2 May 2024

Corporates

DVM Group Kft.
Hungary, Construction

SCOPE

B STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2022**	**2023P**	**2024E**	**2025E**
Scope-adjusted EBITDA interest cover	Positive net int.	Positive net int.	13.0x	9.8x
Scope-adjusted debt/EBITDA	6.3x	10.8x	10.1x	6.5x
Scope-adjusted funds from operations/debt	15%	12%	9%	12%
Scope-adjusted free operating cash flow/debt	-41%	-20%	8%	-23%

Rating rationale

DVM's issuer rating benefits from a robust yet concentrated backlog, a good domestic network and longstanding relationships with its main clients as well as the vertical integration in its business, including a wide range of services in the different stages of the construction value chain. The rating remains constrained by the company's small scale in both a European and Hungarian context. Weak diversification is another 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. While the company has strong liquidity and good debt protection, we foresee the leverage to remain high (Scope-adjusted debt/EBITDA above 6x) due to weaker-than-expected cash flow generation, which could lead to a prolonged period of lower Scope-adjusted EBITDA.

Outlook and rating-change drivers

The Outlook remains Stable and incorporates heightened leverage with Scope-adjusted debt/EBITDA ratio above 6x amid pressure on the company's profitability. However, associated risk is largely mitigated by the company's strong cash cushion, which limits external financing needs and supports good liquidity over the next 12-18 months. The Outlook also reflects the high top-line visibility associated with the record high order backlog of HUF 88bn, which is expected to be realised by 2026. While we expect credit metrics to be in line with the rating category, the company's small size and low diversification continues to pose a significant threat to cash flow stability.

A positive rating is currently considered remote. But it could materialise if the company is able to demonstrate its ability to keep its backlog-to-sales ratio to above 2.5x, including highly profitable projects that ensure a recovery in the Scope-adjusted EBITDA margin to above 7%, combined with greater diversification (customers and projects). At the same time, we expect the company to gradually deleverage after the peak of investments in 2025, bringing the Scope-adjusted debt/EBITDA ratio down below 6x on a sustained basis.

A negative rating action could occur if the Scope-adjusted debt/EBITDA ratio remained above 6x for a prolonged period (beyond 2025) while the company's current strong cash position deteriorated significantly.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
2 May 2024	Affirmation	B/Stable
4 May 2023	Affirmation	B/Stable
28 Apr 2022	Affirmation	B/Stable
2 Jun 2021	Affirmation	B/Stable

Ratings & Outlook

Issuer	B/Stable
Senior unsecured debt	B+

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Related Methodologies and Related Research

General Corporate Rating Methodology; October 2023

Construction and Construction Materials Rating Methodology; January 2024

ESG considerations for the credit ratings of construction and construction-materials corporates; December 2022

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Market position benefits from integrated business, offering a turnkey solution that translates into a time- and cost-efficient model • Good interest cover (positive net financial income) • Robust backlog-to-sales ratio (3.4x as of April 2024) but still concentrated in a limited number of projects (top three projects account for 78% of backlog revenues) • Strong liquidity, with cash and cash equivalents of HUF 7.3bn as at December 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 • Heightened leverage with Scope-adjusted debt/EBITDA ratio above 6x amid pressure on the company's profitability • Low profitability, as measured by the Scope-adjusted EBITDA margin, that remained at below 5% due to increasing material costs and high personal costs

Positive rating-change drivers	Negative rating-change drivers
• Improved backlog of above 2.5x that boosts Scope-adjusted EBITDA margin to above 7% combined with greater diversification (customers and projects) while bringing the Scope-adjusted debt/EBITDA ratio down below 6x on a sustained basis.	• Scope-adjusted debt/EBITDA ratio remained above 6x for a prolonged period (beyond 2025) while the company's current strong cash position deteriorated significantly.

Corporate profile

DVM Group Kft. (DVM), headquartered in Budapest, is a general contracting group that has been providing design-and-construction services in Hungary since 1995. DVM's services include base building and fit-out construction, site supervision and organisation, and coordination of subcontractors, among others. The company's activities are spread across various commercial real estate segments, in particular office, retail, hotel and residential projects. In recent years, DVM has expanded into new business areas through joint ventures to enter the industrial and logistics sectors, as well as the construction of renewable energy projects.

Financial overview

			Scope estimates		
Scope credit ratios	**2022**	**2023P**	**2024E**	**2025E**	**2026E**
Scope-adjusted EBITDA interest cover	Positive net int.	Positive net int.	13.0x	9.8x	17.8x
Scope-adjusted debt/EBITDA	6.3x	10.8x	10.1x	6.5x	3.4x
Scope-adjusted funds from operations/debt	15%	12%	9%	12%	25%
Scope-adjusted free operating cash flow/debt	-41%	-20%	8%	-23%	82%
Scope-adjusted EBITDA in HUF m					
EBITDA	1,398	811	820	1,218	1,537
add: full operating lease payments	0	0	0	0	0
add: dividends received from associates	0	0	44	386	324
Scope-adjusted EBITDA	**1,398**	**811**	**864**	**1,603**	**1,861**
Scope-adjusted funds from operations in HUF m					
Scope-adjusted EBITDA	1,398	811	864	1,603	1,861
less: cash interest as per cash flow statement	49	290	-66	-163	-104
less: cash tax paid as per cash flow statement	-152	-18	-56	-130	-169
Scope-adjusted funds from operations (FFO)	**1,295**	**1,083**	**741**	**1,310**	**1,588**
Free operating cash flow in HUF m					
Funds from operations	1,295	1,083	741	1,310	1,588
Change in working capital	-4,870	5,136	66	-3,692	3,638
less: capital expenditure (net)	0	-7,964	-70	-70	-70
Free operating cash flow (FOCF)	**-3,575**	**-1,744**	**737**	**-2,451**	**5,156**
Net cash interest paid in HUF m					
Net cash interest as per cash flow statement	49	290	-66	-163	-104
add: interest component, operating leases	0	0	0	0	0
Net cash interest paid[1]	**49**	**290**	**-66**	**-163**	**-104**
Scope-adjusted debt in HUF m					
Interest-bearing debt	8,755	8,730	8,714	10,484	6,264
Other liabilities	0	0	0	0	0
Scope-adjusted debt	**8,755**	**8,730**	**8,714**	**10,484**	**6,264**
Cash balance in HUF m					
Cash and equivalents[2]	**8,375**	**7,297**	**4,099**	**2,958**	**9,552**

[1] It reflects only paid interest, not considering potential financial income linked to the loans provided as part of a joint venture agreements.
[2] Netting of cash: generally, only applicable to ratings in the BB category or higher and only if the cash is permanent and accessible.

Table of Content

Environmental, social and governance (ESG) profile[3]

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 considerations

We did not identify any ESG-related rating drivers that would have a relevant impact (positive or negative) on our overall assessment of credit risk.

DVM considers it important to educate the real estate profession and their participants and developers on environmental awareness. It plays an active role in this education via roundtable discussions and presentations. Through environmentally conscious services such as BREEAM, LEED, WELL certification and energy modelling, DVM supports real estate developers and partners in efforts to become environmentally aware. In addition, DVM is a member of professional NGOs (BCSDH, Hungarian GREEN building council, World Green Building Council) that promote environmental awareness and ESG approaches.

[3] 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: 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. Although the company aims to diversify its activities (e.g. by acquiring an 80% equity interest in renewable energy projects), those plans are still at an early stage and do not have a significant impact on DVM's revenues.

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

Small market player, both in a European context and domestically

DVM's top line was affected by a challenging market environment. Market uncertainty, high inflation, and changes in end-user demand led to the postponement of some contracted work, resulting in lower-than-expected revenues. In 2023, DVM revenues amounted to HUF 22.6bn down by 28% (preliminary figures) compared to 2022. Scope-adjusted EBITDA also fell to HUF 800m, 30% below our expectations. Lower revenues and higher fixed costs, including salary increases for high-value employees, have also impacted the company's profitability, as measured by the Scope-adjusted EBITDA margin, which stood at 3.6% in 2023 based on preliminary figures (below our forecast of 5.1%).

DVM remains a small construction company both in a European context and in Hungary, where the market is highly fragmented. 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 the last few years.

Nevertheless, we believe DVM's revenue generation in the next few years will be protected by its strong project backlog of HUF 88bn as of April 2024. Additional support for our expectations comes from: i) planned co-developments, including an 18,000 sq m logistics facility and residential projects; ii) the newly established joint ventures to enter the industrial and logistics sectors, which should benefit from robust tenant demand, and iii) the recent acquisition of an 80% stake in ready-to-built renewable energy projects.

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 that includes longstanding relationships with national and international customers. We believe both factors will support DVM's business going forward.

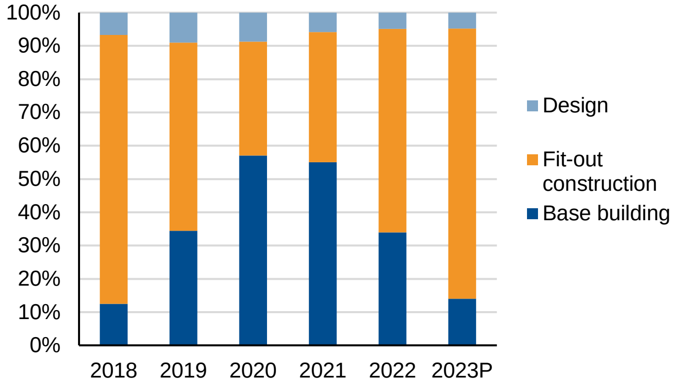
Limited diversification – geographic, segment and customer

Geographical diversification remains limited, as the company's activities are concentrated in its domestic market. This results in full exposure to the macroeconomy of one country, compounded by the company's focus on construction, a cyclical industry in which market downturns tend to affect revenues and earnings.

Most activities relate to only one subsegment in one industry (building construction. Although they serve different end markets, especially office, hospitality and residential, a number of contracts have been delayed. Particularly in hospitality and office-related fit-out projects that were put on hold.

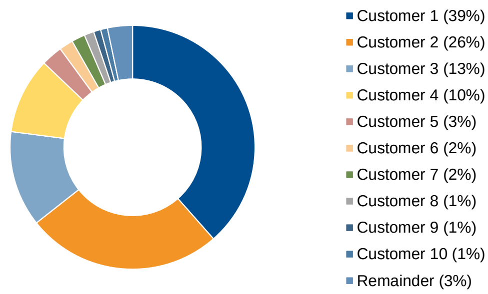
DVM's limited size results in high customer concentration as only a few projects can be executed simultaneously. This means both profitability and operating cash flow can be greatly affected by the failure of single project. This lack of diversification is partially mitigated by strong relationships with local and international clients.

Figure 1: Revenue breakdown by type of project



Sources: DVM, Scope

Figure 2: Revenue breakdown by customer



Sources: DVM, Scope

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

DVM's orderbook benefited significantly from a major residential project signed in December 2023. The project involves the construction of more than 600 apartments and will support the company's cash flow visibility in the coming years. The project backlog reached HUF 88bn as of April 2024, which is 3.4x the average sales of the last three years (1.9x as of April 2023). Although positive, the orderbook is subject to high cluster risk, as 39% of the company's current orderbook is dependent on a single project and client, and the top three account for 78%. The second largest project in the pipeline, an office development by DVM's partner Horizon Development, is also subject to the demand and appetite for office space, creating some uncertainty in the project timing.

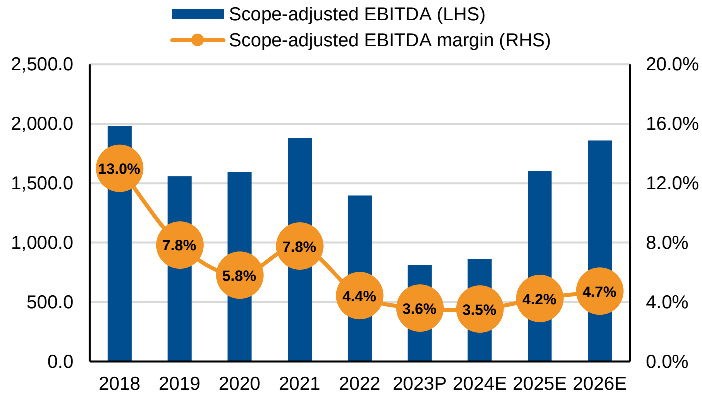
Diversification through co-developments

The slowdown in DVM’s core market is evidenced by: i) project developers postponing investment decisions; ii) access to financing sources becoming difficult; and iii) increased competition – as government developments are on hold – resulting in lower margins for projects and tenders that DVM participates in. In order to diversify its business, DVM has started co-development activities, including an 18,000 sqm logistics facility and a 140-apartment residential project. In addition, DVM has entered the renewable energy sector by acquiring an 80% stake in two ready-to-build photovoltaic projects, which are expected to be operational in Q1 2025. The execution risk is partially mitigated by the involvement of an industry expert in the project. Furthermore, the company has launched a JV to enter the industrial and logistics segment in 2023, having signed two projects worth around HUF 6.9bn. The execution risk is partly mitigated by the involvement of an industry expert partner in the project.

Weaker than expected profitability

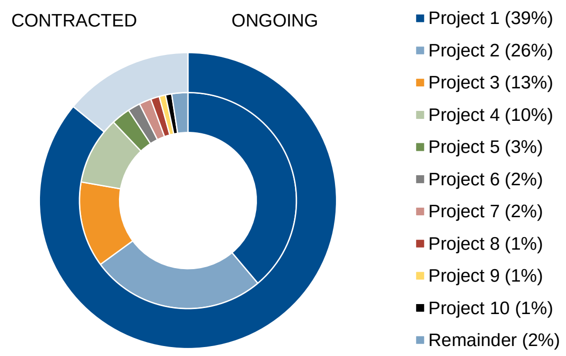
We expect DVM to continue to generate revenues at least at historical levels, supported by its robust backlog. Additionally, DVM's management has adjusted the organisation to provide some flexibility in variable and fixed personnel costs. It also expects higher margins on some residential projects due to strong demand, which will partially help to protect revenues and profitability in the next few years. However, we expect that high raw material prices will continue to put pressure on profitability. Our forecast assumes that DVM's profit margin will remain at 2023 levels in 2024 and improve slightly towards 5% over the next 12-18 months as some of the projects start to bear fruit.

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



Sources: DVM, Scope

Figure 4: Backlog breakdown by project as at Q2 2024



Sources: DVM, Scope

Financial risk profile: B+

Strong debt protection metrics benefit from low debt cost

The company's financial risk profile reflects a robust debt protection, with a positive net interest in 2023, supported by interest income and low debt expense, as the HUF 8bn bond carries a fixed interest rate of 3%. We anticipate that the interest cover to remain strong over the next few years, as the company's high cash balances and related interest income will partially offset the expected higher interest expense due to increased leverage. The interest cover is expected to weaken in 2025 due to of the planned increase in bank loans to finance further co-developments.

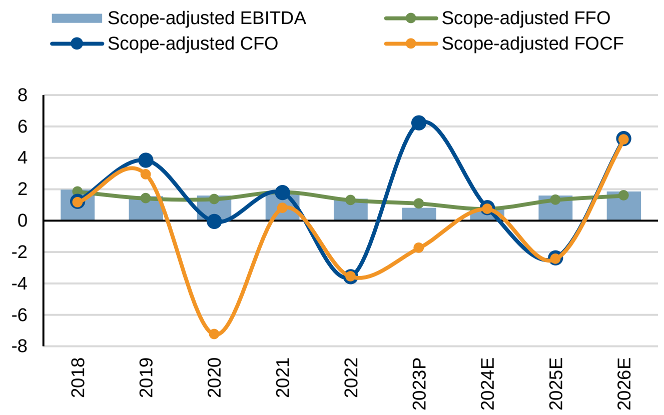
Negative FOCF due to higher working capital

Free cash flow has fluctuated in recent years, with a large cash outflow in 2023 due to a significant increase in financial investments, including loans for residential and renewable energy projects of around HUF 4.1bn). We expect FOCF to continue to fluctuate over the next few years, due to DVM's business plan, but should benefit from its backlog and our expectation that the company will be able to maintain sales at average historical levels. The company will finance part of its planned projects with currently available funds of around HUF 7.3bn as at December 2023.

Weaker-than-expected EBITDA puts pressure on leverage

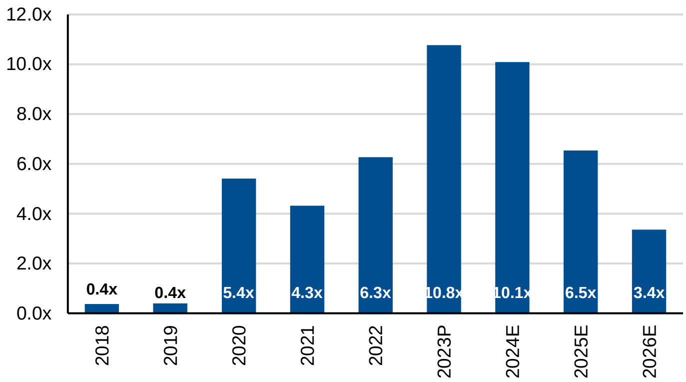
Leverage, as measured by the Scope-adjusted debt/EBITDA, stood at 10.8x as at December 2023, impacted by very low Scope-adjusted EBITDA. Scope-adjusted debt/EBITDA is expected to remain high in 2024 due to: i) weaker-than-expected cash flow generation; and ii) an increase in indebtedness to partially finance the co-development of a logistics facility (HUF 1.8bn in 2025), before stabilising at a level commensurate with the rating category once developments are complete and provide a boost to the company's EBITDA. However, we acknowledge DVM's unrestricted cash and cash equivalents (HUF 7.3bn as at end-2023) which is slightly below its financial debt (HUF 8.8bn as at end-2023) and notes that planned investments are of a discretionary nature.

Figure 5: Cash flows (HUF bn)



Sources: DVM, Scope estimates

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



Sources: DVM, Scope estimates

Adequate liquidity

Liquidity is adequate. It benefits from cash and cash equivalents of HUF 7.3bn as at end-2023, resources that limit external financing needs, and a backloaded debt maturity profile. The profile includes a HUF 8.0bn bond maturing in 2030, with the first instalment of HUF 2.4bn due in 2026. We expect the company's low short-term debt levels to be maintained going forward and sufficiently covered by available financing sources.

Figure 7: Liquidity

in HUF m	2024E	2025E
Short-term debt (t-1)	25	25
Unrestricted cash (t-1)	7,297	4,099
Open committed credit lines (t-1)	0	0
FOCF (t)[4]	737	-2,451
Coverage	**320.2x**	**65.6x**

Source: Scope estimates

Long-term debt rating

Senior unsecured debt: B+

In July 2020, DVM issued a HUF 8.0bn senior unsecured bond (ISIN: HU0000359781) through the Hungarian central bank's Bond Funding for Growth Scheme. The bond has a tenor of 10 years and a fixed coupon of 3%. Bond repayment is in three tranches starting from 2026, with HUF 2.4bn of the face value payable in 2026 and 2028 and the remaining portion payable as a balloon payment at maturity. Bond covenants include no dividend payments before 2022, plus change of control and LTV clauses regarding co-development financing (LTV greater than 50% for single co-development projects and greater than 30% for overall co-developed projects).

Our recovery analysis is based on a hypothetical default scenario occurring at year-end 2025. It assumes outstanding senior unsecured debt of HUF 8.0bn and additional secured bank debt of HUF 1.8bn to partially finance DVM's co-development projects. The result was an 'above average' recovery for the company's unsecured debt. We therefore affirm the B+ rating for this debt category (one notch above the issuer rating).

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

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