Metál Hungária Holding Zrt.
Hungary, Construction

B+ POSITIVE

Corporate profile

Founded in 1996, Metál Hungária Holding Zrt. (MHH) is a construction firm focused solely on the niche market for roofing and cladding, including some activities in the design, manufacturing, assembly, and supply of steel products for its own construction sites. According to the company, MHH is an independent market leader in Hungary for façade cladding and roof covering. As such, it has been involved in all the country's major industrial, logistic, commercial and recreation development projects in recent years.

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA/interest cover	29.2x	27.6x	10.9x	9.1x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	1.0x	3.2x	3.2x	2.9x
Scope-adjusted funds from operations/SaD	105%	27%	26%	27%
Scope-adjusted free operating cash flow/SaD	40%	31%	-2%	32%

Rating rationale

Scope revises Outlook on B+ issuer rating of Metál Hungária Holding Zrt. to Positive from Stable

The Outlook change is driven by the company's resilient operations in 2020, thanks to the competitive advantage afforded by functioning supply chains, and with significant growth forecasted for 2021/22 keeping cash flow and credit metrics stable.

The rating for MHH is driven by the company's leading position in Hungary as a contractor in façade cladding and roof covering, a construction subsegment we consider to benefit from medium barriers to entry. Furthermore, MHH benefits from long-standing relationships with its main clients. Both should help to protect the company's market position in the medium term. In addition, MHH's adequate customer diversification limits the impact of a single customer's default or inadequate payment behaviour.

The rating is mainly constrained by the company's sole exposure to Hungarian construction, leaving cash flows vulnerable to the expected cooldown in the domestic industry. We also view negatively MHH's limited track record in converting its leading market position into elevated, stable profitability, despite the anticipated improvement for 2021. The improved backlog provides some cash flow visibility until 2022. However, we believe this is a short-term exception, driven by strong foreign investments with a focus on large-scale developments, which are driving non-residential building construction in Hungary at present. It is not clear whether these investments will continue going forward. Coupled with generally short project durations (typical for the segment), we forecast that this will burden credit metrics, compounded by anticipated increased indebtedness. We note that the company's financial policy tolerates a certain exposure to foreign exchange rate risk, which is likely to impair leverage and debt protection alike if the Hungarian forint appreciates further against the euro.

Ratings & Outlook

Corporate rating	B+/Positive
Senior unsecured rating	B+

Analyst

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Related Methodology

Corporate Rating Methodology: July 2021

Rating Methodology European Construction Corporates, January 2021

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Outlook and rating-change drivers

The Outlook is Positive and reflects our view that credit metrics will remain at current levels, with SaD/Scope-adjusted EBITDA around 3x. Furthermore, we assume that dividend and dividend-like pay-outs to entities owned by MHH's shareholders will not exceed the company's free operating cash flow (FOCF) on average. The Outlook also incorporates the successful issuance of a second bond under the MNB Bond Funding for Growth Scheme (HUF 6.5bn), mostly to finance an inventory build-up in order to remain competitive in Hungarian construction.

A positive rating action may be warranted if the company's leverage, as measured by SaD/Scope-adjusted EBITDA, remains around 3x on a sustained basis paired with no significant deterioration on the company's competitive positioning.

A negative rating action could occur if SaD/Scope-adjusted EBITDA increases to significantly above 3x. An increase in leverage could be triggered by either: i) an adverse operational development leading to reduced profitability and cash flows; or ii) higher dividend and dividend-like payouts in excess of free operating cash flow.

Rating drivers

Positive rating drivers	Negative rating drivers
• Market leader in its niche segment, with position protected for the medium term through medium entry barriers for speciality construction (façade cladding and roof covering) and long-standing relationships with clients • Adequate customer diversification limits the impact of a single customer's default or inadequate payment behavior • Improved profitability driven by elimination of non-business-related grants to direct owners • Sufficient debt protection despite anticipated increase in indebtedness • Relatively low fixed costs support positive FOCF throughout the construction cycle	• Small construction company, but market leader in its niche segment • Exposed to domestic construction industry, leaving cash flows vulnerable to the expected cooldown • Weak segment diversification as all activities serve the same domestic end-markets • Increase in indebtedness covered by return on investments and suspension of non-recoverable grants • Improved backlog but short project durations (typical for the segment) limit cash flow visibility

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/Scope-adjusted EBITDA to remain around 3x paired with no significant deterioration of MHH's competitive positioning	• SaD/Scope-adjusted EBITDA of significantly above 3x

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA interest cover	29.2x	27.6x	10.9x	9.1x
SaD/EBITDA	1.0x	3.2x	3.2x	2.9x
Scope-adjusted FFO/SaD	105%	27%	26%	27%
FOCF/SaD	40%	31%	-2%	32%
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	3,157	2,865	4,716	4,915
Operating lease payments in respective year	227	227	633	629
Other	0	0	0	0
SaEBITDA	**3,383**	**3,092**	**5,349**	**5,544**
Scope-adjusted FFO in HUF m	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA	3,383	3,092	5,349	5,544
less: (net) cash interest as per cash flow statement	-35	-32	-266	-386
less: interest component operating leases	-80	-80	-225	-224
less: cash tax paid as per cash flow statement	161	-275	-470	-474
Scope-adjusted FFO	**3,429**	**2,705**	**4,388**	**4,460**
SaD in HUF m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	1,748	10,544	14,745	14,000
less: cash and cash equivalents	-417	-7,214	-6,557	-8,828
add: cash not accessible[1]	326	4,985	4,328	6,599
add: operating lease obligations	1,610	1,610	4,499	4,473
SaD	**3,266**	**9,924**	**17,015**	**16,243**

[1] Netting of cash: generally only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible. Thus, cash not accessible represents cash on balance sheet that is not netted, even if it is freely accessible.

Business risk profile: B

Industry risk: BB

MHH predominately acts as a contractor specialised in roofing and façade cladding as well as speciality low-weight construction (cleanrooms). These areas require specialist knowledge in both engineering and manual labour. Thus, we judge market entry barriers for this subsegment to be medium. Together with the generally high cyclicality and low substitution risk of the construction industry, this leads to an associated industry risk assessment of BB

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

Small construction company, but market leader in its niche

Revenues for 2020 remained flat YoY as further growth was halted by postponed or cancelled projects, especially from German car makers. However, Asian customers have filled the gap since late 2020, boosting the company's backlog to HUF 22bn by YE 2020 – the highest since MHH's inception and representing more than a year in revenues. This was particularly driven by MHH's improved access to large-scale projects such as battery factories for Samsung or SK Innovation. Here, the company's long-term relationships with key customers proved advantageous, as did its ability to provide necessary capacities and a functioning supply chain for raw materials. This allowed it to deliver projects in time and quality, thus stabilising its market share.

We anticipate that output will increase in 2021 and 2022. This is based on the order backlog of HUF 44bn as at end-July 2021, providing revenue visibility until YE 2022, and our assumption that the company will benefit from its market position. Thus, we believe MHH will secure some of the larger projects currently up for tender with a total construction value of HUF 159bn.

We forecast that MHH's revenue will stabilise in 2023, at 2019-20 levels. This will be driven by the normalisation of Hungary's construction sector, with some limited visibility of sustained demand from foreign customers beyond 2023. Nonetheless, MHH should be able to defend its market position in the medium term, benefitting from long-standing relationships with its main clients such as Audi or Mercedes Benz. We believe these clients will ramp up capital expenditure in the next two to three years, once supply-chain disruptions – causing some underutilisation of existing factories – are fixed.

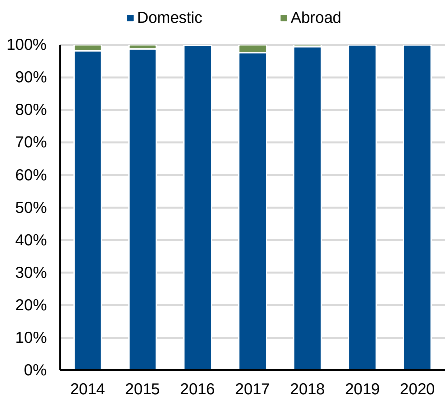
Exposure to domestic construction industry makes cash flows vulnerable

Geographical diversification is weak, as MHH generates almost all of its revenue in the Hungarian construction industry. This is compounded by the fact that construction is a cyclical industry in which revenues and earnings tend to come under pressure in a downturn.

We consider growth in the Hungarian construction market to be unsustainable, with sector growth (in)directly driven by fiscal stimulus or subsidies enabled by capital inflows of foreign direct investments and EU funds. However, political headwinds with the EU (a significant delay in the availability of EU funds) or a strong decline in foreign investment might put pressure on sustained stimulus going forward. Furthermore, we see the sector as overheated, indicated by: i) price growth exceeding inflation; ii) high capacity utilisation and labour shortages; iii) significant project delays, averaging half a year; and iv) the decline in sector confidence since 2019 – interrupted by some short-lived improvements in Q2 2021.

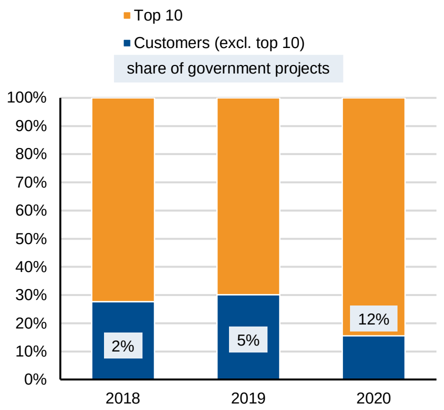
As such, we expect MHH's sole exposure to Hungary – with an only marginal project-related side businesses – to cause revenues to decline to a level similar to 2019-20.

Figure 2: Geographical diversification by revenues



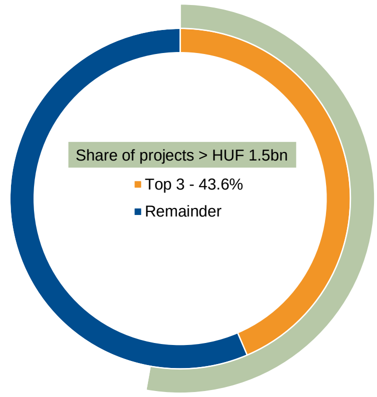
Sources: MHH, Scope

Figure 3: Customer concentration by revenues



Sources: MHH, Scope

Figure 4: Backlog concentration



Sources: MHH, Scope

Weak segment diversification as all activities serve the same domestic end-markets

The company's segment diversification is also weak. MHH focuses on the construction and design of façade cladding and roof coverings, but also has minor operations in steel products as a supplier (trading activities) and producer (building materials). However, these activities are negligible for segment diversification as they serve the same end-markets (construction), exposing MHH to a small number of underlying demand patterns, and thus the industry's inherent cyclicality, leading to high cash flow volatility.

Enlarged, more diversified supplier network will support MHH's market positioning

We see material prices and the availability of basic materials as the main driver of successful project acquisitions in Hungarian construction. MHH has formed long-term relationships with suppliers in the last 15 years and increased its outreach in the last 12 months to regional manufacturers from Belgium, the United Kingdom, Romania and Russia. Thus, we believe MHH is in a good position to gain market share going forward, with at least sufficient access to basic materials to cover the next 12 months in construction works.

Adequate customer diversification

Customer diversification has weakened due to a sharper focus on large-scale projects: the top 10 customers accounted for around 85% of YE 2020's backlog (+ 15pp YoY). The increased share of projects worth above HUF 1.5bn (about 50% of the company's backlog) for which MHH is a sub-contractor, loosens its dependency on the credit quality and payment behaviour of the general contractor or end-customer, as these projects are covered under a payment scheme[2] enforced by Hungarian law. We believe that risks associated with the remainder of the company's backlog are partially mitigated by the adequate credit quality of most of MHH's end-customers.

MHH executes 60-90 projects yearly, pointing to a more granular customer base following the top 10. While these small projects are executed within 3-6 months, we also see higher revenue/intra-year customer diversification, which helped to offset loss in revenue from delayed or cancelled projects in 2020. The relatively low share of government-related contracts (12% of the order backlog as at YE 2020) protects MHH from the decline in demand anticipated for central and local government projects.

[2] To secure timely payment, customers are obliged to pay upfront the costs invoiced by the contractor for the next construction phase. The money is paid into an escrow account.

Improved profitability driven by elimination of non-business-related grants to direct owners

The volatility of MHH's profitability is medium, as measured by its Scope-adjusted EBITDA margin, which has fluctuated between 5% and 9% in the last couple of years (2020: 9%). The anticipated increase in profitability to above 10% in 2021 should be sustained going forward, as related improvement is driven by the implementation of a new corporate structure in 2021 (see also Governance and structure). This structure eliminates non-business-related grants to other ventures of the direct owners of MHH (HUF 0.3bn to HUF 1.7bn annually in 2016-2020), accounted for as other expenses.

MHH's improved profitability provides the company with some headroom to protect market shares if larger peers initiate a fierce price war. However, the company's small scale sets a natural limit to the extent to which this is possible. This is especially the case as other contractors with a focus on façade cladding and roof covering, such as Lindner Group, Yuanda Europe or Porr AG, follow their customers to Hungary. We believe the associated risk is high as MHH's domestic customer base is weak, with more than two-thirds of its revenues stemming from foreign companies.

Improved backlog but with still limited cash flow visibility

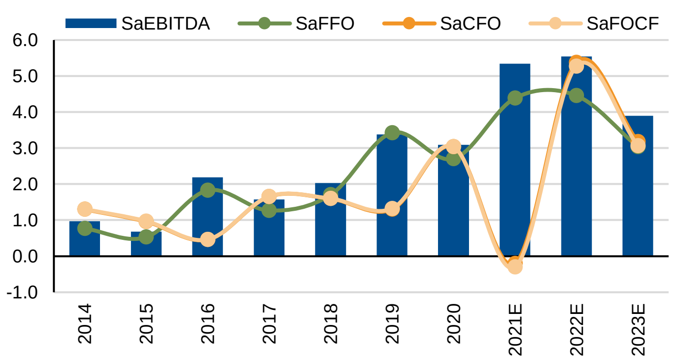
The company's backlog improved to above 1x at YE 2020 (+0.8x YoY), thanks to a higher share of large-scale projects. We believe this is a short-term exception caused by strong foreign investments focussing on large-scale developments, which are driving non-residential building construction in Hungary at present. However, it is not clear whether these investments will continue going forward. We therefore expect MHH's backlog to decline below par in the medium term, however, typical for contractors focusing on façade cladding and roof covering, with project durations averaging 3-6 months[3]. As such, most contracts executed within a year are signed within the same period. Thus, we deem the book-to-bill ratio to be more reliable regarding the company's ability to secure tenders and thereby ensure good future revenues. The book-to-bill ratio has been above 1x for the last couple of years, indicating fairly stable performance despite the volatility in Hungarian construction output in recent years.

Financial risk profile: BB

Low fixed costs support positive Scope-adjusted FOCF through the construction cycle

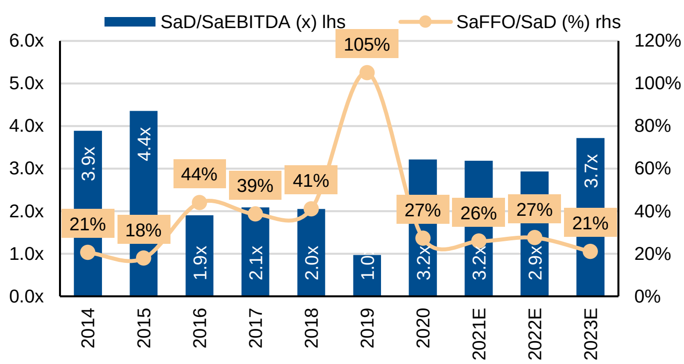
MHH has continuously generated positive, yet volatile, Scope-adjusted FOCF. Volatility will continue to be driven by changes in working capital, with construction work mostly prefinanced by the contractor. Risk for MHH associated with the continuous pre-financing of inventories is partially mitigated by a payment scheme enforced by law, which protects contractors from non-payment or late payments for projects larger than HUF 1.5bn (70% of MHH's backlog).

Figure 5: Cash flows (HUF bn)



Sources: MHH, Scope estimates; 'Sa' = Scope-adjusted

Figure 6: Leverage



Sources: MHH, Scope estimates; 'Sa' = Scope-adjusted

[3] Start of construction work up to delivery

Contractors need to ensure the timely execution of work in order to gain a competitive advantage in bidding wars. This makes proven access to the necessary raw materials and blue-collar workers imperative. Previously, MHH mitigated working capital issues by offering advantageous payments terms for materials, generally 60 days after delivery, while ensuring raw material availability already 12 months in advance. Since late 2020, with the construction industry facing massive supply chain disruptions, vendors have started requesting a down payment when the order is placed. According to the company, an additional HUF 4.2bn of working capital financing will therefore be needed to fund the envisaged project pipeline. This will likely lead to negative Scope-adjusted FOCF in 2021, although we believe this will be a one-off effect. Afterwards, Scope-adjusted FOCF should remain positive and support cash flow cover, with Scope-adjusted FOCF/SaD forecasted at above 20%, but subject to volatility. Our view is based on MHH's low fixed annual cost base, at HUF 3.4bn for 2021-23, including: HUF 2.8bn of operational expenditure; HUF 0.5bn of interest expense; and HUF 0.1bn of mandatory capital expenditure.

Sufficient debt protection despite further increase in indebtedness

We forecast that interest cover will decrease following the increase in the company's indebtedness in 2020. However, it will remain comfortably above 4x despite another rise in indebtedness forecasted for 2021, thanks to its relatively low cost of debt (YE 2020: 2.75%) and improved top line and EBITDA. The early amortisations of the issued HUF 8.0bn bond (2022) and the planned HUF 6.5bn bond issuance (2023) will support debt protection beyond 2022 when the development of the top line will become more uncertain given limited visibility on the future order backlog.

Increase in indebtedness covered by return on investments

Leverage has been stable in recent years, with SaD/Scope-adjusted EBITDA below 2x and Scope-adjusted funds from operations/SaD of above 30%. However, with discretionary capital expenditure in 2020/21 financed with debt (the HUF 8.0bn bond and a HUF 2.4bn secured bank loan), leverage increased significantly to a SaD/Scope-adjusted EBITDA of above 3x (2020: 3.2x) while Scope-adjusted funds from operations/SaD fell to below 30% (2020: 27%).

The debt-financed build-up of inventories to maintain a competitive advantage over competitors will further increase the company's SaD to HUF 16.5bn-17.5bn by YE 2021, from HUF 9.9bn as at YE 2020. We believe the increase will be covered not only by the elimination of recurring non-recoverable grants paid in the past (2020: HUF 1.7bn), but also by a sustained improvement in profitability (up to HUF 0.4bn per year). The latter will benefit from: i) higher-margin real estate holdings; and ii) operational expense savings (acquisition of headquarters, painting facility and machinery). Thus, we forecast that leverage will remain at SaD/Scope-adjusted EBITDA of 3-4x.

Adequate liquidity

Figure 7: Liquidity

in HUF m	2021E	2022E
Short-term debt (t-1)	2,544[4]	821
Unrestricted cash (t-1)	4,985	4,328
Open committed credit lines (t-1)	0	0
Free operating cash flow (t)	-305	5,275
Coverage	**1.8x**	**11.7x**

Source: Scope estimates

Liquidity improved to above 1x in 2020 thanks to the repayment of all revolving working-capital credit facilities, which led to a continuously high portion of short-term debt in the

4 Includes HUF 2,381m related to the Dorottya financing loan (maturity 2027). However, it is shown under short-term liabilities as MHH plans to repay the loan in 2021.

past. Cash sources will comfortably cover cash needs going forward even if increased working capital outflow forecasted for 2021 will burden FOCF (a one-off effect as it only brings forward cash payments to adapt to vendors' payment policies).

Supplementary rating drivers

Financial policy

We note that the company's financial policy tolerates a certain exposure to foreign exchange rate risk. On the one hand, most of MHH's contracts with suppliers and customers are denominated in euros, on the other hand, the company intends to swap its entire corporate financing structure to Hungarian forints following a successful second bond issuance. A further strengthening of the Hungarian forint against the euro is therefore likely to impair leverage and debt protection alike. However, this additional forex risk has not been addressed by the company so far.

Corporate governance and structure

The company is owned in equal shares by József Kreinbacher (CEO) and Josef Unger, with no independent board to provide oversight functions. The credit-negative procedure whereby MHH provides, on a recurring basis, non-business-related grants to Mr. Kreinbacher's other ventures (HUF 0.3bn to HUF 1.7bn accounted for as other expenses) will be eliminated in FY 2021. This is a consequence of a restructuring of ownership interests in the company to be executed by YE 2021. For tax and structural reasons Mr. Kreinbacher has contributed all of his shares in MHH to the newly established Kreinbacher Invest Zrt. (a holding company for Mr. Kreinbacher's equity stakes in different undertakings, including MHH) as a payment in kind. As a consequence, earnings will solely be distributed to Kreinbacher Invest Zrt. via dividends and the holding company will finance Mr. Kreinbacher's other ventures. In addition, both owners have agreed on a significant reduction of Mr. Unger's interest in MHH. Over the course of six years, Mr. Kreinbacher will acquire a 30% equity interest in MHH from Mr. Unger, increasing his interest in MHH to 80%. Acquisition costs will be paid by Kreinbacher Invest Zrt.

Long-term debt rating

Senior unsecured debt: B+

On 13 November 2020, MHH successfully issued a HUF 8bn bond (nominal) with a 3% coupon under the MNB Bond Funding for Growth Scheme, with an average yield of 2.32% (oversubscription led to a cash inflow of HUF 8.4bn).

MHH plans to issue a second senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme in Q4 2021. The planned HUF 6.5bn bond's tenor is 10 years, with HUF 406m in annual amortisation from the second year after its issuance (2023). The coupon will be fixed and payable on an annual basis. Proceeds from the bond are earmarked for the financing of an additional HUF 4.2bn to HUF 4.9bn in working capital for new projects, the refinancing of currently existing working capital facilities, the refinancing of 70% of the HUF 2.3bn loan in relation to the Palazzo Dorottya property[5] as well as up to HUF 0.7bn on developing or purchasing equipment.

Our recovery analysis assumes a potential default in 2022 and is based on MHH's going concern status. As the company is a specialist contractor (façade cladding and roof covering), its enterprise value is linked to 'soft' assets (access to long-term customers and technical knowledge in engineering and manual labour) rather than 'hard' assets.

Average recovery expectation for senior unsecured debt

The estimated EBITDA at default is HUF 1.4bn (implied enterprise value at default of HUF 4.8bn). Based on our recovery analysis, we expect an 'average recovery' for the company's senior unsecured debt (HUF 14.0bn in bonds, HUF 0.3m in guarantees), resulting in the affirmation of the B+ rating for this debt class (the same rating as the issuer rating).

[5] Remainder to be refinanced by available cash

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