6 September 2019

Corporates

Bonafarm Csoport
Hungary, Consumer goods

SCOPE BB- STABLE

Corporate profile

Bonafarm Csoport (Bonafarm) is the largest fresh food producer in Hungary, with a broad, diversified product portfolio. The group is vertically integrated, with activities ranging from crop production and large-scale animal husbandry to the production of food products for wholesale distribution both under its own brands and for third parties. Bonafarm Csoport is the parent company to eight separate business units (five in agriculture and three in the food industry). The company is organised in three major operational groups: Agriculture, Food Industry, and HQ and Administration. There is also a shared service centre (BonOffice Ltd). The Agriculture segment includes Bóly Group (crop and seed production, pig and dairy cattle breeding), Dalmand Co. (crop and seed production, pig breeding), Fiorács Ltd. (crop production, pig breeding), Agroprodukt Group (crop and seed production, pig and dairy cattle breeding), and Bábolna Takarmány Ltd (fodder production). Food Industry includes Pick Szeged Co. (processed meat production), Sole-Mizo Co. (milk processing) and Csányi Pincéstet Co. (wine).

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019E**	**2020F**
EBITDA/interest cover (x)	56x	29x	28x	31x
Scope-adjusted debt (SaD)/EBITDA	3.7x	4.3x	3.7x	3.4x
Scope-adjusted FFO/SaD	28%	22%	24%	26%
Free operating cash flow (FOCF)/SaD	-42%	-5%	-12%	-21%

Rating rationale

Scope Ratings has assigned Bonafarm Csoport an issuer rating of BB- with a Stable Outlook. Senior unsecured debt has been rated BB-.

Company strengths of strong market position and liquidity and prudent financing are offset by increasing leverage, inherent input-price volatility that makes EBITDA vulnerable to market price movements, and a FOCF/Scope-adjusted debt (SaD) ratio that is volatile and largely negative due to the large investment expenditures.

The industry risk profile rating of A- reflects a mixed industry profile of consumer goods and agribusiness. Our view on competitive position reflects the strong market presence in Hungary with increased diversification abroad, tempered by volatile profitability with moderate margins. This leads overall to a business risk profile rating of BB+.

Our rating for the financial risk profile is B. This reflects the increasing leverage, which is expected by us to move towards 5x in the medium term, as well as the relatively volatile FFO/SaD ratio. Cash flow coverage and free cash flow generation show relatively strong volatility and are constrained by ongoing investments. The worse-than-adequate liquidity assessment reflects that Bonafarm carries the debt and liquidity burden on behalf of all group members by maintaining a multi-currency cash pool and overdraft facility, which tempers its relatively good metrics. The issuer rating without supplementary rating drivers is B+. Scope gave a one notch upgrade for parent support.

This results in an overall issuer rating of BB-, with a senior unsecured debt rating of BB-.

Ratings & Outlook

Corporate rating	BB-/Stable
Short-term rating	-
Senior unsecured rating	BB-

Analyst

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Related Methodology

Corporate Rating Methodology

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Outlook

The Outlook is Stable on Bonafarm reflects our expectation of continued strong market position and prudent financial policy. While some fundamentals constrain the rating, the company is also undertaking a large, once-in-a-generation investment programme, reflected in credit metrics in 2021.

A positive rating action could be warranted a sustained improvement of FOCF/SaD to more than 5%. We consider this unlikely during the company's investment phase.

A negative rating action could be warranted upon i) a sustained reduction of FFO/Scope-adjusted debt to below 15% and/or ii) Scope-adjusted debt/EBITDA above 5.0x.

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong market position • Prudent financial policy	• EBITDA vulnerability to market price changes • Negative FOCF/SaD due to heavy investment phase

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Sustained return of FOCF/SaD to more than 5.0%	• Sustained reduction of FFO/SaD to below 15% • SaD/EBITDA above 5.0x

Financial overview

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019E**	**2020F**
EBITDA/interest cover (x)	56x	29x	28x	31x
SaD/EBITDA	3.7x	4.3x	3.7x	3.4x
SaD (excluding subordinated shareholder loan) /EBTIDA	*3.7x*	*4.3x*	*2.7x*	*2.7x*
Scope-adjusted FFO/SaD	28%	22%	24%	26%
Scope-adjusted FFO/SaD (excluding subordinated shareholder loan)	*28%*	*22%*	*32%*	*33%*
FOCF/SaD	-42%	-5%	-12%	-21%
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019E**	**2020F**
EBITDA	12,208	11,576	14,885	19,524
Operating lease payments in respective year	-	-	-	-
Other items	-	-	-	-
Scope-adjusted EBITDA	12,208	11,576	14,885	19,524
Scope funds from operations in HUF m	**2017**	**2018**	**2019E**	**2020F**
EBITDA	12,208	11,576	14,885	19,524
less: (net) cash interest as per P&L statement	-217	-458	-523	-629
less: cash tax paid as per P&L statement	-421	-565	-1,307	-1,921
add: depreciation component, operating leases	-	-	-	-
Scope-adjusted funds from operations	12,612	10,851	13,054	16,974
Scope-adjusted debt in HUF m	**2017**	**2018**	**2019E**	**2020F**
Reported gross financial debt	46,641	50,744	55,979	67,412
Of which: subordinated shareholder loan	*1,827*	*5,978*	*13,831*	*13.831*
less: cash, cash equivalents	-1,044	-1,428	-1,533	-1,784
Cash not accessible	-	-	-	-
add: pension adjustment	-	-	-	-
add: operating lease obligation	-	-	-	-
Other items	-	-	-	-
Scope-adjusted debt	45,598	49,316	54,446	65,627

Business risk profile: BB+

Industry risk profile

Bonafarm is a vertically integrated agribusiness and commodity foods manufacturer. The company derives the majority of its revenues from the sourcing and distribution of crops, food, animals and their products, as well as the inputs of these, and the processing, distribution and marketing of commodity food products. As such it is subject seasonal swings in supply that drive the relatively volatile prices. Additional factors leading to price volatility are crop shortages, disease and government import restrictions, which to a certain degree are mitigated by the non-discretionary nature of commodity food products. Regionally, supply shortages and unpredictable price swings add to short-term volatility.

As roughly 60% of total sales and EBITDA are for fast-moving consumer goods products (meat products, milk products), we use a mixed approach, assigning a 60% weight to the fast-moving consumer goods industry (industry risk profile: A) and 40% to the agribusiness portion (industry risk profile: BBB). Substitution risk is low, leading to an overall industry risk of A-.

High cyclicality

While demand for agribusiness and commodity food products is non-discretionary and would hence have nominally low cyclicality, strong supply swings introduce significant volatility to both costs and prices and hence both revenues and EBITDA. The industry is also inherently subject to both expected and unexpected events (e.g. bad weather, diseases) that alternatively cause supply shortages (increasing prices) and supply gluts (depressing prices), leading to price volatility well in excess of general price changes. The agribusiness sector is consistently more volatile and more subject to large swings than overall economic development. For this and the above reasons, we consider industry cyclicality to be high.

High barriers to entry

Barriers to entry for this sector are also high. Market entry requires the purchase of appropriate land, the construction of specialised infrastructure, and the hiring of qualified personnel. There is also a lag between generating new livestock and processing milk and meat products (as well as the capital costs needed to establish adequate processing capacity). The cost and time needed to generate specialised infrastructure is substantial. Farmers and animal breeders also currently have relatively low unemployment. Further market barriers include intellectual property rights (trademarks, proprietary recipes for meat and milk products), and genetics (specialised high-productivity pig and cow breeds).

Low substitution risks

While agricultural commodity products are generally easy to substitute, either via imports or from other domestic sources, we place substitution risk as low. Bonafarm is the largest vertically integrated agribusiness and commodity food manufacturer in Hungary, resulting in scaling problems for other competing domestic suppliers. Substitution risks are limited given the vertical integration and the resulting control over final products (processed meats and milk products) as consumers are unlikely to accept differences in taste, price and consistency. Further, several of the company's products are certified GMO-free, which cannot be easily reproduced with other inputs that do not possess the necessary value chain certification.

Robust outlook on core market of Hungary

Bonafarm's key market is Hungary, whose economic growth overall is robust despite negative demographic trends and an ageing workforce, reflecting the strong productivity growth. The Hungarian economy is medium-sized and open, with cyclical behaviour tied to that of the eurozone in general. Robust wage increases have helped growth strongly in recent years. Hungary has access to EU markets and a sound infrastructure.

Scope's public finance rating for Hungary is BBB/Positive, reflecting the relatively healthy state of the economy and relatively moderate public finance pressures on the economy. Economic development is aided by Hungary's ongoing absorption of EU structural funds (Hungary is an EU member but has not accessed the euro), as well as private-sector deleveraging. Consumer sentiment is strong, supported by strong wage increases, low unemployment and by the relative strength of the Hungarian forint, reducing import costs.

Market development

The long-term per-capita development of the three key agricultural goods sectors – pork, milk and wine – to a certain degree reflects the changing consumer preferences. While domestic pork consumption previously saw a strong negative shift, it has moved within a growth corridor since 1995 and shown a recent upswing in demand. Domestic milk consumption has grown the strongest, avoiding severe downturns with a moderate upward swing in per-capita milk consumption since 1995. Domestic demand for Hungarian wine has shown significant swings, reflecting strong shifts in consumer preferences in the past and a recovery since 2010 with a stabilisation at lower levels – which also reflects the increasing emphasis on quality rather than quantity and the availability of low-priced imports.

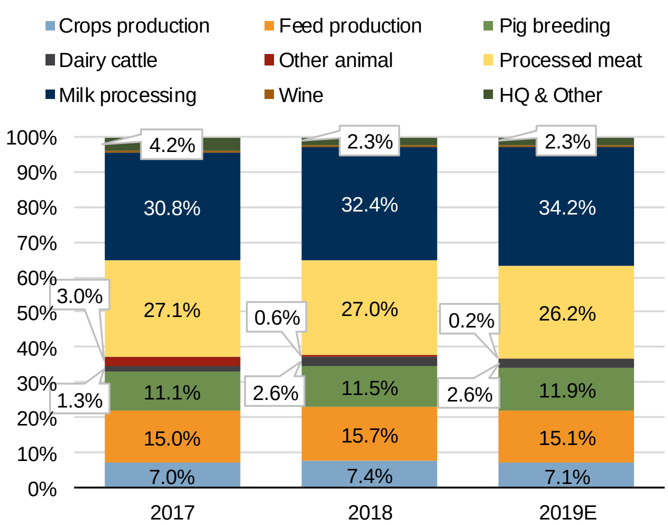
Product and market diversification

The company's diversification is supported by strong vertical integration and reduced concentration risks, tempered by lack of access to key growth markets. For an agribusiness, the company is well diversified, with vertical integration that avoids external cluster risks. Geographical diversification is concentrated on Hungary, with moderate export sales. For the long term, Asian markets are critical, but both Chinese and Japanese markets are currently closed to Bonafarm, nominally due to public health measures[1].

Product diversification

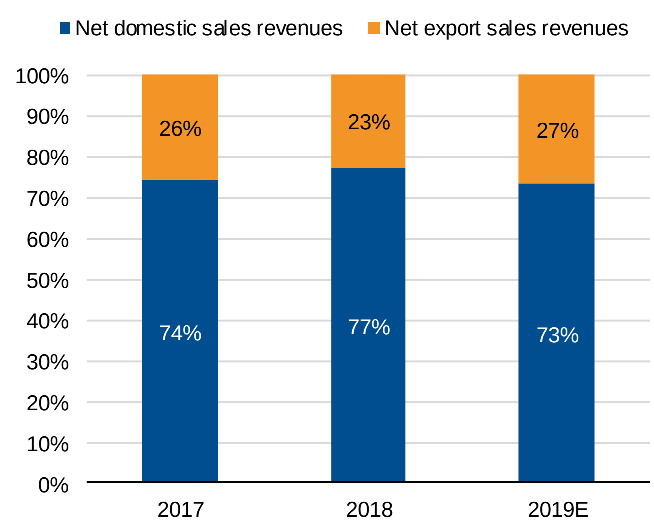
Product diversification can be seen in **Figure 1**, with processed meat and milk processing in 2018 representing nearly 60% of revenues. **Figure 2** indicates the moderate international position of Bonafarm by revenue (consolidated), with a relatively stable export percentage.

Figure 1: Product diversification (sales, % of total)



Source: Bonafarm

Figure 2: Market diversification (sales, % of total)



Source: Bonafarm

Customer diversification

Bonafarm's customer base is widely distributed, with Lidl in Hungary and Germany being key buyers, but has limited concentration risk. Overall, Bonafarm is a price-taker, unable to fully recover cost increases on the market. Bonafarm plans to expand distribution channels for future growth, especially for dairy. Export markets are increasing in importance, with Bonafarm concentrating in key growth markets within Europe.

[1] African swine flu transitioned to Asia via Georgia, Estonia and Russia and can only be dealt with through large-scale herd culling. So far in 2019, more than 1m pigs were culled in China alone. African swine flu transitioned to Hungary via wild boars in 2018 but has not transitioned to domestic pig production.

Profitability

Our view of positive EBITDA development is tempered by moderate growth and volatile behaviour, driven by high vulnerability to market price changes. Large investment levels are negatively impacting profitability into the longer term, despite recent improvements in leverage.

EBITDA margin moderate

EBITDA margins are moderate with an average of 5.9% during 2013-17. Planned investments move this upwards in the long term towards 8%, but EBITDA is not expected to improve beyond this. There is a fair degree of volatility in EBITDA, mainly reflecting cost changes largely outside the control of the company.

Capacity expansion

Planned capex – largely with the Pick subsidiary – are aimed at significantly improving overall EBITDA margins through efficiency gains and expansion of production capacities. Positive effects are expected to be seen first beyond the rating horizon. Investments are planned at almost EUR 600mn over 10 years in four areas: i) Bonafarm Agriculture, with the emphasis on finishing sow site projects and building new feed plants; iii) Pick Szeged, on the new moulded salami production plant; iii) Sole-Mizo, for ongoing capacity expansion; and iv) Csányi Pincésezet Co., for expansion of storage capacity.

Vulnerability to market price input changes

The variability of the relatively low margin is largely driven by cost variations that cannot be co-temporally recouped by higher prices. As a result, the company is vulnerable to market price input changes, as well as end-market price volatility, though to a certain degree buffered by strong diversification and vertical integration to distribute such risks.

Neutral view on corporate governance

We have no issues with overall corporate governance. The company is family-owned with significant cross-holdings between individual companies in accordance with a cash-pool approach for finances. We have no issues with external or internal governance factors. Ownership is transparent.

Financial risk profile: B

Financial risk assumptions

Our key assumptions are as follows: i) no major restructuring of the company or subsidiaries; ii) no major acquisitions or mergers; iii) continuity of management; iv) organic growth for top-line sales by 2%-3% per year; v) continued strong growth of the Hungarian domestic market, with real GDP growth remaining well above 3% into 2021, low unemployment and strong wage growth, and central bank monetary policy continuing to keep interest rates within targets and exchange rates stable; vi) no major agribusiness-related event (e.g. drought, disease); vii) investment plans executed as presented with no meaningful operational or financial risks; and viii) continuity of financial policy, especially the continued avoidance of dividends, leasing and factoring.

Leverage and debt protection

A consortium line of credit (CIB Bank Zrt and Raiffeisen Bank Zrt) of HUF 44.7bn (EUR 139.8m) is jointly and severally, irrevocably and unconditionally guaranteed by Bonafarm, with collateral held by a business share of the company with the banks. There are no liens on the company, nor is there any ongoing litigation that might develop into a liability. The covenants of the consortium line of credit are i) equity ratio of at least 30%; ii) indebtedness not to exceed 4x; iii) net operating cash flows on a two-year average of at least HUF 9bn; iv) annual debt service coverage ratio of at least 1.05x; and v) total assets to shareholder equity of at least 45%. According to the 2018 audited report, all covenants were fulfilled for 2018. Ongoing capex negatively affects credit metrics.

Bonafarm's capital structure includes shareholder loans within a framework agreement that in the past were interest-bearing and as of 1 Jan 2019 are no longer interest-bearing. Scope acknowledges the intent of Bonafarm to convert these shareholder loans to equity but considers these to be debt (until converted) in our Scope adjusted debt calculation. However, we have expanded our tables on page 3 to reflect this and show any potential impact that the conversion would have. As can be seen, key credit metrics will improve if converted, but Scope highlights that the company´s financial risk profile is still hampered by negative free cash flow and its funding needs.

Drop in interest costs

The EBITDA/interest cover ratio is high and reflects the significantly lower interest payments (by more than 80%) they pay today vs pre-2016 (average rate for 2018 was 1.1%, down from averages of 2.9% in 2016 and 15.3% in 2014). The low-interest rate regime has led to expected rates averaging 1.2% during 2018-21. This development has led to a significant improvement in FFO by almost 90%, as net interest payments, measured as a percentage of FFO, fell from 20% in 2015 to 1% in 2017. Free cash flow generation is negative and erratic, reflecting the high levels of investment.

Cash flow coverage and free cash flow generation

Our view on cash flow coverage and free cash flow generation is largely determined by the company's strong ongoing investment phase. Cash flow metrics are also highly variable, reflecting the strong investment-related cash outflow. Once the investment phase ends, we expect cash flow to recover, but this will likely not happen before well into 2022.

Liquidity: negative rating driver

Agreements on cash management and the operation of the group account management system are in place, providing a multi-currency cash pool for all Bonafarm group members in the form of an overdraft facility in both Hungarian forint and euro. Liquid assets in this cash pool in 2018 were HUF 1.4bn, up from 1.0bn in 2017. Provisions for liabilities in 2018 remained unchanged at HUF 758mn.

Bonafarm has the following outstanding non-public bonds: i) HUF 1bn (2036, subscribed 100% by Bonitás 2002 Zrt, the parent company as part of the employee share ownership programme). Short-term liabilities decreased from HUF 38.3bn (2017) to HUF 38.0bn in 2018.

Negative free cash flow, coupled with unrestricted cash positions and undrawn committed lines not covering short-term maturities, as well as limited banking relationships (2 banks) leads us to consider the liquidity position to be a negative rating driver.

Supplementary key rating drivers

Financial policy

The company's financial policy aims at a strong expansion of the core business (Pick Szeged) and organic growth for all business units. The relatively large investment spending by Pick is for the strategic modernisation and expansion of manufacturing capacities, reflecting the wholesale replacement of capacity in place since the 1970s. Bonafarm as the central company within the Bonafarm group carries all the group's debt. Policy is largely prudent and conservative, with only moderate expectations for top-line growth going forward. No adjustments were made for financial policy.

Parent support

The company is a wholly owned subsidiary of Bonitás, the investment company of the Csányi family, with assets (2018) in excess of HUF 171bn. We consider the family willing and able to provide support and upgrade by one notch the stand-alone issuer rating of B+ to result in a final issuer rating of BB-.

Senior unsecured debt

Bonafarm has not yet issued senior unsecured debt. While the company has a strong asset position, limited transparency with regards to capital structure and resulting uncertainty about debt waterfall recovery constrains any upgrade.

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