Baromfi-Coop Kft.
Hungary, Consumer Goods

SCOPE BB- STABLE

Corporate profile

Baromfi-Coop headquartered in Debrecen, Hungary, operates along the whole value chain in the chicken processing industry. While Baromfi-Coop covers the agricultural activities of the group (procurement and corn farming), Master Good focuses on the primary processing of live poultry, the manufacturing of prepared and further processed products, as well as sales. Besides the main farm in Kisvárda, the company operates a hatchery in Petneháza, as well as feed production plants in Nyírkércs, Balsa and Nyírmada. In 2018, Baromfi-Coop generated sales of HUF 82.537m and EBITDA of HUF 11.221m. The entity is fully owned by the managing family Bárány.

Key metrics

		Scope estimates		
Scope credit ratios	**2018**	**2019F**	**2020F**	**2021F**
EBITDA/interest cover (x)	38.1x	8.0x	8.7x	9.0x
Scope-adjusted debt (SaD)/ EBITDA	2.4x	3.9x	3.6x	2.9x
Scope-adjusted FFO/SaD	38%	23%	23%	29%
FOCF/SaD	-33%	-37%	3%	18%

Rating rationale

Scope Ratings has assigned a BB- issuer rating on Hungary-based Baromfi-Coop, together with a senior unsecured debt rating of BB-. The Outlook is Stable.

The credit rating mainly reflects Baromfi-Coop's market position in the Hungarian chicken processing industry and the solid profitability (EBITDA margin). The rating is held back by its weak diversification.

Given its annual production of up to 64m chickens per year, Baromfi-Coop accounts for around 25% of overall Hungarian chicken meat production. Furthermore, we judge its long-term relationship with McDonald's as positive (up to 15% of all chicken products sold by McDonald's in Europe are supplied by the company). However, the company's production output is rather low compared to European competitors, which holds back our assessment of its market share. The company's credit rating is compromised by weak diversification. This is based on 1) a fairly concentrated customer portfolio; and 2) the focus on one poultry species (chicken). Profitability (EBITDA margin) is credit supportive, with reported EBITDA margins averaging 11.8% (2016 to 2018). We therefore rate Baromfi-Coop's business risk profile in the 'BB' category.

The company's financial risk profile (rated 'BB-') is constrained by our expectation of a meaningful deterioration in credit metrics this year, following substantial capex programme, predominantly on the expansion of the farm in Kisvárda. For the current year we project leverage (SaD/EBITDA) of 3.8x, versus 2.1x in 2018. That said, we expected credit metrics to strengthen moderately from 2020 onwards. This is based on higher operating results due to the first-time contribution of investments made and lower capex. Weak liquidity is a negative rating factor, given Baromfi-Coop's substantial amount of short-term debt, negative Free operating cash flow in 2018 and 2019F, and no committed credit lines.

Ratings & Outlook

Corporate ratings	BB-/Stable
Senior unsecured rating	BB-

Analysts

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Related methodology

Corporate Rating Methodology

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Outlook

The Outlook is Stable, reflecting our expectation of a slight improvement from 2020 on. It also includes our assumption of a successful placement of a bond (volume: up to HUF 28.5bn) in 2019, of which up to HUF 19.5bn should be used to repay debt and up to HUF 9.0bn to finance the current capex programme.

A positive rating action could be warranted by SaD/EBITDA of below 3.5x on a sustainable basis. A negative rating action could be required if SaD/EBITDA moves above 4.0x on a sustained basis. This could, in particular, occur if the company orchestrates large M&A or if EBITDA falls short of our projections. Lastly, a rating downgrade could result from continued weak liquidity coverage beyond 2021 (the capex programme ends in 2020).

Rating drivers

Positive rating drivers	Negative rating drivers
• Integrated approach covering the whole value chain, including crop production and processing of chicken meat • Biggest chicken processing company in Hungary (around 25% market share) • Up to 15% of all chicken products sold by McDonald's in Europe are supplied by Baromfi-Coop • Long-term relationships with customers • Solid EBITDA margin (2018: 13.6%) – current investments in automation and ramp-up of byproducts will offset higher expected labour costs	• Rather small size compared to European competitors • Weak diversification, characterised by 1) concentrated customer portfolio; and 2) focus on one poultry species (chicken) • Negative Free cash flows and weak Cashflow cover as a consequence of its large capex programme

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA of below 3.5x on a sustained basis	• Large M&A putting pressure on credit metrics • SaD/EBITDA of above 4.0x on a sustained basis • Continued weak liquidity coverage beyond 2021

Financial overview

		Scope estimates		
Scope credit ratios	**2018**	**2019F**	**2020F**	**2021F**
EBITDA/interest cover (x)	38.1x	8.0x	8.7x	9.0x
Scope-adjusted debt (SaD)/EBITDA	2.4x	3.9x	3.6x	2.9x
Scope-adjusted FFO/SaD	38%	23%	23%	29%
FOCF/SaD	-33%	-37%	3%	18%
Scope-adjusted EBITDA in HUF m	**2018**	**2019F**	**2020F**	**2021F**
EBITDA	11,221,455	12,473,303	13,216,119	13,857,751
Operating lease payments in respective year	0	0	0	0
Other items	0	0	0	0
Scope-adjusted EBITDA	11,221,455	12,473,303	13,216,119	13,857,751
Scope-adjusted funds from operations (FFO) in HUF m	**2018**	**2019F**	**2020F**	**2021F**
EBITDA	11,221,455	12,473,303	13,216,119	13,857,751
less: (net) cash interest as per cash flow statement	-294,177	-1,564,080	-1,513,980	-1,543,880
less: cash tax paid as per cash flow statement	-169,188	-120,238	-131,914	-142,809
less: pension interest	0	0	0	0
add: depreciation component operating leases	0	0	0	0
add: dividends received from equity-accounted entities	0	0	0	0
less: disposal gains on fixed assets included in EBITDA	0	0	0	0
less: capitalised interest	0	0	0	0
Change in provisions	-703,178	517,024	-649,945	-543,075
Scope-adjusted funds from operations	10,054,912	11,306,009	10,920,280	11,627,986
Scope-adjusted debt (SaD) in HUF m	**2018**	**2019F**	**2020F**	**2021F**
Reported gross financial debt	21,963,231	47,737,300	47,324,000	48,844,000
Hybrid bond	-608,305	-940,365	-81,916	-8,744,647
less: cash, cash equivalents	0	0	0	0
Cash not accessible	0	0	0	0
add: pension adjustment	0	0	0	0
add: operating lease obligations	0	0	0	0
Other items (contingent liabilities)	0	0	0	0
Scope-adjusted debt	21,354,926	46,796,935	47,242,084	40,099,353

Business risk profile

We have assigned a blended industry risk of ‘BBB+’ given the company’s activities – the procurement and farming of corn, and the processing of chicken. This is based on our industry risk profiles for fast-paced consumer goods (cyclicality: low; market entry barriers: medium; substitution risk: low; industry outlook: stable) and agriculture (cyclicality: high; market entry barriers: high; substitution risk: low; industry outlook: stable) as well as the company’s EBITDA breakdown by divisions.

The ‘BB‘ business risk profile reflects Baromfi-Coop’s integrated approach, covering the whole value chain in the poultry processing industry. In the light of the company’s annual production capacity of up to 64m chickens yearly, we estimate that Baromfi-Coop accounts for up to 25% of Hungarian chicken meat production. Given the rather fragmented structure of the Hungarian chicken processing industry, we view the company to be the market leader. Furthermore, we judge Baromfi-Coop’s relationship with McDonald’s to be a positive rating driver, as it supplies up to 15% of all chicken products sold by McDonald’s in Europe and McDonald’s has been a company customer for over 15 years. However, Baromfi-Coop’s production output is rather low compared to European competitors. For instance, France-based LDC and Plukon Food Group, located in the Netherlands, process more than 400m chickens per year, compared to up to 64m chickens by Baromfi-Coop.

The company’s credit rating is compromised by weak diversification. This is based on 1) a rather concentrated customer portfolio; and 2) the focus on one poultry species (chicken). According to Baromfi-Coop, its customer portfolio consists of about 250 customers, with its Top 10 customers accounting for up to 60% of sales. This negative factor is somewhat mitigated by the company’s long-term relationships with customers, together with the fact that its biggest customers are large, well-known retail and consumer goods companies such as Aldi, Tesco and McDonald’s. Given the company’s focus on the production of chicken meat, Baromfi-Coop is highly sensitive to a sharp decline in the demand for chicken, e.g. due to an unexpected outbreak of avian influenza in Eastern Europe. In contrast, we believe that the company’s animal stock is well protected from infection and thus from emergency slaughter in such an event. This assumption is grounded on its stringent hygiene regulations, including farms which operate as self-sufficient systems, including waste water purification.

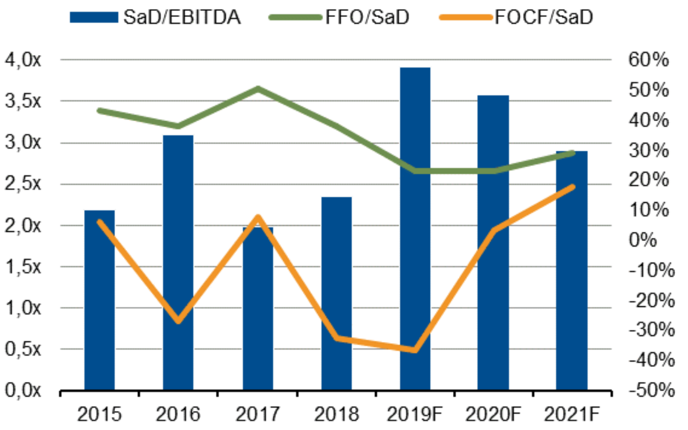
Profitability is credit supportive, based on reported EBITDA margins averaging 11.8% between 2015 and 2018. Our rating case projects a moderate increase in Baromfi-Coop’s EBITDA margin, given 1) its continuing integrated approach, which limits sensitivity to fluctuations in crop prices; 2) efforts to ramp up highly profitable business lines, e.g. the sale of fertilisers and abbatoir waste from chicken processing for the pet food industry; and capex on automation to counterbalance increasing labour costs; and 3) going pricing power.

Financial risk profile

The company’s financial risk profile (rated ‘BB-‘) is constrained by our expectation of a meaningful deterioration in credit metrics this year, following substantial capex programme, predominantly on the expansion of the farm in Kisvárda. This includes a biological treatment plant, and the extension and automation of the cutting unit. Our rating case also includes dividend payments in line with Baromfi-Coop’s stated dividend policy (see supplementary rating drivers), as well as the successful issuance of the intended bond offering (volume: up to HUF 28.5bn) in the current year.

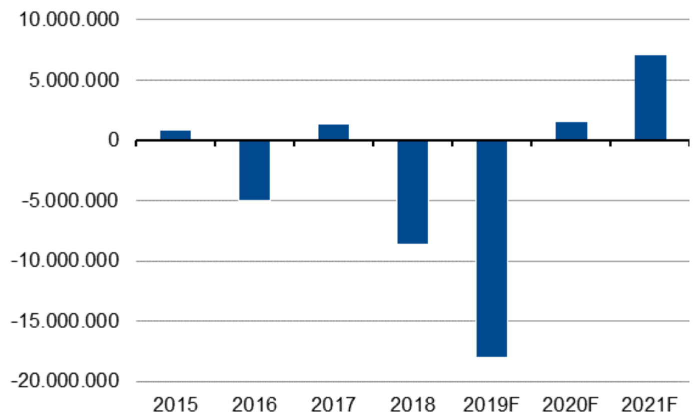
For 2019, we project leverage (SaD/EBITDA) of 3.8x, versus 2.1x in 2018. Given the company’s bank loan covenants, there is some risk of a covenant breach if the financial results for 2019 and 2020 fall short those of our rating case. That said, we expect credit metrics to strengthen moderately from 2020 onwards. This is based on higher operating results due to the first-time contribution of investments made and lower capex. In this context, we project that cash flow cover will make the largest improvement, to 3% in 2020 (2019F: -38%), because most capex will be in the current year and we expect Free cash flow to turn positive.

Figure 1: Credit metrics



Source: Scope

Figure 2: Free cash flow (HUF m)



Source: Scope

Baromfi-Coop's liquidity coverage is weak, with a substantial amount of short-term debt, negative Free operating cash flow in 2018 and 2019F, and no committed credit lines. However, we see potential for stronger liquidity coverage on a sustained basis from 2021 onwards. This is based on the company's intentions to improve its liability transformation profile, expressed by a reduction in short-term debt and an increase in long-term debt, together with our expectation of positive Operating Free cash flow.

Supplementary rating drivers

We consider Baromfi-Coop's financial policy to be neutral. The Barany family has been running the company proactively for more than 100 years and is strongly committed to its long-term success. Although we expect a higher debt level from 2019 onwards, no dividend has been paid in recent years – which is positive for debt holders. As outlined by the company, a maximum of 10% of annual net income can be paid to shareholders. We therefore judge the likelihood of large, debt-financed dividend payments to be limited.

Senior unsecured debt rating

Recovery is based on a hypothetical default scenario in 2020, including the assumption of bank debt is ranked senior secured. The outcome of our recovery analysis indicates an 'average recovery' for senior unsecured debt. This expectation translates into a rating of 'BB-' for this debt category.

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