ÉPKAR Zrt.
Hungary, Construction

SCOPE BB- STABLE

Key metrics

			Scope estimates	
Scope credit ratios	2021	2022	2023E	2024E
Scope-adjusted EBITDA interest cover	16.3x	139.9x	100.8x	32.2x
Scope-adjusted debt/EBITDA	2.5x	1.2x	2.0x	1.7x
Scope-adjusted funds from operations/debt	34%	75%	46%	51%
Scope-adjusted free operating cash flow/debt	-2%	52%	47%	38%

Rating rationale

The affirmation is supported by ÉPKAR’s strong credit metrics, whose resilience during the Covid-19 pandemic was strengthened further by the acquisition of a performing office building in central Budapest in January 2022. The acquisition also helped diversify cash flows through rental income (invoiced in euros). New privately funded projects have further improved the diversification of cash flows away from government contracts, and the company’s backlog has improved to 2.3 years compared to last year’s 2.0 years. Nevertheless, the concentrated business risk profile continues to hold back the rating. We expect leverage of 2.0x as measured by the Scope-adjusted debt/EBITDA ratio at YE 2023E and interest cover of 100x given significant interest income lowering net interest paid.

Outlook and rating-change drivers

The Outlook is Stable and incorporates our view of healthy cash flow via the construction backlog in addition to rental income from the office property, which can cover the cost of debt on its own. We foresee deleveraging in 2024 to a Scope-adjusted debt/EBITDA ratio of around 1.7x based on cash flow visibility from the backlog and assuming rental cash flows remain at current levels. ÉPKAR’s backlog stretches to late 2025, after which there are several large but unfunded projects in the pipeline. Our main concern is dependence on government contracts.

A positive rating action could be warranted by a much stronger business risk profile – evidenced by a higher market share, a larger, more diversified backlog, improved segment diversification, and a larger exposure to market-based projects – while the Scope-adjusted debt/EBITDA ratio stays around or below 2x.

A negative rating action could occur if the Scope-adjusted debt/EBITDA ratio rose above 3.5x on a sustained basis, or if the backlog shrank to less than one year because a public backlog contraction could not be offset by new market-based contracts. Increased leverage could be triggered by either: i) an adverse operational development leading to reduced profitability and cash flows; or ii) additional debt-funded real estate acquisitions. Losing access to EU funding and jeopardising already signed contracts could also constitute a negative rating trigger into 2025.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
9 Nov 2023	Affirmation	BB-/Stable
9 Nov 2022	Affirmation	BB-/Stable
9 Nov 2021	Affirmation	BB-/Stable

Ratings & Outlook

Issuer	BB-/Stable
Senior unsecured debt	BB

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Related Methodologies and Related Research

Corporate Rating Methodology; October 2023

Construction and Construction Materials Rating Methodology; January 2023

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Bloomberg: RESP SCOP

Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Above-average profitability historically, somewhat weakened by the lower margins expected in a cyclical downturn • Moderate leverage after debt-funded acquisition of office building in central Budapest, with relatively strong credit metrics overall • Adequate liquidity, with limited short-term maturities • Domestic market position translates into high market visibility with moderate access to third-party capital and guarantees.	• Small-scale construction company in European context with a lack of geographic and segment diversification, somewhat mitigated by a top-10 position in the domestic market • Concentration issues in backlog (top three account for 32%, top 10 for 72%), somewhat mitigated by some investment-grade counterparties and legally enforced payment scheme affecting most contracts • High dependence on government contracts • Exposure to cyclical Hungarian construction industry

Positive rating-change drivers	Negative rating-change drivers
• Increased market share, more diversified backlog and diversification in terms of segment activities, helping keep the Scope-adjusted debt/EBITDA ratio below 2x on a sustained basis	• Increased leverage, i.e. Scope-adjusted debt/EBITDA ratio above 3.5x on a sustained basis • Worsening Business risk profile as a result of a contracted backlog of less than one year, due to market-based contracts not offsetting potential public infrastructure backlog contraction

Corporate profile

ÉPKAR Kft. is a leading Hungarian construction company that was established in 1981. It is privately owned by its management and employees, and it generated HUF 29bn of revenues in 2022. ÉPKAR's heritage is in Budapest, where it is headquartered. The Hungarian capital accounts for about 50% of ÉPKAR's construction activities, with the other half in the rest of the country. ÉPKAR is predominantly involved in constructing and maintaining buildings, monuments and sports facilities, and it aims to build a real estate portfolio.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022**	**2023 E**	**2024 E**	**2025 E**
Scope-adjusted EBITDA interest cover	n/a	16.3x	139.9x	100.8x	32.2x	33.9x
Scope-adjusted debt/EBITDA	3.0x	2.5x	1.2x	2.0x	1.7x	1.3x
Scope-adjusted funds from operations/debt	33%	34%	75%	46%	51%	70%
Scope-adjusted free operating cash flow/debt	45%	-2%	52%	47%	38%	145%
Scope-adjusted EBITDA in HUF m						
EBITDA	3,165	3,708	5,245	3,756	3,788	2,577
Operating lease payments	0	0	0	0	0	0
Other items	0	0	0	0	0	0
Scope-adjusted EBITDA	3,165	3,708	5,245	3,756	3,788	2,577
Funds from operations in HUF m						
Scope-adjusted EBITDA	3,165	3,708	5,245	3,756	3,788	2,577
less: (net) cash interest paid	237	-227	-37	-37	-118	-76
less: cash tax paid per cash flow statement	-261	-364	-391	-305	-301	-196
Change in provisions	0	0	0	0	0	0
Funds from operations (FFO)	3,141	3,117	4,817	3,413	3,369	2,305
Free operating cash flow in HUF m						
Funds from operations	3,141	3,117	4,817	3,413	3,369	2,305
Change in working capital	1,053	-3,193	-771	441	-460	2,663
Non-operating cash flow	0	0	0	0	0	0
less: capital expenditure (net)	114	-94	-721	-335	-445	-195
less: lease amortisation	0	0	0	0	0	0
Free operating cash flow (FOCF)	4,308	-169	3,324	3,519	2,465	4,773
Net cash interest paid in HUF m						
Net cash interest per cash flow statement	237	-227	-37	-37	-118	-76
add: interest component, operating leases	0	0	0	0	0	0
Change in other items	0	0	0	0	0	0
Net cash interest paid	237	-227	-37	-37	-118	-76
Scope-adjusted debt in HUF m						
Reported gross financial debt	13,645	13,874	12,894	12,737	12,737	12,737
less: subordinated (hybrid) debt	0	0	0	0	0	0
less: cash and cash equivalents	-18,324	-19,383	-9,453	-10,423	-11,344	-14,595
add: non-accessible cash	11,759	11,759	0	0	0	0
add: off-balance sheet debt (guarantees for advance payments)	2,568	2,901	2,980	5,158	5,158	5,158
add: operating lease obligations	0	0	0	0	0	0
Scope-adjusted debt (SaD)	9,647	9,151	6,421	7,471	6,551	3,300

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Environmental, social and governance (ESG) profile[1]

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)

The construction industry exerts a significant impact on the environment and has great potential for reducing energy consumption and associated emissions. However, recent disruptions in supply chains have compelled contractors to swiftly seek out alternative suppliers or accept higher material prices, a situation that is unlikely to change soon. Additionally, new Covid-related hygiene and safety regulations have seriously disrupted construction site operations. Furthermore, increased union influence may raise project costs and extend project timelines.

The most relevant ESG risks for construction companies reside in: i) rising costs and sustainable building materials; ii) efficient technologies; iii) employee health and safety; and iv) litigation and bribery.

We consider ÉPKAR's ESG assessment to be neutral. The company has no explicit ESG strategy but demonstrates a clear and transparent corporate structure and good stakeholder management. ÉPKAR is owned by the Szeivolt family and 38 employee shareholders (2.5%). It does not have an independent board to provide oversight. While we understand this is due to the family-owned nature of the company, an improvement in corporate governance would be positive given its growth in scale.

[1] 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+

While the construction industry is frequently linked to cyclicality (as opposed to industries characterised by unchanging demand patterns), the intensity of these cycles varies depending on the specific business model. We incorporate factors related to economic trends that impact the downside risk associated with cash flows. This downside risk can stem either from: i) volume-related risks due to a significant involvement in building and industrial construction, as well as a substantial reliance on public and government clients; or ii) risks generated by fluctuations in material costs, labour expenses and energy prices. We assess the overall cyclicality of the construction industry as being quite pronounced. However, a significant presence in concession-related and service-oriented ventures can mitigate cyclicality, reducing industry-related risk.

The construction industry is highly cyclical overall, with low barriers to entry and low/medium substitution risk.

Diversification into commercial real estate is beneficial for our overall assessment of the company, and it slightly lifts the industry risk to B+.

Small player in a European context but top 10 in Hungary's fragmented market

In the context of the European construction industry, ÉPKAR is considered a relatively small company, having generated HUF 29bn (EUR 73m) in revenues and HUF 5.2bn (EUR 13m) in Scope-adjusted EBITDA in 2022. However, ÉPKAR holds a place in the top 10 within its domestic market of Hungary, albeit on the lower end, with a market share of 0.5% of the overall construction sector and approximately 3% in its subsegment. This notable market presence in Hungary, despite a relatively modest market share, highlights the extreme fragmentation and competitiveness of the Hungarian construction market, which encompasses more than 56,000 construction companies, according to the European Construction Sector Observatory.

The company's limited size renders its cash flows more susceptible to volatility and restricts the realisation of economies of scale. Nonetheless, this limitation is partially mitigated by its top 10 market position, which provides visibility in the market and moderate access to third-party capital and guarantees, factors that are expected to facilitate ongoing business development. This becomes particularly relevant as the construction sector must shift its focus away from EU-sponsored construction and civil engineering projects and focus more on national sponsored and private projects.

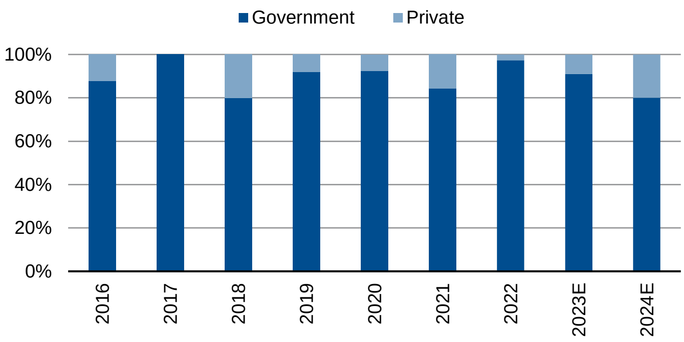
ÉPKAR's geographic diversification is primarily constrained to Hungary. The distribution of its activities closely aligns with the revenue prospects of the domestic construction industry, with a 50% contribution from Budapest and the remaining 50% stemming from other regions of the country. Given the cyclical nature of the industry, there is a heightened risk of revenue and margin compression during a downturn, and ÉPKAR lacks any mitigating exposures to offset this impact.

Commercial real estate generating rental income, though underutilised

To somewhat mitigate this risk, ÉPKAR bought a centrally located commercial real estate building called R70, which generates recurring rental income. The building is currently underutilised with an occupancy rate of 62% after a large tenant moved out, but the company is in the final stages of discussions to let out significant parts again.

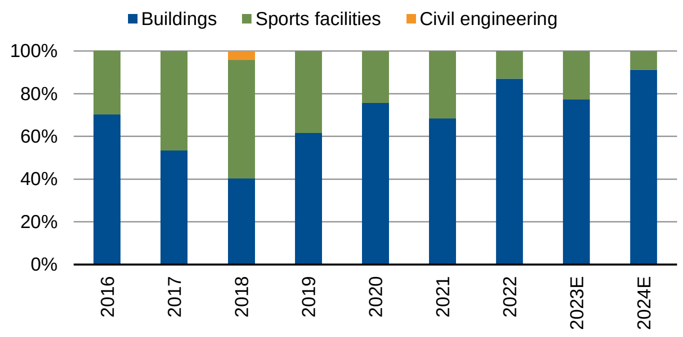
ÉPKAR's segment diversification is constrained as the company primarily operates within three core areas: buildings, civil engineering and sports facilities. The buildings segment encompasses a wide array of projects, including offices, residential structures, event venues, parking facilities, historical landmarks, hospitals and educational institutions. However, these projects do not offer substantial diversification as they share a common structural nature with varying end uses. In contrast, the sports facilities segment provides a degree of diversification due to its civil engineering characteristics and the demand for specialised technical expertise. The dedicated civil engineering division is growing, where ÉPKAR is involved in projects such as train line maintenance.

Figure 1: Project diversification by customer (%)



Sources: ÉPKAR, Scope (estimates)

Figure 2: Project diversification by segment (%)



Sources: ÉPKAR, Scope (estimates)

Customer diversification is relatively limited as Figure 1 illustrates. ÉPKAR's revenue sources were heavily reliant on contracts from central and local governments during the period we analysed, with government-funded projects constituting a significant portion of the backlog. As Hungary is in an ongoing dispute with the European Union, EU funding can no longer be relied upon, and central and local governments need to prefund projects.

Consequently, we anticipate a transformation in ÉPKAR's customer profile over time. To sustain a stable top line, the gap created by the reduction in government projects must be offset by market-based projects as per the company's objectives. Management has identified opportunities in the construction of sports facilities and buildings for major industrial clients and is actively pursuing project tenders in these areas.

Lowered concentration of projects

ÉPKAR's backlog has broadened and boasts lower but still notable concentration, with the three most significant projects accounting for 32% (down from 47%) of the revenue backlog as of Q3 2023, and the top 10 projects making up 72% (down from 83%) of the total. This concentration exposes the company to considerable cash flow volatility should there be any project delays, cost overruns, or issues related to customers deferring payments, potentially stemming from financial distress or insolvency. However, the latter risk is partially mitigated by the majority of the backlog being financially supported either directly by the central government (the Republic of Hungary, rated BBB/Stable by Scope) or indirectly through Budapest's local government with state backing and dependence.

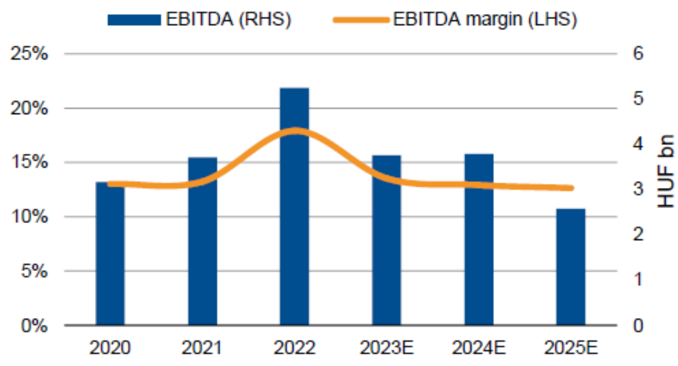
Furthermore, there is an additional layer of protection for contractors under Hungarian law, which enforces a payment scheme that safeguards against non-payment or delayed payments for projects exceeding HUF 1.5bn, making over 90% of the backlog eligible for this protective measure.

Above average profitability

ÉPKAR has consistently maintained strong profitability, averaging around 15% during the period from 2016 to 2022, which significantly exceeds the typical range observed in the construction industry (between 5% and 10%). There were brief dips in profitability in 2017 and 2019 primarily attributable to the timing of revenue recognition.

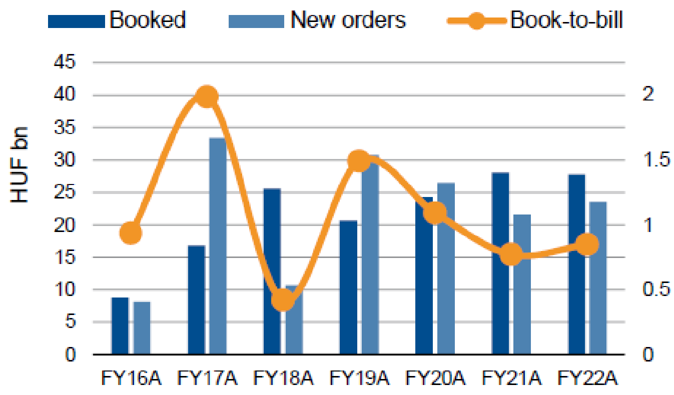
With the backlog effectively covering 100% of expected revenues from 2023 to 2025, we anticipate that these robust margin levels will remain stable throughout that period.

Figure 3: EBITDA and EBITDA margin



Sources: ÉPKAR, Scope (estimates)

Figure 4: New orders, booked, book-to-bill ratio



Sources: ÉPKAR, Scope (estimates)

As of Q3 2023, ÉPKAR's order backlog stands at HUF 61bn, providing coverage for approximately 2.3 years of revenues, versus 2.0 years of coverage at the same time last year. This translates into full coverage by contracted orders for expected revenues in 2023 to 2025, positioning the company favourably compared to local peers.

ÉPKAR's book-to-bill ratio displays significant volatility, ranging from 2.0x (indicating strong demand) to less than 1.0x (reflecting insufficient or weak demand). When we removed all the projects from its signed contract ledger that were dependent on EU funding, the ratio dropped to 0.8x for 2021 then slightly improved to 0.9x for 2022. Applying the same methodology and given the recent uptick in order intake in 2023, the figure will certainly be above 1x for FY 2023E.

Financial risk profile: BBB

Our rating scenario assumes the following:

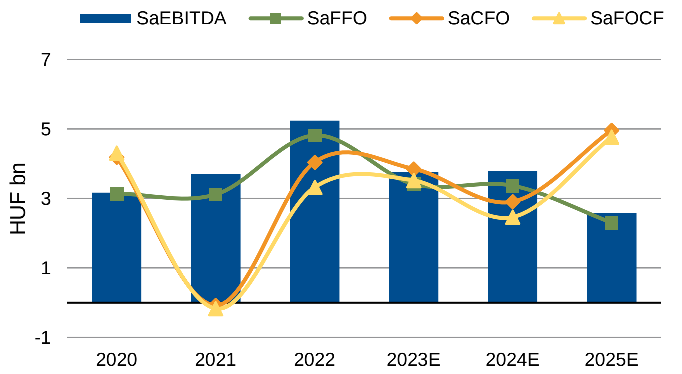
- Revenue growth of -5.1% to HUF 27.8bn in 2023, based on the fully covered backlog; revenue growth of 5.6% to HUF 29.3bn in 2024, based on the fully contracted backlog; thereafter, a slight decline in revenue to HUF 20bn, based only on the backlog
- EBITDA margin of 13%-14% for 2023 to 2025, in line with margins in 2018-20 given the contracted backlogs, with manageable margin compression expected thereafter
- HUF 0.4bn for maintenance/general capex
- Dividend payouts of 50% of net profit yearly in line with management's plans (previously only part of declared dividends were paid out, with the rest accumulating on the balance sheet as other short- or long-term debt, a practice the company intends to maintain)
- Restricted cash relates to cash pledged as collateral for banks to issue guarantees.

Historically, ÉPKAR had minimal debt, resulting in interest income exceeding interest expenses, making the Scope-adjusted EBITDA interest coverage ratio irrelevant. However, in November 2020, the company issued a HUF 11bn bond with a 3% coupon while maintaining other minor debt positions (those have been repaid during 2023). We expect interest coverage to remain strong at significantly above 10x, protected by only one fixed-rate exposure to interest-bearing liabilities (MNB bond) at a very favourable rate of 3%. Given the large cash cushion on the balance sheet, such funds have been placed in a term deposit where they earn significant amounts of interest, improving interest cover significantly.

Given exceptionally high coverage, which is expected to persist even under adverse EBITDA conditions beyond our rating horizon, we have confidence that ÉPKAR will meet its interest payment obligations.

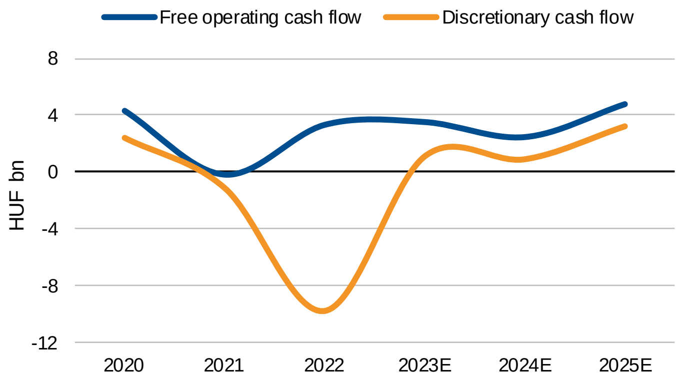
ÉPKAR has consistently generated ample cash flow, enabling it to not only cover capital expenditures but also increase its cash position. Going forward, we expect this to continue for the normal course of its construction business.

Figure 5: Cash flows[2] (excluding real estate acquisition)



Sa=Scope-adjusted; Sources: ÉPKAR, Scope (estimates)

Figure 6: Discretionary cash flows



Sources: ÉPKAR, Scope (estimates)

Historically, ÉPKAR maintained minimal interest-bearing debt, leading to a net cash position when assessing Scope-adjusted debt. The HUF 11bn bond proceeds obtained in November 2020 for the purpose of financing the Budapest commercial real estate acquisition remained unspent, resulting in an ongoing reported net cash position throughout 2020. We adjusted Scope-adjusted debt by considering only cash not designated for the property transaction, resulting in a Scope-adjusted debt/EBITDA ratio of 3x at the end of 2020.

Leverage of 2x expected in 2023e

After the company used bond proceeds for the office acquisition and reaped the benefits at EBITDA level, deleveraging brought the Scope-adjusted debt/EBITDA ratio to 1.2x at YE 2022 due to a strong operational year. Scope expects increased leverage of 2.0x at YE 2023E and projects deleveraging to 1.7x in 2024. It bases this expectation on strong labour cost inflation in 2023 with a related negative impact on expected FY EBITDA and advance payment guarantees that are nearly twice as high as in 2022 (which Scope uses as a proxy for restricted cash, impacting Scope-adjusted debt negatively). Leverage as measured by Scope-adjusted funds from operations/debt will remain comfortably above 30% during the forecasted period.

Nevertheless, in the absence of further debt-financed acquisitions or an external shock to the business, the leverage ratios bode well for the overall financial risk profile.

[2] We exclude discretionary expansion capex from the liquidity calculation because such investments are only made if external financing is available.

Adequate liquidity

We consider ÉPKAR's liquidity to be adequate. In detail:

Balance in HUF m	2023E	2024E	2025E
Unrestricted cash (t-1)	9,453	10,423	11,344
Open committed credit lines (t-1)	0	0	0
Free operating cash flow	3,519	2,465	4,773
Short-term debt (t-1)	157	0	0
Coverage	8254%	No ST debt	No ST debt

Unrestricted cash comfortably exceeds short-term debt, and upcoming short-term maturities are likely to be manageable for the foreseeable future given the long maturity of the bond.

Long-term ratings

Senior unsecured debt rating: BB

ÉPKAR issued a HUF 11bn senior unsecured corporate bond in Q4 2020 under the Hungarian central bank's Bond Funding for Growth Scheme. The bond has a 3% fixed annual coupon and a 10-year tenor, and it will amortise by 10% in the seventh year, 20% in each of the eighth and ninth years, and 50% at maturity in 2030. Bond proceeds were earmarked for financing capex to acquire performing Class A/B commercial real estate in Budapest, which the company did with the acquisition of the R70 building. The company plans to leave the property portfolio unencumbered.

We still expect an 'above average' recovery for the company's unsecured debt and affirm the BB rating for this debt class (one notch above the issuer rating).

We note that ÉPKAR's senior unsecured bond issued under the Hungarian central bank's bond scheme has an accelerated repayment clause. The clause requires ÉPKAR to repay the nominal amount (HUF 11bn) within 90 days after the bond rating falls below B-, which could have default implications. Taking into consideration the BB rating of the bond rating, we consider this scenario remote at present.

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