Bonafarm Csoport
Hungary, Consumer Goods

SCOPE BB- STABLE

Corporate profile

Bonafarm Csoport (Bonafarm) is the largest fresh food producer in Hungary, with a broad, diversified product portfolio. The group is vertically integrated, with activities ranging from crop production and large-scale animal husbandry to the production of food products for wholesale distribution, both under its own brands and for third parties. Bonafarm Csoport is the parent company to eight separate business units (five in agriculture and three in the food industry). The company is organised into three major operational groups: Agriculture, Food Industry, and HQ and Administration. There is also a shared service centre (BonOffice Ltd). The Agriculture segment includes Bóly Group (crop and seed production, pig and dairy cattle breeding), Dalmand Co. (crop and seed production, pig breeding), Fiorács Ltd. (crop production, pig breeding), Agroprodukt Group (crop and seed production, pig and dairy cattle breeding), and Bábolna Takarmány Ltd (fodder production). Food Industry includes Pick Szeged Co. (processed meat production), Sole-Mizo Co. (milk processing) and Csányi Pincéstet Co. (wine).

Key metrics

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	28.6x	48.3x	127.7x	26.4x
Scope-adjusted debt (SaD)/EBITDA	4.2x	3.3x	4.6x	5.6x
Scope-adjusted FFO/SaD	22.2%	30.4%	21.2%	17.1%
FOCF/SaD	-4.9%	-35.8%	-12.3%	-46.5%

Rating rationale

Scope Ratings has affirmed the issuer rating of BB-/Stable for Bonafarm Csoport. Senior unsecured debt has also been affirmed at BB-. Improved growth, supported by strong positioning, support the rating, but with continued vulnerability to price swings. The large, planned capex programme has been delayed due to the revision of overall investment planning.

Bonafarm's strengths continue to be its strong market and asset position, with prudent financing. These remain offset by leveraged financing and inherent input price volatility, resulting in the increased vulnerability of EBITDA to market price movements. Free operating cash flow (FOCF)/Scope-adjusted debt (SaD) also continues to be volatile and negative due to ongoing capex for a new production facility for wholly owned subsidiary Pick-Szeged Zrt. The industry risk profile rating remains at A-, reflecting a mix of consumer goods (A) and agribusiness (BBB). The competitive position rating of BB reflects a strong presence in Hungarian markets with increasing diversification abroad but is tempered by volatile profitability with moderate margins. This leads to an overall business risk profile rating of BB+.

While financial metrics have improved, the financial risk profile remains at B. The delay in capex reflects an active management of investment risks, in part due to Covid-19 but also due to administrative delays and the redefining of investment goals for the Bonafarm group as a whole, with overall long-term investments moving from the original plan of EUR 600m to EUR 500m. The delay in capex does not change the fundamental volatility of the funds from operations (FFO)/SaD ratio, cash flow coverage and free cash flow generation. In addition, Bonafarm carries the debt and liquidity burden on behalf of all group members and leverage will remain high during the planned once-in-a-generation capex programme. The issuer rating without supplementary rating drivers is B+. We continue to assign a one-notch upgrade for parent support.

Ratings & Outlook

Corporate ratings	BB-/Stable
Short-term rating	-
Senior unsecured rating	BB-

Analysts

John Francis Opie
+49 69 6677389 13
jf.opie@scoperatings.com

Related Methodology

Corporate Rating Methodology, February 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

Outlook

The Outlook continues to be Stable. The large, once-in-a-lifetime capex programme has been delayed and changed credit metrics will revert to their previous levels once this is executed. A positive rating action could be warranted if Bonafarm achieves a sustained improvement in FOCF/SaD to more than 5%. A negative rating action could be warranted by a sustained increase in FFO/SaD to below 15% and/or a sustained movement of SaD/EBITDA to more than 5x.

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong market position • Prudent financial policy	• EBITDA vulnerable to market price changes • FOCF/SaD negative due to long ongoing investment phase

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Sustained return of FOCF/SaD to greater than 5%	• Sustained movement of SaD/EBITDA to more than 5x • Sustained movement of FFO/SaD to below 15%

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
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Scope-adjusted debt (SaD)/EBITDA	4.2x	3.3x	4.6x	5.6x
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Free operating cash flow/SaD	-4.9%	-35.8%	-12.3%	-46.5%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	11,576	16,034	14,165	12.864
Operating lease payments in respective year	-	-	-	-
Other	-	-	-	-
Scope-adjusted EBITDA	11,576	16,034	14,165	12.864
Scope-adjusted funds from operations in HUF m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	11,576	16,034	14,165	12.864
less: (net) cash interest as per cash flow statement	-405	-332	-111	-488
less: cash tax paid as per cash flow statement	-565	-105	-241	-110
add: depreciation component, operating leases	-	-	-	-
Scope-adjusted funds from operations	10,905	16,213	13,813	12,266
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020F**	**2021F**
Reported gross financial debt	50,569	65,314	66,400	73,433
less: hybrid bonds	-	-	-	-
less: cash and cash equivalents	-1,435	-12,009	-1,104	-1,692
add: cash not accessible	-	-	-	-
add: pension adjustment	-	-	-	-
add: operating lease obligations	-	-	-	-
Other	-	-	-	-
Scope-adjusted debt	49,134	53,304	65,295	71,742

Business risk profile: BB+

Industry Risk Profile

As a vertically integrated agribusiness and commodity foods manufacturer, Bonafarm's revenues come primarily from the sourcing and distribution of crops, food, animals and their products, as well as their inputs, and the processing, distribution and marketing of commodity food products. The business is subject to seasonal swings in supply that drive relatively volatile prices. Additional factors affecting price volatility are crop shortages due to weather and climate factors, disease, and government import restrictions. These are, to a certain degree, mitigated by the non-discretionary nature of commodity food products. Regional supply shortages and unpredictable price swings add to short-term volatility. We used a blended approach to assign Bonafarm's industry risk profile, with roughly 60% of total sales and EBITDA for fast-moving (meat and milk products) consumer goods (industry risk profile: A) and the remainder from agribusiness (industry risk profile: BBB). With low substitution risk (food is non-discretionary), the overall industry risk profile is A-.

High cyclicality

Non-discretionary products normally have low cyclicality, but for agribusiness and commodity food products, strong supply swings introduce significant volatility to both costs and prices, resulting in volatile revenues and EBITDA. Both expected (crop forecasts) and unexpected events (bad weather, diseases) can lead to volatility, with supply shortages (increasing prices) and supply gluts (decreasing prices) leading to price volatility well in excess of more general price changes. For these reasons, we consider industry cyclicality to be high.

High barriers to entry

Barriers to entry are high. This reflects the need to purchase appropriate land, construct specialised infrastructure and hire qualified personnel. Further, there are significant temporal lags in animal husbandry between breeding livestock and processing the resulting milk and meat products, as well as capital costs to establish adequate processing capacity. Costs to generate specialised infrastructure are also substantial. There continues to be relatively low unemployment among farmers and animal breeders in Hungary, making it difficult to find qualified personnel. Additional market barriers are intellectual property rights (trademarks, proprietary recipes for milk and meat products) and genetics (specialised, proprietary high-productivity breeds).

Low substitution risks

Substitution risks are low, although agricultural commodity products can be easily substituted (either via imports or alternative domestic sources). Since Bonafarm is the largest vertically integrated (plot to plate) agribusiness and commodity food manufacturer in Hungary, alternative suppliers cannot offer the same kind of scale and product coverage. Hence vertical integration and the resulting control over final products (processed meat and milk products) limit substitution risks, as consumers are unlikely to accept differences in price, taste and consistency. Bonafarm also provides the necessary value chain certification for certified GMO products that cannot be easily reproduced with alternative inputs.

Robust outlook on core Hungarian market despite negative Covid-19 effects

Bonafarm's main market is Hungary, whose overall economic growth, despite the negative effects of the Covid-19 pandemic, remains relatively robust, but is challenged by negative demographic trends that result in an ageing workforce. Productivity growth to meet this challenge has been strong. The Hungarian economy is open and medium-sized, with cyclical behaviour matching that of the eurozone in general. Robust wage growth, aided by productivity increases, has helped consumer demand grow strongly in recent years. Access to EU markets and a sound infrastructure support the robust outlook.

Scope's public finance rating for Hungary is BBB+/Stable, reflecting the relatively healthy state of the economy and moderate public finance pressure. Government actions to curtail and mitigate Covid-19 pandemic effects have been robust (around 5% of GDP) and have helped Hungary avoid an extreme downturn, despite the strong exposure to global value chains. Economic development continues to be aided by the ongoing absorption of EU structural funds (Hungary continues its independent monetary stance by maintaining the Hungarian forint) and private sector deleveraging. Consumer sentiment has recovered well after a sharp downturn and remains supported by relatively low unemployment and strong wage increases. The Hungarian forint has weakened, placing some pressure on import prices, but this increases pricing room for domestic manufacturers.

Market development

Market development continues to reflect slow changes in consumer preferences. One effect of the Covid-19 pandemic has been to increase demand for food consumed at home, rather than in restaurants. Bonafarm has profited greatly from this due to its market leader position in the production of milk and meat products in Hungary.

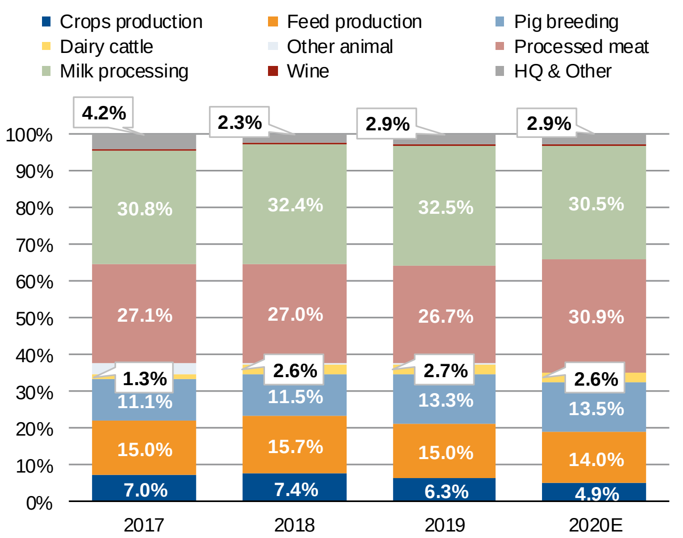
Product and market diversification

Bonafarm profits from strong vertical integration and reduced concentration risks, but lacks access to key growth markets (China, Japan), the result of the Asian Swine Flu pandemic there and the risk of a transition of the African Swine Flu to Hungarian herds. For an agribusiness, the company is well diversified. Geographical diversification is concentrated on Hungary and export sales are moderate.

Product diversification

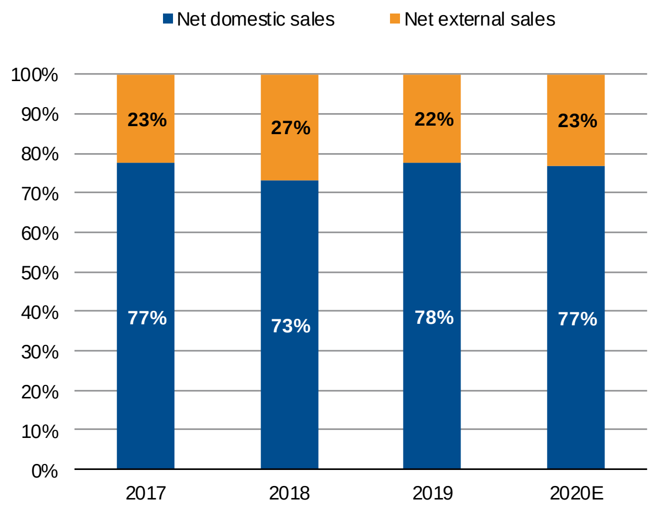
Product diversification (**Figure 1**) was dominated by processed meat and milk processing in 2019, at around 59% of total revenues, down slightly from 2018, but this is expected to increase somewhat in 2020 to over 60%. Market diversification (**Figure 2**) shows the relatively moderate international position of revenues (consolidated) at Bonafarm with relatively stable development.

Figure 1: Product diversification (sales, % of total)



Source: Bonafarm

Figure 2: Market diversification (sales, % of total)



Source: Bonafarm

Customer diversification

Bonafarm continues to have a widely distributed customer base with limited concentration risk. The company is increasingly becoming a price-setter, allowing it to recover cost increases on the market, but it remains sensitive to price developments. The expansion of distribution channels for future growth, especially for dairy, continues. Bonafarm is also maintaining its focus on key growth markets within Europe.

Profitability

Our view of EBITDA development is tempered by moderate growth and high volatility, driven by reduced but continuing vulnerability to market price changes. The large capex programme will negatively impact profitability into the longer term, despite some improvements in leverage.

Capacity expansion

The planned capacity expansion, which continues to be primarily for the Pick Szeged subsidiary, is aimed at improving EBITDA margins through efficiency gains and the expansion of production capacities. Positive effects remain after the rating horizon. Investment plans have been revised, but continue for around EUR 500m over 10 years in four areas: i) Bonafarm Agriculture; ii) Pick-Szeged for a new moulded salami production plant; iii) Sole-Mizo for ongoing capacity expansion; and iv) Csányi Pincészet for expansion of storage capacity.

Vulnerability to market price input changes

Bonafarm's margins are relatively low and continue to be driven by cost variations that can only partially be recouped by higher prices. Bonafarm has reduced its vulnerability to market price input changes, as well as price volatility in end markets, aided by strong diversification and vertical integration to reduce risks, but remains vulnerable to market input price swings.

Neutral view on corporate governance

We have no issues with overall corporate governance. The company is family-owned with a cash pool for finances and crossholdings between group companies. We have a neutral view of external or internal governance factors, and ownership is transparent.

Financial risk profile: B

Financial risk assumptions

Our key assumptions remain: i) no major restructuring of the company or subsidiaries; ii) no major acquisitions or mergers; iii) continuity of management; iv) organic growth for top-line sales of 2% to 3% per year; v) continued strength of the Hungarian domestic market, with low unemployment, strong wage growth and interest rates and exchange rates stable and within targets, supported by central bank monetary policy; vi) no major agribusiness-related events (drought, disease, excluding Covid-19); vii) investment plans executed without meaningful operational or financial risks; and viii) continuity of financial policy with the avoidance of dividends, leasing and factoring.

Leverage and debt protection

The consortium line of credit (CIB Bank Zrt, Raiffeisen Bank Zrt) of HUF 44.7bn (around EUR 140m) remains in place, jointly and severally, irrevocably and unconditionally guaranteed by Bonafarm, collateralised via a business share of Bonafarm with the banks. There are no other liens on the company, nor is there litigation outstanding and ongoing that might develop into a liability. Covenants for the consortium line of credit include: i) an equity ratio of at least 30%; ii) indebtedness not to exceed 4x; iii) net operating cash flows on a two-year average of at least HUF 9bn; iv) annual debt service coverage ratio of at least 1.05x; and v) total assets to shareholder equity of at least 45%. According to the 2019 audited report, all covenants were fulfilled. Ongoing and planned capex negatively affects credit metrics. We note that previous shareholder loans have been converted into equity.

Interest burden low

Bonafarm's EBITDA/interest cover ratio is very strong and reflects the low interest rate environment, with a 2% coupon on the HUF 27bn bond. Net interest payments are expected to increase moderately as interest becomes due on the bond, but relatively high interest income mitigates any negative impact.

Cash flow coverage and free cash flow generation

Our view of Bonafarm's cash flow coverage and free cash flow generation is primarily determined by the ongoing once-in-a-lifetime investment programme. Cash flow metrics are variable, reflecting strong changes in investment-related cash outflow. Once the investment phase is rolled out and completed, we expect stronger and less volatile cash flows, but this will happen largely after the rating horizon.

Liquidity adequate

Changes to the investment plan will lead to a strong reduction in short-term debt in the near term, reducing liquidity concerns. Bonafarm has agreements on cash management and the operation of group account management in place and provides a multi-currency cash pool for the Bonafarm Group in the form of overdraft facilities in both Hungarian forints and euros. There is, in addition to the outstanding public bond of HUF 27bn, an outstanding non-public bond of HUF 1bn (2036, 100% subscribed by Bonitás 2002 Zrt, the parent company of Bonafarm, representing part of the employee share ownership programme). Short-term debt owed to banks decreased slightly in 2019 to HUF 5.2bn from HUF 5.6bn in 2018 and is expected to drop to HUF 250m in 2020. There is no short-term bank debt expected for 2021 and 2022. Despite negative free cash flow and a limited banking relationship (two banks), Bonafarm's liquidity position is adequate, reflecting a relative lack of short-term maturities and an adequate level of undrawn committed lines.

Supplementary key rating drivers: +1

Financial policy

Bonafarm's financial policy continues to aim at a strong expansion of its core businesses (primarily Pick Szeged) and organic growth overall. The Pick Szeged investment focuses on strategic modernisation and expansion and replaces a production plant from the 1970s. Bonafarm carries all group debt. We view financial policy as largely prudent and conservative and have moderate expectations for top-line growth. No adjustments were made for financial policy.

Parent support

The investment company of the Csányi family, Bonitás 2002 Zrt, is the whole owner of Bonafarm. Total assets of Bonitás 2002 Zrt in 2018 were in excess of HUF 387bn. We consider the family willing and able to provide support and upgrade by one notch the stand-alone issuer rating of B+ to the final issuer rating of BB-

Senior unsecured debt

Bonafarm has not issued senior unsecured debt. While the company has a strong asset position, we have not provided uplift for any potential recovery.

Outlook

The Outlook continues to be Stable. The large, once-in-a-lifetime capex programme has been delayed and changed credit metrics will revert to their previous levels once this is executed. A positive rating action could be warranted if Bonafarm achieves a sustained improvement in FOCF/SaD to more than 5%. A negative rating action could be warranted by a sustained increase in FFO/SaD to below 15% and/or a sustained movement of SaD/EBITDA to more than 5x.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

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

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

London

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

Madrid

Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan

Regus Porta Venezia
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director: Guillaume Jolivet.