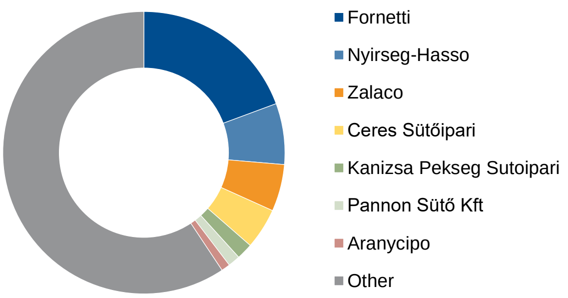
		Scope estimates		
Scope credit ratios	**2018**	**2019A**	**2020F**	**2021F**
EBITDA/interest cover (x)	28.9x	22.0x	8.1x	8.6x
SaD/EBITDA	2.6x	4.1x	4.0x	3.3x
Scope-adjusted FFO/SaD	37%	23%	21%	25%
FOCF/SaD	-25%	-50%	-7%	15%
Scope-adjusted EBITDA in HUF m	**2018**	**2019A**	**2020F**	**2021F**
EBITDA	887	1,153	1,465	1,855
Operating lease payments in respective year	175	210	235	250
Other				
Scope-adjusted EBITDA	1,062	1,363	1,700	2,105
Scope-adjusted funds from operations in HUF m	**2018**	**2019A**	**2020F**	**2021F**
EBITDA	887	1,153	1,465	1,855
less: (net) cash interest as per cash flow statement	-7	-29	-175	-207
less: cash tax paid as per cash flow statement	-19	-47	-67	-84
add: depreciation component, operating leases	146	177	200	213
Scope FFO	1,007	1,254	1,422	1,777
Scope-adjusted debt in HUF m	**2018**	**2019A**	**2020F**	**2021F**
Reported gross financial debt	695	3,445	6,445	5,045
Cash, cash equivalents	-48	-131	-1,993	-418
Operating leases	1,238	1,376	1,445	1,517
Bank guarantees	835	835	835	835
SaD	2,721	5,525	6,732	6,979

Business risk profile

Competitive position – overview

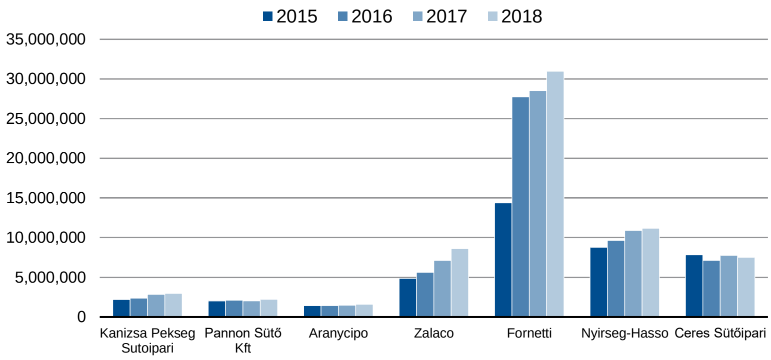
Zalaco's competitive position is supported by its leading position in western Hungary's bakery market and relatively high profitability margins. Despite significant market shares and a prominent presence in western Hungary, Zalaco only has mid-single-digit market shares in the national market. In recent years, Zalaco has become market leader of Transdanubia's bakery market, with its retail chain supplying a broad range of fresh products daily and a gradual increase in production and sales capacities for frozen products.

Figure 1: Hungarian bakery market shares



Source: Zalaco, Scope

Figure 2: Top-line development of Zalaco's domestic competitors (HUF '000s)

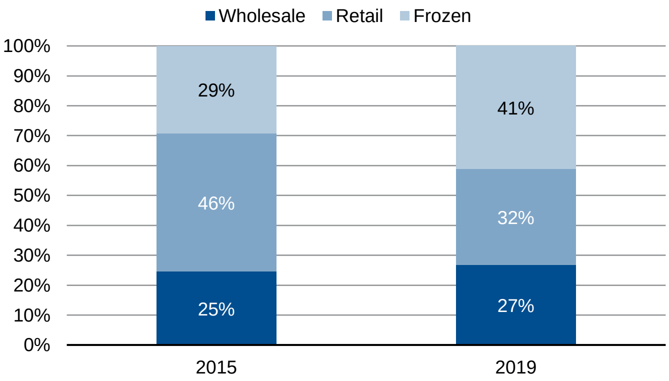


Source: Zalaco, Scope

The company has a proven track record of annual top-line growth averaging 20% in the last three years, mainly driven by a solid partnership with Lidl and its potential to grow. We therefore expect Zalaco to increase (at least double) its market shares on the domestic market in the medium term. This should be achieved by ramping up already-finalised greenfield investment to boost production capacity and outreach in western Hungary and by making acquisitions to gain access to Budapest or other cities.

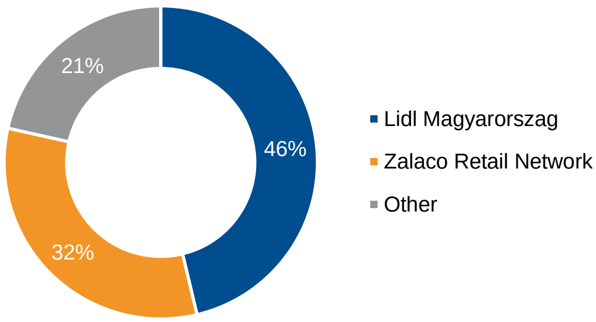
Geographical diversification is the main constraint for Zalaco's business risk profile, because it is focused on one country (further limited by exposure to one region) and one industry. In 2018, the company started to export its products, mostly to neighbouring Western countries, but so far exports account for no more than 2% of total sales.

Figure 3: Revenue split by division



Source: Zalaco, Scope

Figure 4: Customer concentration



Source: Zalaco, Scope

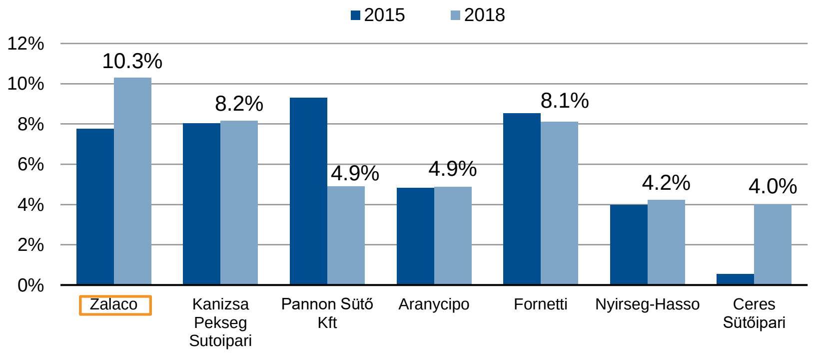
We deem positive future opportunities to gradually increase Zalaco's exports of frozen products but this isn't included in our base case scenario for time being.

Zalaco has high customer concentration in its international retail chains: Lidl accounted for 54% of 2019 sales, while smaller domestic chains and public institutions accounted for only about 5%. At the same time, effective cooperation and a positive track record with international retail chains supports the ability of small-cap companies to deliver quality-oriented products, maintain sustainable business operations and achieve growth potential.

Solid and robust profitability

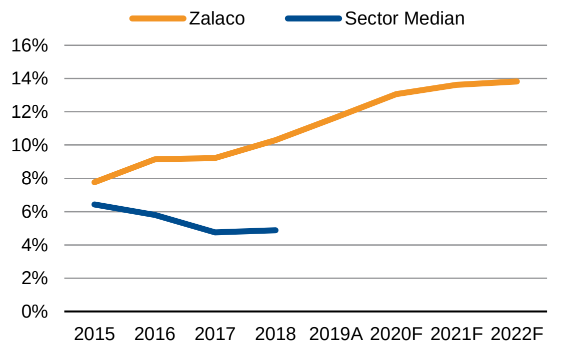
Although Zalaco does not compare well to its European consumer goods peers, due to its smaller scale, the company has relatively high and stable profitability margins in a local context. Despite price pressure in the Hungarian bakery market (since 2015 the bakery sector's EBITDA median has decreased by 2 pp), Zalaco has been able to slightly improve its profitability performance by 2-3 pp.

Figure 5: Local Peer's EBITDA margin trends



Source: Hungarian central statistical office, Scope

Figure 6: Hungarian bakery sector profitability median vs Zalaco



Source: Scope

Unlike most of its domestic competitors, Zalaco is not seeing declining profitability margins. Stable profitability is supported by: i) a vertically integrated business model; ii) well-established sales channels. In the short to medium term Zalaco's profitability would be positively affected by an automated production facility, which would mitigate labour shortages and reduce scrap percentages. We expect a gradual increase in EBITDA margins, reaching 14% in 2022 following fully ramped-up automated production lines and ongoing greenfield investment, giving Zalaco the advantage of scale in the region in which it operates.

In the foreseeable future, we do not expect any major changes in food safety standards, requiring the restructuring of processes. Zalaco mainly has state-of-the-art production facilities, which comply with all food safety standards.

Zalaco's ownership structure – Groti Pekseg (parent company of Zalaco) is owned by Berta family – does not compare with those of Western public companies. However, participation in the MNB Bond programme aims to provide outside investors with better transparency. Furthermore, we did not identify any corporate governance-related concerns during the rating process. We therefore have a neutral view of Zalaco's current corporate governance.

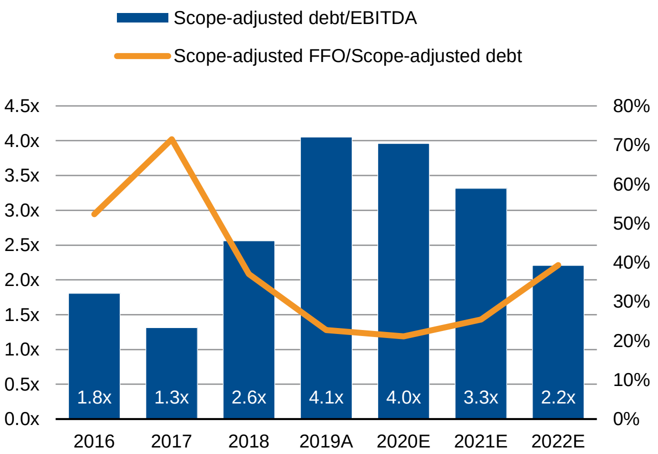
Financial risk profile

Comfortable credit metrics

Zalaco's financial risk profile benefits from its solid operating performance. We expect strong revenue growth, as already confirmed by previous years, which showed above 15% annual growth. This should lead to a parallel increase in operating profits, resulting in a stable underlying EBITDA margin of about 12%, which is likely enabled significant operating cash flow generation. Significant capital expenditure of about HUF 1.3bn and HUF 4.4bn in 2018 and 2019 respectively – compared to annual maintenance capex of about HUF 100m – resulted in negative free operating free cash flow. Despite the healthy

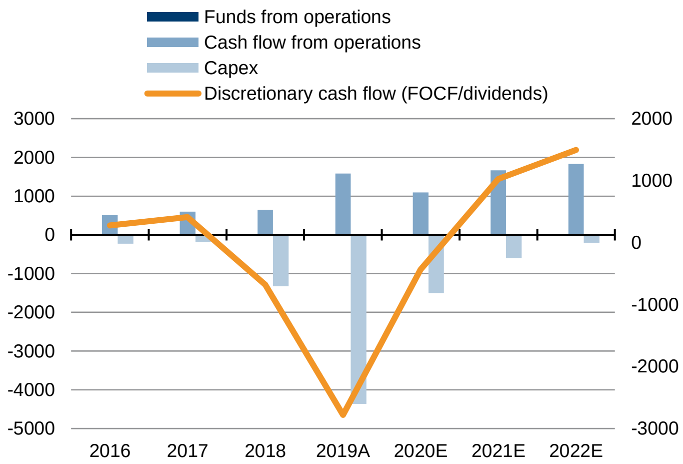
30% EBITDA increase, leverage, as expressed by SaD/adjusted EBITDA, increased to over 4x in 2019, mainly driven by the new investment loan of HUF 2.3bn.

Figure 7: Leverage



Source: Zalaco, Scope estimates

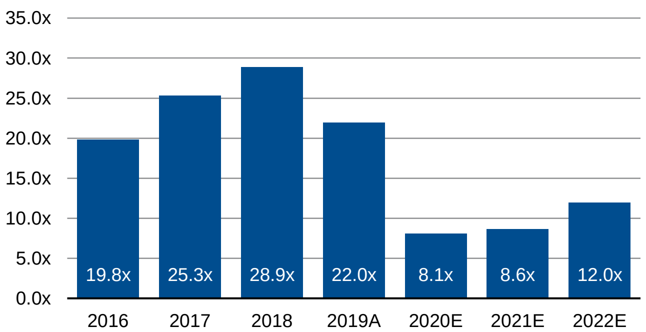
Figure 8: Cash flow generation



Source: Zalaco, Scope estimates

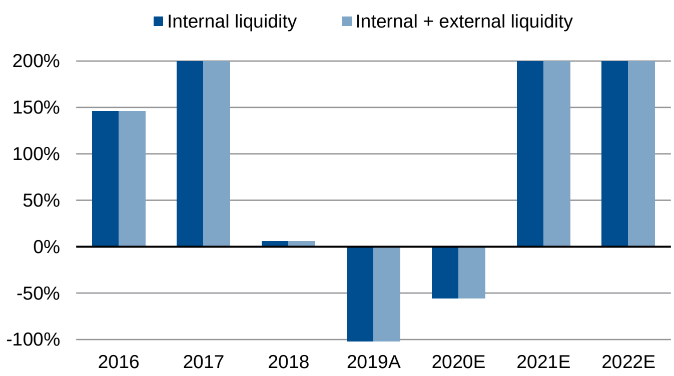
Our rating case incorporates a potential issue of HUF 4.0bn in bonds, which will be used to refinance existing loans, as well as for potential acquisitions and capital expenditures. We expect gradual deleveraging after 2021 when the high capex phase will be over. We expect FFO/SaD and SaD/EBITDA to reach 30% and 3x respectively in 2022. This is based on our assumption of: i) two ramped-up automatic production lines, which will increase the annual production capacity of frozen bakery products by 14 tonnes per day; and ii) acquisitions diversifying Zalaco's sales exposure into additional regions of the domestic market.

Figure 9: EBITDA cash coverage



Source: Zalaco, Scope estimates

Figure 10: Liquidity profile



Source: Zalaco, Scope estimates

Zalaco's liquidity profile deteriorated in 2018-2019, mainly affected by negative free operating cash flow. Despite a lack of committed credit lines, we believe that Zalaco's liquidity is highly likely to become adequate in the medium term. This is based assumption that it will be able to use substantial free cash generation to re/finance short-term debt maturities. Debt is likely to be reduced in the future given a successful bond placement, which is partially be used to replace some of Zalaco's short-term working capital loans.

Most of Zalaco's cash inflows from operations (95%) are exposed to the domestic market. However, a devaluation of the Hungarian currency against the euro/US dollar, global recessions or shocks (e.g. Covid-19), would not have a material impact on the company's business profile. This is because: i) Zalaco provides goods for which demand is countercyclical in recessions; and ii) the company's forex risk exposure is limited – with no notable dependence on external customers or exposure to imported raw materials. Despite the solid demand on product portfolio Zalaco's supply chain and profitability may suffer from extension of lockdowns due to Covid-19.

Outlook and rating-change drivers

The Stable Outlook reflects our expectation that Zalaco's expansion strategy and increasing demand for its product portfolio will improve FFO/SaD to around 20% without significantly exceeding a SaD/EBITDA ratio of 4x.

A positive rating action could be warranted if FFO/SaD exceeds 20% on a sustained basis and SaD/EBITDA (Scope-adjusted figures) consistently trends below 3.5x. A decrease in leverage may be achieved by an increase in profitability following the successful implementation of the company's expansion strategy.

A negative rating action could result from a deterioration in credit metrics, as indicated by FFO/SaD of below 10% and SaD/EBITDA of above 5.0x on a sustained basis. An increase in leverage could be triggered by an adverse operational development leading to reduced profitability or an additional need for external financing for capital expenditures, M&A or unplanned intercompany loans.

Long-term and short-term debt ratings

Zalaco plans to issue a HUF 4.0bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. The planned bond with a bullet loan structure has a 3.5% coupon and 10 years' maturity. Proceeds from the bond are allocated for refinancing, expansion and M&A.

Our hypothetical default year is YE 2022, simulating a scenario in which the company has issued the new, proposed HUF 4.0bn senior unsecured bond and proceeds have been used accordingly. Although our recovery analysis indicates a relatively high recovery rate for senior unsecured debt, we have limited the uplift for the instrument to zero notches (average recovery) due to senior secured loan outstanding.

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
F-75008 Paris

Phone +33 1 8288 5557

London

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

Phone +44 203-457 0 4444

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

© 2020 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Analysis GmbH, Scope Investor Services GmbH and Scope Risk Solutions GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided 'as is' without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5 D-10785 Berlin.
Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director: Guillaume Jolivet.