7 March 2022

Corporates

Zalaco Sütőipari Zrt.
Hungary, Consumer Goods

SCOPE B+ STABLE

Corporate profile

Zalaco Sütőipari Zrt.'s core business is the production of bread and fresh bakery products. The Hungarian company has expanded its sales and production capacity and increased its product portfolio. It currently distributes nearly 400 bakery and confectionery products, with production plants established in Zalaegerszeg, Ajka and Sopron between 2014 and 2017. In addition, Zalaco operates around 50 of its own bakeries.

Key metrics

			Scope estimates	
Scope credit ratios	2020	2021P	2022E	2023E
EBITDA/interest cover (x)	24.7x	10.0x	7.6x	8.2x
Scope-adjusted debt (SaD)/EBITDA	4.7x	4.5x	4.3x	3.7x
Scope-adjusted funds from operations/SaD	19%	19%	20%	24%
Free operating cash flow/SaD	-2%	-2%	-14%	6%

Rating rationale

Scope Ratings GmbH has today affirmed its B+ issuer rating on Zalaco Sütőipari Zrt. and revised the Outlook to Stable from Positive. Scope has upgraded its rating for the senior unsecured debt category to BB- from B+.

The Outlook change back to Stable from Positive is mainly driven by an EBITDA generation that was 28.6% lower than expected in FY 2021. Despite organic growth in most business lines and the successful implementation of an automated frozen product line, significant increases in raw material and utility costs have put under pressure EBITDA generation potential of company (based on 2021 preliminary figures). The increase in the company's cost base was mitigated by the increase in selling prices (retail +10%, frozen +6% and wholesale +16%) in FY2021. However, lower-than-expected EBITDA for YE 2021 and following change of cash generation potential in upcoming years limits deleveraging potential of company. While the company has announced additional price increases on some products, we do not expect any significant improvement of EBITDA margins in the short term.

Outlook and rating-change drivers

The Stable Outlook reflects our expectation that the company will maintain organic growth while profitability margins remain stable, leading to the Scope-adjusted debt (SaD)/EBITDA ratio remaining at around 4x.

A positive rating action is possible if funds from operations (FFO)/SaD exceeds 20% on a sustained basis and SaD/Scope-adjusted EBITDA consistently trends below 3.5x. A decrease in leverage may be achieved through an increase in profitability following the successful implementation of additional production capacity in frozen products.

A negative rating action could result from a deterioration in credit metrics, as indicated by a FFO/SaD of below 10% and a SaD/EBITDA of above 5.x on a sustained basis. An increase in leverage could be triggered by an adverse operational development, leading to reduced profitability or the need for additional external financing for capital expenditure, M&A or dividend payments.

Ratings & Outlook

Corporate rating	B+/Stable
Senior unsecured debt rating	BB-

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Related Methodologies

Corporate Rating Methodology, July 2021

Rating Methodology: Consumer Products, September 2021

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Bloomberg: RESP SCOP

Rating drivers

Positive rating drivers	Negative rating drivers
• Relatively high profitability margins • Vertically integrated value chain and business operations • Operational sustainability following decades of partnerships with international value chains	• High capex requirements turning free operating cash flow negative • Workforce shortage • Small scale compared to international peers • High customer concentration risk

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Increased scale and diversification • FFO/SaD of above 20% • SaD/EBITDA of below 3.5x	• Additional debt-funded acquisitions • FFO/SaD of below 10% • SaD/EBITDA of above 5x

Financial overview

			Scope estimates	
Scope credit ratios	**2020**	**2021P[1]**	**2022E**	**2023E**
EBITDA/interest cover (x)	24.7x	10.0x	7.6x	8.2x
SaD/EBITDA	4.7x	4.5x	4.3x	3.7x
Scope-adjusted FFO/SaD	19%	19%	20%	24%
Free operating cash flow/SaD	-2%	-2%	-14%	6%
Scope-adjusted EBITDA in HUF m	**2020**	**2021P**	**2022E**	**2023E**
EBITDA	1,080	1,374	1,393	1,610
Operating lease payments in respective year	157	155	155	155
Scope-adjusted EBITDA	1,237	1,529	1,548	1,765
Scope-adjusted FFO in HUF m	**2020**	**2021P**	**2022E**	**2023E**
EBITDA	1,080	1,374	1,393	1,610
less: (net) cash interest as per cash flow statement	-106	-120	-169	-179
less: cash tax paid as per cash flow statement	-23	-30	-17	-22
add: depreciation component, operating leases	125	122	121	119
Scope-adjusted FFO	1,076	1,346	1,328	1,528
SaD in HUF m	**2020**	**2021P**	**2022E**	**2023E**
Reported gross financial debt	6,327	5,437	5,187	4,887
less: hybrid bonds	0	0	0	0
less: cash and cash equivalents	-2,000	0	0	0
add: cash not accessible	0	0	0	0
add: pension adjustment	0	0	0	0
add: operating lease obligations	654	668	701	737
Other	835	835	835	835
SaD	4,097	5,354	5,713	5,585

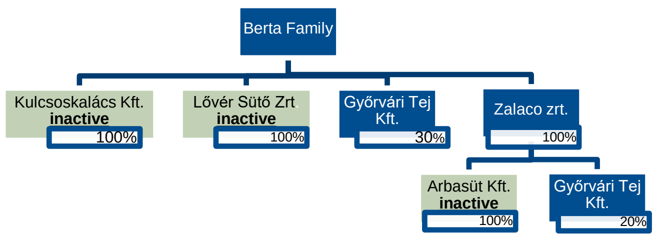
[1] Preliminary results

Business risk profile (B+)

Business risk profile assessed at B+

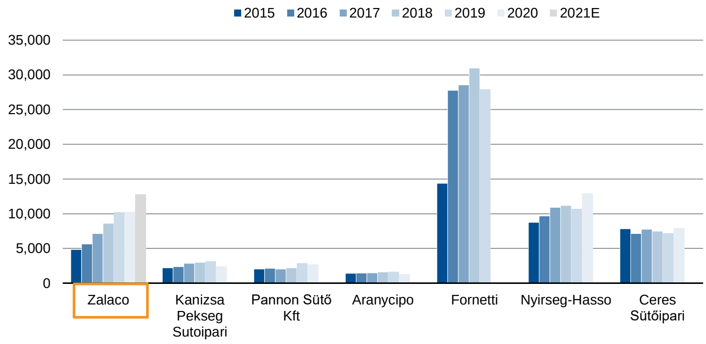
Zalaco's business risk profile continues to benefit from stable demand in the underlying non-durable consumer products industry, which has low cyclicality, medium barriers to entry and low substitution risk.

Figure 1: Organisational structure (as of December 2021)



Source: Zalaco

Figure 2: Top-line development of Zalaco's local competitors (HUF m)

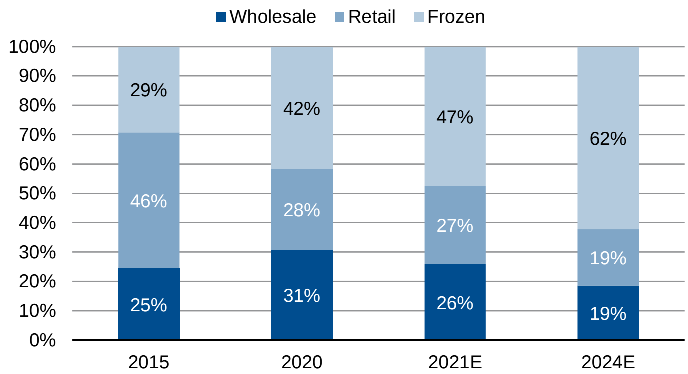


Source: Zalaco, Scope estimates

Significant sales exposure to Lidl

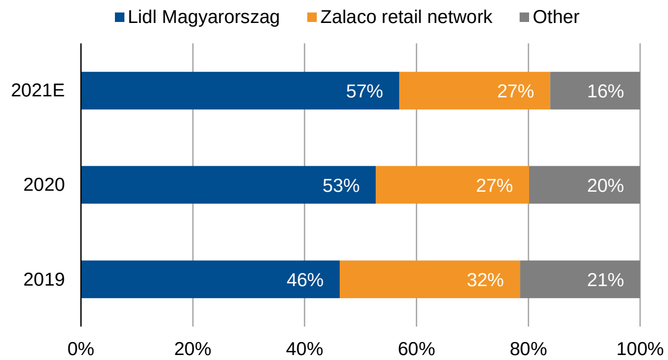
Geographical diversification remains the main constraint in Zalaco's business risk profile, as the Covid-19 pandemic interrupted frozen product exports and limited the company's exposure to one specific region. This is expected to remain so until end-2022 as international retail chains are postponing commercial negotiations. Furthermore, Zalaco's sales remain highly concentrated on international retail chains. For example, Lidl accounted for about 57% of sales in FY 2021 (53% in FY 2020) and this share is expected to increase in the medium term as frozen product sales develop. The risk of this significant exposure to Lidl is partially mitigated by Zalaco's ability to deliver quality-oriented products and to maintain sustainable business operations.

Figure 3: Zalaco's revenue by segment



Source: Zalaco, Scope estimates

Figure 4: Customer concentration

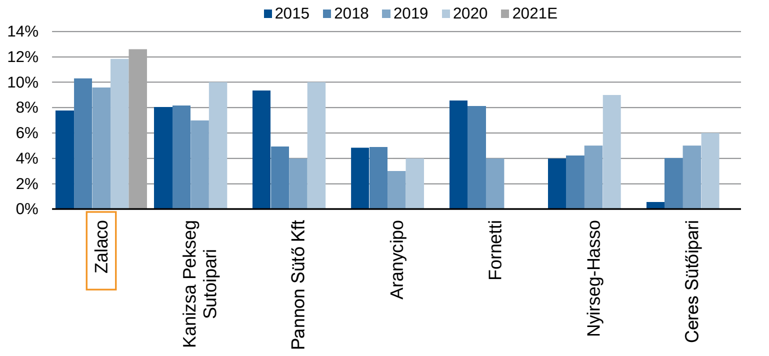


Source: Zalaco, Scope estimates

Relatively high profitability margins

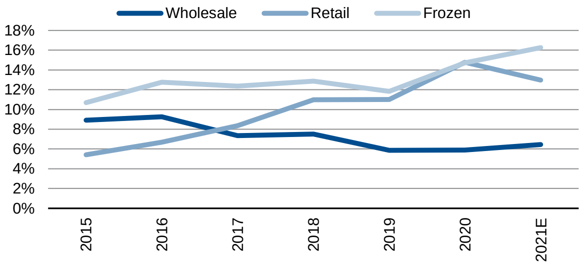
While the main positive element is the company's profitability (relatively high EBITDA margins compared to local peers), raw material and utility cost increases in FY 2021 have hampered overall profitability. This was partially mitigated by the high-margin nature of a fully ramped-up frozen product automated production line.

Figure 5: Profitability margins compared to domestic and regional peers



Source: Zalaco, Scope estimates

Figure 6: Zalaco's EBITDA by division



Source: Zalaco, Scope estimates

Financial risk profile (B+)

Adjustments and assumptions

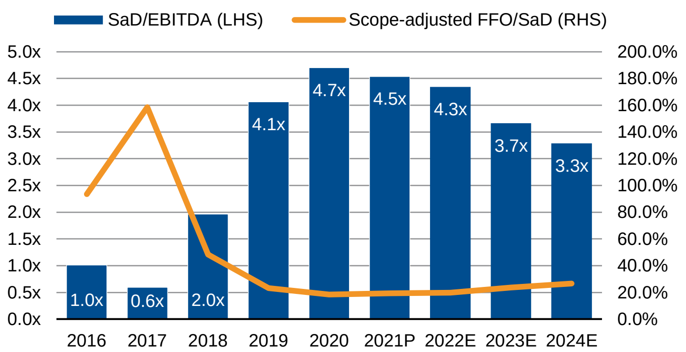
Our SaD calculations incorporate the following adjustments and assumptions:

- Double-digit percentage top-line growth going forward
- Expected increase in group EBITDA margin as a result of a fully ramped-up, new automated production line and higher expected margins from export sales, which will be more visible from 2023
- Expected capex of around HUF 1.9 in 2022 for finalising production line instalments
- Adding-back of operating leases for 50 retail stores, which are off-balance sheet debt according to Hungarian GAAP
- Netting of 80% of available cash and cash equivalents for fiscal year 2020 (this amount excluded from 2021)
- Dividend pay-outs at roughly 25% of last year's net profit, in line with company guidance
- Inclusion in Scope-adjusted EBITDA item of received government funds

Financial risk profile affirmed at B+

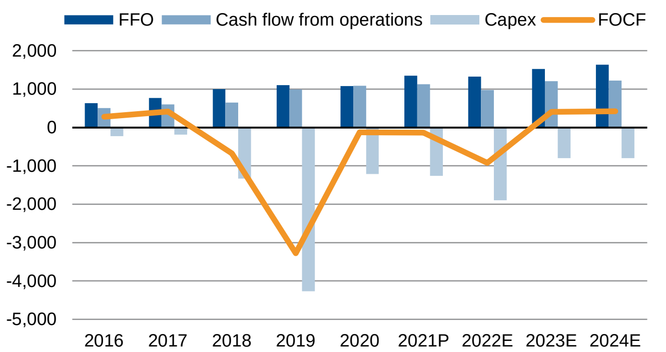
Zalaco's financial risk profile is supported by a still comfortable operating profitability reflected by substantial cash flow generation. The significantly lower-than-expected EBITDA for FY 2021 has restrained the deleveraging potential of the company going forward. The capital expenditure required for the new production line is expected to fully repay in FY 2022, which will result in negative free operating cash flow. We expect the heavy capex phase to dissipate after YE 2022 but steady demand for frozen products from international retail chains might trigger a new expansion phase if the company needs to increase production capacity. There is no change in relation to Zalaco's M&A plans but Covid-19 delayed negotiations and government subsidies boosted the liquidity of bakeries, which postponed potential targeted acquisitions by Zalaco. Thus, M&A will not take place in the horizon of our base case but rather after 2024 when liquidity issues are expected for companies in the fresh bakery industry.

Figure 7: Leverage



Source: Scope estimates

Figure 8: Cash flow generation (HUFm)



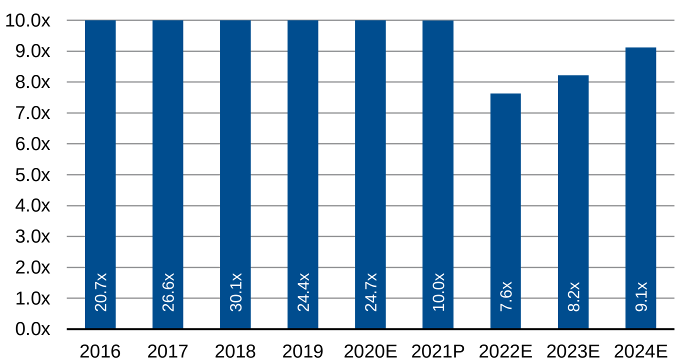
Source: Scope

We expect the gradual deleveraging to slow even further going forward. Our base case anticipates FFO/SaD and SaD/EBITDA reaching 37% and 3.3x respectively in 2024. This is based on our assumptions of i) increased revenue generation mainly driven by the frozen products business line (the additional automated production line is expected to be functional by end-2022); ii) expected price increases in 2022 and iii) a new product portfolio mainly for retail sales.

Adequate liquidity profile

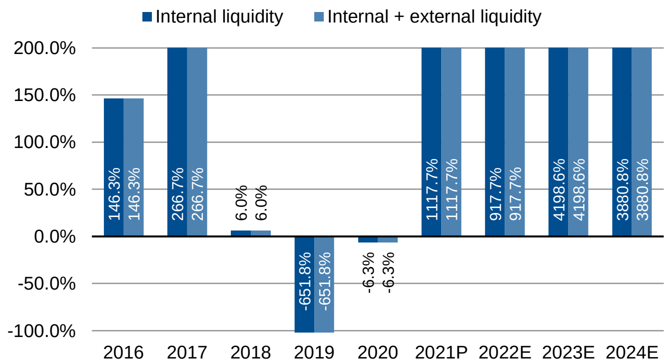
Zalaco's liquidity profile remains adequate. Despite a lack of committed credit lines, the liquidity profile benefits from its bond repayment structure after refinancing all short-term working capital loans (HUF 1.2bn) in 2020. Furthermore, a significant cash cushion at around HUF 1bn together with the expected free operating cash flow from YE 2023 minimises short-term refinancing risks.

Figure 9: EBITDA interest cover



Source: Scope estimates

Figure 10: Liquidity



Source: Scope estimates

Supplementary rating drivers

Credit-neutral supplementary rating drivers

There are explicit adjustments for supplementary rating drivers. We view the group's restructuring finalised at YE 2021 positively. The restructuring aims to provide outside investors with better transparency and increase operational efficiency. While the owner's commitment and transparency are positive factors, there is a key person risk.

Long-term debt ratings

Senior unsecured debt rated at BB-

The senior unsecured debt including the HUF 4.4bn bond (ISIN HU0000359765) has been upgraded to BB- from B+. This reflects our expectation of an 'above-average' recovery for senior unsecured debt positions in the hypothetical event of a company default. The recovery analysis is based on a hypothetical default scenario in 2024, which assumes an outstanding senior secured debt of HUF 975m including financial guarantees and a higher liquidation value, mainly driven by the successful integration of capex investment that mitigate project execution risks.

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