Pick Szeged Zrt.
Hungary, Consumer Products

SCOPE BB STABLE

Rating rationale

Scope has upgraded the rating of Pick Szeged to BB/Stable from BB-/Stable along with upgrading the senior unsecured debt rating to BB from BB-.

The ratings are based on the parent's rating as Bonafarm Zrt. fully owns, consolidates and unconditionally and irrevocably guarantees Pick Szeged Zrt.

The upgrade is driven by the Bonafarm group's exceptional operating performance in 2022 followed by good H1 2023 results, with Scope-adjusted EBITDA up by 80.7% in 2022 compared to 2021 and a related decrease in Scope-adjusted debt/EBITDA to 0.9x from 2.4x. While the performance in 2022 was an outlier due to the volatile input prices (which the company managed well), Scope projects leverage to stay below 2x in the medium-term (excluding potential M&A), underpinning Scope's view of a better financial risk profile and hence the rating upgrade.

Pick Szeged's business risk profile reflects a strong presence both in the Hungarian market through its 150-year-old brand and in key export markets such as Germany for its famous winter salami (PICK). However, inflation-led changes in demand, volatile input prices, wage increases and limited diversification temper the rating. Pick Szeged is tackling the effects of inflation with a strong pricing response, workforce optimisation and changes in its product portfolio, resulting in a shift in focus towards products that see higher demand when purchasing power is low (i.e. cheaper and private label products).

Pick Szeged's rating is based on the unconditional and irrevocable guarantee of the parent Bonafarm Zrt. and its full consolidation within the group, therefore the financial risk profile assessment is equalised with that of Bonafarm Zrt.

Pick Szeged can access a cash pool provided by its parent for investment, albeit the issuer is rather a contributor to the group cash pool. Pick Szeged's strong cash flow and low-cost fixed-rate debt can be used up to a limited amount by Bonafarm Group and its strategic partners. Overall, Pick Szeged's rating remains in line with the parent's, upgraded to BB with Stable Outlook.

Outlook and rating-change drivers

The Outlook for Pick Szeged is Stable, mirroring that of the parent due consolidation, ownership and guarantee. The Stable Outlook reflects Scope's expectation that Bonafarm Group can tackle inflation and maintain margins as well as execute capex plans while keeping Scope-adjusted debt/EBITDA below 3.5x.

An upgrade or downgrade of the parent could result in the same rating action for Pick Szeged.

A positive rating action is possible if Scope-adjusted free operating cash flow/debt can be sustained above 5% following the execution of the capex plan and production ramp-up while keeping Scope-adjusted debt/EBITDA below 3.0x at Bonafarm Group level.

A negative rating action could be warranted by i) Scope-adjusted funds from operations/debt decreasing towards 15%; and/or ii) Scope-adjusted debt/EBITDA increasing towards 4x at Bonafarm Group level. The latter could be caused by more debt taken on due to i) higher construction costs; ii) a slow production ramp-up; iii) a significant change in market input prices; iv) weaker pricing power in main segments due to further delays in modernisation that weaken market share; and/or v) M&A.

Ratings & Outlook

Issuer	BB/Stable
Senior unsecured debt	BB

Analyst

Barna Gáspár
+49 30 278913 25
b.gaspar@scoperatings.com

Related Methodologies

Corporate Rating Methodology, July 2022

Consumer Products Rating Methodology, November 2022

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
17 Aug 2023	Upgrade	BB/Stable
23 Aug 2022	Outlook change	BB-/Stable
17 Sep 2021	Outlook change	BB-/Positive
21 Sep 2020	Affirmation	BB-/Stable

Rating and rating-change drivers

Positive rating drivers

- Market leader in Hungary in processed meat, enabling pricing power
- Access to group cash pool for working capital and investments
- Strong parent support from Bonafarm Zrt. and from the ultimate beneficial owner

Negative rating drivers

- Negative Scope-adjusted free operating cash flow/debt due to heavy investment phase
- EBITDA vulnerability to market price changes and demand shocks, especially the recently increasing ZMP index (German slaughter pigs index) and increasing labour costs
- Slow execution of investments to replace old technologies in meat processing while construction prices soar in Hungary, mitigated by higher-than-expected subsidy and owner's equity contribution and possibility to postpone strategic capex in other operating areas
- Higher production-related headcount than peers' due to delayed investments, low automation at Pick Szeged and production sites being situated at multiple locations

Positive rating-change drivers

Upgrade of parent, i.e.:

- Return of Scope-adjusted free operating cash flow/debt above 5% following executed investment strategy and production ramp-up
- Scope-adjusted debt/EBITDA forecasts remain below 3.0x

Negative rating-change drivers

Downgrade of parent, i.e.:

- Scope-adjusted debt/EBITDA increasing towards 4x through debt to cover higher construction costs, slow production ramp-up, significant market input price changes, loss of pricing power in main segments and/or M&A and/or
- Scope-adjusted funds from operations/debt decreasing towards 15%, e.g. due to significant further delay in modernisation of production facilities exemplified by shrinking market share and/or margins, or higher operating costs

Corporate profile

Pick Szeged Zrt. manufactures processed meat for wholesale distribution and is the market leader in its segment. The company, founded in 1869, celebrated its 150th anniversary in 2019. Pick Szeged is owned 99.99% by Bonafarm Zrt., which itself is owned indirectly by renowned businessman and banker Dr Sándor Csányi through holding company Bonitás 2002 Zrt. Pick Szeged was acquired by Bonafarm Zrt. in the 2000s and has been consolidated in Bonafarm Group since 2009. Bonafarm Group, which consists of Bonafarm Zrt. and its fully consolidated subsidiaries (including Pick Szeged Zrt.), is Hungary’s largest fresh food producer, with a broad, diversified product portfolio.

In June 2023, Bonitás 2002 Zrt. transferred its shares to a Csányi family trust named Unity Asset Manager Foundation for generational change purposes. Ownership interests in Bonafarm Group can be only inherited within the Csányi family. Therefore, we view the family’s involvement in the business as supportive to the rating.

Pick Szeged owns three subsidiaries in Hungary (local handball team PICK Kézilabda Zrt. and some smaller subsidiaries), one in Germany (PICK Deutschland GmbH), one in Slovakia (PICK SLOVAKIA s.r.o.) and one in Romania (PICK ARAD S.R.L.) for distribution and sales purposes. Pick Szeged owns two major brands, PICK and Herz. The company’s key product is PICK winter salami, which is also the flagship product for Bonafarm Group and enjoys ‘Hungaricum’ status as a commodity representing Hungarian heritage. There are four production sites, all in southern Hungary: two in Szeged, one in Baja and one in Alsómocsolád.

Table of Content

Environmental, social and governance (ESG) profile

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)

Circular economy in focus

The ESG profile of Pick Szeged must be viewed together with its parent's to capture its high vertical integration as well as common management and ownership.

Bonafarm is the largest Hungarian vertically integrated consumer products and agricultural company with substantial investments in farming and livestock. Production is from crops to processed food, which contributes to the circular economy. Group entities have started developing and implementing ESG principles, which is visible in the group's environmental footprint. The agricultural and livestock leg is rather modern (save for further investments in crop irrigation) while the processed food plants are rather old and need significant investment, which has been under planning for several years. Therefore, the real change will come from the new and more efficient plant.

Decisions driven by family owners

The Csányi family keeps a hands-on approach to strategic decisions.

Pick Szeged was one of the first issuers in the Hungarian Bond for Growth programme after issuing a HUF 27bn bond in 2019. The proceeds are meant for building a new integrated meat processing plant since the current plant was built in the 1970s. The issuance was done very early, when the greenfield/brownfield investment was in the planning phase. Pick's management has somewhat changed since then.

Scope views Pick Szeged's and Bonafarm Group's ESG strategy as credit neutral.

Business risk profile

Industry risk profile

We categorise Pick Szeged as a producer of non-durable consumer goods (Industry risk of A). We see substitution risk as high because Pick Szeged has a limited product range (processed meat, over 50% is salami). Other suppliers are available, but consumers perceive Pick Szeged's meat products as unique and superior. However, we note the recent shift among consumers to substitute processed meat for other types of foods and cheaper and/or non-branded alternatives.

High cyclicality

Input prices for meat, the key ingredient, are strongly cyclical. While both agribusiness and commodity food products are non-discretionary and hence normally have low cyclicality, strong supply swings introduce significant volatility to both costs and prices and hence to both 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) causing price volatility well above more general price changes. The industry is also subject to volume volatility.

Medium entry barriers

Market entry barriers for non-durable consumer goods are medium. The limited product range leads to an inherent risk of product substitution. Consumer preferences change over time and the processed meat segment is no exception, with the availability and consumption of alternatives on the rise.

High substitution risk

While alternative foods do not share the same attributes as processed meat, they are readily available. For this reason and the above factors, we view substitution risk as high. Pick Szeged's ability to generate high volumes at a high quality (important for wholesalers and for export) mitigates this risk. Bonafarm Group also provides the necessary value chain certification for non-GMO products that cannot be easily reproduced with alternative inputs.

Core market of Hungary hit by inflation and dispute with EU

Pick Szeged's home market is Hungary, where PICK winter salami has been granted 'Hungaricum' status as a commodity representing the local heritage. Our public finance rating for Hungary is BBB/Stable. The country's economic growth after the Covid-19 pandemic is being challenged by record-high inflation, a weakening local currency, delays in receiving certain EU funds and the related dispute on rule of law, and labour shortages due to an ageing workforce and wage pressure. These are affecting the government's ability to provide investment grants, from which Pick (and Bonafarm Group) benefit greatly.

Soaring food prices result in shrinking market, even for the strongest players

In 2022, revenues of Pick Szeged increased 13.6% YoY (domestic up 15.6% and exports up 8.5% YoY), while the food consumer price increased 44.8% YoY and agricultural producer price by 41.4% YoY. In 2023, inflation in the first half was around 20% and the Hungarian Statistics Office expects it at around 20% for the full year. Food retail volumes have been decreasing in 2023, for the first time in a decade. In 2024, single-digit inflation is foreseen, albeit with no significant real wage correction, meaning further demand shocks may occur. Pick Szeged's revenues increased 11% in H1 2023 compared to H1 2022, which shows the lower volumes and also the shift towards cheaper products. The result is a decrease in profitability to a reported EBITDA margin of 6.7% in H1 2023, which is still superior compared to its largest competitors in the Hungarian market.

Negative value chain effect evident in strategic partner's sector

Access to key markets (China, Japan) remains an issue because certain pork parks still have to be sold frozen due to a previous outbreak of the African Swine Fever. The effect was seen in the results of pig slaughterhouse MCS Slaughterhouse, a strategic partner owned by Sándor Csányi but not part of Bonafarm Group. The profitability of the slaughterhouse stabilised in 2021. Pick Szeged purchased HUF 7.5bn of raw materials in 2022 from MCS Slaughterhouse through a market-based transfer pricing agreement, which is 12.6% of its materials costs. This points towards strong strategic partnerships but also shows diversification of purchasing sources.

Domestic market leader and strong export focus towards Germany

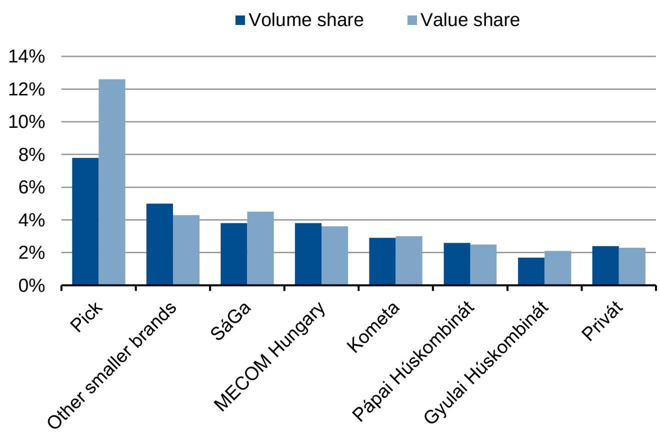
Pick Szeged continues to dominate its market, though its capacity development plans are rather moderate compared to those of competitors.

Geographical diversification is concentrated on Hungary and export sales are moderate at more than a quarter of revenues (mainly to Germany for the salami product).

In the first five months of 2023, volumes in Hungary's processed meat market decreased by 1.1% (against a decrease of 3% in H1 2022) and their value decreased by around 2% (against a 6.8% increase in H1 2021). This points towards not only consumer preferences changing towards cheaper products but also a general decrease in purchase power due to inflation, resulting in lower demand.

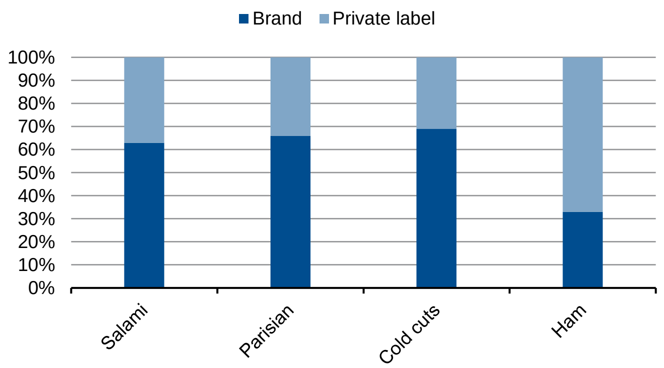
Pick Szeged's share of the private-label market remains concentrated on ham and cold cuts as its moulded salami is a strong branded product. Volume shares decreased by 1 pp to slightly below 8%, while value shares decreased by 2 pp to 12.6%, which shows strong price acceptance among consumers for the brand and its products but also some decrease in market shares and volumes. In Hungary, Pick Szeged still has one of the highest share of branded products within its portfolio; therefore, we expect it to keep its top position in its fragmented market. We note, however, Pick Szeged's low share of brands relating to ham and premium protein-based products, towards which consumer preference is shifting. This is because salami accounts for more than half of its business and has a strong export focus, while the cold cuts and mid-priced ham are for domestic consumption and do not have a large-volume premium product offering compared to regional peers.

Figure 1: Market share of Pick Szeged, Jan-May 2023



Source: Bonafarm/Pick

Figure 2: Pick Szeged's share of branded and private label sales by turnover, Jan-May 2023



Source: Bonafarm/Pick

Product diversification constrained

Pick Szeged's customer base is highly diversified, including all relevant retail chains in Hungary. Sales are balanced among retailers as the PICK brand is in high demand in Hungary. Despite this and Pick Szeged's broad supplier base, the concentration on a single sector (meat products with a focus on salami) constrains diversification and a significant cluster risk remains. This is mitigated somewhat by a relatively good international standing and regional distribution agreements with retailers. Other constraints include a potential shift in consumer sentiment away from meat products, a concentration towards higher-protein products in industrialised countries, unfavourable domestic demographic trends, and a continued decrease in affordability.

Improving profitability in line with other non-durable consumer product companies

EBITDA margins are moderate with 5%-6% during 2015-2018, improving to 9% in 2020 and to 16% in 2021 and 12.4% in 2022 (adjusted upwards due to a non-cash, extraordinary write-off of HUF 2.6bn). EBITDA is moderately volatile, mainly reflecting non-controllable costs (such as labour and input costs) offset by strong price increases. A large portion of sow meat is bought from MCS Slaughterhouse at an arm's length basis. Nevertheless, MCS Slaughterhouse has an inferior margin to Pick Szeged's, but it became profitable in 2021. A combined margin of the slaughtering and meat processing business would be around 12.1% in 2022 (+2% YoY), which is strong for a Hungarian food producer.

Slow execution of investments allowing competition to gain market share

Pick Szeged is one of the largest employers in Hungary, with a headcount of more than 2,000. However, the ratio of revenue to headcount is half the level of main competitors. The seemingly low efficiency is mostly due to its old production technology (also with modernisation delayed), facilities being situated in multiple locations, and the manual nature of some production processes (salami). The large headcount in production will not be solved in the medium term as new government subsidies come with headcount requirements. For the medium term, Pick Szeged aims to increase output capacity by one-quarter. At the same time, some competitors in processed pork and poultry products in Hungary are set to double capacity.

Strong brands enable pricing power in Hungary

Pick Szeged is the market leader in Hungary with high-quality products and high brand awareness. This leading position enables premium pricing for salami and certain milk products, which the group is using well in negotiations with retailers, and is despite the better operating efficiency at most competitors. We see the sustained market leadership by both sales and brand as key to keeping pricing power and volumes.

Financial risk profile

Pick Szeged's rating is based on the unconditional and irrevocable guarantee by the parent Bonafarm Zrt. and its full consolidation within the group, therefore the financial risk profile assessment is equalised with that of Bonafarm Zrt.

We have taken a more conservative view on the financial risk profile instead of adjusting separately for financial policy due to the volatile metrics. We overweighted the financial risk profile because the major capex planned in 2019 still has not been contracted despite the soaring construction costs. Furthermore, the group's financial policies ensure large headroom between covenants (net debt/EBITDA of 4x) and actual figures (net debt/EBITDA of 1-2x), giving space to increase leverage moderately.

Financial risk assumptions

Our key financial assumptions for Bonafarm Group are: i) no major restructuring of the company or subsidiaries; ii) group strategic capex (above depreciation) of HUF 76bn net of subsidies during 2023-2025; iii) continuity of management; iv) organic top-line sales growth at below inflation of 3% in 2023 (against 20% inflation), due to changes in the product portfolio towards low value-added and private label products combined with shrinking demand, then 5% a year; v) wage growth in Hungary at close to inflation; vi) no major agribusiness-related event (e.g. drought, disease); vii) investment plans executed as presented with no meaningful operational or financial risks; and viii) continuity of financial policy, especially in terms of no dividends, no new large debt issuances and meeting the net debt/EBITDA covenant of up to 4.0x in loan agreements.

Improving leverage ahead of large brownfield investment

The consortial secured financing provided by CIB Bank Zrt (member of Intesa Group) and Raiffeisen Bank Zrt of HUF 44.7bn (EUR 139.8m) is guaranteed by Bonafarm Group. The covenants of the consortium credit line for the group are i) an equity ratio of at least 30%; ii) maximum indebtedness of 4x; iii) two-year average net operating cash flows 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%. In 2022, all covenants were fulfilled with good headroom. Ongoing capex will negatively affect credit metrics, but still with adequate covenant headroom.

We maintain the same issuer rating for Pick Szeged as its parent, Bonafarm Zrt., as the subsidiary can access the group cash pool to finance investments and working capital.

Strong interest cover coupled with greater cash flow headroom

EBITDA/interest cover has always been strong at Bonafarm Zrt and by extension at Pick Szeged. The Hungarian central bank's regime of low interest rates combined with state-subsidised financing opportunities has allowed Bonafarm Group to contract debt with an average interest rate of 1.3% (calculated for 2022 on the drawn exposure). 80% of committed financing facilities have fixed interest rates. Hence, we expect the double-digit base rate in Hungary to have no major impact, with the group interest rate remaining below 2%, providing excellent debt protection.

The financing structure includes low amortisation and high balloon or bullet facilities, which allow a good debt service coverage ratio. The issued HUF 27bn bond is repayable only at maturity in 2029, which provides great cash flow headroom.

Negative Scope-adjusted free operating cash flow/debt due to investments

Pick Szeged has several large production sites in need of modernisation. As such, we expect very negative Scope-adjusted free operating cash flow/debt once the large investment kicks in.

The heavy investment phase continues to influence our assessments of cash flow coverage and free cash flow generation. The ratios are highly variable, reflecting the deeply negative investment cash flow. Once this phase ends, we expect a robust return to positive cash flow, but this will only happen beyond the rating horizon.

Increasing construction costs offset by owner's contribution

Since the investment plans for the Pick Szeged facility were made and the related bond issued in 2019, construction costs in Hungary have soared. The Hungarian Investment Promotion Agency recently granted a HUF 10.6bn non-refundable subsidy towards the HUF 39bn investment in the meat processing plant. Cost overruns may increase leverage by 0.3x-0.5x in 2026, depending on how these are financed and the construction prices negotiated.

Adequate liquidity supported by group cash pool

Given the cash-pooling agreements between Bonafarm and its subsidiaries and the full consolidation and interlinkage, we assess Pick Szeged's liquidity as equal to its parent, at adequate level.

MCS Slaughterhouse (not a group entity) was granted limited access to the cash pool in 2022. Pick Szeged is a contributor to the cash pool, which may lower its liquidity moderately though not significantly.

Supplementary rating drivers

Neutral financial policy

Group financial policy continues to aim for a strong expansion of core businesses (primarily Pick Szeged) and organic growth overall. We view financial policy as largely prudent as management is committed to keeping net debt/EBITDA at a maximum of 3.5x; loan covenants allow up to 4x.

Parent support:

Dr. Sándor Csányi had been for a long time Hungary's richest individual; currently he is second and has several executive positions at blue-chip companies as well as assets across different industries. Forbes magazine estimated his wealth in 2021 at HUF 420bn (around EUR 1.2bn). Dr Csányi fully controls Bonafarm Group through Bonitás 2002 Zrt. and has supported the group significantly with equity and owner loans since its inception. Equity increases in 2016-2022 amount to more than HUF 50bn and for 2023-25 dr Csányi plans to invest a further HUF 8.8bn in owner's loans and equity.

The direct ownership was transferred into a family trust, without any change in the family ownership model. Therefore, we maintain the one-notch uplift for parent support, reinforced by the recent and planned equity increases.

Long-term debt ratings

Senior unsecured debt rating: BB

Scope has upgraded the rating on senior unsecured debt issued by Pick Szeged to BB from BB-, which is in line with the issuer rating.

Pick Szeged Zrt. issued a HUF 27.0bn senior unsecured bond unconditionally and irrevocably guaranteed by the parent company, Bonafarm Zrt. (ISIN: HU0000359336, issued in December 2019), through the Hungarian Central Bank's Bond Funding for Growth Scheme. The only bond issuance within Bonafarm Group was performed at Pick Szeged level, while Bonafarm Group has other senior unsecured debt ranking pari passu in the form of payables.

The senior unsecured bonds issued by Pick Szeged rank below the HUF 23bn senior secured bank debt of Bonafarm Group. Bonafarm Group has a strong asset base, but due to the old meat processed products plant and assets under construction to replace it, Scope has applied a high discount. As a result, Scope expects therefore an 'average' recovery for outstanding senior unsecured debt in a hypothetical default scenario in 2025.

The bond proceeds are earmarked for the new meat processed products plant, which is in preparatory phase, and for general group financing purposes. The bond proceeds have been set aside as cash and in Hungarian sovereign bonds until construction starts. The bond has a tenor of 10 years and a fixed coupon of 2.0%. Bonds have bullet repayment. Scope notes that Pick Szeged's senior unsecured bond issued under the Hungarian Central Bank's bond scheme has accelerated repayment clauses. The clauses require Pick Szeged to repay the nominal amount (HUF 27.0bn) in case of rating deterioration (two-year cure period for a B/B- rating, immediate repayment after the bond rating falls below B-, which could have default implications). In addition to the rating deterioration covenant, soft covenants include those addressing cross default (with the senior secured club facilities agreement having a net debt/EBITDA covenant of 4.0x, mitigated by the large headroom to actual levels) and a change of control (initially limited to dr. Sándor Csányi as final beneficial owner; in 2023 bondholders agreed to a change of control to a Csányi family trust).

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

10 avenue de Messine
FR-75008 Paris

Phone +33 6 6289 3512

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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