Market Építő Zrt
Hungary, Construction

BB- STABLE

Corporate profile

Market Építő Zrt. ('Market'), founded in 1996, is a leading construction company with operations based exclusively in Hungary. The group employs about 1,000 people and generated EUR 455m in turnover during 2018. Headquarters are located in Budapest. Market is owned by GARHART Zrt (51%, an investment holding wholly owned by Istvan Garancsi) and Sandor Scheer (49%, CEO and founder of Market). Market is involved in the construction of buildings, industrial facilities and sport facilities. Building projects encompass a wide range including offices, public facilities, residential buildings and hotels. The construction segment's increase over the past years has been driven by high demand for offices and public facilities. Industrial projects deal with logistics centres, car-making and tyre plants, and electric battery factories.

Key metrics

			Scope estimates	
Scope credit ratios	2017	2018	2019F	2020F
EBITDA/interest cover (x)	5165x	405x	159x	8x
Scope-adjusted debt (SaD)/EBITDA	Net cash	Net cash	Net cash	Net cash
Scope-adjusted FFO/SaD	14%	Net cash	Net cash	Net cash
Free operating cash flow (FOCF)/SaD	(-) FOCF	Net cash	Net cash	Net cash

Rating rationale

Scope has assigned a first-time issuer credit rating to Hungary-based Market Építő Zrt of BB- with a Stable Outlook. Senior unsecured debt has been rated at BB.

The issuer rating is largely supported by Market's leading position in the Hungarian construction sector. The group's positioning towards large-scale projects has led to substantial growth over the past five years. The company's creditworthiness is also supported by strong liquidity, net cash position and stable operating margin. Development capex, financed by the bond-purchase programme of the Hungarian central bank (MNB), should improve Market's diversification and integration and thereby strengthen its business model, through investments in a new concrete plant and various real estate opportunities. This should allow Market to continue benefiting from strong growth anticipated for Hungary's construction sector for the next 12-18 months. The planned issuance of a EUR 63m MNB bond is not expected to weigh significantly on the already strong financial risk profile.

The rating is constrained by Market's limited overall size, non-existent geographical diversification, and concentration issues regarding the backlog and business operations. These three factors make Market highly sensitive to business cycles. The low profitability represents another rating constraint. We do not expect this to improve materially over the next three years, with a structural shortage of raw materials and workers leading to cost pressures. The reduction of EU funding by 2020 and an Hungarian economic slowdown might weigh on Market's cash flows, through a deterioration of working capital owing to reduced advance payments and shorter supplier payment terms.

Ratings & Outlook

Corporate ratings	BB-/Stable
Senior Unsecured Debt	BB

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Related Methodologies

Corporate Rating Methodology

European Construction Methodology

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Outlook

The Outlook is Stable and incorporates our expectation of stable credit metrics, with a net cash position and an EBITDA interest coverage of above 7x. We expect the company to retain its strong liquidity position. Our Outlook is based on annual capex spending (including organic expansion and acquisition capex) of around EUR 35m for the period 2019 - 2020 and a stable Scope-adjusted EBITDA of around EUR 20m-25m. Furthermore, we expect no negative impact on credit metrics from the group's plans to pay dividends from 2018 onwards, at up to 75% of net income.

A positive rating action is likely if Market's business risk profile improved materially such as diversification by segment or geography. However, Scope does not foresee any material changes to this regard on a short to medium term basis.

A negative rating action could be required if leverage reached 2x on a sustainable basis for the next few years.

Rating for unsecured debt

We expect an 'above-average recovery' for current and future senior unsecured debt. Such recovery expectations translate into a BB rating for the senior unsecured category (incorporating a one-notch uplift to the issuer). Our expectations are based on a distressed enterprise value under the assumption of a going concern of around HUF 18.4bn (EUR 59m) in 2021, including a 10% reduction for administrative claims in a liquidation. Existing debt positions are senior unsecured and rank pari passu to the planned MNB bond (issuance expected of HUF 20bn).

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong leading position in the Hungarian construction market • Net cash position combined with a conservative approach to address a forecasted slowdown in the Hungarian economy by 2020. • Significant EUR 40m capex programme to reduce supply/demand uncertainty and diversify activities to improve integration • Core business in Hungarian construction, which exhibits strong fundamentals with double-digit growth for 2019 • Good credit metrics supported by low gross debt levels and strong liquidity	• Small European contractor with a lack of geographical diversification limiting ability to offset business cycles • Concentration issues regarding backlog (top six projects account for 63%, mitigated by investment grade counterparties) and business segment (mainly buildings) • Low profitability hampered by material increase in prices and wages, mitigated by a low to medium volatility in operating margins

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Market's Business Risk Profile improves: significant geographical diversification and the development of new business segments. However, this deemed as remote for the time being	• Scope-adjusted debt/EBITDA of greater than 2x on a sustained basis.

Financial overview

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	5,165x	405x	159x	8x
Scope-adjusted debt (SaD)/EBITDA	Net cash	Net cash	Net cash	Net cash
Scope-adjusted FFO/SaD (%)	14%	Net cash	Net cash	Net cash
FOCF/SaD	(-) FOCF	Net cash	Net cash	Net cash
Scope-adjusted EBITDA in EUR m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	22	20	20	25
Operating lease payments in respective year	0	0	0	0
Other items	0	0	0	0
Scope-adjusted EBITDA	22	20	20	25
Scope-adjusted funds from operations in EUR m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	22	20	20	25
less: (net) cash interest as per cash flow statement	0	0	0	-3
less: cash tax paid as per cash flow statement	-1	-1	-2	-1
add: depreciation component, operating leases	0	0	0	0
Scope-adjusted funds from operations	21	20	23	21
Scope-adjusted debt in EUR m	**2017**	**2018**	**2019F**	**2020F**
Reported gross financial debt	6	7	69	69
Hybrid bond	0	0	0	0
less: cash and cash equivalents	-56	-45	-103	-56
add: cash not accessible	7	9	10	7
add: pension adjustment	0	0	0	0
add: operating lease obligations	0	0	0	0
Other items	0	0	0	0
Scope-adjusted debt	-42	-29	-23	-3

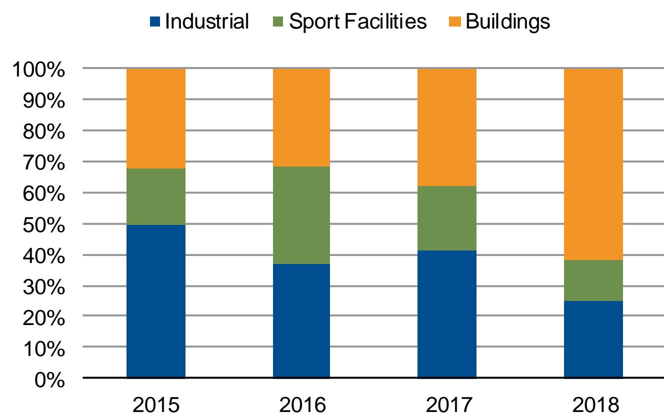
Business risk profile

Company involved in a highly cyclical sector

Market is involved in the construction of buildings, industrial facilities and sport facilities.

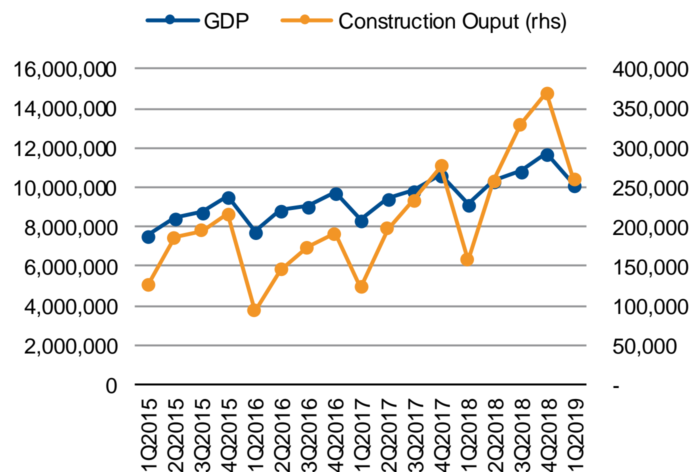
The group's building projects encompass a wide range including offices, public facilities, residential buildings and hotels. This wide range, however, does not provide the required diversification as the projects belong to the same operating sub-segment according to Scope's methodology (structures are built on a similar basis; only end-users differ). This segment's growth in recent years has been driven by high demand for offices and public facilities. Industrial projects deal with logistics centres, car-making and tyre plants and electric battery factories. The construction of sport facilities has civil engineering features that require different technical skills. These three types of operations and lack of risk mitigants (concession types provide recurring revenues) make the group highly exposed to cyclicality.

Figure 1: Revenues by types of projects Market – 2015 to 2018



Source: Market, Scope

Figure 2: Hungarian GDP vs Hungarian Construction sector – 2015 to 2018



Source: KSH, Scope

Low barriers to entry with low to medium substitution risk

In line with its strategy, the group does not bid for civil engineering projects (bridge, roads, railways) because of their complexity. Its industrial projects in terms of logistics centres are not considered complicated. Therefore, construction companies from Eastern Europe or Austria can easily participate in tenders. Nevertheless, some large-scale structures are challenging in terms of the construction method and time constraints (e.g. for the stadium and dome for the Budapest zoo). Indeed, Market has won some contracts thanks to its ability to deliver projects quickly.

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

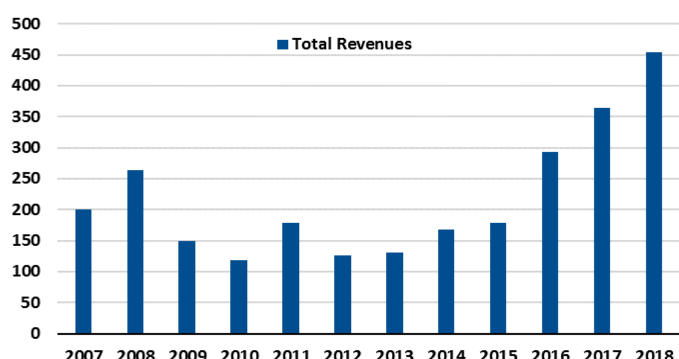
Small tier-3 European construction company…

The group is small in terms of revenues and EBITDA. This is due to its core and unique market of Hungary, whose overall output in 2017 and 2018 was limited at EUR 4.2bn and EUR 5.9bn, respectively. Nevertheless, the group ranks first domestically with an 8% market share (14% if considering only the building sub-segment). This is thanks to its strong track record and well-established position in the highly fragmented Hungarian construction sector (56,095 companies in 2016 according to the European Construction Sector Observatory). Market's strategy focuses only on Hungarian large-scale and visible projects. The group runs between 50 and 60 projects a year with the main ones accounting for up to 50% of Market's FY revenues.

…but leading position in Hungary benefiting from growing domestic market

Market is Hungary's leading construction company by far with a turnover of EUR 455m, twice that of its direct competitor, Zalai. This is the payoff of a well-rounded strategy focusing on the buildings segment. In Hungary, this sub-segment is larger than the civil engineering segment (58% vs 42%) and has also been more dynamic (+66% since 2009 vs +4% for civil engineering). Market has a strong footprint in central Hungary – the Budapest region, accounting for almost half of the construction sector – where it derives a large share of its revenues thanks to a sizeable pool of large-scale projects.

Figure 3: Total Revenues (EURm) – 2007 to 2018



Source: Market, Scope

Figure 4: Top 6 Construction companies in Hungary (by EURm revenues)

Ranking 2018	Company	2017	2018	Variation
1	Market	364	455	25%
2	Zalai Altalanos	113	226	99%
3	Strabag Altalanos	126	165	31%
4	Meszaros es Tarsa	64	159	148%
5	West Hungaria Bau	134	157	18%
6	R-Kord	118	112	-4%

Source: Market, Scope

Weak geographical diversification with no intention to expand abroad; limited diversification by segment…

Market's only regional exposure since its founding has been its domestic market of Hungary, allowing the group to take advantage of the local sector's strong growth between 2000 and 2008 (+106%, according to KSH). Due to the 2008 financial crisis combined with the mild recession in 2012, construction output in Hungary declined by 21% during that period, leading to a drop of Market's turnover (see figure 3). The company could not offset the decline due to its lack of diversification, needing eight years to regain the turnover levels during 2008. Although present in most of Hungary's regions, we view Market's footprint as very concentrated. The building segment accounts for 67% of group EBITDA while industrial sites represent 33%.

… but slight improvement expected thanks to future side businesses

We view as positive the intent to diversify into real estate and building materials, funded by two-thirds of the planned bond issuance (HUF 20bn or EUR 63m in total) under the MNB programme, even if they are implemented in-house to support Market's contracting business. One-third of the bond proceeds will finance a precast concrete plant near Budapest, with plans for completion by the end of Q1 2020 and for 50% utilisation by 2022. Concrete will serve Market's own projects and reduce its exposure to raw material prices. EBITDA contribution is expected to reach between EUR 2-2.5m or 10% of FY 2018 EBITDA. One-third of the bond proceeds will be used for real estate investment

opportunities including hotels, flats and offices in two different historical monuments in Budapest.

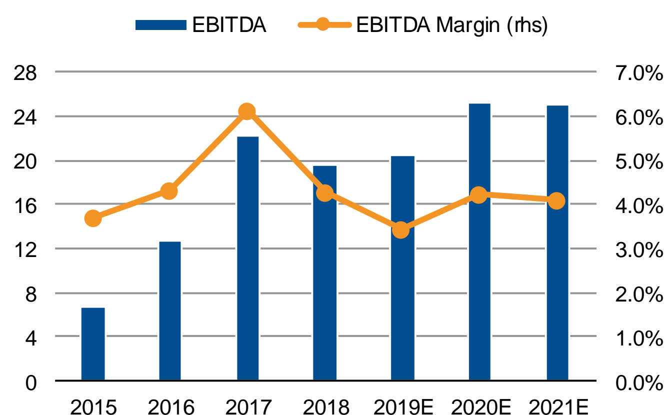
Concentrated backlog mitigated by client quality

We judge diversification of the backlog (a rough indication of future revenue diversification) to be constrained, with the top six accounting for 63% of the total backlog at YE 2018. This concentration, consistent with its strategy to focus on large-scale projects, implies an overreliance on a limited number of projects that could materially impair revenue and EBITDA in the event issues arise for one of them. The remaining backlog is composed of 17 projects with an average cost of EUR 34m. However, the credit quality of the respective clients (two-thirds of top six are investment grade credit quality) mitigates associated risks to a certain extent.

Low but stable profitability constrained by increases in raw material prices and wages

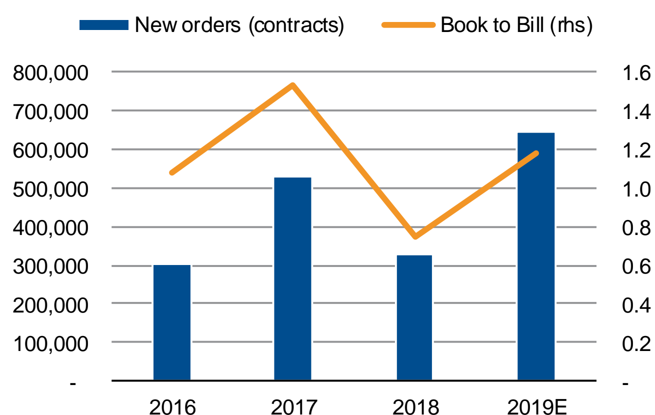
Apart from the overperformance observed in 2016, the group has maintained an EBITDA margin of between 4% and 5%, which is at the lower end of the construction industry range (5%-10%). This low operating margin arises from i) its business mix, which prioritizes large, visible projects over profitability criteria; and ii) the booming Hungarian construction sector, which has led to shortages in both raw materials and qualified staff. The lack of domestic material production (for example, concrete in the case of Market) has forced contractors to import goods, driving prices up. In addition, wage costs have increased in a bid to lure back Hungarian construction staff currently working in European countries with better pay conditions.

Figure 5: EBITDA (EURm) and EBITDA margin – 2015 to 2021E



Source: Market, Scope

Figure 6: New orders (EURm) & book-to-bill ratio – 2016 to 2019E



Source: Market, Scope

Strong visibility of revenues until 2021 with large order backlog

In our view, the current order backlog of EUR 1.8bn as at YE 2018 provides some revenue visibility for the next few years. The backlog represents 3.9x of 2018 group revenues.

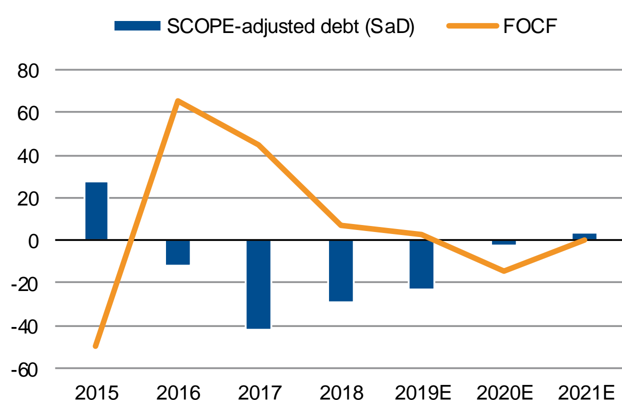
Financial risk profile

Main assumptions for our projections:

- Revenue growth for 2019, 2020 and 2021 in line with the company's projections and the backlog
- Decreasing margin in 2019 due to rising expenses for both raw materials and workers, then an improvement in subsequent years as the new concrete plant reduces the raw materials exposure
- Depreciation increasing until 2020, with EUR 40m of additional capex financed by the MNB bond
- Interest costs to increase by EUR 3m yearly, assuming a EUR 63m bond issuance with a 5% coupon

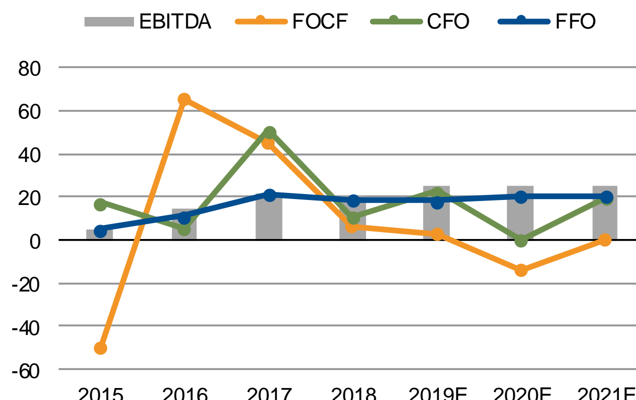
- Net capex increase by EUR 40m during 2019-21, from EUR 5m in 2018 (maintenance capex) to EUR 20m in 2019, EUR 15m in 2020 and EUR 20m in 2021
- Remaining bond proceeds to increase cash balance
- Dividend pay-out at 50% of net income (company policy sets the maximum at 75%)
- HUF 500m (EUR 2m) bolt-on acquisitions in 2019
- No change in provisions, no pensions and no operating leases
- Restricted cash relating to cash pledged as collateral for banks to issue guarantees

Figure 7: Scope-adjusted debt (SaD) and Free operating cash flows (FOCF) – 2015 to 2021E



Source: Market, Scope

Figure 8: Cash flows – 2015 to 2021E



Source: Market, Scope

Consistently positive FOCF with net cash position in 2016-18 expected to deteriorate from 2020

Operating cash flow generation has covered capex and led to a sustainable net cash position. As such, free operating cash flow (FOCF) to Scope-adjusted debt (SaD) was negative for FY 2018, with the net cash position at positive EUR 29m. We expect the same for 2019 before FOCF deteriorates from 2020 onwards. This is due to two factors. The first is an increase in working capital consumption due to tougher expected market conditions: In 2020, the company anticipates a slight slowdown in Hungary's economy driven by a decrease in EU funds, which will decrease the level of advance customer payments and will shorten supplier payment terms. The second factor is the EUR 40m development capex planned for between 2019 and 2021.

High EBITDA interest expense cover expected to remain above 7x after the bond issuance

EBITDA interest expense cover, while very volatile, has been high at above 20x during 2015-18, including positive interest income in 2016. The volatility of debt protection arises from the very low level of gross interest costs ranging from EUR -0.3m to EUR 0.2m, with an average cost of debt of 3% due to historically low gross debt levels. We anticipate debt protection to remain at 8x from 2020 onwards, due to a significant change in future debt levels from the issuance at the end of 2019 of a new EUR 63m MNB bond with a 5% fixed coupon.

No net debt at group level thanks to a conservative approach and good cash flow

Since 2016, the company's consolidated leverage, measured by SaD/EBITDA and funds from operations (FFO)/SaD, has been negative due to the consistently low level of gross debt in line with the company's conservative approach – an asset-light strategy combined with small bolt-on acquisitions – helped by recurring positive free cash flow. We forecast the company to remain debt-free on a net basis between 2019 and 2020, with adequate visibility of EBITDA. However, in view of the MNB bond issuance to fund new large investments, we expect SaD to increase to around EUR 3m at YE 2021, from EUR -3m at YE 2020, in addition to the negative impact on working capital as mentioned above.

Strong liquidity supported by headroom provided by ample unrestricted cash balance and undrawn credit facilities

We view Market's liquidity as strong. This is based on our expectation that liquidity sources will exceed their uses by about 35x-37x in the next 12 months following consistently high liquidity in the past.

Figure 9: Market: Liquidity

Liquidity (EUR Mio.)	2015	2016	2017	2018	2019E
Unrestricted cash position	16	20	49	36	93
Undrawn committed lines	26	26	26	25	25
Short-term maturities	15	8	3	3	3
Free cash flow	68	44	9	7	-14
Short-term debt coverage	**7x**	**12x**	**27x**	**25x**	**38x**

Source: Market, Scope

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