ENSI Kft.
Hungary, Construction

B+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023 E**	**2024 E**
Scope-adjusted EBITDA/interest cover	N/A	N/A	N/A	10.9x
Scope-adjusted debt/EBITDA	N/A	4.0x	2.0x	2.8x
Scope-adjusted funds from operations/debt	N/A	27%	57%	30%
Scope-adjusted free operating cash flow/debt	N/A	35%	31%	32%

Rating rationale

ENSI Kft.'s business risk profile (assessed at B) continues to be driven by strong operating profitability, with a Scope-adjusted EBITDA margin showing gradual improvement since 2021 (2022: 7.3%, 8M 2023: 13.2%). Beyond 2023, we expect the Scope-adjusted EBITDA margin to remain under pressure from the softening end-market demand, on top of still sizeable cost inflation projected for 2024. ENSI's order book for as of October 2023 was around HUF 35bn, a significant improvement compared to the previous review in January 2023 (HUF 31.5bn). The business risk profile is constrained by ENSI's still limited absolute size in a European and global context. Additionally, the business risk profile is also constrained by limited diversification in terms of activity, geographies and customer portfolio. The limited diversification and small absolute size make the company more vulnerable to macroeconomic shocks and reduce its ability to mitigate economic cycles.

The financial risk profile (assessed at BB+) is supported by robust credit metrics. We assume leverage, measured by Scope-adjusted debt/EBITDA, to be around 3x in the coming years. Due to the fact the company has historically operated without bank debt, ENSI used to have minimal interest expense. The EBITDA interest cover is forecasted to gradually deteriorate, reaching around 11x until 2024, and below 10x in 2025 due to the more conservative profitability forecast. While cash flow cover, measured by Scope-adjusted free operating cash flow/debt, is expected to be more volatile than EBITDA, driven by the change in working capital needs, it is expected to remain at 20%-30%. We expect liquidity to remain adequate, with no short-term debt amortisation until 2027 and positive free operating cash flow.

Outlook and rating-change drivers

The Outlook is Stable and incorporates our assumption that ENSI's credit metrics will remain stable despite a more challenging market environment, with a Scope-adjusted debt/EBITDA ratio below 4x in upcoming years.

A positive rating action is remote but could be warranted if ENSI managed to improve its business risk profile. This could occur if ENSI provided higher visibility on future cash flow and achieved greater geographical diversification while improving profitability to near historical averages (Scope-adjusted EBITDA of around 14%) and keeping its Scope-adjusted debt/EBITDA ratio around 3.0x in the medium term.

A negative rating action might occur if ENSI failed to achieve a Scope-adjusted EBITDA margin above 7%, which would also lead to increased leverage, measured by Scope-adjusted debt/EBITDA increasing to above 4.0x.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
12 December 2023	Monitoring review	B+/Stable
19 January 2023	Affirmation	B+/Stable
17 January 2023	New	B+/Stable

Ratings & Outlook

Issuer	B+/Stable
Senior unsecured debt	B+

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Related Methodologies

General Corporate Rating Methodology; October 2023

Construction and Construction Materials Rating Methodology; January 2023

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Solid financial risk profile with robust interest coverage and modest leverage • Strong order book, significantly higher contracted backlog compared to the last review • Market leader in niche segment, with a 20% market share in the field of mechanical engineering	• Small-scale construction company in both the European and Hungarian contexts with a lack of geographic diversification • Weak diversification, both in terms of geographical scope and customer portfolio • Operating profitability under pressure by more challenging market conditions

Positive rating-change drivers	Negative rating-change drivers
• Higher visibility in terms of future cash flow and better geographical diversification • Scope-adjusted debt/EBITDA around 3.0x in the medium term	• Scope-adjusted debt/EBITDA significantly above 4.0x • Scope-adjusted EBITDA margin below 7% in the medium term

Corporate profile

ENSI is a Hungarian construction company specialised in mechanical engineering (heating, cooling, ventilation, hot water, lighting) with over 25 years of experience in its domestic market. The company was established in 1994 and is owned by the Németh family: the founder and CEO László Németh and his three sons. The company's headquarters are in Budapest. On top of mechanical engineering implementation, which accounts for about 90% of total revenue, the company also engages in professional consulting, planning and maintenance activities through specialised members of the ENSI group.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021[1]**	**2022**	**2023 E**	**2024 E**	**2025 E**
Scope-adjusted EBITDA/interest cover	N/A	N/A	Net interest income	Net interest income	10.9x	7.2x
Scope-adjusted debt/EBITDA	N/A	N/A	4.0x	2.0x	2.8x	2.9x
Scope-adjusted funds from operations/debt	N/A	N/A	27%	57%	30%	28%
Scope-adjusted free operating cash flow/debt	N/A	N/A	35%	31%	32%	25%
Scope-adjusted EBITDA in HUF m						
EBITDA	1,821	903	1,362	2,811	1,955	1,874
Other items	0	0	0	0	0	0
Scope-adjusted EBITDA	**1,821**	**903**	**1,362**	**2,811**	**1,955**	**1,874**
Funds from operations in HUF m						
Scope-adjusted EBITDA	1,821	903	1,362	2,811	1,955	1,874
less: (net) cash interest paid	10	-0	118	619	-179	-261
less: cash tax paid per cash flow statement	-184	-97	-101	-311	-163	-148
add: dividends from associates	36	42	132	38	43	48
Funds from operations	**1,683**	**848**	**1,511**	**3,157**	**1,656**	**1,513**
Free operating cash flow in HUF m						
Funds from operations	1,672	848	1,511	3,157	1,656	1,513
Change in working capital	-991	-1,037	431	-1462	129	-144
less: capital expenditure (net)	0	-214	-6	-10	-14	-14
Free operating cash flow (FOCF)	**681**	**-403**	**1,936**	**1,684**	**1,772**	**1,355**
Net cash interest paid in HUF m						
Interest income	11	0	382	880	83	0
Interest expense as per cash flow statement	-1	0	-263	-261	-261	-261
Change in other items	0	0	0	0	0	0
Net cash interest paid	**10**	**0**	**118**	**619**	**-179**	**-261**
Scope-adjusted debt in HUF m						
Reported gross financial debt	0	0	5,500	5,500	5,500	5,500
less: cash and cash equivalents	N/A	N/A	N/A	N/A	N/A	N/A
add: non-accessible cash	0	0	0	0	0	0
Other items	0	0	0	0	0	0
Scope-adjusted debt	**0**	**0**	**5,500**	**5,500**	**5,500**	**5,500**

[1] In FY 2020 and 2021 ENSI operated with no financial debt

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Environmental, social and governance (ESG) profile[2]

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)

Credit-neutral ESG factors

No drivers of the credit rating are considered ESG-related factors with a substantial impact on the overall assessment of credit risk.

ENSI is a family-owned company, with László Németh as the majority shareholder and owner of the company. He is supported by a five-people management team of financial and engineering professionals, reducing the key person risk that is typical of family-owned companies. The company has no independent supervisory board.

In 2022, ENSI formulated a dedicated ESG Strategy, defining the following goals for the next 10 years:

i) Reduction of carbon footprint by 50 % by 2028

ii) Zero carbon emission by 2033

[2] 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

ENSI predominantly acts as a contractor specialised in mechanical engineering. We consider this activity as part of the buildings subsector of the construction industry. This subsector is characterised by a low need for capital investment but a high need for specialised knowledge, competencies and references to ensure competitiveness. We assess the market entry barriers as low, together with the high cyclicality and low substitution risk of the construction industry, leading to an associated industry risk assessment of B.

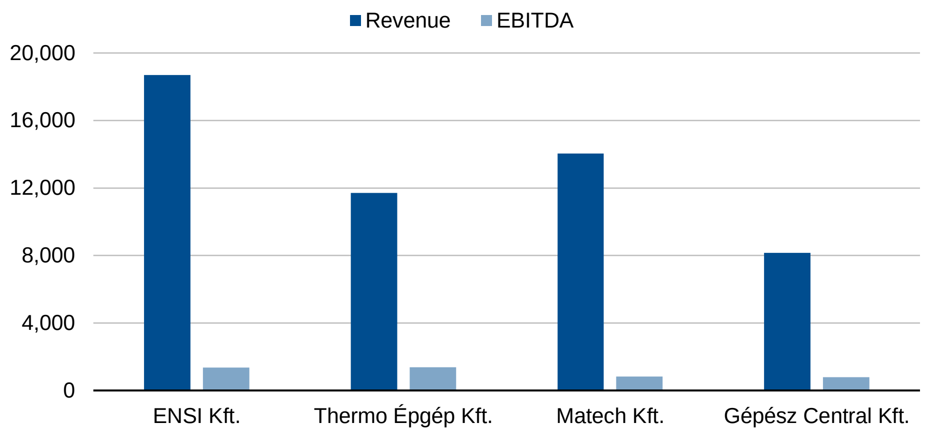
Business risk profile: B

The business risk profile of ENSI is constrained by its small size by global standards, limited diversification in terms of activity, geographies and customers. The business risk profile is supported by operating profitability gradually improving since 2021 and a strong order book accounting for more than HUF 35bn as of October 2023.

ENSI is a small constructor in the contexts of the European and Hungarian construction markets. Small size leads to more volatile cash flow and higher exposure to external shocks. ENSI's small size is in part compensated for by its market leadership in Hungary in its niche of mechanical engineering. In previous years, ENSI's revenue had been very volatile. While ENSI was subject to rapid revenue growth until 2021, revenue has decreased by about 9% in 2022 to HUF 18.7bn. Based on the interim management accounts for 2023 (8M 2023 revenue: HUF 20.2bn), we forecast a 39% revenue increase in 2023.

ENSI's size is limited compared to leading Hungarian construction companies, which are general contractors with a wide scope of activities and a strong focus on public procurement. However, ENSI is a market leader in its niche with a market share of 20%. Its direct competitors include family-owned SMEs with strong focus either on a geographical region or on a particular project type. ENSI focuses on large projects (more than 20,000 sq m) that involve specialised knowledge and high added value. Despite its small relative size, the company has an impressive list of references from a wide range of public and private projects.

Figure 1: ENSI Kft. and direct peers by revenue in 2022 (HUF m)



Sources: Public information, Scope

Limited diversification in terms of activities and geographies

As the company is only active in Hungary, geographical diversification is weak. Its previous focus on the Budapest area has shifted towards other regions of Hungary, as only 26% of its ongoing projects centre on the Budapest area, with the rest in rural areas. The company remains active in one segment of the construction industry based on the 2023 order book:

buildings. This makes the company more vulnerable to shifts in demand and slowdown of sector growth. The weak segment diversification is partially mitigated by a wide range of projects undertaken within the buildings segment: sports facilities, offices, factories and industrial complexes.

In 2023, ENSI participated in 21 projects overall (2022: 16 projects), with the two largest ones in terms in revenue being the BMW Assembly hall and the T6/T7 Nestlé pet food factory in Bük. Based on the number of projects, the concentration within the order book is low, but there is significant exposure to different phases of the construction of BMW's manufacturing plant located in Debrecen, Hungary.

Customer diversification is unchanged compared to the previous review. Customer concentration is high, with revenue from Market Építő Zrt, the biggest customer of ENSI, accounting for 50% of total revenue in 2022 (top five: 84 %). We expect the strong cooperation between ENSI and Market to continue beyond 2023 based on the issuer's current order book.

Gradual improvement in profitability since 2021

In 2021 and 2022, the EBITDA margin was hindered by the delays and cost overruns related to supply chain issues in multiple major projects, which were only completed in 2023. Based on the interim financial information, the EBITDA margin for 2023 is forecasted close to 11%. We expect a gradual deterioration of profitabiltiy based on the following assumptions: i) softening demand from the end-market due to negative macroeconomic conditions; and ii) lingering strong inflationary pressure on the cost side. The EBITDA forecast in the financial base case is slightly below management's forecast (2024: 8%, 2025: 8.5%).

Financial risk profile: BB+

Limited leverage, expected to develop in line with the profitability

Other than a HUF 5.5bn senior unsecured bond issued in January 2022, ENSI still operates without any short- or long-term debt. We assume leverage, measured by Scope-adjusted debt/EBITDA, to be around 3x in upcoming years. As no additional debt intake is assumed in the medium term, the development of leverage is highly dependent on the profitability of ENSI. As we expect the EBITDA margin to gradually deteriorate, Scope-adjusted debt/EBITDA is expected to change in a similar manner.

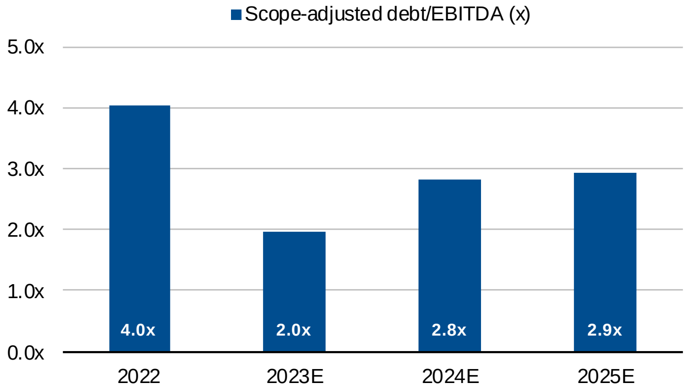
Scope-adjusted debt does not account for performance guarantees since they have never been drawn since the creation of the company. Restricted cash (related to the cash deposit required for the guarantees) is calculated in Scope-adjusted debt, but the effect has historically been minimal. We assume that will remain negligible.

Positive interest income due to short-term investing of unused bond proceeds

Due to the fact the company has historically operated without bank debt, ENSI used to have minimal interest expense. Since the HUF 5.5bn bond issuance in 2022 with 4.75% coupon rate, the company's interest expense has increased to HUF 261m yearly. Additionally, the unused bond proceeds generate interest income, as half of the funds that are not yet spent on acquisition is kept in monthly deposit. The EBITDA interest cover is forecasted to gradually deteriorate in line with the lower interest income, at 11x until 2024, and below 10x in 2025 due to the more conservative profitability forecast.

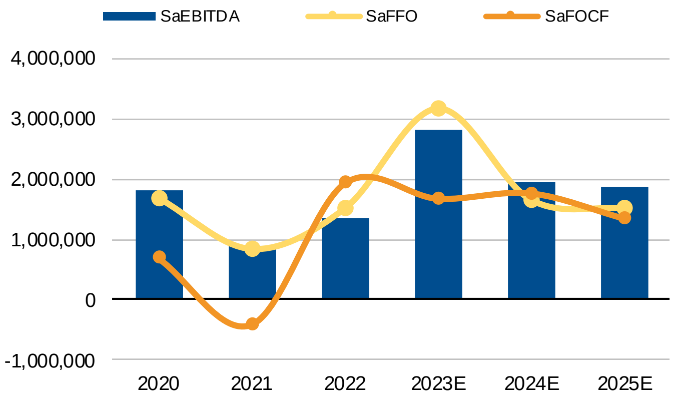
Taking into consideration the assumption that interest payments will remain stagnant (coupon rate of the bond fixed for the whole tenor), ENSI is expected to comfortably meet its interest payment obligations in the medium term.

Figure 2: Leverage



Sources: ENSI, Scope (estimates)

Figure 3: Cash flows (HUF '000s)



Sa: Scope-adjusted
Sources:ENSI, Scope (estimates)

Volatile FOCF

Scope-adjusted FOCF is more volatile than EBITDA, which is mainly affected by the change in working capital needs (down HUF 1.5bn in 2023). Still we forecast positive FOCF going forward within a range of HUF 1-2bn which takes into account capex needed for daily operation. Other investments – most prominently the expected business acquisition in 2023-2024 – is included in the discretionary cash flow. Discretionary cash flow also includes expected dividend payments (based on the business plan of the company: in 2023 HUF 1.2bn, in 2024 HUF 2.2bn and in 2025 HUF 1.2bn).

Adequate liquidity

Liquidity is expected to remain adequate beyond 2023, as in 2024 sources (HUF 5.8bn of cash available as at YE 2023 and Scope-adjusted free operating cash flow of HUF 1.8bn forecasted for 2024) are expected to fully cover uses (no short-term debt as of YE 2023). As the amortisation of the HUF 5.5bn bond starts in 2027 and ENSI has no additional debt, no debt maturity is assumed before 2027. We expect that a worsening of liquidity due, for example, to delayed customer payments or cost overruns is remote at this time thanks to the significant cash balance available to the company.

Balance in HUF m	2022	2023E	2024E
Unrestricted cash (t-1)	1,775	2,611	5,800
Open committed credit lines (t-1)	0	0	0
Free operating cash flow (t)	1,936	1,684	1,772
Short-term debt (t-1)	0	0	0
Coverage	**No short-term debt**	**No short-term debt**	**No short-term debt**

We highlight that ENSI's senior unsecured bond issued under the Hungarian National Bank's Bond Funding for Growth Scheme has a covenant requiring the accelerated repayment of the outstanding nominal debt amount (HUF 5.5bn) if the debt rating of the bond stays below B+ for more than two years (grace period) or drops below B- (accelerated repayment within 30 days). Such a development could adversely affect the company's liquidity profile. The rating headroom to entering the grace period is zero notches. Given the limited headroom, the company must at least maintain its current credit profile to avoid triggering the rating-related covenant.

Long-term debt rating

Senior unsecured debt rating: B+

ENSI issued a HUF 5.5bn senior unsecured bond (ISIN: HU0000361258) in January 2022 through the Hungarian Central Bank's Bond Funding for Growth Scheme. The bond proceeds are currently unused but earmarked for M&A, including the acquisition of engineering material wholesalers and retailers, in line with the company's strategy to enter this related segment and achieve synergies and economies of scale. The bond has a tenor of 10 years and a fixed coupon of 4.75%. Bond repayment is in six tranches; 10% of the face value is payable each year between 2027 and 2031, and 50% at maturity in 2032.

We have rated ENSI's senior unsecured debt B+, the same level as the issuer rating. The recovery analysis is based on a hypothetical default scenario at YE 2024. We have decided to use the going concern scenario in the analysis due to the asset-light nature of the company and the assumption that its business activity generates its enterprise value. Recovery is 'average' for senior unsecured debt holders in this scenario.

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