DVM Group Kft.
Hungary, Construction

SCOPE B STABLE

Corporate profile

DVM Group Kft. (DVM), headquartered in Budapest, is a general construction provider and leading design-and-build service provider in Hungary. Main services include base building and fit-out construction, site supervision, organisation, and coordination of subcontractors. In December 2020, D.V.M. Construction Kft., DVM Fővállalkozás Kft. and DVM Design Kft. merged to form DVM Group Kft. DVM has nearly 140 employees.

Key metrics

			Scope estimates	
Scope credit ratios	2020	2021P	2022E	2023E
Scope-adjusted EBITDA/interest cover	11.8x	7.7x	5.6x	4.8x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	5.4x	4.3x	6.0x	5.9x
Scope-adjusted funds from operations/SaD	16%	22%	14%	13%
Scope-adjusted free operating cash flow/SaD	-84%	6%	1%	8%

Rating rationale

Scope affirms B rating of DVM Group Kft., with Stable Outlook.

The rating affirmation reflects a recovery in profitability margins in 2021 despite sharp material cost inflation, but also weaker-than-expected earnings in the same year. The pandemic has led to project delays and changes in end-user demand, while some contracted work has been put on hold, resulting in revenue declines. 2021 revenues declined 12% YoY based on preliminary figures. Profitability, measured by the Scope-adjusted EBITDA margin, recovered to around 7.9% in 2021. We expect rising prices for raw materials will put pressure on profitability. This will be partially mitigated by the company's strategy to negotiate new contract conditions and avoiding bearing all risks for material and subcontractor fees. Whilst this strategy should somewhat hedge the company against material cost inflation, it also implies a longer negotiating period before signing new contracts and could result in a weaker backlog of projects.

DVM's business risk profile continues to benefit from its good vertical integration. This includes a wide range of services in the different stages of the construction value chain (design, project management, contracting, base building, and fit-out services). The rating remains constrained by the company's small scale in both a European and Hungarian context. Weak diversification is a further constraint, namely: i) a lack of geographical diversification; ii) a high reliance on one segment (building activities); iii) a strong reliance on certain key customers; and iv) a concentrated backlog.

The financial risk profile reflects robust debt protection, as indicated by a Scope-adjusted interest cover ratio of 7.7x and a SaD/Scope-adjusted EBITDA ratio of 4.3x as at December 2021 (based on preliminary financials). These metrics are in line with the rating category. Free operating cash flow (FOCF) has been volatile in the last few years, driven primarily by the company's investment activities, although it turned slightly positive in 2021.

We foresee leverage as measured by SaD/Scope-adjusted EBITDA to slightly increase from 2022 on due to: i) weaker-than-expected cash flow generation; and ii) the increase in leverage to partially finance the logistic facilities (HUF 1.7bn in 2023) before stabilising at a level commensurate with the rating category once developments are complete and provide a boost to the top line.

Ratings & Outlook

Corporate rating	B/Stable
Senior unsecured debt rating	B+

Analyst

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Related Methodologies

Corporate Rating Methodology: July 2021

Construction and Construction Materials Rating Methodology January 2022

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We anticipate debt protection to decline in the coming years due to higher balance sheet leverage. However, Scope-adjusted EBITDA interest cover is forecast to remain above 5.0x on average in the next few years.

Outlook and rating-change drivers

The Outlook remains Stable for DVM and incorporates our view that the company will continue to generate positive operating cash flows based on its current backlog. It also reflects our expectations of a successful execution of current co-development projects as well as the SaD/Scope-adjusted EBITDA ratio remaining below 6x and Scope-adjusted interest cover remaining around 5x. While we believe that credit metrics will remain consistent with the rating category, the company's small size and low diversification significantly threaten cash flow stability. And so we expect a tangible improvement in cash flow diversification going forward, which could be driven by a higher share of EBITDA from the more granular fit-out business. We also highlight the potential for further cost inflation paired with a weaker economic outlook and greater uncertainty across Europe as a result of the military conflict in Ukraine.

A positive rating action could occur if our rating scenario materialised, including maintenance of a backlog-to-sales ratio above 2.5x combined with greater diversification (customers and projects) while improving the SaD/Scope-adjusted EBITDA ratio to below 4x on a sustained basis.

A negative rating action could occur if SaD/Scope-adjusted EBITDA increased to above 6x on a sustained basis or liquidity worsened due to, for example, delayed payments by customers, or delays or cost overruns in projects in the current pipeline.

Rating drivers

Positive rating drivers	Negative rating drivers
• Market position benefiting from an integrated business, offering a turnkey solution that translates into a time- and cost-efficient model • Strong debt protection that stood at 7.7x in FY 2021 • Positive but low level of Scope-adjusted FOCF, supported by expected positive Scope-adjusted funds from operations, which cover investments planned for the next few years, and because the company will not pay dividends before 2023	• Small-scale construction company in the European context, with a lack of geographic diversification exposing it to its domestic construction industry, leaving cash flows vulnerable to an expected cooldown • Improved backlog-to-sales ratio (2.8x as of April 2022) but still concentrated in a limited number of projects (top three projects account for 68% of backlog revenues; top 10 account for 99%), partially mitigated by long-standing relations with main clients

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Backlog-to-sales ratio of above 2.5x on a sustained basis combined with higher diversification (customers and projects) while improving SaD/Scope-adjusted EBITDA to below 4x on a sustained basis	• SaD/Scope-adjusted EBITDA increased above 6x on a sustained basis • Worsening liquidity due, for example, to delayed customer payments or cost overruns in projects in the current pipeline

Financial overview

			Scope estimates	
Scope credit ratios	**2020**	**2021P**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover[1]	11.8x	7.7x	5.6x	4.8x
SaD/Scope-adjusted EBITDA	5.4x	4.3x	6.0x	5.9x
Scope-adjusted funds from operations/SaD	16%	22%	14%	13%
Scope-adjusted FOCF/SaD	-84%	6%	1%	8%
Scope-adjusted EBITDA in HUF m				
EBITDA	1,592.4	1,911.2	1,351.5	1,662.9
less: disposal gains from fixed assets included in EBITDA	0.0	0.0	0.0	0.0
Others	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	1,592.4	1,911.2	1,351.5	1,662.9
Scope-adjusted funds from operations in HUF m				
Scope-adjusted EBITDA	1,592.4	1,911.2	1,351.5	1,662.9
less: cash interest as per cash flow statement	-72.2	7.7	-136.3	-263.4
less: interest component operating leases	0.0	0.0	0.0	0.0
less: cash tax paid as per cash flow statement	-154.5	-136.8	-73.9	-100.8
less: capitalised interest	0.0	0.0	0.0	0.0
Scope-adjusted funds from operations	1,365.6	1,782.2	1,141.3	1,298.8
SaD in HUF m				
Interest-bearing debt[2]	8,614.2	8,123.2	8,121.2	9,834.2
Other liabilities	0.0	0.0	0.0	0.0
SaD	**8,614.2**	**8,123.2**	**8,121.2**	**9,834.2**
Cash balance in HUF m				
Cash and equivalents[3]	2,729.9	4,802.3	6,666.6	6,686.6

[1] Considers only interest expenses
[2] Includes leasing.
[3] Netting of cash: generally, only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible.

Business risk profile: B-

Industry risk: B

DVM is mainly focused on design, base building and fit-out but it also works in building refurbishment. Although they are in different stages, all businesses are directly linked to the construction industry. The company's portfolio includes various commercial real estate segments, especially office, retail, hotel and some residential and logistic projects.

We consider the construction industry to be highly cyclical overall, with medium barriers to entry and low/medium substitution risk.

Small market player, both in the European context and domestically

DVM had a slowdown in 2021 after strong performance and peak revenue growth in 2020. According to preliminary figures for 2021, it generated revenues of HUF 24.2bn and Scope-adjusted EBITDA of HUF 1.9bn (excluding provisions of about HUF 346m). Revenues declined by 12% compared to the 2020 level (22% compared to our rating case), though Scope-adjusted EBITDA increased by 20%. The pandemic has led to project delays and changes in end-user demand, and some contracted work has been put on hold, resulting in revenue declines.

Nonetheless, we believe DVM's revenue generation will be protected in the next few years by its strong project backlog of HUF 68.4bn as of April 2022 and a higher expected contribution from fit-out activities. Additional support for our expectations comes from planned co-developments, including i) a 6,000 sq m office refurbishment; and ii) an 18,000 sq m logistic facility, which should benefit from robust tenant demand for this type of premises. Despite this, we expect DVM to remain a small construction company both in a European context and in Hungary, which has a highly fragmented market. Small size is a negative rating driver as it limits the company's ability to benefit from economies of scale and diversification to offset the impact of economic cycles, as evidenced in 2021.

Market position benefits from one-stop-shop model offering both time- and cost-efficiency

The company's business model continues to benefit from a vertically integrated service chain that has continued to develop over the years. DVM's 'one-stop shop' business model offers clients a turnkey solution in which design and implementation run in parallel, generating efficiencies in terms of both the cost and duration of projects. Further, its market position is supported by a good domestic network including long-standing relationships with national and international customers. We believe both factors will support DVM's business going forward.

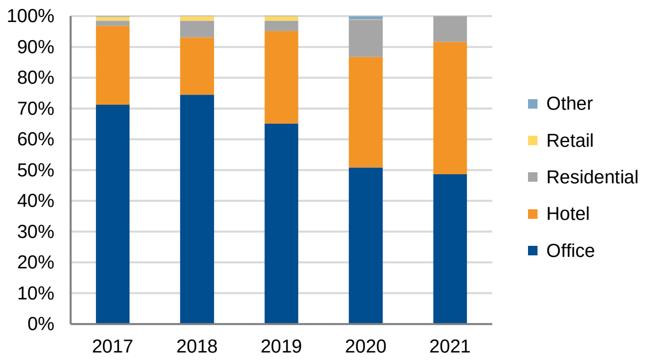
Limited diversification – geography, segment and customers

Geographical diversification remains limited. Whilst some of DVM's business lines enable it to offer services in international markets – for example through ArchViz – the company's activities are concentrated on its domestic market. This results in full exposure to the macroeconomy of one market, compounded by the company's focus on construction, a cyclical industry in which market downturns tend to affect revenues and earnings.

All activities relate to just one sub-segment in one industry (building construction) but they serve different end markets, especially office, hospitality and residential, so they benefit from different underlying demand patterns. This has partially mitigated the impact of the pandemic, which led to delays in some contracted work, particularly in hospitality and office-related fit-out projects that were put on hold.

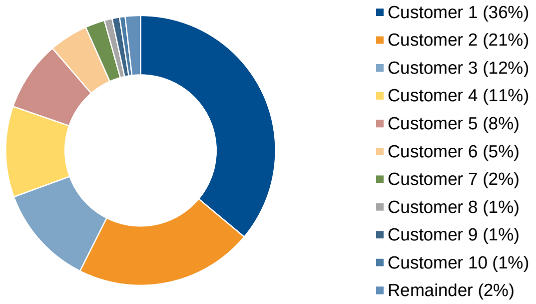
DVM's limited size results in high customer concentration as only a few projects can be executed simultaneously (20 in 2021). This means both profitability and cash flow from operations can be greatly affected by the failure of one project. This lack of diversification is partially mitigated by strong relationships with local and international clients. While no long-term contracts are in place, these partnerships have provided DVM with recurring mandates.

Figure 1: Revenue breakdown by type of project



Sources: DVM, Scope

Figure 2: Revenue breakdown by customer (%)



Sources: DVM, Scope

Strong backlog, but still concentrated on a limited number of projects

While DVM's backlog has been strong in the last few years (HUF 68.4bn as at April 2022, HUF 75bn as at YE 2020) it is still concentrated, with the top three projects accounting for 68% of future contracted revenues. This concentration bears the risk of significant cash flow volatility if projects are delayed or cancelled. Limited backlog diversification also exposes the company to slowdowns in certain segments. Hotel projects, for example, represent 31% of the company's backlog, and hospitality has been one of the segments hit hardest by the pandemic.

To partially mitigate this risk, DVM has started some co-development projects, with a total cost of about HUF 10bn. As part of this plan, the company has set up a joint venture with MV Development Limited for an office refurbishment project (with a HUF 6.4bn loan to acquire the headquarters of Henkel Hungary). In addition, DVM has acquired a plot to develop a logistic building for a total cost of HUF 3.4bn.

Profitability improved slightly in 2021

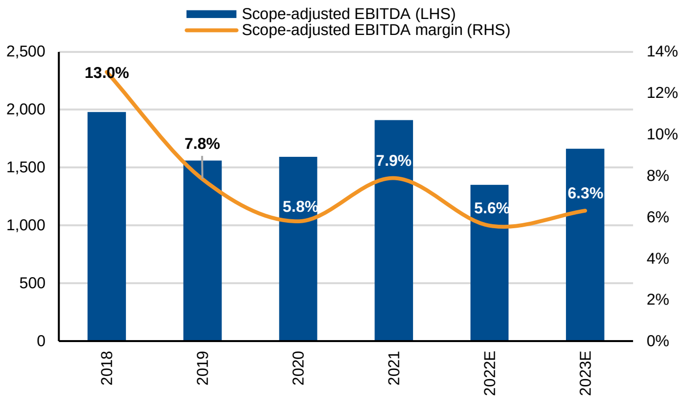
Profitability, as measured by the Scope-adjusted EBITDA margin, recovered to 7.9% in FY 2021 from 5.8% in FY 2020, supported by higher demand for complex high-margin projects, even in the base-building segment. Rising prices for raw materials are expected to put some pressure on profitability. This will be partially mitigated by the company's strategy to: i) conduct frequent project budget reviews; ii) appoint subcontractors and construction material providers at engagement letter signing; and iii) sign construction projects under a fixed general contractor fee instead of contracting for overall projects (thus avoiding bearing all risks for material and subcontractor fees).

Our forecast assumes that DVM will keep its profit margin around 6% over the next 12-18 months. The company will manage to offset rising costs through updated contract terms, although it does face some risk from projects signed before the pandemic (17% of current backlog).

Backlog provides some visibility on future cash flows

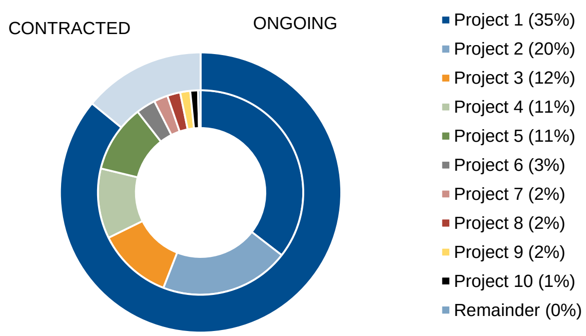
The strong backlog (HUF 68.4bn as of April 2022) results in a backlog-to-sales ratio of 2.8x (2.7x in 2020). This provides some cash flow visibility on revenues in the next few years. However, limited diversification exposes the company to significant cash flow volatility risk should any projects be delayed or cancelled.

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



Sources: DVM, Scope estimates

Figure 4: Backlog breakdown by project as at Q2 2022



Sources: DVM, Scope estimates

Financial risk profile: B+

Adequate debt protection metrics despite expected debt increase

DVM previously had little financial debt and its interest expenses were low before 2020. This changed with the bond issuance in 2020 (3% coupon). However, debt protection, as measured by the Scope-adjusted EBITDA interest coverage ratio, remained strong and stood at 7.7x in FY 2021, based on preliminary figures. We do not expect a significant rise in financial debt in the next few years, except for the additional loan to finance logistic development in 2023 (about HUF 1.7bn). Further, the company expects to benefit from financial interest income resulting from the remaining loans it provided as part of the joint venture agreement for the Henkel development. This should help keep its Scope-adjusted EBITDA interest coverage at adequate levels of around 5x during the next few years. Given this adequate coverage ratio, we believe the company will be able to meet interest payment obligations in the next two years even with the increase in indebtedness.

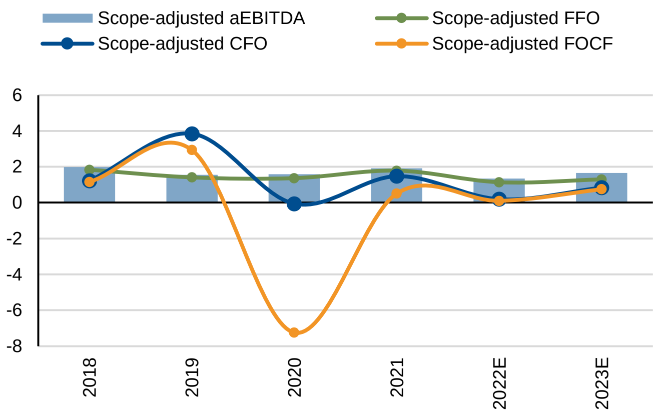
Stable but relatively low FOCF

We expect stable and positive funds from operations in the next few years. This is based on DVM's backlog and our expectation that the company will be able to maintain turnover at average historical levels. The company will finance part of its planned projects by using current available funds of around HUF 4.8bn as of December 2021, including cash available and short-term investments.

Growth strategy comes at the expense of higher leverage

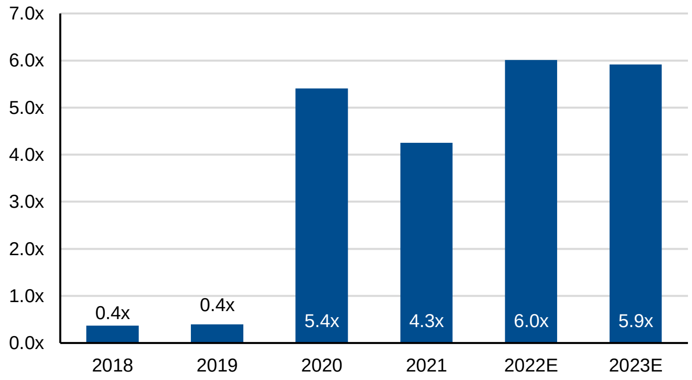
DVM's debt strategy has typically been conservative as evidenced by its very low levels of debt until 2019. In 2020, the company issued a HUF 8bn senior unsecured bond under the central bank's Bond Funding for Growth Scheme to partially finance its significant capex programme. The company has financed the present co-developments using bond proceeds. We expect bank financing to be involved in the development of the logistic building, but not before 2023.

Figure 5: Cash flows (HUF bn)



Sources: DVM, Scope estimates

Figure 6: Leverage (SaD/Scope-adjusted EBITDA)



Sources: DVM, Scope estimates

Adequate liquidity

DVM's liquidity is adequate. It benefits from cash and cash equivalents of HUF 4.8bn as at December 2021 and a backloaded debt maturity profile comprising a HUF 8bn bond maturing in 2030 with a first instalment (HUF 2.4bn) due in 2026 and no significant amounts due in the next few years. We expect the company's low short-term debt levels to remain stable going forward and be sufficiently covered by available financing sources.

Figure 1: Liquidity

in HUF m	2021P	2022E
Short-term debt (t-1)	0	52
Unrestricted cash (t-1)[4]	2,730	4,802
Open committed credit lines (t-1)	0	0
FOCF (t)[5]	508	103
Coverage	No short-term debt	94.3x

Source: Scope estimates

Supplementary rating drivers: +/- 0 notches

ESG profile: neutral

The construction industry has a massive environmental impact. Industry efforts have focused on reducing energy use and associated emissions. However, the recent disruption in supply chains has forced contractors to quickly find alternative suppliers or pay higher materials prices, a situation that is unlikely to alleviate in the near term. New Covid-related regulations regarding cleanliness and safety have also drastically affected operations at construction sites. Increased union influence could also lead to increased costs and timelines on projects.

The following ESG risks are the most relevant for construction companies: i) rising costs and sustainable building materials; ii) efficient technologies; iii) employee health and safety; and iv) litigation and bribery.

Long-term debt rating

Senior unsecured debt: B+

DVM issued a HUF 8bn senior unsecured bond (ISIN HU0000359781) in 2020 under the Hungarian National Bank's Bond Funding for Growth Scheme. The bond has a 3% coupon and a 10-year tenor.

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[4] Includes marketable securities.
[5] We exclude discretionary expansion capex from our liquidity calculation as such investments are only made if external financing is available.

Our recovery analysis is based on a hypothetical default scenario in 2023, which assumes outstanding senior unsecured debt of HUF 8bn and additional bank loan of HUF 1.7bn to partially finance DVM's co-development projects. We expect an 'above average recovery' for the company's unsecured debt. Therefore, we affirm the B+ rating for this debt category (one notch above the issuer rating).

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