Market Építő Zrt.
Hungary, Construction

BB- STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	25.0x	29.5x	15.8x	7.6x
Scope-adjusted debt/EBITDA	1.7x	0.8x	0.7x	1.8x
Scope-adjusted funds from operations (FFO)/debt	55%	120%	123%	45%
Scope-adjusted free operating cash flow (FOCF)/debt	51%	47%	47%	-63%

Rating rationale

Market Építő Zrt’s rating is supported by its leading position in Hungarian construction, strong results in 2021 that have led to a higher-than-expected EBITDA margin, and strong credit metrics including low leverage. However, we expect the good profitability to be under pressure from impending headwinds, which include a shorter backlog, a raw material shortage and wage inflation. The rating also benefits from the conservative approach of preserving liquidity to provide a buffer against a downturn in Hungarian construction. The significant capex, including for the ramp-up of the PreBeton concrete plant and of Market’s real estate division (MAM), will help to reduce the supply-demand uncertainty in Markets construction business and provide better economies of scale along the vertically integrated business. The rating is constrained by Market’s small size, lack of geographic diversification, and concentration regarding its backlog and business segments (mainly active in buildings).

Outlook and rating-change drivers

The Outlook is Stable and incorporates our expectation of Scope-adjusted debt/EBITDA between 1-2x. We expect the company to retain its strong liquidity position. The rating Outlook is based on total capex (including organic expansion and acquisition capex) of around HUF 42bn for the period between 2022-24 and Scope-adjusted EBITDA of above HUF 21bn.

A positive rating action could occur if Market’s business risk profile improved materially through, for example, improved segment or geographic diversification while credit metrics remain in line with our expectation. However, we do not foresee such an improvement in the short to medium term.

A negative rating action could be required if investments under the business plan and in real estate projects weighed on leverage, resulting in Scope-adjusted debt/EBITDA moving towards 4x

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
26 Jul 2022	Affirmation	BB-/Stable
31 Aug 2021	Outlook change	BB-/Stable
1 Sep 2020	Outlook change	BB-/Negative

Ratings & Outlook

Issuer	BB-/Stable
Senior unsecured debt	BB-

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Related Methodologies and Related Research

Corporate Rating Methodology; July 2022

Construction and Construction Materials Rating Methodology; January 2022

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Bloomberg: RESP SCOP

Positive rating drivers	Negative rating drivers
• The leader in Hungarian construction • Low leverage combined with a conservative approach to cope with a potential downturn in the Hungarian construction market • Significant capex plan to reduce supply/demand uncertainty and diversify activities to improve integration • Good credit metrics supported by low gross debt and strong liquidity	• Small size in a European context, with a lack of geographic diversification that limits ability to offset business cycles • Concentration issues regarding backlog (top five projects account for 54% of backlog, mitigated by investment-grade counterparties) and business segment (mainly buildings) • Adequate profitability hampered by rising materials prices and wages and volatility in operating margin driven by FX effect

Positive rating-change drivers	Negative rating-change drivers
• Improved business risk profile through significant geographic expansion and development of new segments while credit metrics remain in line with our expectations	• Scope-adjusted debt/EBITDA moving towards 4x

Corporate profile

Market Építő Zrt. (Market), founded in 1996, is Hungary's leading construction company. It has exclusively domestic operations, employs about 1,000 people and generated HUF 298bn in turnover in 2021. Its headquarters are in Budapest. Market is owned by GARHART Zrt. (51%), an investment holding company wholly owned by Istvan Garancsi; and Sandor Scheer (49%), Market's CEO and founder. The company is involved in the construction of buildings, industrial facilities and sport facilities. Building projects encompass offices, public facilities, residential buildings and hotels. Growth in the construction segment over the past few years has been driven by high demand for offices and public facilities. Market's industrial projects include logistics centres, auto and tyre production plants and electric battery factories.

Financial overview

				Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	51.5x	25.0x	29.5x	15.8x	7.6x	6.7x
Scope-adjusted debt/EBITDA	0.6x	1.7x	0.8x	0.7x	1.8x	2.0x
Scope-adjusted FFO/debt	165%	55%	120%	123%	45%	39%
Scope-adjusted FOCF/debt	143%	51%	47%	47%	-63%	16%
Scope-adjusted EBITDA in HUF m						
EBITDA	9,926	22,239	41,697	30,251	27,611	23,704
Operating lease payments	0	241	329	329	329	329
Other items	10	0	0	0	0	0
Scope-adjusted EBITDA	**9,936**	**22,480**	**42,026**	**30,579**	**27,940**	**24,033**
FFO in HUF m						
Scope-adjusted EBITDA	9,936	22,480	42,026	30,579	27,940	24,033
less: (net) cash interest paid	-193	-878	-1,380	-1,868	-3,599	-3,527
less: cash tax paid per cash flow statement	-373	-811	-2,862	-2,330	-1,833	-1,392
less: interest component, operating lease	0	-22	-44	-66	-66	-66
Change in provisions	202	154	493	0	0	0
FFO	**9,572**	**20,922**	**38,233**	**26,315**	**22,442**	**19,047**
FOCF in HUF m						
FFO	9,572	20,922	38,233	26,315	22,442	19,047
Change in working capital	6,681	20,770	-13,583	1,442	-11,294	-546
less: capital expenditure (net)	-7,927	-22,071	-9,291	-17,410	-42,350	-10,564
less: operating lease payments	0	-218	-285	-263	-263	-263
FOCF	**8,326**	**19,403**	**15,074**	**10,084**	**-31,464**	**7,674**
Net cash interest paid in HUF m						
Net cash interest per cash flow statement	193	878	1,380	1,868	3,599	3,527
add: interest component, operating leases	0	22	44	66	66	66
Net cash interest paid	**193**	**900**	**1,424**	**1,934**	**3,665**	**3,593**
Scope-adjusted debt in HUF m						
Reported gross financial debt	22,805	54,321	47,635	54,931	83,559	81,942
less: cash and cash equivalents	-37,918	-74,348	-84,836	-90,915	-70,059	-59,926
add: non-accessible cash[1]	20,918	57,348	67,836	56,116	35,260	25,127
add: operating lease obligations	0	447	1,316	1,316	1,316	1,316
Scope-adjusted debt (SaD)	**5,805**	**37,768**	**31,951**	**21,448**	**50,075**	**48,458**

[1] Cash balance is high going forward but might be used to cover cash needs related to MAM (Market Asset Management) and fund additional growth (both organic and external) as the issuer declared it would be opportunistic in this regard. Thus, we calculate accessible cash of around HUF 17bn until 2021 (the same as the amount before the company tapped capital markets in 2019) and around HUF 34.8bn from 2022. The increase is based on our expectation that i) liquid funds will be more permanent than in the last year as most investments have already been made; and ii) limited opportunistic investments in the medium term due to an expected slowdown in the market for real estate development.

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Environmental, social and governance (ESG) profile[2]

Environment	Social	Governance
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)	Labour management	Management and supervision (supervisory boards and key person risk)
Efficiencies (e.g. in production)	Health and safety (e.g. staff and customers)	Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)	Clients and supply chain (geographical/product diversification)	Corporate structure (complexity)
Physical risks (e.g. business/asset vulnerability, diversification)	Regulatory and reputational risks	Stakeholder management (shareholder payouts and respect for creditor interests)

Legend

Green leaf (ESG factor: credit-positive)

Red leaf (ESG factor: credit-negative)

Grey leaf (ESG factor: credit-neutral)

ESG analysis is credit neutral

The construction industry has a massive impact on the environment. To date, efforts have largely focused on reducing energy usage and associated emissions. More recently, concerns over supply chain disruptions have left contractors scrambling to find alternative suppliers or paying higher prices for materials. There is no indication that this will improve in the near term. Furthermore, the Covid-19 pandemic heavily impacted the construction industry and construction sites via updated regulations emphasising hygiene and strict safety protocols. This has also increased union influence in projects, potentially adding extra costs and time to projects.

Generally, we believe the focus should be on the following main ESG-related risks of relevance for construction companies: i) rising costs and sustainable building materials; ii) efficient technology; iii) employee health and safety; and iv) litigation and bribery.

[2] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e. those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.

Business risk profile: B+

Industry risk profile: B

Market is involved in the construction of buildings, industrial facilities and sport facilities. The company's building projects encompass offices, public facilities, residential buildings and hotels. However, this wide range does not provide adequate diversification as the projects belong to the same operating subsegment according to our methodology (the structures are built on a similar basis; only the 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, auto and tyre production 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 a lack of risk mitigants (concession types provide recurring revenues) make the company highly exposed to cyclicality.

Despite the company's recent investment plan, which includes real estate projects, the industry risk profile remains unchanged and is only related to the construction sector. Real estate activities will generate HUF 60bn-62bn of revenues for 2021-24, a small share of Market's operations (7% of total revenues in the last four years). Market is the main contractor for all these projects, which increases its building capacity.

Low barriers to entry with low-to-medium substitution risk

In line with its strategy, the company does not bid for civil engineering projects (bridges, roads, railways). Its industrial projects in terms of logistics centres are not complicated. This means construction companies from Eastern Europe or Austria can easily participate in tenders. Nevertheless, large structures can be challenging in terms of construction methods and time constraints (e.g. for the stadium and dome of the Budapest Zoo, already completed). Market has won some contracts thanks to its ability to deliver projects quickly. Market does not only build large structures (e.g. stadium, MOL HQ – the highest building in Hungary) but also large projects, involving tens of large buildings (e.g. SKI Battery factories, BMW factory).

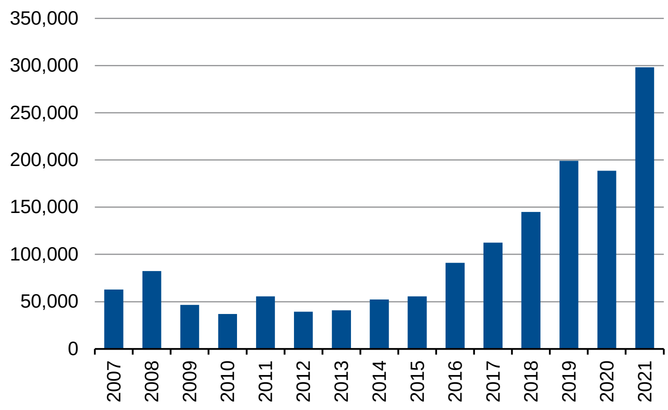
Small, tier three European construction company …

The company is small in terms of revenues and EBITDA. This is due to its core and only market of Hungary, which remains limited in terms of size. Nevertheless, the company ranks first domestically with a market share of 5% (9% considering only the building subsegment). This is thanks to its strong track record and well-established position in the highly fragmented Hungarian construction sector (26,812 companies in 2020). Market's strategy focuses only on large, visible projects. The company manages between 50 and 60 projects a year, with the main projects accounting for up to 50% of its full-year revenues.

… but a leading position in Hungary benefiting from growing domestic market

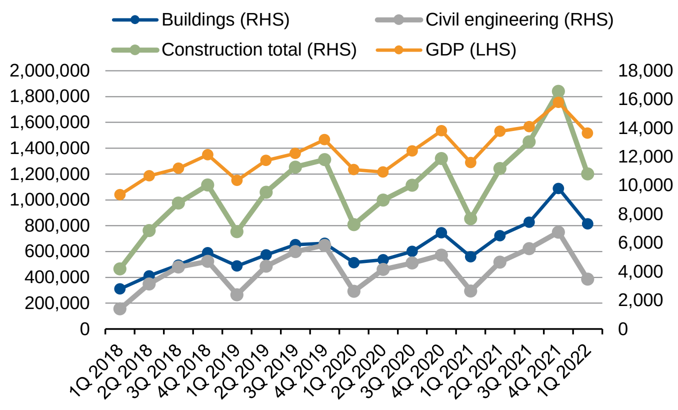
Market is Hungary's leading construction company by far with a turnover of HUF 298bn (EUR 0.7bn) in 2021, significantly more than that of its direct competitors. This building subsegment is larger than the civil engineering segment (60% vs 40%) in Hungary, and it has also been more dynamic than the latter (up 162% since 2018 vs 147% for civil engineering projects). Market has a strong footprint in Central Hungary – including the Budapest region, which accounts for almost half of the construction sector – where it derives a large share of its revenues from a sizeable pool of large projects.

Figure 1: Total revenues (HUF m) – 2007 to 2021



Sources: Market, Scope

Figure 2: Hungarian GDP (in HUF bn) vs Hungarian construction sector (in HUF bn)– 2018 to Q1 2022



Sources: Market, Scope

Weak geographic diversification with no wish to expand abroad; low segment diversification …

Hungary has been Market's only regional exposure since its founding, allowing it to take advantage of the local sector's strong growth between 2000 and 2008 (up 106% according to KSH). Due to the 2008 financial crisis and a mild recession in 2012, construction output in Hungary declined by 21% during that period, leading to a drop in Market's turnover (see Figure 1). The company could not offset this decline due to a lack of diversification, and it needed eight years to regain its 2008 turnover levels. Although Market is present in most of Hungary's regions, we view its footprint as very concentrated. The building segment accounted for 90% of company EBITDA in 2021 while industrial sites represented 10%, although these types of construction are similar.

… but slight improvement expected thanks to future side businesses

We view as positive the current process to diversify into real estate projects, six of which involve office buildings, hotels, residential buildings and a logistics centre. This large growth plan is funded by a mix of a second bond (HUF 22bn) under the Hungarian National Bank's programme and secured bank loans. These projects are implemented in house to support Market's contracting business. Nevertheless, the overall impact on the company's diversification remains limited as they account for less than 10% of Market's revenues over the construction period.

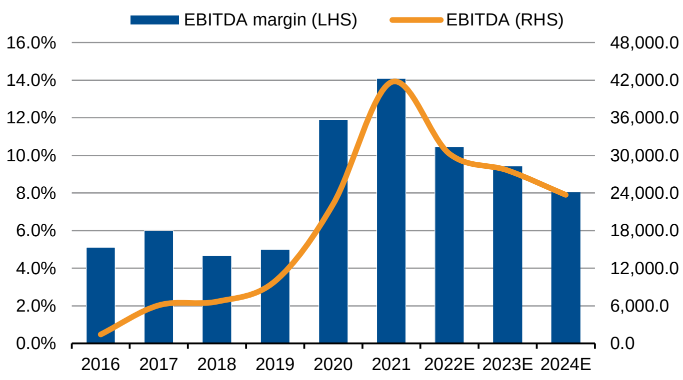
Strong but concentrated backlog mitigated by client quality

We judge diversification of the backlog (a rough indication of future revenue diversification) to be weak, with the top five orders accounting for 54% of the total backlog at YE 2021. This concentration is consistent with the company's strategy to focus on large projects but could lead to a material impairment of revenue and EBITDA. The credit quality of the respective clients (three out of five are investment-grade) mitigates associated risks to a certain extent.

Profitability improved in 2021 despite price inflation for raw materials and wages

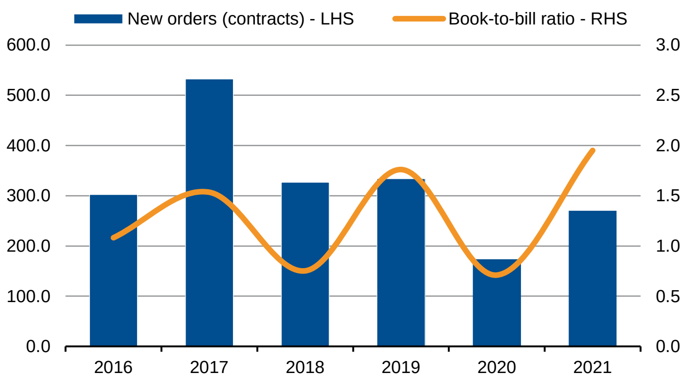
Apart from underperformance in 2016, the Scope-adjusted EBITDA margin has remained between 4% and 5%, which was at the lower end of the construction industry's range until 2019. This low operating margin was due to: i) the business mix, which prioritises large, visible projects over profitability; and ii) the booming Hungarian construction sector, which has led to shortages in raw materials and qualified staff. Although business conditions remain overheated, Market managed to lower costs in 2021 by implementing better sourcing of raw materials, renegotiating contracts with suppliers, reducing intermediaries and improving its in-house material supply with the launch of a concrete manufacturing plant. This has helped the Scope-adjusted EBITDA margin reach an all-time high of 14.1% and should help it remain stronger than pre-2020 levels of above 8%. The lack of materials production in Hungary (for example, concrete in Market's case) has forced contractors to import goods, driving prices up. Market has improved its bargaining power with subcontractors through its strategy of owning subsidiaries that perform a large array of services for it, such as earthworks, electrical fittings and engineering. However, additional headwinds coming from wage inflation, difficulties with raw materials supply (cement, for instance) and a volatile EUR/HUF exchange rate are expected to put pressure on profitability going forward.

Figure 3: Scope-adjusted EBITDA margin and Scope-adjusted EBITDA (HUF m)



Sources: Market, Scope estimates

Figure 4: Backlog (in HUF bn) and book-to-bill ratio (x)



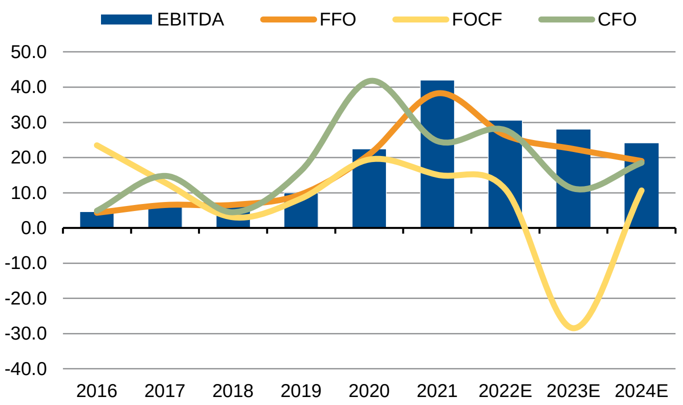
Sources: Market, Scope

Adequate visibility of revenues until 2023 with correct order backlog

We consider the order backlog of HUF 447bn as at YE 2021 to provide some revenue visibility for the next few years. The backlog represents 1.5x of 2021 company revenues.

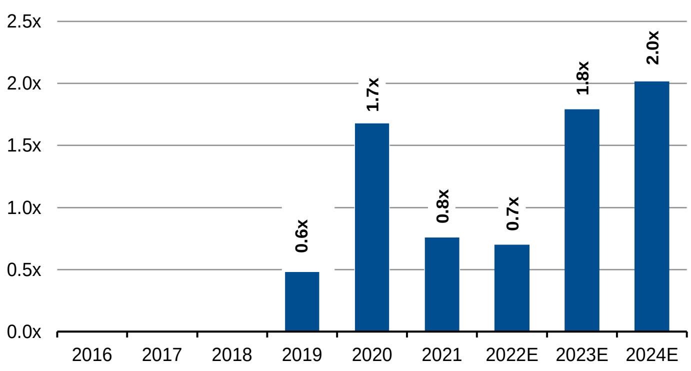
Financial risk profile: BBB+

Figure 5: Cash flows (HUF bn)



Sources: Market, Scope estimates

Figure 6: Scope-adjusted debt/EBITDA



Sources: Market, Scope estimates

Reduced debt protection going forward but sufficient to serve interest payments

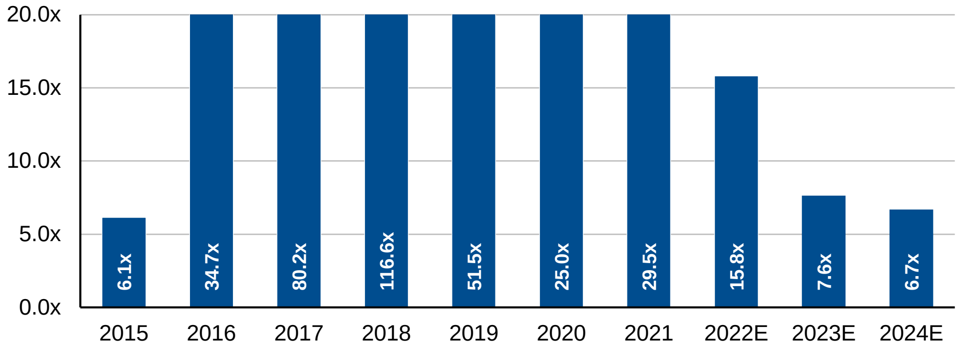
Scope-adjusted EBITDA/interest expense coverage, while very volatile, has been high at above 20x during 2015-21. The volatility of debt protection arises from a very low level of gross interest costs, with an average cost of debt of 3% and historically low gross debt levels. We anticipate debt protection to drop below 10x from 2023 onwards due to a significant change in future debt levels from the increase in bank loans to fund MAM's project, which we expect will reach HUF 39bn in bank loans in 2023 (vs HUF 2.6bn in 2021). The main part of these bank loans will be denominated in EUR.

This will impair debt protection, pushing it down to a forecasted level of around 7x going forward. However, these new levels are seen to be sufficient to enable the company to serve interest payments. They even provide some headroom to cover potential volatility in cash flow driven by the HUF/EUR exchange rate.

Risk posed by negative Scope-adjusted FOCF mitigated by low net debt

FOCF has been very volatile historically. This has been driven by working capital swings and a gradual increase in capex. The positive impact from working capital nearly covered capex in 2019 and 2020. FOCF is likely to be negative in 2023, driven by high capex (mainly for the BEM palace and a logistics centre). These projects are aimed at maximising Market's capacity as a contractor. Working capital is expected to remain volatile in the coming years driven by the change of supply contracts' terms and raw materials inflation. This will contribute negatively to operating cash flow in 2023 despite revenues levelling off. Indeed, sales in 2022 and 2023 are expected to be in line with 2021.

Figure 7: Scope-adjusted EBITDA/interest cover



Sources: Market, Scope estimates

Slight increase in leverage caused by strong growth of own development projects

Since 2016, consolidated leverage metrics, as measured by Scope-adjusted debt/EBITDA and Scope-adjusted FFO/debt, have been negative due to a consistently net cash position. This is in line with the company's conservative approach – an asset-light strategy combined with small bolt-on acquisitions – helped by positive recurring free cash flow. This strategy has slightly changed with its development of real estate. The company became leveraged on a net basis in 2019. Leverage is expected to increase to 2.0x on the medium term due the continuous decrease in EBITDA, combined with large investments estimated at around HUF 42bn for the 2022-24 period.

Scope-adjusted debt/EBITDA is expected to level off at around 1x in 2022, which is manageable. This is mainly driven by positive FOCF covering discretionary spending (mostly dividends), reducing the impact from the lower EBITDA anticipated for 2022. Since Market remains opportunistic regarding its real estate projects and could take on more projects in the near future, we believe most of its cash balance will be spent in 2022-24, and we have adjusted this part as restricted cash. However, we expect liquid funds to be more permanent than in the last year as most investments have already been made. We also expect limited opportunistic investments in the medium term due to an expected slowdown in the market for real estate development.

Adequate liquidity supported by headroom from unrestricted cash and undrawn credit

We view Market's liquidity as adequate. This is based on our expectation that liquidity sources will exceed uses more than 100% in the next 12 months following consistently high liquidity in the past.

Balance in HUF m	2022E	2023E	2024E
Unrestricted cash (t-1)	17,000	34,800	34,800
Open committed credit lines (t-1)	7,225	4,700	4,700
FOCF	10,084	-31,464	7,674
Short-term debt (t-1)	594	214	1,403
Coverage	**>200%**	**>200%**	**>200%**

Long-term debt ratings

Senior unsecured debt rating: BB-

Market issued HUF 42bn in bonds under the Hungarian National Bank's Funding for Growth Scheme.

Our recovery analysis is based on the enterprise value calculated as a going concern. We estimate the recovery for all senior secured debt to be average, justifying a debt class rating equal to that of the issuer (BB-).

Appendix: Peer comparison

	Market Építő Zrt.	Duna Aszfalt Kft.	Masterplast Nyrt.	Metál Hungária Holding Zrt.	Bayer Construct Zrt.
	BB-/Stable	BB-/Positive	BB-/Stable	B+/Positive	B+/Stable
Last reporting date	31 Dec 2021	31 Dec 2020	31 Dec 2021	31 Dec 2020	31 Dec 2020
Business risk profile					
Scope-adjusted EBITDA (EUR m)	105	150	23	10	20
Backlog	1.5x	2.0x	n/a	1.2x	1.5x
Scope-adjusted EBITDA margin	14%	22%	12%	9%	19%
Financial risk profile					
Scope-adjusted EBITDA/interest cover	29.5x	67.9x	20.7x	27.6x	8.7x
Scope-adjusted debt/EBITDA	0.8x	0.8x	2.5x	3.2x	6.2x
Scope-adjusted FFO/debt	120%	110%	37%	27%	14%
Scope-adjusted FOCF/debt	47%	Negative FOCF	Negative FOCF	31%	Negative FOCF

Sources: Public information, Scope

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