Duna Aszfalt Zrt.
Hungary, Construction

SCOPE BB- STABLE

Corporate profile

Founded in 1996 and 100% owned by László Szíjj, the Duna Aszfalt group is one of the largest players in Hungarian road construction and renovation. Further segments include laying utility lines, constructing water and sewage treatment structures, and building bridges. Moreover, Duna Aszfalt provides heavy equipment and operates asphalt-mixing plants, quarries, and emulsion production and laboratory facilities. For the 2019 business year, consolidated revenues totalled HUF 270.5bn (approx. EUR 800m) and EBITDA stood at HUF 54.9bn (approx. EUR 165m).

Key metrics

* Not consolidated			Scope estimates	
Scope credit ratios	**2018***	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	N/A	343.6x	56.1x	42.8x
Scope-adjusted debt (SaD)/EBITDA	2.6x	1.8x	1.2x	1.3x
Scope-adjusted funds from operations/SaD	37%	40%	66%	70%
Free operating cash flow (FOCF)/SaD	27%	14%	0%	3%

Rating rationale

Scope Ratings affirms the BB- issuer rating on Duna Aszfalt Zrt. (in October 2020 Duna Aszfalt has changed its company form, from a Kft. to Zrt.) with a Stable Outlook. Scope also affirms the BB rating for the senior unsecured debt category.

Duna Aszfalt reported consolidated numbers in 2019 after acquiring 100% of Magyar Vakond Kft. Consolidated revenues were HUF 271bn (around EUR 800m) and consolidated EBITDA was HUF 55bn (EUR 165m; margin at 20.3%). Although these levels are substantially more than Duna Aszfalt's stand-alone figures, which we used for our initial rating assessment, the group is still a small, niche construction company focused on motorways in Hungary. The B rated business risk profile remains constrained by geographical diversification and the very concentrated business model. Further factors limiting the business risk profile include the high dependency on state tenders (Hungarian state-owned companies accounted for around 65% of total revenues in 2019), the short average project length (three years), and the low backlog-to-sales ratio (1.6x at year-end 2019). Profitability remains the main supportive factor for the business risk profile.

Duna Aszfalt's BB+ rated financial risk profile remains unchanged. In view of the higher EBITDA and stable debt level, credit metrics based on consolidated numbers are slightly better than those previously calculated for the individual entity. At year-end 2019, we calculate a Scope-adjusted debt (SaD)/EBITDA ratio of 1.8x. For year-end 2020, despite an expected drop in EBITDA, we anticipate SaD/EBITDA to improve to 1.0-1.5x, reflecting a lower expected SaD, in particular driven by the planned conversion of around HUF 29bn in long-term financial assets into cash in 2020. Nevertheless, we remain cautious about the sustainability of the current credit metrics. Firstly, they are heavily influenced by the lucrative contracts received in 2016 and to be executed over the next two years. Secondly, Duna Aszfalt's reasoning for the planned reduction in long-term financial assets is to prepare for large projects and future acquisitions. Thus, the cash position expected at year-end 2020 (our expectation is around HUF 65bn) is unsustainable, in our view.

Ratings & Outlook

Corporate ratings	BB-/Stable
Senior unsecured rating	BB

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Related Methodologies

Corporate Rating Methodology, February 2020

Rating Methodology European Construction, January 2020

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Outlook and rating-change drivers

The Stable Outlook reflects our expectation that the company will successfully execute its currently profitable order backlog. It also reflects our expectation that Duna Aszfalt will use its significant expected liquidity buffer for large projects and acquisitions. This is likely to result in the low expected leverage at year-end 2020 reverting to our rating case, with a SaD/EBITDA in the 2-3x range.

A positive rating action is possible if Duna Aszfalt improves its business risk profile, e.g. through better diversification of its order backlog, increased cash flow predictability and a lower dependency on state orders, while maintaining the financial risk profile at least in line with our rating case.

A negative rating action could result if SaD/EBITDA reached above 3.5x on a sustained basis, due, for example, to new contracts being less profitable.

Rating drivers

Positive rating drivers	Negative rating drivers
• Very solid profitability, but with uncertain sustainability • Marked improvement in credit metrics as EBITDA boosted by state tenders won in 2016 • Good recent track record in winning new 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 • Full revenue concentration in Hungary, high concentration in both construction and motorway construction • Dependency on state tenders • Short average project length, low backlog-to-sales ratio, and low visibility after current backlog executed

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Improved business risk profile e.g. through a better diversification of its order backlog, increased cash flow predictability and lower dependency on state orders, while retaining the financial risk profile at least in line with our rating case	• SaD/EBITDA of above 3.5x on a sustained basis, possibly due to less profitable new tenders

Financial overview

* Not consolidated			Scope estimates	
Scope credit ratios	**2018***	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	na	343.6x	56.1x	42.8x
SaD/EBITDA	2.6x	1.8x	1.2x	1.3x
Scope-adjusted funds from operations/SaD	37%	40%	66%	70%
Free operating cash flow/SaD	27%	14%	0%	3%
Scope-adjusted EBITDA in HUF m	**2018***	**2019**	**2020F**	**2021F**
EBITDA	22,295	54,887	44,527	38,500
Operating lease payments in respective year				
Other	7,350	14,652	6,000	
Scope-adjusted EBITDA	29,645	69,539	50,527	38,500
Scope-adjusted funds from operations in HUF m	**2018***	**2019**	**2020F**	**2021F**
EBITDA	29,645	69,539	50,527	38,500
less: (net) cash interest as per cash flow statement		-202	-900	-900
less: cash tax paid as per cash flow statement	-967	-2,870	-3,215	-2,754
add: depreciation component, operating leases				
Scope-adjusted funds from operations	28,679	66,467	46,412	34,846
Scope-adjusted debt in HUF m	**2018***	**2019**	**2020F**	**2021F**
Reported gross financial debt	0	31,078	30,000	30,000
less: cash and cash equivalents	-20,179	-44,458	-68,430	-55,039
add: cash not accessible		5,500	5,500	5,500
add: pension adjustment				
add: operating lease obligations				
add: advances	73,364	89,260	49,300	25,000
add: guarantees	24,240	44,667	44,667	44,667
Scope-adjusted debt	77,424	126,047	61,037	50,128

Business risk profile: B

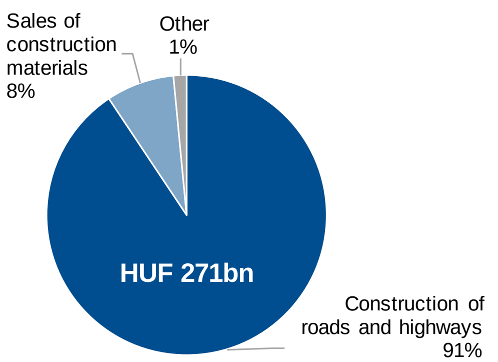
B rated business risk profile remains unchanged

The business risk profile remains rated at B. The business risk profile rating remains constrained by geographical diversification and the very concentrated business model. Construction represents more than 90% of the company's total revenues, of which 60% relate to motorways. Further factors limiting the business risk profile include the high dependency on state tenders (Hungarian state-owned companies accounted for around 65% of total revenues in 2019), the short average project length (three years), and the low backlog-to-sales ratio (1.6x at year-end 2019).

Profitability remains the main supportive factor for the business risk profile

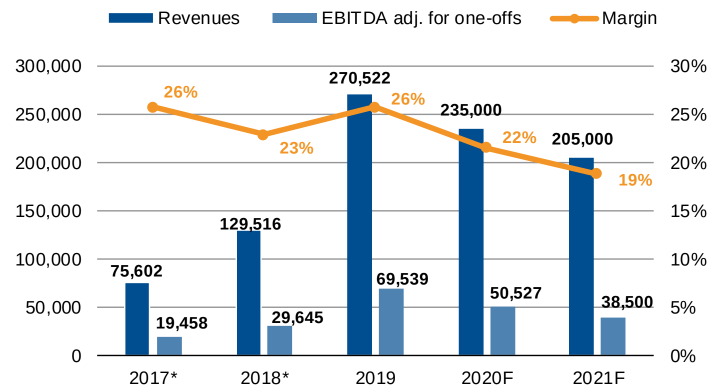
In 2019, consolidated EBITDA was HUF 55bn (margin 20.3%), negatively impacted by HUF 14.7bn in provisions to cover risks on completed works, calculated as 4% of the total project value still under warranty. Excluding provisions, the 2019 EBITDA margin was 26%. As consolidated numbers are only available for 2019, a year-on-year comparison is limited.

Figure 1: Breakdown of revenues by segment, 2019



Source: Duna Aszfalt, Scope

Figure 2: Trend in revenues and EBITDA (HUF bn)



* Not consolidated; Source: Duna Aszfalt, Scope

Sustainability of current profitability is under question

The current profitability levels are due to lucrative motorway construction tenders secured by the company in 2016. Before 2017, the EBITDA margin was significantly lower at around 10% and comparable to those of sector peers. However, there is low visibility after the existing backlog is executed. This puts the sustainability of current profitability under question. Thus, we will take a cautious view until the company shows it can maintain current profitability through new tenders. That said, current levels should stay for some time, given the order backlog is 1.6 times the size of 2019 revenues.

As of H1 2020, revenues were HUF 106bn and EBITDA was HUF 17bn. The EBITDA margin decreased to 13.9% owing to HUF 6bn of new provisions to account for potential delays in ongoing projects due to the Covid-19 crisis. Excluding provisions, EBITDA margin was around 22%.

For 2020, we project revenues of HUF 235bn and an EBITDA margin of around 19%

For end-2020, Duna Aszfalt expects consolidated revenues of HUF 250bn and EBITDA of around HUF 50bn (margin of around 20%). However, this would require revenues to increase by around 34% between H1 2020 and H2 2020. Duna Aszfalt's rationale is that two-thirds of construction industry revenues tend to be generated later in the year. We have taken a more conservative approach in view of the pandemic-related uncertainties. For 2020, we instead project revenues of HUF 235bn, based on the order backlog at year-end 2019, and an EBITDA margin of around 19% (22% excluding provisions). For 2021, we forecast HUF 205bn in revenues (compared with Duna Aszfalt's HUF 215bn) and an EBITDA margin of around 19%.

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 company's well-established credentials on projects with state owned companies. State tenders accounted for around 65% of total revenues in 2019, which creates a high dependency.

Financial risk profile: BB+

BB+ rated financial risk profile remains unchanged

The financial risk profile remains rated at BB+. Reported financial debt at year-end 2019 was HUF 31bn, mainly consisting of HUF 30bn of 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) advances, given their expected reduction, 100% of prepayments were added to SaD. According to Duna Aszfalt, HUF 5.5bn of cash is encumbered, relating to good performance bonds. SaD therefore amounts to around HUF 126bn at end-December 2019. We expect SaD to decrease to around HUF 61bn at year-end 2020 (HUF 94bn at end-June 2020), due to reduced advances and plans to convert HUF 29bn in long-term financial assets into cash in 2020 (HUF 14bn already realised as of H1 2020).

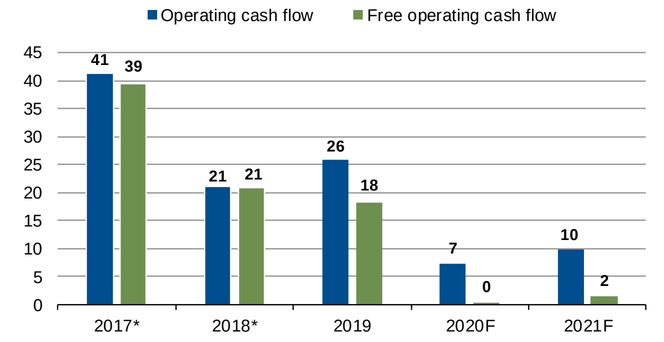
Credit metrics boosted by consolidated numbers, but we remain cautious regarding the sustainability of these levels

In view of the higher EBITDA and stable debt level, credit metrics based on consolidated numbers are slightly better than those previously calculated for the individual entity. At year-end 2019, we calculate a SaD/EBITDA ratio of 1.8x and a free operating cash flow/SaD of 15%. For year-end 2020, despite an expected drop in EBITDA, we anticipate SaD/EBITDA to improve to 1.0-1.5x, reflecting a lower expected SaD. Nevertheless, we remain cautious regarding the sustainability of these levels. Firstly, they are heavily influenced by the lucrative contracts secured in 2016. Secondly, the planned reduction in long-term financial assets will be done to prepare for large projects and acquisitions. Thus, the cash position expected at year-end 2020 (our expectation is around HUF 65bn) is unsustainable, in our view.

Reduction in advances and lower EBITDA are expected to weigh on cash flow in 2020 and 2021

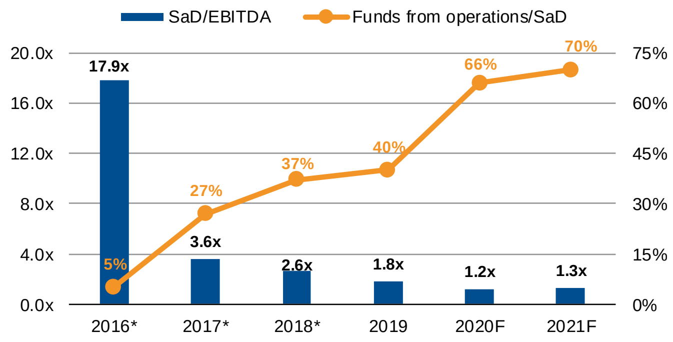
In 2019, consolidated operating cash flow was around HUF 26bn and free operating cash flow was around HUF 18bn after deducting net capex of around HUF 8bn. Capex in 2019 (HUF 9.4bn) was higher than previous levels due to investments in capital equipment for new projects; thus, the company forecasts capex to normalise in 2020 and 2021. In 2019, cash benefited from HUF 6bn in disposal proceeds but reduced by the consideration paid for the Magyar Vakond and HUF 18.7bn of dividend payments. In H1 2020, operating cash flow was HUF 11.9bn and free operating cash flow was HUF 10.4bn after deducting net capex of HUF 1.7bn. At end-2020, we expect operating cash flow of HUF 7bn, reduced by the reduction in advances in the latter part of the year, and free operating cash flow of around zero. For 2021, we expect operating cash flow of around HUF 10bn, reflecting lower EBITDA and a further reduction in advances, and free operating cash flow of around HUF 2bn.

Figure 3: **Trend in cash flow (HUF bn)**



* Not consolidated; Source: Duna Aszfalt, Scope

Figure 4: **Key credit metrics, 2016 to 2021F**



* Not consolidated; Source: Duna Aszfalt, Scope

Better-than-adequate liquidity and financial flexibility

With no major short-term maturities and a solid cash position at year-end 2019, we view Duna Aszfalt's liquidity and financial flexibility to be better than adequate. At year-end 2019, cash totalled HUF 33bn (HUF 57bn at end-June 2020), of which HUF 5.5bn is encumbered, as mentioned above. In addition, marketable securities amounted to HUF 11.5bn (HUF 3bn at end-June 2020), which included real estate funds and listed Hungarian stocks, among others.

Due to travel restrictions triggered by Covid-19, Duna Aszfalt decided to slow its expansion into neighbouring countries and revised its investment plan. The revised investment programme for 2020 totalling HUF 4.7bn (EUR 13.4m) covers new business in Hungary and selected projects, while the programme for 2021 totalling HUF 6.5bn (EUR 18.6m) is focused on new business in Hungary. Furthermore, Duna Aszfalt plans to distribute HUF 4bn in dividends in 2020.

As mentioned previously, the company plans to raise cash by reducing long-term financial assets.

All in all, we expect a cash position of around HUF 65bn at year-end 2020.

Long-term and short-term debt ratings

BB rating on senior unsecured debt class affirmed

We have affirmed the current BB rating for the senior unsecured debt class, one notch above the issuer rating. We expect an 'above average' recovery for senior unsecured debt. Our recovery analysis is based on a liquidation value in a hypothetical default in 2021 of HUF 75bn. This value is based on a haircut of around 60% on the assets and reflect liquidation costs for the assets of 10%. In line with the company's plans, we assume the business plan can be executed without the need for additional bank debt or other senior-ranked financing, with the HUF 30bn unsecured corporate notes issued under the Bond Funding for Growth Scheme being the only financial instrument to consider. According to Duna Aszfalt, roughly HUF 2bn of its consolidated real estate assets are encumbered. Moreover, our recovery rate calculation assumes i) payables having a higher seniority than the bond; and ii) the same seniority for advances received in comparison to the bond. This view is based on the legal opinion provided by local legal counsel.

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