Szinorg Universal Zrt.
Hungary, Construction

B STABLE

Corporate profile

Szinorg Universal Vagyonkezelö Zrt. (Szinorg), headquartered in Debrecen, is one of the largest construction companies in eastern Hungary. Its activities include the construction, development, and property and facility management of real estate assets. The group's three largest subsidiaries by revenues are construction companies Hunép Zrt. and HC Épító Kft., and Hadju-Alu Zrt, which provides building materials.

Key metrics

			Scope estimates		
Scope credit ratios	2017	2018	2019F	2020F	2021F
EBITDA interest cover (x)	1,801.6x	164.6x	39.7x	10.9x	3.1x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	net cash	0.5x	7.9x
Scope-adjusted funds from operations/SaD	net cash	net cash	net cash	162%	7%
Scope-adjusted free operating cash flow/SaD	net cash	net cash	net cash	(202%)	(61%)

Rating rationale

Scope assigns a first-time issuer rating of B/Stable to Szinorg Universal Zrt.

The B issuer rating is supported by Szinorg's strong liquidity, healthy debt protection, and balanced outreach to public and private customers, including long-standing relations with its main clients. The rating is further supported by the company's good regional position, which translates into market visibility and gives moderate access to third-party financing.

The rating is mainly constrained by the company's small scale in both a European and Hungarian context, which weakens its ability to mitigate economic cycles. Weak diversification is a further constraint, namely i) a lack of geographical diversification (predominantly active in eastern Hungary); ii) a high reliance on one segment (building activities); and iii) limited cash flow visibility, with a concentrated backlog equating to only one year in revenues. The rating is further limited by the anticipated increase in leverage driven by the company's aggressive expansion, with relatively high capital expenditure dedicated to building up a real estate portfolio.

Outlook and rating-change drivers

The Outlook is Stable and incorporates our view of a slowdown in the Hungarian construction industry, with revenues from construction to stabilise at HUF 16bn. We assume Szinorg will be able to partially balance the decline in construction revenues by building up a real estate portfolio that can generate recurring income and/or sales proceeds, which should help keep its top line close to current levels in the medium term. The Outlook also incorporates the successful placement in H1 2020 of the HUF 5bn bond under the MNB Bond Funding for Growth Scheme. Proceeds are earmarked for capital expenditure to build up the real estate portfolio.

A positive rating action is seen to be remote but may be warranted if the company can increase visibility on revenues beyond 2020, helping to keep Scope-adjusted debt (SaD) to EBITDA below 3.5x on a sustained basis. This could be driven by, for example, an improving order backlog, benefitting from a higher granularity of customers and more complex projects extending respective execution periods.

A negative rating action could occur if real estate developments suffer from significant delays or cost overruns but also if liquidity were to worsen. The latter could happen if, for example, i) customers delay payments significantly; or ii) the company becomes exposed to the non-recoverable cost overruns of its projects.

Ratings & Outlook

Corporate rating	B/Stable
Senior unsecured rating	B+

Analyst

Rigel Patricia Scheller
+49 30 27891 319
r.scheller@scoperatings.com

Related Methodologies

Corporate Rating Methodology

Rating Methodology European Construction Corporates

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Rating drivers

Positive rating drivers	Negative rating drivers
• Regional market position translating into local market visibility as well as moderate access to third-party finance sources and guarantees • Strong liquidity supported by available undrawn overdrafts totalling HUF 3.1bn as at December 2019 • Healthy debt protection despite the anticipated strong increase in interest-bearing debt	• Small-scale construction company in a European context, with a lack of geographic and segment diversification, somewhat mitigated by the company's strong position within a niche market • Short and concentrated contracted backlog providing limited visibility on future revenues (top three projects accounting for 51% of backlog revenues, top 10 for 90%) • Negative free operating cash flow, which also translates into negative Scope cash flow metrics; while this is typical for companies in investment phases, it indicates a continued need for external financing

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Increased visibility on revenues beyond 2020 in addition to keeping SaD to Scope-adjusted EBITDA below 3.5x on a sustained basis	• Worsening of liquidity due to, for example, delayed customer payments or cost overruns • Real estate developments to suffer from delays or cost overruns

Financial overview

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA/interest cover (x)	1,801.6x	164.6x	39.7x	10.9x	3.1x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	net cash	0.5x	7.9x
Scope-adjusted funds from operations/SaD	net cash	net cash	net cash	162%	7%
Scope-adjusted free operating cash flow/SaD	net cash	net cash	net cash	(202%)	(61%)
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA	1,624.8	1,820.5	1,386.9	1,565.4	936.9
less: disposal gains from fixed assets included in EBITDA	28.5	(9.8)	(333.8)	0.0	0.0
Other	51.1	174.1	(231.1)	0.0	0.0
Scope-adjusted EBITDA	1,704.4	1,984.8	821.9	1,565.4	936.9
Scope-adjusted funds from operations in HUF m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Scope-adjusted EBITDA	1,704.4	1,984.8	821.9	1,565.4	936.9
less: cash interest as per cash flow statement	(0.9)	(12.1)	(20.7)	(143.8)	(301.5)
less: interest component, operating leases	0.0	0.0	0.0	0.0	0.0
less: cash tax paid as per cash flow statement	(80.0)	(60.5)	(98.7)	(95.0)	(97.0)
less: capitalised interest	0.0	0.0	0.0	0.0	0.0
Scope-adjusted funds from operations	1,623.4	1,912.3	702.5	1,326.6	538.4
Scope-adjusted debt in HUF m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Interest-bearing debt	78.0	39.0	0.0	6,877.3	11,554.8
Subordinated liabilities	1,277.4	1,277.4	1,277.4	1,277.4	1,277.4
Other liabilities	710.5	1,276.2	1,155.2	1,155.2	1,155.2
Cash	(4,048.4)	(6,721.8)	(9,090.9)	(8,492.5)	(6,596.7)
Restricted cash	0.0	0.0	0.0	0.0	0.0
Off-balance sheet debt	0.0	0.0	0.0	0.0	0.0
Scope-adjusted debt	(1,982.5)	(4,129.1)	(6,658.3)	817.4	7,390.7

Business risk profile: B

Industry risk: B

While the construction industry is often associated with cyclical features when compared to industries with inelastic demand patterns, these cycles vary depending on the individual business model. We incorporate exposures to economic trends that affect the downside volatility of cash flows. Downside volatility can arise from either i) volume risks from a high exposure to buildings, industrial construction and public/government customers; or ii) risks from price fluctuations on materials, labour and energy. We view the overall construction industry's cyclicality to be high. However, a large share of concession-related and service business can lower a company's exposure to cyclicality, thus reducing industry risk.

Cyclicality: high

Market entry barriers: low

The construction sector has low market entry barriers as initial investments are low and proprietary technologies are not needed to enter local markets. This applies in particular to the building segment.

Substitution risk: low

Substitution risk is low as it is unlikely that any technology will replace the fundamental role played by construction companies in addressing the need for new commercial and residential buildings as well as in heavy and civil engineering (the construction of railway tracks, bridges, highways, tunnels, airports and other functional capital-intensive ventures). Such construction work will be fueled by population growth, globalisation and urbanisation worldwide.

Figure 1: Industry risk assessment: European construction corporates

Cyclicality \ Barriers to entry	Low	Medium	High
High	CCC/**B**	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Source: Scope

Industry outlook: stable

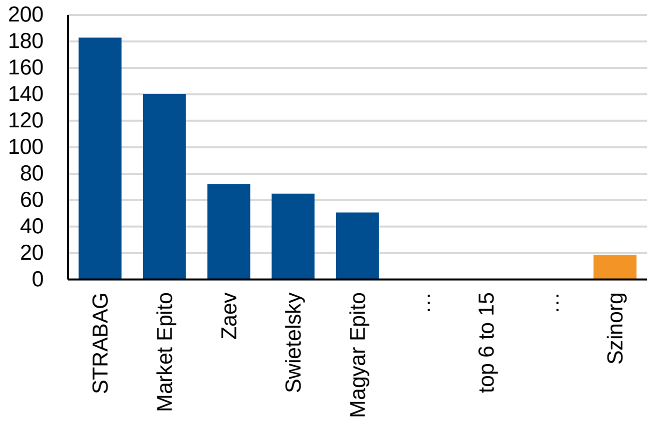
The European construction sector's credit outlook is stable. The strong order backlog coupled with enduring capacity constraints, mostly related to labour, will outweigh the impact of cooling demand for new projects (Construction Outlook 2020)

Small player both in a European context and domestically

Szinorg is a small construction company both in a European context and in Hungary, a highly fragmented market. It is at the lower end of the top 25 construction companies in Hungary, with only HUF 19bn (EUR 58m) in revenues and HUF 2bn (EUR 6m) in Scope-adjusted EBITDA in 2018, equating to just 1% of the total market. This small size leads to more volatile cash flows and limited economies of scale. On the other hand, Szinorg is ranked among the top five in its core market of eastern Hungary.

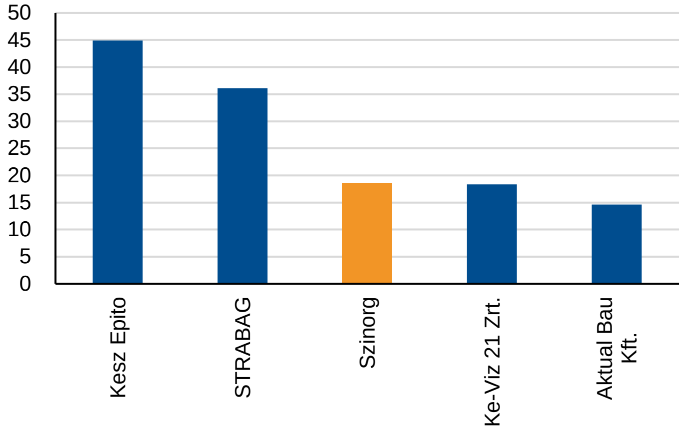
The issuer is predominantly exposed to construction, via its two subsidiaries, Hunép Zrt. and HC Épító Kft. (87% of 2018 revenues). Both companies are contractors in building and civil engineering. Among the largest executed projects are the International School of Debrecen (HUF 3.6bn in revenues I 7,384 sq m), the Forest Office (HUF 9.3bn I 22,000 sq m), the Debrecen Stadium (HUF 12.7bn), the Campus Hotel (HUF 7.2bn I 423 rooms) and the Palace of Sciences at the University of Debrecen (HUF 1.0bn).

Figure 2: Contractors in Hungary by 2018 revenue (HUF bn)



Source: EMIS, Szinorg, Scope

Figure 3: Contractors in eastern Hungary by 2018 revenue (HUF bn)



Source: EMIS, Szinorg, Scope

Weak diversification across geographies with a portfolio highly focused on Debrecen

Geographical diversification is limited. Activities are concentrated in eastern Hungary, with more than 80% of revenues from projects in Debrecen and surrounding areas. The company has some residential developments in Budapest (through HP Épító), but intends to maintain its focus on Debrecen, as it defines itself as a market specialist and prefers to benefit from its good local knowledge and networks. While this seems prudent given Szinorg's small size, it leads to a full exposure to the macroeconomic environment of one region, further compounded by its focus on construction, a cyclical industry in which market downturns tend to affect revenues and earnings.

Real estate developments and accommodation services to partially mitigate any slowdown in construction activity

To partially mitigate this risk, Szinorg plans to establish a real estate portfolio that can generate recurring income and/or sales proceeds. This strategy includes HUF 27.9bn of investments from 2020 on, focused on real estate developments and financed by bond proceeds (HUF 5bn), bank debt (HUF 16bn) and equity (HUF 7bn). According to the company, the development pipeline consists of eight projects that are diversified across different asset classes: residential (29% of investments), retail and mixed (5%), industrial (37%) and offices (29%). Execution risk related to the establishment of this portfolio is high, given Szinorg's limited experience in large-scale real estate portfolios.

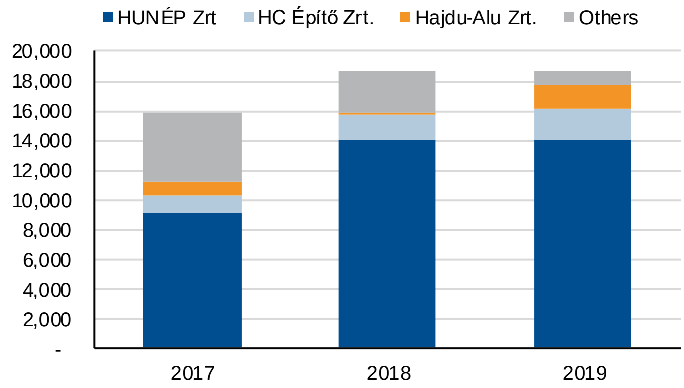
Concentrated customer structure, with some long-term customers in the portfolio

Szinorg's limited size results in high customer concentration as only a few projects can be executed simultaneously. This means both profitability and cash flow from operations can be affected greatly by the failure of one project. However, Szinorg also runs small projects to diversify its customer base.

The company has a strong relationship with the University of Debrecen, with about HUF 65bn of completed projects over the last 19 years, including different university premises and student accommodation. Szinorg also operates the student accommodations, which provides some, although negligible, recurring income (1% of total revenues in 2019). As such, we believe the anticipated growth in the number of students at Debrecen University will be beneficial.

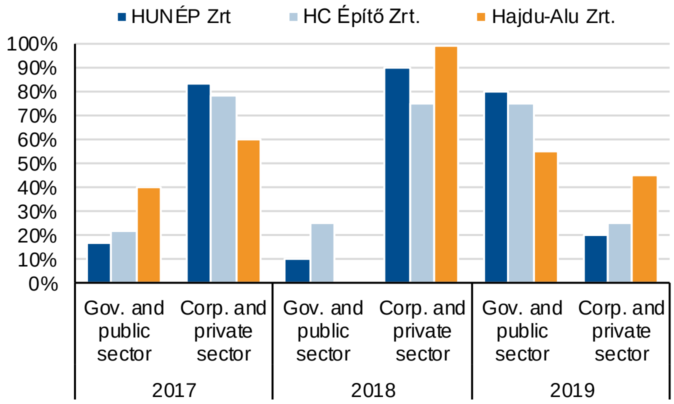
The ratio of public to private customers has strongly varied: in terms of revenues, it was predominately private during 2017-18 and mostly public during 2019 (Figure 5). Szinorg's history of securing tenders for privately and publicly financed projects in almost equal shares (67% of the last three years' revenues from private and 33% from public) partially mitigates the risk of weakening demand from one of the two customer groups.

Figure 4: Revenue breakdown by company (HUF m)



Source: Szinorg, Scope

Figure 5: Revenues breakdown by type of customer (%)



Source: Szinorg, Scope

Relatively concentrated backlog

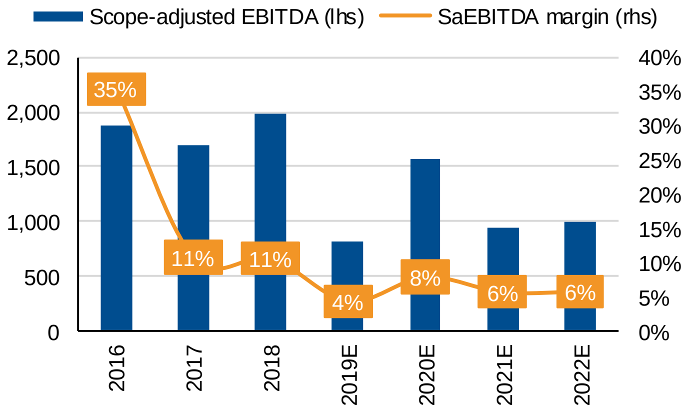
Szinorg's backlog is concentrated, with the top three projects accounting for 51% of future contracted revenues. The largest project (Innovation Centre in Debrecen) represents 20% of the total backlog, the second largest 16% (construction and installation work at Rátka Winery), and the third largest 15% (under the Modern Cities Programme). The remainder is distributed among 13 other projects. This concentration bears the risk of significant cash flow volatility if projects are delayed or customers defer or cancel payments (e.g. due to bankruptcy). The latter is partially mitigated by a payment scheme enforced by law[1] that protects contractors from non-payment or late payments for projects larger than HUF 1.5bn (81% of Szinorg's backlog).

One-year backlog provides limited visibility on future cash flows

Szinorg's order backlog amounts to HUF 19.3bn as at YE 2019 (1x 2019 revenues), thus providing limited visibility on future cash flow.

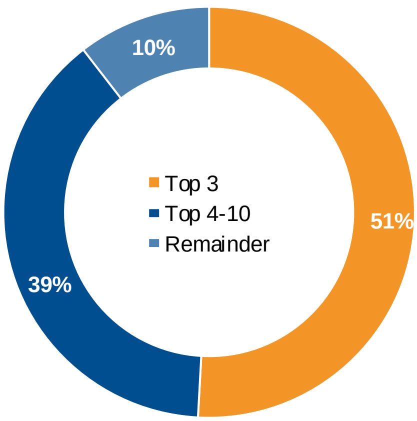
The company's profitability, as measured by the EBITDA margin, has ranged between 4% to 11% in the last three years (Figure 6). While traditional construction peers in Hungary have shown higher margins in recent boom years, we judge these to be unsustainable once the economy cools as expected. Thus, we forecast sustainable margins at around 7% going forward. Szinorg's low profitability combined with its small scale weakens its ability to defend market share if larger peers initiate a price war.

Figure 6: EBITDA and EBITDA margin



Source: Szinorg, Scope estimates, 'Sa' = Scope-adjusted

Figure 7: Customer concentration of 2020 backlog



Source: Szinorg, Scope estimates

Strong market expertise of management

Szinorg was transformed into a business corporation in 1991 and privatised in December

[1] Customers are obliged to pay upfront the costs invoiced by the contractor for the next construction phase on an escrow account to secure timely payment.

1992, from which time it has operated as a 100% Hungarian-owned joint-stock private company. The company is managed by its majority shareholders, who have strong market expertise through years of experience in construction, including the building or restoration of offices and industrial sites and civil engineering. The chairman and CEO of the group, Gyula Szucs, has spent 40 years at Szinorg; other executives have similarly long tenures.

Financial risk profile: B+

Our rating scenario assumes the following:

- Revenue growth according to the company's backlog as per year-end 2019, but declining in 2021 based on the expected slowdown in Hungarian construction
- Capital expenditure of around HUF 18bn between 2020 and 2022
- Issuance of a HUF 5bn bullet bond in H1 2020 under the MNB Bond Funding for Growth Scheme, with an estimated coupon of 3%, (fixed and paid semi-annually) and a maturity of 10 years; bond proceeds are intended for capital expenditure
- Dividend payouts for minority shareholders of approx. 20% of the previous year's net profit and in line with previous years' levels

Weaker debt protection following the debt increase in 2020

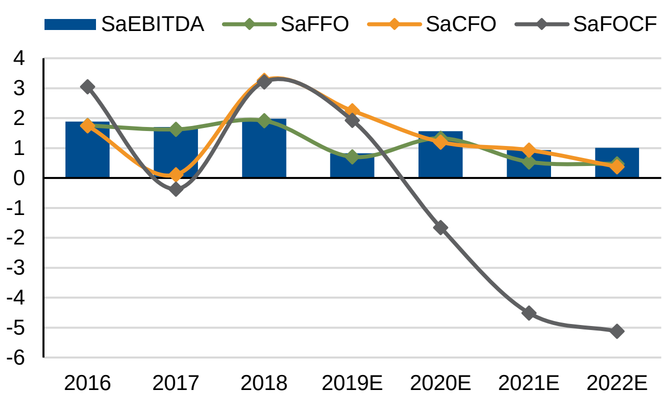
As Szinorg has had relatively little debt in the past, interest expenses have been low. This has resulted a strong EBITDA interest coverage ratio of 39.7x for FY 2019. The planned HUF 5bn bond issuance and additional loans for investment purposes will have a negative impact on debt protection, with Scope-adjusted EBITDA interest coverage expected to drop to around 3x in 2021.

However, given the still relatively high coverage – despite the increase in indebtedness – we believe the company can meet interest payment obligations in the next two years.

Negative free operating cash flows driven by development pipeline from 2020 on

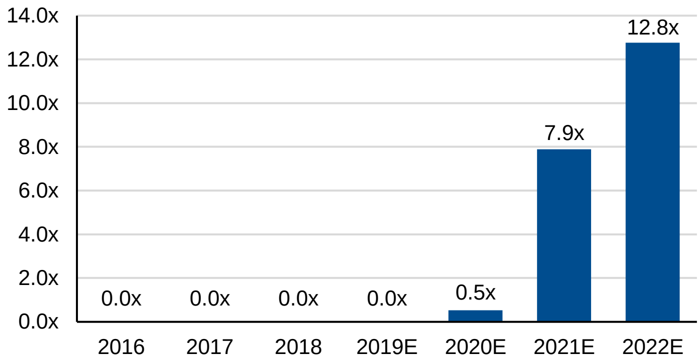
For the next few years, we anticipate relatively stable and positive operational cash flows (Scope-adjusted EBITDA, Scope-adjusted funds from operations and Scope-adjusted cash flow from operations), based on Szinorg's backlog in 2020 and the expectation that the company can maintain turnover at around HUF 17bn or higher. Scope-adjusted free operating cash flow has been more volatile and is expected to remain negative, driven by real estate developments planned from 2020 on.

Figure 8: Cash flows (HUF bn)



Source: Szinorg, Scope estimates; 'Sa' = Scope-adjusted

Figure 9: Leverage (SaD/SaEBITDA)



Source: Szinorg, Scope estimates; 'Sa' = Scope-adjusted

Growth strategy at the expense of strong increase in leverage

The company's debt strategy has been prudent and conservative, evidenced by its very low levels of debt (net cash as at December 2019). However, we anticipate a steady increase in leverage, driven by Szinorg's significant capex programme starting in 2020, which will be predominantly financed by debt.

Given the company's targeted increase in its real estate exposure, we have also considered the issuer's loan/value ratio to assess leverage. We forecast the loan/value ratio to increase to around 64%[2] in the coming years (including the HUF 5.0bn bond and HUF 10.3bn in bank loans necessary to finance business plans until 2022). The company's low leverage gives it sufficient financial headroom to execute its portfolio expansion plans, even if this entails increased costs.

Strong liquidity

We consider Szinorg's liquidity to be strong, in detail:

Figure 9: Liquidity

in HUF m	2019E	2020E
Short-term debt (t)	399	399
Unrestricted cash (t)	9,091	8,493
Open committed credit lines (t)	3,087	3,087
Free operating cash flow (t+1)[3]	(1,654)	(4,508)
Coverage	**26.4x**	**17.7x**

Source: Scope estimates

We anticipate the company's low short-term debt levels to be maintained going forward and to be sufficiently covered by available financing sources. The company also has good relationships with several Hungarian banks, reflected in the revolving overdrafts totalling HUF 3.1bn provided by five different Hungarian banks for more than 10 years, as well as HUF 6bn of bank guarantees, which can be used towards future activities.

Given the long maturity of the prospective MNB bond, upcoming short-term maturities are likely to be manageable for the foreseeable future.

Outlook and rating-change drivers

Outlook: Stable

The Outlook is Stable and incorporates our view of a slowdown in the Hungarian construction industry, with revenues from construction to stabilise at HUF 16bn. We assume Szinorg will be able to partially balance the decline in construction revenues by building up a real estate portfolio that can generate recurring income and/or sales proceeds, which should help keep its top line close to current levels in the medium term. The Outlook also incorporates the successful placement in H1 2020 of the HUF 5bn bond under the MNB Bond Funding for Growth Scheme. Proceeds are earmarked for capital expenditure to build up a real estate portfolio.

A positive rating action is seen to be remote but may be warranted if the company can increase visibility on revenues beyond 2020, helping to keep SaD to EBITDA below 3.5x on a sustained basis. This could be driven by, for example, an improving order backlog, benefitting from a higher granularity of customers and more complex projects extending respective execution periods.

A negative rating action could occur if real estate developments suffer from significant delays or cost overruns but also if liquidity were to worsen. The latter could happen if, for example, i) customers delay payments significantly; or ii) the company becomes exposed to the non-recoverable cost overruns of its projects.

[2] Secured bank debt plus bond proceeds to the fair value of the development pipeline (including an estimated hidden reserve of HUF 5bn, according to the company)
[3] We exclude discretionary expansion capex from the liquidity calculation, as such investments are made only if external financing is available.

Long-term and short-term debt instrument ratings

The rated entity plans to issue a HUF 5bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. The planned bond has a 3% coupon and is non-amortising with a tenor until 2030. Proceeds from the bond are earmarked for financing the capital expenditure to build up a real estate portfolio that generates recurring income.

Senior unsecured debt: B+

Our recovery analysis is based on a hypothetical default scenario in 2021, which assumes outstanding senior unsecured debt of HUF 5.0bn in addition to HUF 10bn of bank loans. We expect an 'above average recovery' for the company's unsecured debt, resulting in a B+ rating for this debt class (one notch above the issuer rating).

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer