DVM Group Kft.
Hungary, Construction

B STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022P**	**2023E**	**2024E**
Scope-adjusted EBITDA interest cover	11.8x	7.6x	5.3x	4.1x
Scope-adjusted debt/EBITDA	5.4x	4.3x	6.3x	7.6x
Scope-adjusted funds from operations/debt	16%	22%	12%	11%
Scope-adjusted free operating cash flow/debt	-84%	10%	-47%	27%

Rating rationale

DVM's issuer rating benefits from its good vertical integration. This includes a wide range of services in the different stages of the construction value chain (design, project management, contracting, base building and fit-out services). DVM also has a good domestic network and longstanding relationships with its main clients. 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 certain key customers; and iv) a concentrated backlog. While the company has strong liquidity and healthy debt protection, we foresee an increase in leverage, as measured by Scope-adjusted debt/EBITDA, to remain 6x in 2023, due to weaker-than-expected cash flow generation, which could lead to a prolonged period of lower Scope-adjusted EBITDA.

Outlook and rating-change drivers

The Outlook remains Stable and incorporates the risk that the Scope-adjusted debt/EBITDA ratio will remain above 6x amid pressure on the company's profitability. However, this is mitigated by a strong cash cushion available to the company, which limits external financing needs and supports good liquidity over the next 12-18 months. The Outlook also reflects a recovery in the company's Scope-adjusted EBITDA margin to above 5% (after it fell to a trough in 2022) and interest cover remaining firmly above 10x. While we expect credit metrics to be in line with the rating category, the company's small size and low diversification pose a significant threat to cash flow stability. Hence, we expect a noticeable improvement in cash flow diversification going forward, which could be driven by a higher share of EBITDA from the more granular fit-out business.

A positive rating is currently considered remote. But it could materialise if the company demonstrated an ability to improve its backlog-to-sales ratio to above 2.5x, including highly profitable projects that ensure a recovery in the Scope-adjusted EBITDA margin to above 7% – in combination with greater diversification (customers and projects). At the same time, we expect the company to gradually deleverage after investments peak in 2024, bringing the Scope-adjusted debt/EBITDA ratio down below 6x on a sustained basis.

A negative rating action could occur if the Scope-adjusted debt/EBITDA ratio remained above 6x for a prolonged period (beyond 2024) while the company's current strong cash position deteriorated significantly.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
4 May 2023	Affirmation	B/Stable
28 Apr 2022	Affirmation	B/Stable
2 Jun 2021	Affirmation	B/Stable

Ratings & Outlook

Issuer	B/Stable
Senior unsecured debt	B+

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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
• Market position benefits from integrated business, offering a turnkey solution that translates into a time- and cost-efficient model • Strong interest cover that stood at 5.3x in FY 2022 based on preliminary figures • Strong liquidity, with cash and cash equivalents of HUF 8.3bn as at December 2022	• Small-scale construction company in the European context, with a lack of geographic diversification exposing it to its domestic construction industry, leaving cash flows vulnerable to an expected cooldown • Robust backlog-to-sales ratio (1.9x as of April 2023) still concentrated in a limited number of projects (top three projects account for 79% of backlog revenues; top 10 account for 99%), partially mitigated by longstanding relations with main clients • Low profitability, as measured by the Scope-adjusted EBITDA margin, that stood below 5% due to increasing material costs and increasing personal costs

Positive rating-change drivers	Negative rating-change drivers
• Improved backlog of above 2.5x that boosts Scope-adjusted EBITDA margin to above 7% combined with greater diversification (customers and projects) while bringing the Scope-adjusted debt/EBITDA ratio down below 6x on a sustained basis.	• Scope-adjusted debt/EBITDA ratio remained above 6x for a prolonged period (beyond 2024) while the company's current strong cash position deteriorated significantly.

Corporate profile

DVM Group Kft. (DVM), headquartered in Budapest, is a leading design-and-build service provider in Hungary since 1995. DVM's services include base building and fit-out construction, site supervision, organisation, and coordination of subcontractors, among others. In December 2020, D.V.M. Construction Kft., D.V.M. Fővállalkozás Kft. and D.V.M. Design Kft. merged to form D.V.M. Group Kft. The group employs over 160 people.

Financial overview

				Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022P**	**2023E**	**2024E**
Scope-adjusted EBITDA interest cover	11.8x	7.6x	5.3x	4.1x	3.1x
Scope-adjusted debt/EBITDA	5.4x	4.3x	6.3x	7.6x	8.2x
Scope-adjusted funds from operations/debt	16%	22%	12%	11%	12%
Scope-adjusted free operating cash flow/debt	-84%	10%	-47%	27%	8%
Scope-adjusted EBITDA in HUF m					
EBITDA	1,592	1,882	1,398	1,157	1,280
add: full operating lease payments	0	0	0	0	0
less: disposal gains from fixed assets included in EBITDA	0	0	0	0	0
Scope-adjusted EBITDA	**1,592**	**1,882**	**1,398**	**1,157**	**1,280**
Scope-adjusted funds from operations in HUF m					
Scope-adjusted EBITDA	1,592	1,882	1,398	1,157	1,280
less: cash interest as per cash flow statement	-72	8	-204	-163	46
less: cash tax paid as per cash flow statement	-155	-72	-152	-39	-89
Scope-adjusted funds from operations (FFO)	**1,366**	**1,818**	**1,043**	**955**	**1,238**
Free operating cash flow in HUF m					
Funds from operations	1,366	1,818	1,043	955	1,238
Change in working capital	-1,425	-50	-5,054	1,524	-325
less: capital expenditure (net)	-7,191	-980	-94	-87	-87
Free operating cash flow (FOCF)	**-7,251**	**789**	**-4,105**	**2,391**	**826**
Net cash interest paid in HUF m					
Net cash interest as per cash flow statement	135	248	262	285	410
add: interest component, operating leases	0	0	0	0	0
Net cash interest paid[1]	**135**	**248**	**262**	**285**	**410**
Scope-adjusted debt in HUF m					
Interest-bearing debt	8,614	8,123	8,755	8,755	10,534
Other liabilities	0	0	0	0	0
Scope-adjusted debt	**8,614**	**8,123**	**8,755**	**8,755**	**10,534**
Cash balance in HUF m					
Cash and equivalents[2]	**2,730**	**4,802**	**8,375**	**8,820**	**3,853**

[1] It reflects only paid interest, not considering potential financial income linked to the loans provided as part of a joint venture agreements.
[2] Netting of cash: generally, only applicable to ratings in the BB category or higher and only if the cash is permanent and accessible.

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Environmental, social and governance (ESG) profile[3]

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

We did not identify any ESG-related rating drivers that would have a relevant impact (positive or negative) on our overall assessment of credit risk.

DVM considers it important to educate the real estate profession and their participants and developers on environmental awareness. It plays an active role in this education via roundtable discussions and presentations. Through environmentally conscious services such as BREEAM, LEED, WELL certification and energy modelling, DVM supports real estate developers and partners in efforts to become environmentally aware. In addition, DVM is a member of professional NGOs (BCSDH, Hungarian GREEN building council, World Green Building Council) that promote environmental awareness and ESG approaches.

[3] 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

DVM is mainly focused on design, base building and fit-out but it also works in building refurbishment. Although they are in different stages, all businesses are directly linked to the construction industry. The company's portfolio includes various commercial real estate segments, especially office, retail, hotel and some residential and logistic projects. Although the company aims to diversify its activities (for example, by acquiring a renewable energy project), those plans are still at an early stage and do not have a significant impact on DVM's revenues.

We consider the construction industry to be highly cyclical overall, with medium barriers to entry and low/medium substitution risk.

Small market player, both in a European context and domestically

The company generated revenues of HUF 31.6bn based on preliminary figures (30% more revenue than in 2021 and 31% more than our forecast), mainly driven by fit-out construction works. Despite this, we expect DVM to remain a small construction company both in a European context and in Hungary, which has a highly fragmented market. Small size is a negative rating driver as it limits the company's ability to benefit from economies of scale and diversification to offset the impact of economic cycles, as evidenced in 2021.

Nonetheless, we believe DVM's revenue generation will be protected in the next few years by its strong project backlog of HUF 52bn as of April 2023 and a higher expected contribution from fit-out activities. Additional support for our expectations comes from planned co-developments, including an 18,000 sq m logistics facility, which should benefit from robust tenant demand, and the recent acquisition of a renewable energy project.

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

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

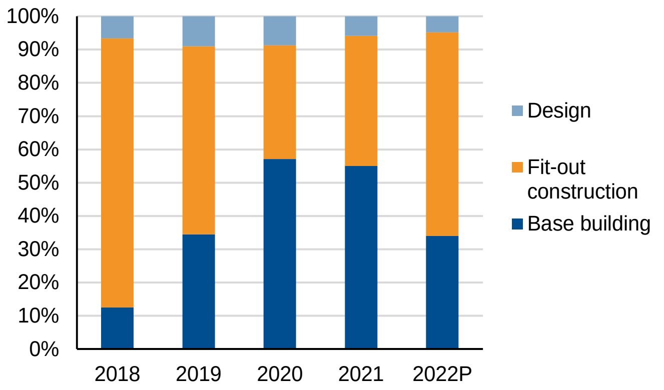
Limited diversification – geographic, segment and customer

Geographical diversification remains limited. Whilst some of DVM's business lines enable it to offer services in international markets – through ArchViz, for example – the company's activities are concentrated in its domestic market. This results in full exposure to the macroeconomy of one country, 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 subsegment in one industry (building construction) but they serve different end markets, especially office, hospitality and residential, so they benefit from different underlying demand patterns. This has partially mitigated the impact of the pandemic in 2020 and 2021, which led to delays in some contracted work, particularly in hospitality and office-related fit-out projects that were put on hold.

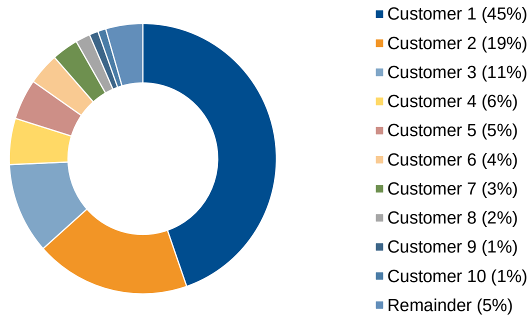
DVM's limited size results in high customer concentration as only a few projects can be executed simultaneously (20 in 2022). This means both profitability and cash flow from operations can be greatly affected by the failure of one project. This lack of diversification is partially mitigated by strong relationships with local and international clients. While no long-term contracts are in place, these partnerships have provided DVM with recurring mandates.

Figure 1: Revenue breakdown by type of project



Sources: DVM, Scope

Figure 2: Revenue breakdown by customer (%)



Sources: DVM, Scope

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

While DVM's backlog has been strong in the last few years (HUF 52bn as at April 2023), it is still concentrated, with the top three projects accounting for 79% of future contracted revenues. This concentration bears the risk of significant cash flow volatility if projects are delayed or cancelled. Limited backlog diversification also exposes the company to slowdowns in certain segments. Office projects, for example, represent 60% of the company's backlog, and demand for office space has been one of the segments hit hardest by the pandemic.

Diversification through co-developments

The slowdown in DVM's core market is evidenced by: i) project developers postponing investment decisions; ii) access to financing sources becoming difficult; and iii) increased competition – as state developments are on hold – resulting in lower margins for projects and tenders that DVM participates in. To mitigate declining demand, DVM's aims to benefit from planned co-developments, including a 18,000 sq m logistics facility and a residential project comprising 140 apartments. In addition, DVM has decided (in 2022) to enter the renewable energy sector by acquiring an 80% equity interest in a 20 MW photovoltaic project at the 'ready-to-build' stage, to begin operation in 2025. Execution risk is partially mitigated by engaging an industry expert partner on the project.

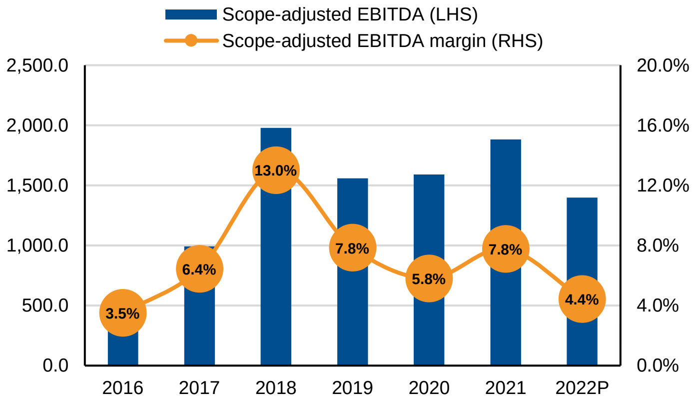
Energy crisis and high material prices have impacted the company's profitability

While top-line figures have improved considerably, increasing energy costs in 2022 have impacted the company's profitability, as measured by the Scope-adjusted EBITDA margin, which stood at 4.4% in 2022 (7.8% in 2021). This was mainly due to the high energy intensity involved in the manufacture of building materials, with base building projects subject to fixed-price contracts, and salary increases to retain high-quality staff. We expect high prices for raw materials and increasing personnel costs will continue to put pressure on profitability. This will be partially mitigated by the company's strategy to: i) conduct frequent project budget reviews; ii) appoint subcontractors and construction material providers at engagement letter signing; and iii) sign construction projects under a fixed general contractor fee instead of contracting for overall projects (thus avoiding bearing all risks for material and subcontractor fees). Our forecast assumes that DVM will keep its profit margin around 5% over the next 12-18 months.

Backlog providing some visibility on future cash flows

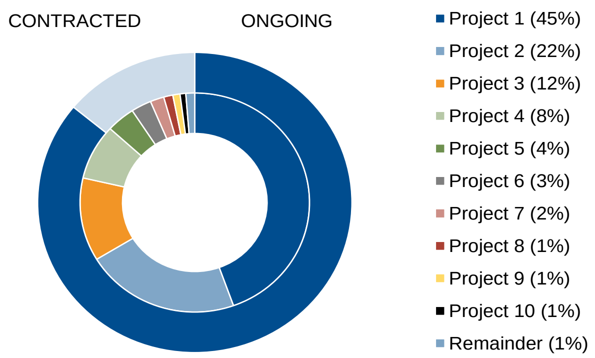
DVM's backlog of projects has weakened to HUF 52bn as of April 2023 (from HUF 68bn as of May 2022), equating to 1.9x the average revenue of the last three years. This provides some cash flow visibility on revenues in the next few years. However, limited diversification exposes the company to significant cash flow volatility risk should any projects be delayed or cancelled.

Figure 3: Scope-adjusted EBITDA and Scope-adjusted EBITDA margin (HUF m)



Sources: DVM, Scope

Figure 4: Backlog breakdown by project as at Q2 2023



Sources: DVM, Scope

Financial risk profile: B+

Adequate debt protection metrics despite expected debt increase

Debt protection, as measured by the Scope-adjusted EBITDA interest coverage ratio, remained strong and stood at 5.3x in FY 2022 based on preliminary figures. We do not expect a significant rise in financial debt in the next few years except for the additional loan to finance logistics development in 2024 (about HUF 1.7bn). Further, the company expects to benefit from interest income linked to the loans it provided as part of a joint venture agreement for the renewable energy project and the development of residential apartments. This should help keep its Scope-adjusted EBITDA interest coverage at adequate levels of above 4x during 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 an increase in indebtedness.

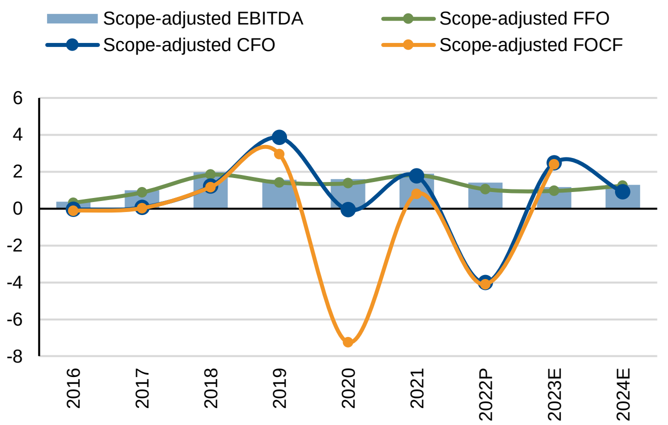
Negative FOCF due to higher working capital

Free cash flows have fluctuated in the last few years, with large cash outflows in 2022 due to a significant increase in working capital. We expect FOCF to turn positive in the next few years, due to DVM's backlog and our expectation that the company will be able to maintain sales at average historical levels. The company will finance part of its planned projects by using current available funds of around HUF 8.4bn as of December 2022, including cash and short-term investments.

Growth strategy comes at the expense of higher leverage

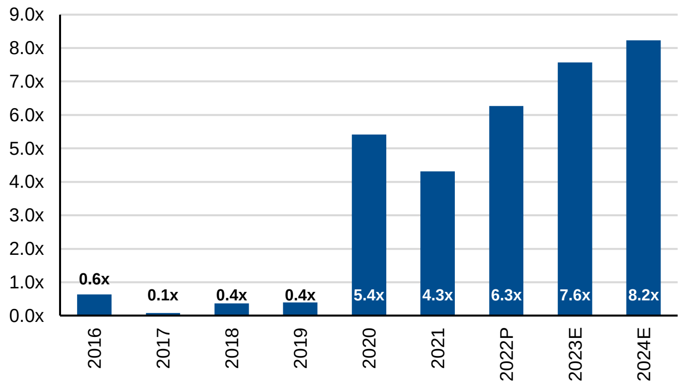
Leverage, as measured by the Scope-adjusted debt/EBITDA, stood at 6.3x as at December 2022. Scope-adjusted debt/EBITDA is expected to remain above 6x in 2023 due to: i) weaker-than-expected cash flow generation; and ii) an increase in indebtedness to partially finance the co-development of a logistics facility (HUF 1.7bn in 2024), before stabilising at a level commensurate with the rating category once developments are complete and provide a boost to the company's top line. However, we acknowledge DVM's unrestricted cash and cash equivalents (HUF 8.4bn as at end-2022) that almost exceed its limited financial debt (HUF 8.8bn as at end-2022) and that planned investments are of a discretionary nature.

Figure 5: Cash flows (HUF bn)



Sources: DVM, Scope estimates

Figure 6: Leverage (Scope-adjusted debt/EBITDA)



Sources: DVM, Scope estimates

Adequate liquidity

Liquidity is adequate. It benefits from cash and cash equivalents of HUF 8.4bn as at December 2022 and a backloaded debt maturity profile comprising a HUF 8.0bn bond maturing in 2030, with a first instalment (HUF 2.4bn) due in 2026 and no significant amounts due in the coming years. We expect the company's low short-term debt levels to be maintained going forward and sufficiently covered by available financing sources.

Figure 7: Liquidity

in HUF m	2022P	2023E
Short-term debt (t-1)	31	0
Unrestricted cash (t-1)	4,802	8,375
Open committed credit lines (t-1)	0	0
FOCF (t)[4]	-4,105	2,391
Coverage	**22.2x**	**No ST debt**

Source: Scope estimates

Long-term debt rating

Senior unsecured debt: B+

In July 2020, DVM issued a HUF 8.0bn senior unsecured bond (ISIN: HU0000359781) through the Hungarian central bank's Bond Funding for Growth Scheme. The bond proceeds were used for co-developments (HUF 0.8bn) and working capital purposes (HUF 2.0bn), while the remainder is to be invested in planned co-development projects. The bond has a tenor of 10 years and a fixed coupon of 3%. Bond repayment is in three tranches starting from 2026, with HUF 2.4bn of the face value payable in 2026 and 2028 and the remaining portion payable as a balloon payment at maturity. Bond covenants include no dividend payments before 2022, plus change of control and LTV clauses regarding co-development financing (LTV greater than 50% for single co-development projects and greater than 30% for overall co-developed projects).

Our recovery analysis is based on a hypothetical default scenario occurring at year-end 2024. It assumes outstanding senior unsecured debt of HUF 8.0bn and additional secured bank debt of HUF 1.7bn to partially finance DVM's co-development projects. 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).

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

Appendix: Peer comparison

	DVM Group Kft.	Duna Aszfalt Zrt.	Market Építő Zrt.	Bayer Construct Zrt.	Szinorg Universal Zrt.
	B/Stable	BB-/Stable	BB-/Stable	B+/Negative	B/Negative
Last reporting date	31 Dec 2022P	31 Dec 2021	31 Dec 2021	31 Dec 2021	31 Dec 2022E
Business risk profile					
Scope-adjusted EBITDA (EUR m)	4	150	105	23	4
Backlog (years)	1.9	1.4	1.5	1.4	1.3
Scope-adjusted EBITDA margin	4%	22%	14%	11%	4%
Financial risk profile					
Scope-adjusted EBITDA interest cover	5.3x	73.2x	29.5x	9.8x	Net cash interest
Scope-adjusted debt/EBITDA	6.3x	1.0x	0.8x	6.9x	8.0x
Scope-adjusted FFO/debt	12%	90%	120%	12%	10%
Scope-adjusted FOCF/debt	-47%	18%	47%	14%	-131%

* Subscription ratings available on ScopeOne

Sources: Public information, Scope

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