Metál Hungária Holding Zrt.
Hungary, Construction

SCOPE B+ STABLE

Corporate profile

Founded in 1996, Metál Hungária Holding Zrt. (MHH) is a construction firm focused solely on the niche market for roofing and cladding including some activities to design, manufacturing, assembly, and supply of steelworks for its own construction sites. According to the company, MHH is an independent market leader in Hungary for façade cladding and roof covering. As such, it has been involved in all the country's major industrial, logistic, commercial, and recreation development projects in recent years.

Key metrics

		Scope estimates		
Scope credit ratios	**2018**	**2019F**	**2020E**	**2021E**
Scope-adjusted EBITDA/interest cover (x)	14.1x	23.5x	12.6x	4.4x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	1.9x	1.0x	1.9x	3.9x
Scope-adjusted funds from operations (SaFFO)/SaD	44%	88%	43%	19%
Scope-adjusted free operating cash flow (SaFOCF)/SaD	40%	13%	41%	41%

Rating rationale

Scope Ratings has today assigned a first-time issuer rating of B+/Stable to Metal Hungaria Holding Zrt.

The rating for MHH is driven by the company's leading position in Hungary as a contractor in façade cladding and roof covering, a construction subsegment we judge to benefit from medium barriers to entry. Furthermore, the issuer benefits from long-standing relations with its main clients. Both should help to protect the company's market position in the medium term. In addition, MHH's adequate customer diversification limits the impact of a single customer's default or inadequate payment behaviour.

The rating is mainly constrained by the company's sole exposure to Hungarian construction, leaving cash flows vulnerable to the expected cooldown in the domestic industry. We also view negatively the limited track record in converting its leading market position into an elevated, stable profitability, despite the anticipated improvement for 2019. A major negative rating driver is the limited cash flow visibility from the below-par backlog, caused by the short project durations typical in the segment. This is forecasted to burden credit metrics, compounded by the anticipated increased indebtedness this year via a capex programme financed with debt.

Outlook and rating-change drivers

The Outlook is Stable and reflects our view that credit metrics will deteriorate following the debt-financed capex programme, although EBITDA interest cover will remain strong at above 4x, as will Scope-adjusted debt to Scope-adjusted EBITDA (SaD/SaEBITDA) at 3-4x. Furthermore, we assume that dividend and dividend-like payouts to entities owned by MHH's shareholders do not exceed HUF 2bn annually. The Outlook also incorporates the successful issuance of the HUF 8bn (EUR 24m) bond under MNB Bond Funding for Growth Scheme, leading to improved liquidity, with bond proceeds also used to replace short-term debt.

Ratings & Outlook

Corporate ratings	B+/Stable
Senior unsecured rating	B+

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Related Methodologies

Corporate Rating Methodology

Rating Methodology European Construction Corporates

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A positive rating action is seen to be remote but may be warranted if the company's business risk profile improves significantly through e.g. a larger market outreach and higher diversification, while keeping leverage as measured by SaD/SaEBITDA below 2.5x on a sustained basis.

A negative rating action could occur if SaD/SaEBITDA increases to above 5.0x on a sustained basis or if liquidity were to worsen. An increase in leverage could be triggered by either i) an adverse operational development leading to reduced profitability and cash flows; or ii) higher dividend and dividend-like payouts in excess of HUF 2bn annually. Liquidity could worsen if, for example, i) customers delay payments significantly; or ii) the company becomes exposed to the non-recoverable cost overruns of its projects.

Rating drivers

Positive rating drivers	Negative rating drivers
• Market leader in its niche segment, with position protected for the medium term through medium entry barriers for speciality construction (façade cladding and roof covering) and its longstanding relations with clients • Adequate customer diversification limiting the impact of a single customer's default or inadequate payment behavior • Sufficient debt protection despite anticipated increase in indebtedness • Relatively low fixed costs, supporting positive free operating cash flow throughout the construction cycle	• Small construction company, but market leader in its niche segment • Exposed to domestic construction industry, leaving cash flows vulnerable to the expected cooldown • Weak segment diversification as all activities serve the same domestic end-markets • Volatile and relatively low profitability also likely to have peaked in 2019 • Below-par backlog with short project durations (typical for the segment) limiting cash flow visibility • Increase in leverage with low visibility if debt-financed expansion capex keeps cash flows at current level

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Improved business risk profile, while keeping SaD/SaEBITDA below 2.5x	• SaD/SaEBITDA of above 5x • Worsened liquidity

Financial overview

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019F**	**2020E**	**2021E**
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Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	1.9x	1.9x	1.0x	1.9x	3.9x
Scope-adjusted funds from operations (SaFFO)/SaD	41%	44%	88%	43%	19%
Scope-adjusted free operating cash flow (SaFOCF)/SaD	55%	40%	13%	41%	41%
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019F**	**2020E**	**2021E**
EBITDA	1,325	1,772	4,669	4,011	1,491
Operating lease payments in respective year	235	300	418	418	355
Other	0	0	0	0	0
Scope-adjusted EBITDA	**1,560**	**2,072**	**5,087**	**4,429**	**1,846**
Scope-adjusted funds from operations in HUF m	**2018**	**2018**	**2019F**	**2020E**	**2021E**
Scope-adjusted EBITDA	1,560	2,072	5,087	4,429	1,846
less: cash interest as per cash flow statement	(47)	(41)	(68)	(203)	(296)
less: interest component, operating leases	(84)	(106)	(149)	(149)	(26)
less: cash tax paid as per cash flow statement	(173)	(197)	(390)	(405)	(88)
Scope-adjusted funds from operations	**1,257**	**1,728**	**4,480**	**3,673**	**1,336**
Scope-adjusted debt in HUF m	**2018**	**2018**	**2019F**	**2020E**	**2021E**
Reported gross financial debt	2,463	2,937	2,481	10,771	10,421
less: cash and cash equivalents (accessible)	(1,102)	(1,098)	(336)	(5,165)	(5,775)
add: operating lease obligations	1,672	2,129	2,970	2,970	2,522
Scope-adjusted debt	**3,033**	**3,968**	**5,115**	**8,575**	**7,167**

Business risk profile: B

Industry risk: BB

While the construction industry is often associated with cyclical features when compared to industries with inelastic demand patterns, these cycles vary depending on the individual business model. We incorporate exposures to economic trends that affect the downside volatility of cash flows. Downside volatility can arise from either i) volume risks from a high exposure to buildings, industrial construction and public/government customers; or ii) risks from price fluctuations on materials, labour and energy. We view the overall construction industry's cyclicality to be high. However, a large share of concession-related and service business can lower a company's exposure to cyclicality, thus reducing industry risk.

Cyclicality: high

Market entry barriers: low

The construction sector has low market entry barriers as initial investments are low and proprietary technologies are not needed to enter local markets. This applies in particular to the building segment. However, MHH predominately acts as a contractor specialised in roofing and façade cladding as well as speciality low-weight construction (cleanrooms). These areas require specialist knowledge in both engineering and manual labour. Thus, we judge market entry barriers for this subsegment to be medium.

Substitution risk: low

Substitution risk is low as it is unlikely that any technology will replace the fundamental role played by construction companies in addressing the need for new commercial and residential buildings as well as in heavy and civil engineering (the construction of railway tracks, bridges, highways, tunnels, airports and other functional capital-intensive ventures). Such construction work will be fueled by population growth, globalisation and urbanisation worldwide.

Figure 1: 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

Industry outlook: stable

The European construction sector's credit outlook is stable. The strong order backlog coupled with enduring capacity constraints, mostly related to labour, will outweigh the impact of cooling demand for new projects (Construction Outlook 2020)

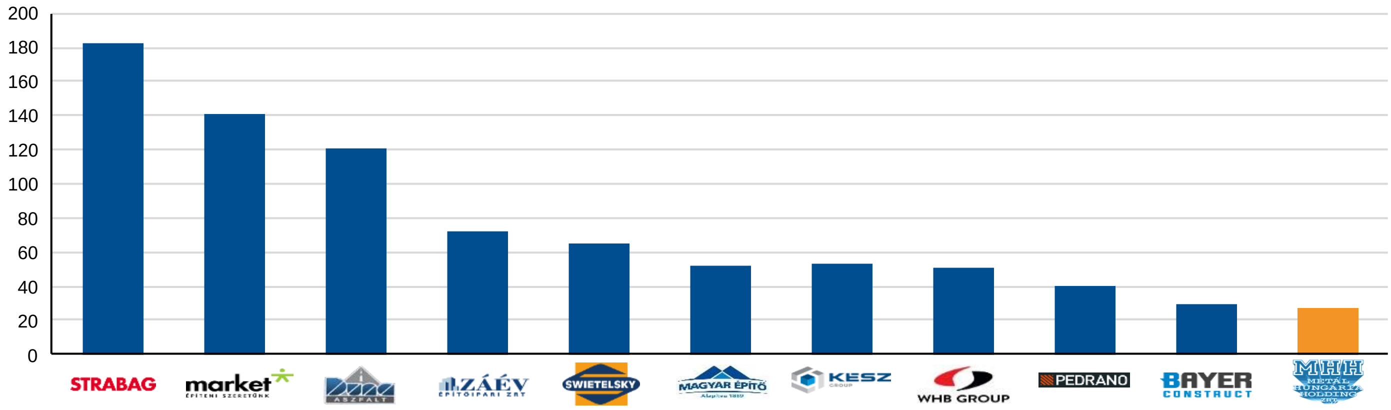
MHH is a small construction firm in a European context. Its small size leads to more volatile cash flows and limited economies of scale. However, MHH is a top 10 contractor in Hungary's overall fragmented construction industry, with revenues of HUF 33.5bn (EUR 103m) and a SaEBITDA of HUF 5.1bn (EUR 16m), both forecasted for 2019, equating to a 1% market share.

According to the company, MHH is Hungary's market leader in the niche segment of façade cladding and roof covering. Thus, MHH has been involved in all the major industrial, logistic, commercial, and recreation development projects in recent years in Hungary.

Small construction company, but market leader in its niche of façade cladding and roof covering

Revenues for 2019 are estimated to have jumped strongly by 42% YoY, driven by MHH's access to large scale-projects such as a battery factory (SK Innovation). We anticipate output to increase between 2019 and 2020, based on the order backlog of HUF 12bn as at YE 2019 and our assumption that the issuer will benefit from its market position. Thus, we believe MHH will secure some of the 20 projects currently up for tender, whose combined construction volume is HUF 101bn spread across 2020-22. However, revenue is forecast to stabilise in 2021, at slightly above 2016-18 levels, driven by the normalisation of Hungary's construction sector after years of unsustainable growth as well as the muted capital expenditure anticipated among MHH's main customers for the next few years. Nonetheless, MHH should be able to defend its market position in the short to medium term, benefitting from its long-standing relations with main clients such as Audi or Mercedes Benz.

Figure 2: MHH and peers (total revenues in 2018 in HUF bn)



Sources: EMIS, Scope

Exposed to domestic construction industry, leaving cash flows vulnerable to the expected cooldown

Geographical diversification is weak, as MHH generates almost all of its revenue in the Hungarian construction industry, compounded by the fact that construction is a cyclical industry in which revenues and earnings tend to come under pressure in a downturn.

We consider growth in the Hungarian construction market to be unsustainable. The expansion of the contract portfolio stopped at the end of 2018 and has been decreasing since March 2019. According to Danube Capital, this is a sign of an overheated market at its peak, with the other signs being i) price growth exceeding inflation; ii) high capacity utilisation and labour shortages; iii) the significant delays in projects, averaging half a year; and iv) the decline in sector confidence since 2019. As such, we expect MHH's sole exposure to Hungary – with only marginal project related side businesses – to lead to declining revenues going forward, but at a slightly elevated level compared to during 2016-18.

Weak segment diversification as all activities serve the same domestic end-markets

The company's segment diversification is weak as well. MHH focuses on the construction and design of façade cladding and roof coverings, but also has minor operations in steelworks as a supplier (trading activities) and producer (building materials). However, the latter activities are negligible for segment diversification as they serve the same end-markets (construction), exposing MHH to a small number of underlying demand patterns, and thus the industries' inherent cyclicality, leading to high cash flow volatility.

Adequate customer diversification limiting the impact of a single customer's default or inadequate payment behaviour

Customer diversification is slightly better that that of similar-sized peers: Top 10 customers accounted for around 40% of revenues in 2018 and 2019, and 60-90 projects are executed yearly, pointing to a more granular customer base following the top 10.

However, the high granularity of the customer structure comes at the expense of:

- a comparatively high share of projects worth below HUF 1.5bn (70%-80% of revenues) for which MHH is a sub-contractor, which creates a dependency on the credit quality and payment behavior of the general contractor or end-customer; and

- a relatively low order backlog, as small projects are executed[1] within 3-6 months and are thus not signed well in advance.

We believe the advantages of the relatively granular customer structure outweigh the associated risks, especially as most of MHH's end-customers have adequate credit quality.

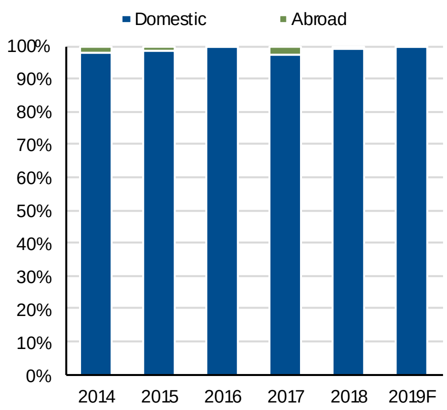
The relatively low share of government-related contracts (17% of the order backlog as at YE 2019 and below 5% in revenues for 2018-19) protects MHH from the steep decline in demand anticipated for central and local government projects.

Please note: In 2016-19, EU funds channelled via central government into the Hungarian construction industry have almost tripled to EUR 2,250m from EUR 900m. Due to the end of the EU funding cycle, this source of investment is projected to decrease by 83% until 2022 to around EUR 400m, according to the MNB.

Volatile and relatively low profitability also likely to have peaked in 2019

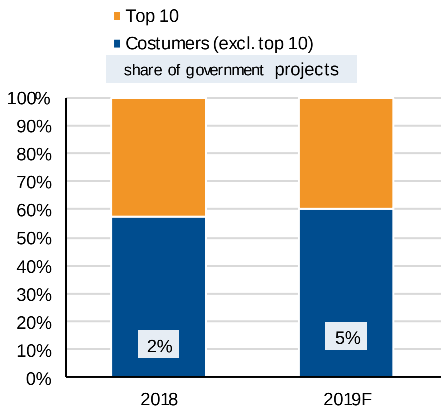
The volatility of MHH's profitability is high, as measured by its SaEBITDA margin, fluctuating between 4% and 9% in the last couple of years (2019F: 15%). Despite the anticipated increase in profitability for 2019, we believe that the SaEBITDA margin will decline to around 7% going forward, a level we judge to be sustainable. The decline will be driven by the expectation of higher costs along with a reduced top line.

Figure 3: Geographical diversification by revenues



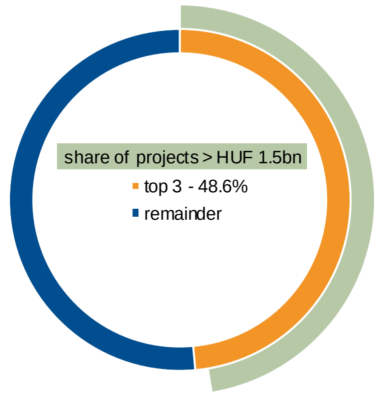
Sources: MHH, Scope

Figure 4: Customer concentration by revenues



Sources: MHH, Scope

Figure 5: Backlog concentration



Sources: MHH, Scope

MHH's low profitability, in conjunction with its small scale, entails the risk that it cannot protect its market shares if larger peers initiate a fierce price war. This might occur if other contractors with a focus on façade cladding and roof covering, such as Lindner Group, Yuanda Europe or Porr AG, follow their customers to Hungary. We believe the associated risk to be high as MHH's domestic customer base is weak, with more than two-thirds of its revenues stemming from foreign companies.

Below-par backlog with short project durations (although typical for the segment) limit cash flow visibility

The company's backlog will continue to be below par as it only covers 0.4 years of revenues (as at YE 2019). The relatively low order backlog is typical for contractors focusing on façade cladding and roof covering, as the durations of these project average 3-6 months[1]. As such, most contracts executed within a year are signed within the same period. Thus, we deem the book-to-bill ratio to be more reliable regarding the company's ability to secure tenders and thereby ensure good future revenues. The book-to-bill has been above 1x for the last couple of years, indicating somewhat stable performance despite the volatility in Hungarian construction output in recent years.

[1] start of construction work up to delivery

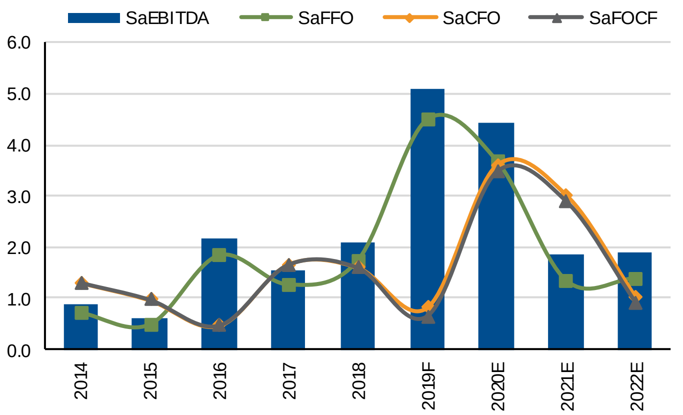
Nonetheless, the low backlog limits the visibility of future cash flows, thus increasing the potential volatility of the company's top line.

Financial risk profile: BB

Our rating scenario assumes the following:

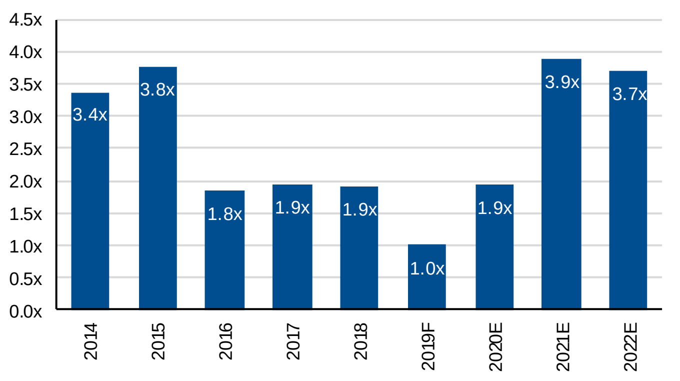
- Revenue to grow according to the company's backlog as per year-end 2019, but to decline in 2021 (-35%) based on the expected slowdown in Hungarian construction, reverting to historical top line levels
- All expenses grow in line with inflation as forecasted by the European Commission in November 2019
- Mandatory capital expenditure of around HUF 0.1bn between 2019 and 2022
- Discretionary capital expenditure of HUF 6.5bn in 2020-21 to acquire machinery (HUF 0.5bn), build a new steel production facility (HUF 1.0bn), acquire an income-producing real estate property in Budapest (HUF 3.5bn) and develop a real estate property (new headquarters for HUF 1.5bn)
- Savings from machinery acquisition and construction of steel production facility of HUF 0.2bn annually starting in FY 2021
- Net rental income from income-producing Budapest asset of HUF 0.2bn annually
- Issuance of a HUF 8bn bond (balloon repayment) in H1 2020 under the MNB Bond Funding for Growth Scheme, with an estimated coupon of 3% (fixed), amortisation from 2023 on (HUF 0.5bn p.a.) and a maturity of 10 years
- Acquisition of Budapest property financed by a secured loan (HUF 2.4bn; seven years; three-month Euribor + 2.00%; HUF 350m annual amortisation)
- Operating leases to be contracted over a 10-year period
- Dividend payouts of maximum HUF 1.2bn annually
- Stable non-business (dividend-like) expenses of HUF 0.8bn annually

Figure 6: Cash flows (HUF bn)



Sources: MHH, Scope estimates ; 'Sa' = Scope-adjusted

Figure 7: Leverage (SaD/SaEBITDA)



Sources: MHH, Scope estimates ; 'Sa' = Scope-adjusted

Sufficient debt protection despite anticipated increase in indebtedness

MHH benefits from strong debt protection, as evidenced by an EBITDA interest cover of continuously above 6x (2019F: 23x). This results from i) the company's relatively low indebtedness of HUF 2.4bn in interest-bearing liabilities as at YE 2019; and ii) its relatively low cost of debt. The latter has been driven by the current low interest rate environment, which helped to reduce the weighted average cost of debt to 1.7% as at YE 2019, from 3.1% as at YE 2015. We anticipate debt protection to drop to around 4x going forward based on i) the forecasted sharp increase in debt to HUF 10.7bn by YE 2020; and ii) projections of SaEBITDA at historical levels for beyond 2020. Our view is further supported by the introduction of more expensive fixed-rate funding (HUF 8bn bond; coupon: 3%) as well as the secured loan to finance the property acquisition that bears an anticipated margin of 200bp.

Low fixed costs supporting positive free operating cash flows throughout the construction cycle

MHH continuously generated positive, while volatile, Scope-adjusted free operating cash flow (SaFOCF). Volatility will continue to be driven by changes in working capital, with construction work mostly prefinanced by the contractor. Risk of continuous pre-financing of inventories by MHH is partially mitigated by a payment scheme enforced by law[2] that protects contractors from non-payment or late payments for projects larger than HUF 1.5bn (70% of MHH's backlog).

We anticipate SaFOCF to remain volatile, driven by top-line developments. However, we also believe SaFOCF will remain positive and support cash flow cover, with SaFOCF/SaD forecasted at around 15%. SaFOCF is forecasted to remain at break-even at least, based on the issuer's low fixed annual cost base, at HUF5.4bn for 2019-22 including:

- HUF 5.0bn of operational expenditure;
- HUF 0.3bn of interest expense; and
- HUF 0.1bn of mandatory capital expenditure.

Increase in leverage with low visibility if debt-financed expansion capex keeps cash flows at current levels

Leverage has been stable in recent years, with SaD/SaEBITDA below 2x (2019F: 1x) and Scope-adjusted funds from operations (SaFFO) to SaD of above 30% (2019F: 89%). However, with discretionary capital expenditure to be financed with debt (HUF 8.0bn bond and a HUF 2.4bn secured bank loan), we forecast leverage to increase, to a SaD/SaEBITDA of between 3x to 4x, while SaFFO/SaD is forecasted to fall to around 20% going forward. Forecasted leverage is sustainable, in our view, as the company's SaD/SaEBITDA has stayed below 4x within the last decade.

Liquidity: adequate

We consider MHH's liquidity to be adequate, in detail:

Figure 8: Liquidity

in HUF m	2019F	2020E
Short-term debt (t)	2,110	350
Unrestricted cash (t)	159	4,988
Open committed credit lines (t)	0	0
Free operating cash flow (t+1)[3]	3,483	2,903
Coverage	**1.7x**	**22.5x**

Source: Scope estimates

However, liquidity was weak in the last couple of years, mainly driven by persistently high short-term debt from revolving working-capital facilities. Nonetheless, we expect liquidity to recover in 2020. This is based on our assumptions that i) the HUF 8bn (EUR 24m) bond will be issued successfully in Q2 2020, with part of the proceeds used to repay short-term debt; and ii) SaFOCF will continue to be positive. We also believe the company is well equipped to cover intra-year working capital swings using available cash (HUF 5bn of bond proceeds dedicated to finance working capital).

[2] Customers are obliged to pay upfront the costs invoiced by the contractor for the next construction phase on an escrow account to secure timely payment.
[3] We exclude discretionary expansion capex from the liquidity calculation, as such investments are made only if external financing is available.

Corporate Governance

The company is owned in equal shares by József Kreinbacher (CEO) and Josef Unger with no independent board in place that provides oversight functions.

The company pays on a recurring basis non-business related grants to other ventures, investments of the direct owners of MHH (HUF 0.3bn to HUF 1.0bn annually in between 2016 to 2019). To capture this credit-negative procedure of recurring pay-out of dividend-like payments to a sister company not related to MHH's business, these grants remained included in Scope-adjusted EBITDA, thus impacting both the company's business as well as financial risk profile.

Long-term and short-term debt instrument ratings

Senior unsecured debt: B+

MHH plans to issue a HUF 8bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. The planned bond has a 3.0% coupon and is amortising from 2023 until its tenor ends in 2030. Proceeds are earmarked for refinancing short-term working-capital facilities, purchasing machinery, building a new steelwork production facility and developing a new office building (new headquarters for MHH).

Our recovery analysis assumes a potential default in 2021 and is based on MHH's going concern status. Our view is based on the company's business as a specialist contractor (façade cladding and roof covering). Thus, the enterprise value is not linked to 'hard' assets but to 'soft' assets (access to long-term customers and technical knowledge in both engineering and manual labour). However, we assume that secured debt at default (HUF 2.1bn) will be satisfied by the disposal of the dedicated collateral (Budapest property). Consequently, we exclude the Budapest property from the assumed EBITDA at default of HUF 755m (implied enterprise value at default of HUF 2.8bn).

Based on our recovery analysis, we expect an 'average recovery' for the company's senior unsecured debt (HUF 8.0bn bond, HUF 0.2 in guarantees and HUF 0.4bn in additional bank debt), resulting in a B+ rating for this debt class (the same rating as the issuer rating).

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