DVM Group Kft.
Hungary, Construction

B STABLE

Corporate profile

DVM Group Kft. (DVM) is the legal successor to D.V.M. Construction Kft. In December 2020 three entities of the group – D.V.M. Construction Kft., DVM Fővállalkozás Kft. and DVM Design Kft. – merged to form DVM Group Kft. DVM, headquartered in Budapest, is a leading design-and-build service provider in Hungary. DVM's services include base building and fit-out construction, site supervision and organisation, as well as the coordination of subcontractors.

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA/Scope- adjusted interest cover (x)	68.9x	11.8x	7.8x	10.5x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	Net cash	3.7x	2.9x	2.5x
Scope-adjusted FFO/SaD	Net cash	23%	32%	38%
Scope-adjusted free operating cash flows FOCF/SaD	Net cash	-133%	1%	26%

Rating rationale

Scope affirms B/Stable issuer rating of DVM Group Kft.

The rating affirmation of DVM is driven by its strong performance in 2020. The company generated revenues of HUF 27bn (38% more revenue than in 2019 and 52% more than our forecast), despite the impact of Covid-19 on the economy. This performance was mainly supported by DVM's base-building activities, which held up well during the pandemic. DVM's backlog of projects has also grown, totalling HUF 75bn as of May 2021 (2.7x 2020 revenues). While top-line figures have improved considerably, the crisis has impacted the company's profitability (-2 pp below the previous year). This was mainly due to: i) postponements in several fit-out projects – activities which have higher profitability margins; and ii) increased material prices, with base-building projects subject to fixed contracts. Nonetheless, the improved backlog and a higher expected contribution from fit-out activities will help the company to protect revenues and profitability in the next few years. DVM's pipeline of projects will also benefit from planned co-developments, including a 6,000 sqm office development and a logistics facility, both investments totalling approx. HUF 10.7bn.

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 some key customers; and iv) a concentrated backlog.

The company's financial risk profile reflects moderate leverage. Scope-adjusted debt (SaD)/Scope-adjusted EBITDA was 3.7x as of December 2020 and we expect it to decrease to below 3x in the next few years. Free operating cash flow was negative in 2020, driven primarily by the company's investment activities, mainly co-development projects. However, we expect free operating cash flow to remain slightly positive in the next few years as the outstanding capex (HUF 3.7bn) planned in the period to 2022 can be mostly covered by operational cash flows.

Ratings & Outlook

Corporate ratings	B/Stable
Senior unsecured rating	B+

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Related Methodology

Corporate Rating Methodology, February 2020

Rating Methodology European Construction Corporates January 2021

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Outlook and rating-change drivers

The Outlook for DVM remains Stable and incorporates our view that the company will continue to produce positive operational cash flows based on its current backlog. It also reflects our expectations of a successful execution of current co-development projects as well as a decrease in SaD/Scope-adjusted EBITDA to below 3x. While we believe that credit metrics will improve, especially leverage, the company's small size and low diversification significantly threaten cash flow stability. Thus, we expect a tangible improvement in cash flow diversification going forward, which could be driven by a higher EBITDA share of the more granular fit-out business.

A positive rating action might occur if our rating scenario materialises, including the sustained maintenance of a backlog above 2.5x, combined with higher diversification (customers and projects) while keeping SaD/Scope-adjusted EBITDA below 3.5x on a sustained basis.

A negative rating action could occur if projects suffered significant delays or cost overruns, or if liquidity worsened. The latter could happen 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 position benefits from an integrated business, offering a turn-key solution that translates into a time- and cost-efficient model • Strong debt protection despite increased interest-bearing debt	• Small-scale construction company in a European context, with a lack of geographic diversification exposing it to its domestic construction industry • Improved backlog to sales ratio (2.7x as of May 2021) but still concentrated in a limited number of projects (top three projects accounting for 66% of backlog revenues; top 10 for 93%) partially mitigated by long-standing relations with main clients • Positive but low level of Scope-adjusted free operating cash flow, supported by expected positive Scope-adjusted FFO that cover the investments planned in the next few years and because the company will not pay dividends before 2023

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Maintenance of backlog at above 2.5x on a sustained basis combined with higher diversification (customers and projects) while keeping SaD/Scope-adjusted EBITDA below 3.5x on a sustained basis	• Worsening liquidity due, for example, to delayed customer payments or cost overruns • Delays or cost overruns for real estate developments

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA/interest cover (x)	68.9x	11.8x	7.8x	10.5x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA (x)	Net cash	3.7x	2.9x	2.5x
Scope-adjusted FFO/SaD (%)	Net cash	23%	32%	38%
Scope-adjusted FOCF/SaD (%)	Net cash	-133%	1%	26%
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	1,559.5	1,592.4	1,990.0	2,515.2
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	1,559.5	1,592.4	1,990.0	2,515.2
Scope funds from operations in HUF m	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA	1,559.5	1,592.4	1,990.0	2,515.2
less: cash interest as per cashflow statement	-17.1	-72.2	35.8	52.3
less: interest component operating leases	0.0	0.0	0.0	0.0
less: cash tax paid as per cashflow statement	-133.6	-154.5	-148.1	-171.2
less: capitalised interest	0.0	0.0	0.0	0.0
Scope funds from operations	1,408.8	1,365.6	1,877.7	2,396.4
Scope-adjusted debt in HUF m	**2019**	**2020**	**2021E**	**2022E**
Interest-bearing debt	621.5	8,614.2	8,080.8	8,070.8
Other liabilities	0.0	0.0	0.0	0.0
Cash	-1,586.8	-2,729.9	-2,247.3	-1,768.5
Restricted cash	0.0	0.0	0.0	0.0
Off-balance sheet debt	0.0	0.0	0.0	0.0
Scope-adjusted debt	-965.3	5,884.2	5,833.5	6,302.3

Business risk profile: B

Industry risk: B

DVM is mainly focused on design, base building, fit-out and building refurbishment. All of these activities are directly linked to the construction industry, although they do represent different construction stages. The company portfolio includes various commercial real estate segments, of which the main ones are: office, retail, hotel and some residential and industrial projects.

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 construction activities have not been interrupted by the impact of pandemic on the economy. Performance in 2020 was strong. The company generated revenues of HUF 27bn (38% more revenue than in 2019 and 52% more than our forecast), despite the impact of the Covid-19 outbreak on the economy. Performance was mainly supported by DVM's base-building activities, which held up well during the pandemic (135% growth YoY). Despite this development, DVM remains a small construction company both in a European context and in Hungary, a highly fragmented market. The company's small size restricts its ability to benefit from economies of scale or diversification as only a limited number of projects can be executed simultaneously.

Nonetheless, we believe that DVM's revenue generation will be protected in the next few years by its robust backlog of projects. These totalled HUF 75bn as of May 2021, significantly above the HUF 45bn of April 2020 and equating 2.7x of 2020 revenues. In addition, the company targets growth via co-development projects (total investments of about HUF 10,7bn) thus strengthening the future pipeline for the group, as well as the acquisition of subcontractors. As part of this plan, the company has set up a joint venture with MV Development Limited for a new 6,000 sqm office development (contributing a HUF 6.4bn loan to finance the acquisition and development cost of this project). In addition, DVM has acquired a plot to develop a logistics building with a total cost of HUF 4.3bn. Despite this, we expect DVM to remain relatively small.

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

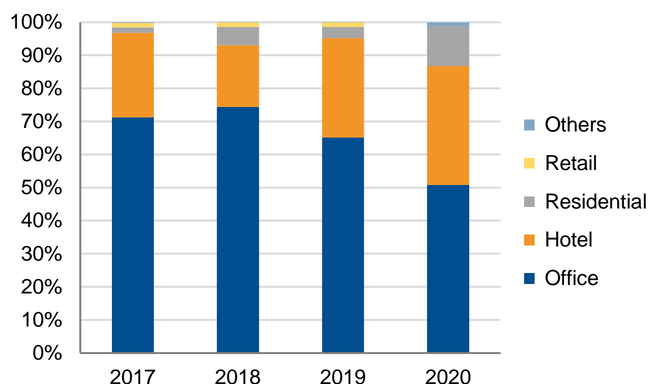
The company's business model benefits from a vertically integrated service chain that has continued to develop over the years. DVM's 'one-stop shop' business model offers clients a turn-key solution in which design and implementation run in parallel, generating efficiencies in both the cost and duration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

Exposed to domestic construction market – one geography and segment

Geographical diversification is 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.

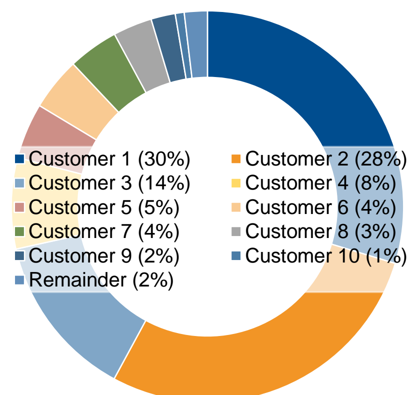
All activities relate to just one sub-segment in one industry (building construction) but they serve different end-markets, mostly office, hospitality and residential, thus benefitting from different underlying demand patterns. This has partially mitigated the impact of the pandemic, which led to delays in public procurements and private tenders; some contracted work has been rescheduled, particularly in the hospitality segment.

Figure 1: Revenue breakdown by type of project (HUF m)



Source: DVM, Scope

Figure 2: Revenue breakdown by customer (%) as at Q2 2021



Source: DVM, Scope

Concentrated customer structure, with some long-term customers in the portfolio

DVM's limited size results in high customer concentration as only a few projects can be executed simultaneously. 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.

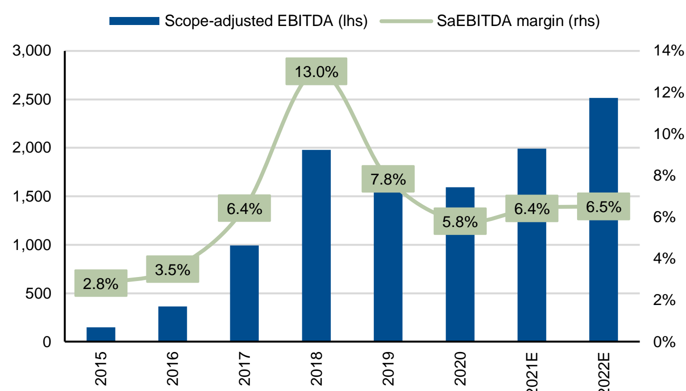
Improved backlog, but still concentrated on a limited number of projects

The company's backlog as of May 2021 amounts to HUF 75bn (HUF 45bn in April 2020), resulting in an improved backlog-to-sales ratio of 2.7x. However, DVM's backlog is still concentrated, with the top three projects accounting for 66% of future contracted revenues and the top 10 for 93%. The largest project, the construction of a five-star luxury hotel, represents 30% of the total backlog while the second largest (office building) represents 25%. The remainder is distributed across 19 other projects. This concentration poses the risk of significant cash flow volatility if projects are delayed or cancelled. The latter is partially mitigated by a payment scheme enforced by law that protects contractors from non-payment or late payments for projects larger than HUF 1.5bn (98% of DVM's backlog). Limited backlog diversification also exposes the company to the slowdown in certain segments. Hotel projects, for example, represent 42% of the company's backlog and hospitality has been one of the segments hardest hit by the Covid-19 outbreak.

Weaker profitability, expected to recover in the next few years

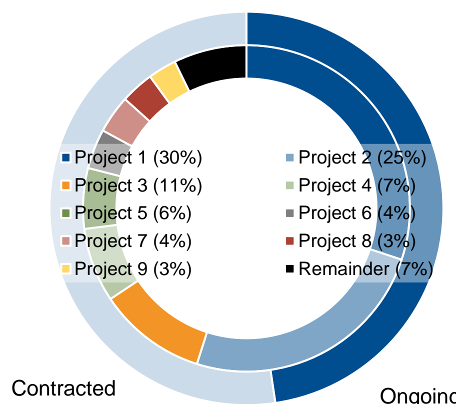
Profitability in 2020, as measured by the Scope-adjusted EBITDA margin, was impacted by the pandemic. This was due to: i) postponements in several fit-out projects, which have higher profitability margins; and ii) increased material prices – as base-building projects are subject to fixed contracts the company cannot pass the costs on to clients. This resulted in a lower Scope-adjusted EBITDA margin of 5.8% as of December 2020 (2pp below the margin in 2019). Nonetheless, we expect the improved backlog and an increased contribution from fit-out activities to help protect revenues and profitability in the next few years.

Figure 3: Scope-adjusted EBITDA and Scope-adjusted EBITDA margin



Source: DVM, Scope estimates, 'Sa' = Scope-adjusted

Figure 4: Backlog breakdown by project as at Q2 2021



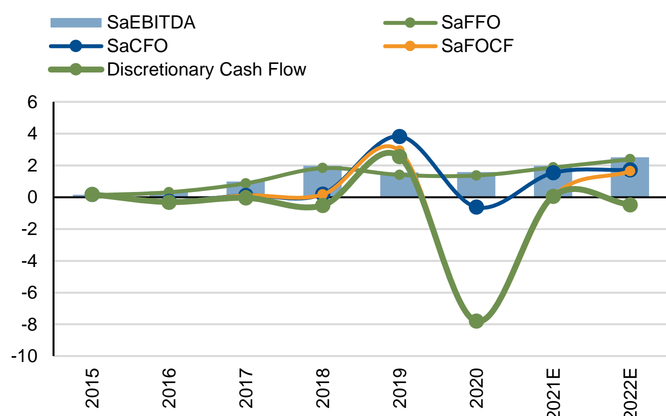
Source: DVM, Scope estimates

Financial risk profile: B+

Adequate debt protection metrics despite debt increase in 2020

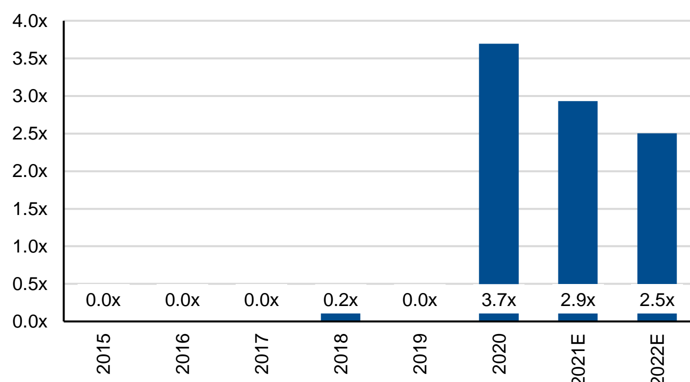
DVM has had relatively little financial debt in the past, keeping interest expenses low. This resulted in a strong Scope-adjusted EBITDA interest coverage ratio in the years prior to 2019. The issuance of the HUF 8bn bond in 2020 (3% coupon) increased financial costs. We do not expect a significative rise in financial debt in the next few years, except for the additional loan to finance the logistics development in 2023 (50% of the total cost of HUF 4.3bn). Further, the company expects to benefit from financial interest income resulting from the loans it provided as part of the joint venture agreement for the Henkel development. This should help to keep Scope-adjusted EBITDA interest coverage at adequate levels of above 5x in 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.

Figure 5: Cash flows (HUF bn)



Source: DVM, Scope estimates; 'Sa' = Scope-adjusted

Figure 6: Leverage (SaD/SaEBITDA)



Source: DVM, Scope estimates; 'Sa' = Scope-adjusted

Positive but low free operating cash flow

We expect stable and positive funds from operations in the coming years. This is based on DVM's backlog and our expectation that the company will be able to maintain turnover of at least HUF 30bn. Free operating cash flow has been more volatile with most of the investment phase completed in 2020. We expect it to remain slightly low but positive.

Growth strategy at the expense of increase in leverage

DVM's debt strategy has been conservative, evidenced by its very low levels of debt until 2019. In 2020, the company issued a HUF 8bn senior unsecured bond under the MNB Bond Funding for Growth Scheme to partially finance its significant capex programme. The company has financed the present co-developments using current available funds. We expect bank financing to be involved in the development of the logistics building (total cost of HUF 4.3bn, 50% financed via a bank loan) but not before 2023.

Regarding contingent liabilities, DVM and Horizon Development are the second range guarantor in the Unicredit loan (about EUR 54.5m) used to finance the development of Szervita Square, while Szervita Square (asset market value of EUR 63.2m as of March 2021), is the first range guarantee. The probability that the guarantee will be called upon is remote.

Adequate liquidity

DVM's liquidity is adequate. Liquidity benefits from a back-loaded debt maturity profile – mainly the HUF 8bn bond with a 10 year tenor and no significant amount due in the coming years. We expect the company's low short-term debt levels to be maintained going forward and to be sufficiently covered by available financing sources. The liquidity gap in 2020 was mainly financed with the bond proceeds.

Figure 7: Liquidity

in HUF m	2020	2021E	2022E
Short-term debt (t-1)	36	33	10
Unrestricted cash (t-1)	1,587	2,730	2,247
Open committed credit lines (t-1)	0	0	0
Free operating cash flow (t)[1]	-7,803	51	1,636
Coverage	-171.7x	83.3x	388.3x

Source: Scope estimates

Long-term and short-term debt ratings

Senior unsecured debt: B+

DVM issued a HUF 8bn senior unsecured corporate bond (ISIN HU0000359781) under the MNB Bond Funding for Growth Scheme in the second half of 2020. The bond has a 3% coupon and is amortising, starting in 2026, with a tenor until 2030.

Our recovery analysis was based on a hypothetical default scenario occurring at year-end 2022, in which we assumed outstanding senior unsecured debt of HUF 8.0bn and no additional secured bank debt. 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).

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

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