Duna Aszfalt Zrt.
Hungary, Construction

SCOPE BB- STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	73.2x	21.7x	11.5x	5.0x
Scope-adjusted debt/EBITDA	1.0x	1.1x	2.2x	3.3x
Scope-adjusted funds from operations/debt	90%	74%	38%	22%
Scope-adjusted free operating cash flow/debt	18%	-37%	20%	17%

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 adequate credit metrics for its rating category.

Constraints include the group's relatively small scale in a 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 67% of its revenue in H1 2023. The group also remains largely dependent on governmental demand and strategy (more than 50% of Duna Aszfalt's revenue came from Hungarian state-owned companies).

Outlook and rating-change drivers

The Stable Outlook is based on our expectation about Duna Aszfalt's continued operations backed by the current order backlog despite weaker profitability compared to prior years. Our rating case foresee credit metrics will remain robust albeit deteriorating amid potential M&A activity and associated debt funding. In light of the company's perceived resilience and robust financial setup, the Outlook has also been maintained Stable despite lower visibility on business fundamentals, including a weaker economic environment and slow recovery of public procurements, due to uncertainty surrounding EU funds.

A positive rating action is possible if the group's order backlog strengthened, 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. Likewise, a negative rating action 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
12 Oct 2023	Affirmation	BB-/Stable
14 Oct 2022	Outlook change	BB-/Stable
15 Oct 2021	Outlook change	BB-/Positive
21 Oct 2020	Affirmation	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 2023

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
• Good profitability still above peers, but with uncertain sustainability once the backlog dries up • Robust credit metrics, including low leverage (Scope-adjusted debt/EBITDA stood at 1.1x as at end-2022) and debt protection, as measured by the Scope-adjusted EBITDA/interest cover, comfortably above 10x as at end-2022 • 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 to below 1x • Leverage (Scope-adjusted debt/EBITDA) increasing to and sustained at above 3.5x

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	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover (x)	73.2x	21.7x	11.5x	5.0x
Scope-adjusted debt/Scope-adjusted EBITDA (x)	1.0x	1.1x	2.2x	3.3x
Scope-adjusted funds from operations/debt (%)	90%	74%	38%	22%
Scope-adjusted free operating cash flow/debt (%)	18%	-37%	20%	17%
Scope-adjusted EBITDA in HUF m				
EBITDA	65,301	22,235	28,275	27,642
less: disposal gains from fixed assets included in EBITDA	0	0	0	0
Others adjustments[1]	1,701	10,134	0	0
Scope-adjusted EBITDA	**67,002**	**32,369**	**28,275**	**27,642**
Scope funds from operations in HUF m				
Scope-adjusted EBITDA	67,002	32,369	28,275	27,642
less: cash interest as per cashflow statement	-916	-1,489	-2,456	-5,568
less: cash tax paid as per cashflow statement	-4,872	-3,744	-2,001	-1,449
Funds from operations	**61,214**	**27,135**	**23,819**	**20,625**
Free operating cash flow in HUF m				
Funds from operations	61,214	27,135	23,819	20,625
Change in working capital	-32,542	-29,384	-6,209	906
less: capital expenditure (net)	-16,180	-11,011	-5,346	-5,873
Free operating cash flow	**12,493**	**-13,260**	**12,264**	**15,658**
Net cash interest paid in HUF m				
Net cash interest per cash flow statement	-916	-1,489	-2,456	-5,568
Change in other items	0	0	0	0
Net cash interest paid	**-916**	**-1,489**	**-2,456**	**-5,568**
Scope-adjusted debt in HUF m				
Reported gross financial debt	30,000	30,000	30,000	50,000
add: other financial debt[2]	41,799	24,918	30,000	30,000
less: cash and cash equivalents	-70,811	-87,377	-60,971	-51,868
add: non-accessible cash[3,4]	5,500	5,500	0	0
add: Off-Balance Sheet Debt[5]	61,793	63,670	63,670	63,670
Scope-adjusted debt	**68,281**	**36,711**	**62,699**	**91,802**

1 Net provisions
2 Includes Advance payments and shareholder loan.
3 Netting of cash: generally only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible
4 While the cash balance will remain high, part of it is earmarked for financing the group's investment plan, mainly business expansion in CEE countries.
5 Includes performance and default guarantees

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Environmental, social and governance (ESG) profile[6]

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 consider that regulatory and reputational risks are negative rating drivers (ESG factor). Duna Aszfalt's market position in recent years has been supported by winning state tenders, thanks to the group's well-established credentials for projects with state-owned companies. State tenders accounted for around 50% of total revenue in 2022, which creates a high dependency on public procurements.

[6] 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 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.

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

Duna Aszfalt's performance remained resilient in 2022 despite weaker-than-expected earnings. The current order backlog provides some cash flow visibility. The company generated a revenue of HUF 242.6bn (20% below the exceptional 2021 performance) and Scope-adjusted EBITDA of HUF 32bn (respectively 4% and 17% below our forecast). Duna Aszfalt's profitability – as measured by its Scope-adjusted EBITDA margin – has been impacted by increased material prices and stood at 13% in 2022, lower than in previous years (22% in 2021, adjusted for provisions and impairments).

Although it has performed well in recent years, 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 mostly 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.

Only 5% of revenue was generated outside Hungary, but the company expects this share to increase in the next years backed by signed contracts in Poland and expected new contracts in Romania. Duna Aszfalt's business plan includes new acquisitions in Central and Eastern Europe (construction companies with the same or similar scope of activities). This would improve geographic diversification, but negotiations are still at an early stage.

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 71% of revenue in 2022.

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 50% of Duna Aszfalt's revenue since 2017.

Robust order backlog although shrinking pool of public construction projects

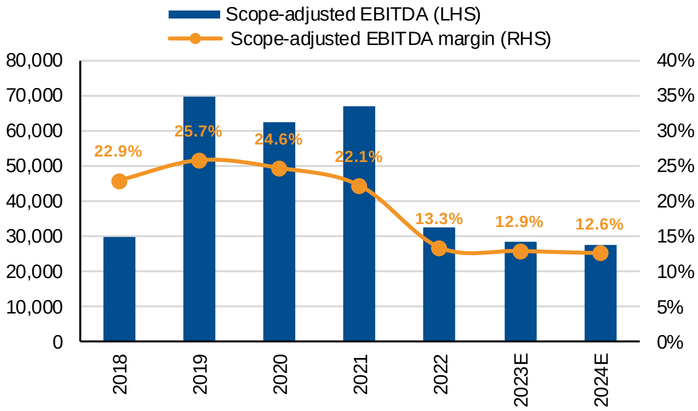
After years of fiscal stimulus linked to EU funding priorities and local governmental policies boosted Duna Aszfalt's niche market, the Hungarian construction sector is facing heightened uncertainty due to a shrinking pool of public construction projects, a result of general budget restrictions and uncertainty surrounding EU funds. The Hungarian government announced on 20 May 2023 a reduction of its planned budget for 2023 and 2024, reduced spending in Duna Aszfalt's niche market[7]. Tenders have become scarcer, leading to lower volumes and thinner margins and we do not expect a fast recovery.

However, we acknowledge that Duna Aszfalt continues to source new projects, with 56% of the pipeline signed in H1 2023. The group's backlog of projects totalled HUF 489bn as of August 2023 (compared to HUF 424bn as of September 2022). Two main projects were signed early this year: i) the construction of a section of M4 expressway; and ii) the

[7] https://www.portfolio.hu/gazdasag/20230531/megvan-a-kormany-2024-es-terveinek-legnagyobb-nyertese-618414

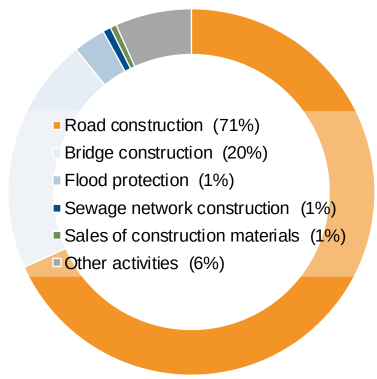
completion of construction on the section between the M49 expressway, the M3 highway and Ököritófülpös; to be implemented by 2025 and 2026 respectively. Although these projects strengthen the backlog, they reinforce the group's high dependency on state tenders (through Hungarian state-owned companies). The order book as of January 2023 amounts to HUF 489bn, resulting in a backlog of 1.8x and providing top line visibility for the next two years.

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



Source: Duna Aszfalt, Scope estimates

Figure 2: Revenue breakdown, 2022



Source: Duna Aszfalt

Increasing raw material prices weaken profitability

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 were insufficient to offset the impact of rising construction material prices and supply chain disruptions.

As we had anticipated, increasing raw material prices have negatively impacted profitability in 2022. Profitability, as measured by the Scope-adjusted EBITDA margin, reached 13% for FY 2022 (2 pp below our forecast and 9 pp below 2021). We expect the margin to remain below 15% in the next few years.

Financial risk profile: BB+

Financial risk profile still solid but expected to weaken

Duna Aszfalt's financial risk profile supports its issuer rating. The group's reported indebtedness has been largely driven by the HUF 30bn corporate notes issued under the Hungarian Central Bank's Bond Funding for Growth Scheme. However, we anticipate that credit metrics will deteriorate in the coming years, as they are heavily influenced by the expected additional debt to finance the company's business plan. To calculate Scope-adjusted debt, we adjusted for i) guarantees, adding 100% of performance and default guarantees; ii) advance payments; and iii) an interest-bearing shareholder loan, due at end-2023.

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

Duna Aszfalt's leverage benefits from its low gross indebtedness. Leverage, as measured by Scope-adjusted debt/EBITDA, was 1.1x as of December 2022, below our expectations. This resulted from higher-than-expected Scope-adjusted debt (49% below our forecast). We expect that Scope-adjusted debt/EBITDA will increase to above 2x in 2023. In 2022, the company acquired Dömper Kft, a Hungarian construction company, among other investments. It is financing the investment through its own resources. In addition, the company is negotiating two potential acquisitions in Central and Eastern European (CEE) countries and further geographic expansion outside the CEE region. The company intends to take on HUF 15bn of financial debt in 2024. This investment phase would likely have a strong impact on gross and net debt (with lower cash balances foreseen in the coming years). We expect overall leverage to increase to above 3x by YE 2024.

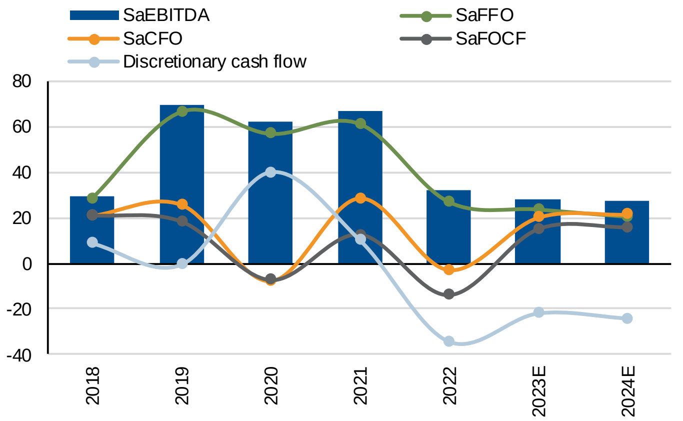
Debt protection impacted by higher financing cost

Debt protection, as measured by Scope-adjusted EBITDA interest cover, remained strong and stood at 21.7x in 2022. In 2022, financial expenses increased significantly due to interest payments corresponding to a shareholder loan (subject to a yearly variable interest rate). We expect higher financial expenses in 2024 amid its partially debt-funded investment phase over the next few years. This would mean a significant increase in total financial expenses amid the current interest rate environment in Hungary. We expect Scope-adjusted EBITDA interest cover to decrease to around 5x by the end of 2024 but to remain adequate for the rating category.

Reduced profitability and investment phase hinder operating cash flow

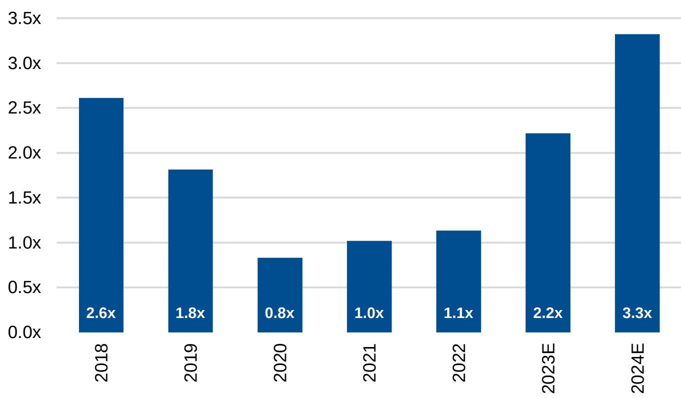
As the order backlog will likely generate lower margins, operating cash flow will likely weaken. The group's FOCF has been volatile and will likely remain under pressure due to working capital requirements. We expect it to remain positive for 2023 on the back of stable revenues but a decreasing EBITDA margin.

Figure 3: Cash flows (HUF bn)



CFO: cash flow from operations
FFO: funds from operations
FOCF: free operating cash flow
Sa: Scope-adjusted
Source: Duna Aszfalt, Scope estimates

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



Source: Duna Aszfalt, 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. In 2022, the company received a shareholder loan, due at end-2023. We understand that notwithstanding the contractual maturity date of the loan, the owner is committed to having his current financing repaid as cash flow permits and to allow Duna Aszfalt to maintain a strong liquidity position. The group's cash balances stood at HUF 21bn by end-June 2023. Marketable securities (such as real estate funds) of HUF 53bn as at end-June 2023 enhance the group's liquidity. Given the long maturity of the bond and no other short-term financial obligations, we believe short-term debt and capex coverage will be adequate over the next few years.

Balance in HUF m	2023E	2024E
Unrestricted cash (t-1)	81,877	60,971
Open committed credit lines (t-1)	0	0
Free operating cash flow (t)	12,264	15,658
Short-term debt (t-1)	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 i) the business plan will be executed with HUF 15bn of additional bank debt; and 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 a local legal expert.

Duna Aszfalt's senior unsecured bond issued under the Hungarian Central Bank's bond scheme has an accelerated repayment clause. The clause requires Duna Aszfalt to repay the nominal amount (HUF 30bn) in case of a rating deterioration pertaining to the bond rating below B+ (two-year cure period for a B/B- rating, repayment within 90 days after the bond rating falls below B-, which could have default implications). In addition to the rating-related covenant, other covenants include a maximum dividend payment of 30% of the EBITDA if the rating deteriorated to below B+. Pointing to the current BB debt rating, Duna Aszfalt has a comfortable headroom on the rating-related covenant.

Our recovery analysis is based on a liquidation value of HUF 118bn in a hypothetical default in 2024. This value is based on a reasonable haircut on assets and reflects liquidation costs of 10% for the assets. We expect an above-average recovery for senior unsecured debt. Thus, we affirm the BB rating for the senior unsecured debt category, which is one notch above the issuer rating. The uplift is limited by the risk and possibility of senior secured debt potentially increasing in the path to default (volatility of capital structure and share of senior unsecured debt).

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