Duna Aszfalt Zrt.
Hungary, Construction

SCOPE BB- STABLE

Key metrics

			Scope estimates	
Scope credit ratios	2020	2021	2022E	2023E
Scope-adjusted EBITDA/interest cover	67.9x	73.2x	43.5x	14.7x
Scope-adjusted debt/EBITDA	0.8x	1.0x	2.1x	2.9x
Scope-adjusted funds from operations/debt	110%	90%	44%	30%
Scope-adjusted free operating cash flow/debt	-14%	18%	13%	24%

Rating rationale

Duna Aszfalt Zrt.'s issuer rating benefits from its position as one of the largest construction companies in Hungary. The group's robust order backlog has backed its solid performance in recent years. The rating is further supported by robust credit metrics, including low leverage and strong debt protection.

Constraints include the group's relatively small scale in the European context, which weakens its ability to mitigate economic cycles. Weak diversification is a further constraint, as Duna Aszfalt is strongly focused on the construction sector in Hungary. Within the sector, the group has a high exposure to motorway construction, where it generated more than 68% of its revenue in H1 2022. The group also remains largely dependent on governmental demand and strategy (more than 63% of Duna Aszfalt's revenue came from Hungarian state-owned companies).

Outlook and rating-change drivers

The Stable Outlook is based on continued operations backed by an existing order backlog amid weaker profitability due to rising construction materials prices. Our base case foresees credit metrics to remain robust but factors in the lower visibility on business fundamentals, including a weaker economic environment and inflationary pressures, but also the expectation of a gradual recovery of public procurements.

A positive rating action is possible if the group's backlog strengthens, providing greater visibility on future cash flow and lowering dependency on state orders, paired with an unchanged solid financial risk profile.

A negative rating action could result from an order backlog dropping below 1x. This could be triggered by a deterioration in market conditions and fewer projects being added to the backlog. A downgrade could be required if Duna Aszfalt's leverage, as measured by Scope-adjusted debt/EBITDA, significatively deteriorated to above 3.5x on a sustained basis.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
14 Oct 2022	Outlook change	BB-/Stable
15 Oct 2021	Outlook change	BB-/Positive
21 Oct 2020	Affirmation	BB-/Stable
6 Sep 2019	Initial rating	BB-/Stable

Ratings & Outlook

Issuer	BB-/Stable
Senior unsecured debt	BB

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Related Methodologies and Related Research

General Corporate Rating Methodology; July 2022

Construction and Construction Materials Rating Methodology; January 2022

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Positive rating drivers	Negative rating drivers
• Solid profitability, but with uncertain sustainability once backlog dries up • Robust credit metrics, including low leverage (SaD/EBITDA stood at 1x as at end-year 2021) and debt protection, as measured by the Scope-adjusted EBITDA/interest cover, comfortably above 10x • Record of winning tenders	• Uncertain ability to maintain current profitability and credit metrics through new tenders • Focus on local industrial and civil engineering projects, a segment with high cyclicality and low entry barriers • Revenue concentration in Hungary, high concentration in both construction and motorway construction • Dependence on state tenders • Relatively low backlog-to-sales ratio; low visibility after the current backlog is processed • Market position relying on the group's well-established credentials for projects with state-owned companies, resulting in regulatory and reputational risks (ESG factor)

Positive rating-change drivers	Negative rating-change drivers
• Strengthened order backlog on a sustained basis, increasing cash flow predictability and lower dependence on state orders, paired with an unchanged solid financial risk profile	• Order backlog dropping below 1x • Leverage (SaD/EBITDA) increasing above 3.5x on a sustained basis

Corporate profile

Founded in 1996 and 100% owned by László Szíjj, Duna Aszfalt is one of the largest players in Hungarian road construction and renovation. Further segments include the laying of utility lines, the construction of water and sewage treatment structures, and bridge building. Duna Aszfalt also provides heavy equipment and operates asphalt-mixing plants, quarries as well as emulsion production and laboratory facilities.

Financial overview

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover (x)	67.9x	73.2x	43.5x	14.7x
Scope-adjusted debt/SaEBITDA (x)	0.8x	1.0x	2.1x	2.9x
Scope-adjusted funds from operations/debt(%)	110%	90%	44%	30%
Scope-adjusted free operating cash flow/debt (%)	-14%	18%	13%	24%
Scope-adjusted EBITDA in HUF m	**2020**	**2021**	**2022E**	**2023E**
EBITDA	57,613	65,301	39,185	29,835
less: disposal gains from fixed assets included in EBITDA	0	0	0	0
Others adjustments[1]	4,825	1,701	0	0
Scope-adjusted EBITDA	**62,438**	**67,002**	**39,185**	**29,835**
Scope funds from operations in HUF m	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA	62,438	67,002	39,185	29,835
less: cash interest as per cashflow statement	-920	-916	-900	-2,025
less: cash tax paid as per cashflow statement	-4,672	-4,872	-2,752	-1,847
Funds from operations (FFO)	**56,847**	**61,214**	**35,534**	**25,963**
Free operating cash flow in HUF m	**2020**	**2021**	**2022E**	**2023E**
Funds from operations	56,847	61,214	35,534	25,963
Change in working capital	-64,480	-32,542	-18,654	295
less: capital expenditure (net)	407.2	-16,180	-6,092	-5,162
Free operating cash flow (FOCF)	**-7,226**	**12,493**	**10,788**	**21,096**
Net cash interest paid in HUF m	**2020**	**2021**	**2022E**	**2023E**
Net cash interest per cash flow statement	-920	-916	-900	-2,025
Change in other items	0	0	0	0
Net cash interest paid	**-920**	**-916**	**-900**	**-2,025**
Scope-adjusted debt in HUF m	**2020**	**2021**	**2022E**	**2023E**
Reported gross financial debt	30,000	30,000	30,000	45,000
add: advanced payments	47,979	41,799	15,000	12,000
less: cash and cash equivalents	-81,074	-70,811	-46,580	-32,486
add: non-accessible cash[2,3]	5,500	5,500	25,000	5,000
add: Off-Balance Sheet Debt[4]	49,451	61,793	57,999	57,999
Scope-adjusted debt (SaD)	**51,856**	**68,281**	**81,419**	**87,513**

[1] Net provisions
[2] Netting of cash: generally only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible
[3] While the cash balance will remain high, part of it is earmarked for financing the group's investment plan, mainly business expansion, as well as concessions in non-European markets. We estimate that accessible cash stands at around HUF 30bn, equal to that prior extensively tapping capital markets.
[4] Includes performance and default guarantees

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Environmental, social and governance (ESG) profile[5]

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

The construction industry has a considerable impact on the environment. Industry efforts have focused on reducing energy use and associated emissions. However, the recent disruption in supply chains has forced contractors to quickly find alternative suppliers or pay higher materials prices, a situation that is unlikely to change in the near term. New Covid-19-related regulations regarding cleanliness and safety have also drastically affected operations at construction sites. A higher union influence could also increase costs and extend timelines on projects.

The most relevant ESG risks for construction companies reside in: i) rising costs and sustainable building materials; ii) efficient technologies; iii) employee health and safety; and iv) litigation and bribery.

We deem regulatory and reputational risks to be a negative ESG factor. We believe that Duna Aszfalt's market position in recent years was gained by winning state tenders thanks to the group's well-established credentials on projects with state owned companies. State tenders account for more than 63% of total revenues in 2021, which creates a high dependency.

[5] 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 and material impact on the rated entity's cash flow and, by extension, its credit quality.

Business risk profile: B

Industry risk profile: B

Duna Aszfalt operates as a main constructor. The group has a very concentrated business model as around 90% of its revenue in the last few years has come from construction, with a focus on motorways. Other construction activities include the laying of utility lines, the construction of water and sewage treatment structures and bridges.

The construction industry is highly cyclical overall, with low barriers to entry and low/medium substitution risk.

The construction segment has been impacted by the greater uncertainty in the overall market environment, resulting in a potential squeeze on profitability, while inflationary pressures, supply chain disruptions and increasing interest rates weigh on operating and financing costs, respectively. Public procurements have slowed down due to the Hungarian electoral calendar combined with uncertainty around the upcoming inflow of European Funds to Hungary.

Small construction player in the European context, but leader in its niche market

Duna Aszfalt's performance was resilient in 2021, with a revenue of HUF 303bn and Scope-adjusted EBITDA of HUF 67bn (respectively 6% and 8% above our forecast). However, Duna Aszfalt remains a relatively small construction group within Europe. Its limited size is a negative rating driver as it implies greater sensitivity to unforeseen shocks, greater cash flow volatility and limited economies of scale.

Limited diversification by geography and segment

Geographical diversification remains limited as the group's activities are concentrated in Hungary, creating a full exposure to the macroeconomic environment of one country. This is compounded by Duna Aszfalt's focus on construction, a cyclical industry in which market downturns tend to strongly affect revenue and earnings.

Diversification across business segments remains limited. Duna Aszfalt covers various construction segments but the group has a relatively high exposure to motorway construction, where it generated over 63% of revenue in 2021.

Concentrated customer structure, strongly exposed to state tenders

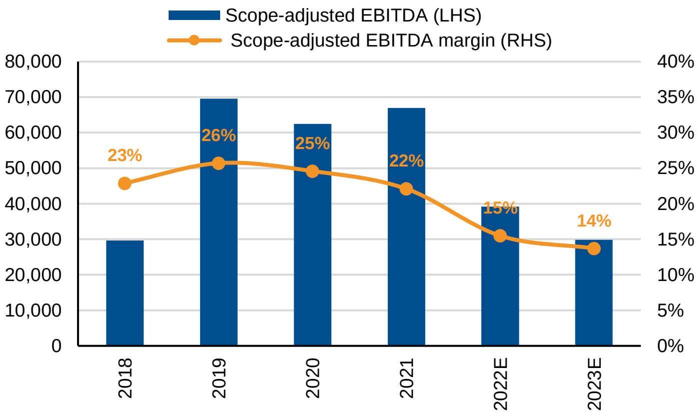
A further restraining factor for the group's business risk profile is its high dependence on state tenders and thus on government demand and strategy. Government-related projects have represented more than 65% of Duna Aszfalt's revenue since 2017.

Shrinking order backlog risk due to increasing scarcity of tenders

Years of fiscal stimulus linked to EU funding priorities and local governmental policies boosted Duna Aszfalt's niche market. Tenders have become scarcer, leading to lower volumes and thinner margins. Duna Aszfalt's order backlog totals HUF 424bn as of September 2022 (compared to HUF 498bn in previous year), equating to 1.4x of 2021 revenue. This backlog provides only limited long-term visibility on cash flow and could weaken the group's credit profile.

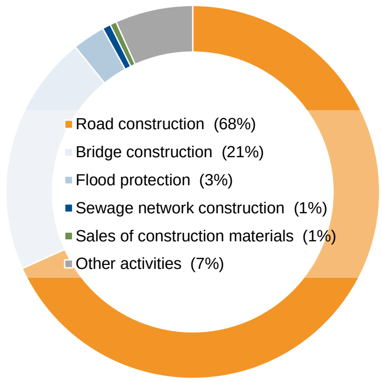
The group's strong dependence on public infrastructure projects could result in weaker cash flow. Since EU funding has been a major source of funding for infrastructure projects in Hungary, uncertainty surrounding access to it may cause a decline in the number of public procurements and tenders. The Hungarian government announced that it would freeze or postpone HUF 2,400bn of public investment in 2022 and 2023, adding to the uncertainty. The freeze includes 284 projects in Hungary, predominantly infrastructure investments in their initial phase. Duna Aszfalt's main projects are not included in the list, so the impact of this freeze will likely be negligible for the current backlog.

Figure 1: EBITDA (in HUF m) and EBITDA margin



Source: Scope estimates

Figure 2: Revenue breakdown, H1 2022



Source: Scope estimates

Increasing raw material prices weaken profitability

Profitability continues to be the main supportive factor for the group's business risk profile. Scope-adjusted EBITDA was HUF 67bn in 2021 adjusted for net provisions and HUF 11bn of impairments. Profitability, as measured by the Scope-adjusted EBITDA margin, reached 22% in 2021.

In the last couple of years, Duna Aszfalt has been sourcing new projects and made efforts to internally source several building materials or acquire supplies in bulk to keep construction material stock under control. However, those efforts will likely be insufficient to offset the impact of rising construction material prices and supply chain disruptions.

Scope-adjusted EBITDA margin dropped to 17% in H1 2022. We expect that profitability will continue to weaken and that Duna Aszfalt's Scope-adjusted EBITDA margin will decrease to below 15% in the next few years.

Financial risk profile: BBB-

BBB- rated financial risk profile remains unchanged

Duna Aszfalt's issuer rating remains supported by its sound financial risk profile. The reported group's indebtedness continues to be largely driven by the HUF 30bn corporate notes issued under the Hungarian Central Bank's Bond Funding for Growth Scheme. To calculate Scope adjusted debt (SaD), we adjusted for i) guarantees, adding 100% of performance and default guarantees; and ii) advance payments. SaD therefore amounts to around HUF 68.3bn at end-December 2021 (HUF 51.9bn at end-December 2020).

Leverage still benefits from a low gross indebtedness but is expected to increase

Duna Aszfalt's leverage benefits from its low gross indebtness. Leverage, as measured by Scope-adjusted debt/EBITDA, was 1x as of December 2021, slightly below our expectations. This resulted from higher-than-expected Scope-adjusted EBITDA (8% above our forecast) as well as lower Scope-adjusted debt (25% below). We expect that Scope-adjusted debt/EBITDA will increase to above 2x in the next few years and remain cautious about the sustainability of current credit metrics. Firstly, the group plans to add a HUF 15bn loan to finance part of the investment plan. Secondly, credit metrics are heavily influenced by the profitability of contracts in Duna Aszfalt's current order backlog and new order intakes. In previous years Duna Aszfalt has reduced long-term financial assets and increased cash balances to prepare for large projects and future acquisitions. Thus, the cash and cash equivalents position at end-2021 (HUF 70.8bn) is not permanent, in our view.

Strong debt protection

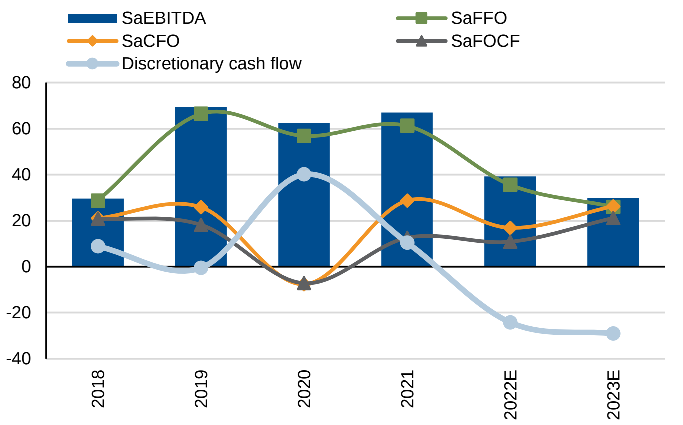
Debt protection, as measured by the Scope-adjusted EBITDA interest cover, remained strong. Financial costs increased following the bond issuance (3% coupon) and additional bank loans (HUF 15bn) to partly finance Duna Aszfalt's investment plan, would significantly increase total financial expenses, amid the current interest rate environment

Hungary. However, we expect debt protection to remain strong given the group's remaining backlog and associated operating cash flow.

Reduced advance payments hinder operating cash flow

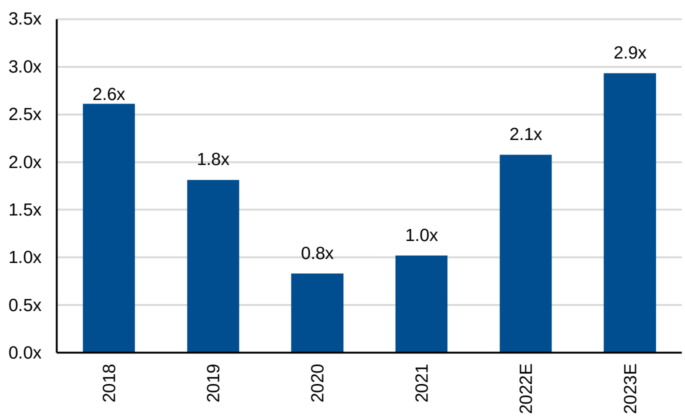
As the order backlog dries up, cash flow will likely weaken. The group's FOCF has been volatile and is assumed to remain under pressure due to working capital requirements as the group does not expect continuing high advance payments from customers. In the past, infrastructure development projects were implemented in a very favourable financing context, as the main contractor was entitled to a 50% advance immediately after signing the construction contract. However, it is not certain that these conditions would be maintained for Duna Aszfalt's future projects. While we expect a recovery in orders related to governmental stimulus, timing is still uncertain.

Figure 3: Cash flows (HUF bn)



Source: Scope estimates
Sa = Scope-adjusted

Figure 4: Leverage (Scope-adjusted debt/EBITDA)



Source: Scope estimates

Adequate liquidity

Liquidity is adequate and benefits from a backloaded debt maturity profile comprising a HUF 30bn bond with a bullet maturity in 2029 and no significant amount due in coming years. In line with our expectations, the group's reported cash balances remained strong with HUF 62bn by end-2021. Marketable securities of HUF 8.9bn (such as real estate funds) and expected positive FOCF for 2022 enhance the group's liquidity. Given the long maturity of the bond, upcoming short-term maturities will be manageable. All in all, the group has a sufficient cash buffer to finance its investment programme (about HUF 85bn).

Balance in HUF m	2022E	2023E
Unrestricted cash (t-1)	65,311	21,580
Open committed credit lines (t-1)	0	0
Free operating cash flow	10,788	21,096
Short-term debt (t-1)	0.0	0.0
Coverage	**>200%**	**>200%**

Long-term debt rating

Senior unsecured debt rating: BB

The recovery calculation considers the HUF 30bn unsecured corporate bond issued under the Hungarian National Bank's Bond Funding for Growth Scheme. In line with the group's plans, we assume that i) the business plan will be executed with HUF 15bn of additional bank debt; ii) payables have a higher seniority than the bond; and iii) advances received have the same seniority as the bond. This view is based on the legal opinion provided by the local legal counsel.

Our recovery analysis is based on a liquidation value of HUF 119bn in a hypothetical default in 2023. This value is based on a haircut of around 60% on assets and reflects liquidation costs of 10% for the assets. We expect an above-average recovery for senior unsecured debt, hence the BB rating for the senior unsecured debt category, which is one notch above the issuer rating. The uplift is limited by the risk of senior secured debt potentially increasing in the path to default due to the volatility of capital structure and share of senior unsecured debt.

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