Zalaco Sütőipari Zrt.
Hungary, Consumer Goods

B+ Positive

Corporate profile

Zalaco Sütőipari Zrt.'s (Zalaco) core business is the production of bread and fresh bakery products. The company has expanded sales and production capacity and increased its product portfolio. It currently distributes almost 400 bakery and confectionery products, with production plants established in Zalaegerszeg, Ajka and Sopron between 2014 and 2017. In addition, Zalaco operates around 50 of its own bakeries.

Key metrics

			Scope estimates	
Scope credit ratios	2019	2020	2021E	2022E
EBITDA/interest cover (x)	30.6x	25.2x	10.9x	15.2x
Scope-adjusted debt (SaD)/EBITDA	4.1x	4.3x	3.0x	2.5x
Scope-adjusted FFO/SaD	24%	21%	29%	35%
FOCF/SaD	-80%	-21%	16%	26%

Rating rationale

Issuer rating benefits from underlying industry, solid profitability and low leverage constrained by limited scale, high customer concentration and negative free operating cash flows. The Outlook change reflects anticipated lower-than-expected leverage going forward.

Zalaco's business activities were partially interrupted by the impact of Covid-19 in 2020. The crisis delayed the implementation of the company's automated frozen product line, while lockdown regulations strongly affected wholesale and retail sales, which resulted in lower-than-expected top-line growth (based on 2020 preliminary figures).

At the beginning of the second half of 2020, the company issued a senior unsecured bond for a total of HUF 4.4bn (roughly EUR 12m). Bond proceeds were partially used to re-finance bank loans and fund capital investments; The pandemic postponed planned M&A negotiations.

Zalaco's business risk profile (affirmed at B+) continues to benefit from stable underlying demand. The rating is also supported by the company's profitability (relatively high EBITDA margins compared to local peers) which further improved in 2020 thanks to the high-margin nature of frozen products. Geographical diversification remains the main constraint on Zalaco's business risk profile, with high customer concentration on Lidl.

Zalaco does not use its own brand in its wholesale business segment. However, we view positively the Zalaco brand value, which is limited to the region in which the company operates.

Zalaco's financial risk profile (affirmed at B+) is supported by comfortable operating profitability, reflected in substantial cash flow generation that puts leverage in the low BB category. As was anticipated in Scope's previous rating report, Zalaco's liquidity profile improved after the successful bond placement. Despite a lack of committed credit lines, the company's liquidity profile is benefiting from the bond's repayment structure after refinancing all short-term working capital loans (HUF 1.2bn) in 2020. Expected positive free operating cash flows (above HUF 1.0bn) and material available cash minimises the company's short-term refinancing risks.

Ther is no explicit adjustment for supplementary rating drivers.

Ratings & Outlook

Corporate ratings	B+/Positive
Senior unsecured rating	B+

Analyst

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Related Methodology

Corporate Rating Methodology, February 2020

Rating Methodology: Consumer Products, September 2020

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Outlook and rating-change drivers

Stable Outlook

The positive Outlook reflects Scope's expectation that the company will execute its M&A plans after 2022 while existing long term investment loans are expected to be repaid in 2021, leading to the SaD/EBITDA ratio advancing towards 3.5x by 2021. The positive rating outlook also reflects successful implementation of frozen products automated production line.

Rating upside

A positive rating action could be warranted if FFO/SaD exceeds 20% on a sustained basis and SaD/Scope-adjusted EBITDA consistently trends below 3.5x. A decrease in leverage may be achieved by an increase in profitability following the successful implementation of the company's expansion strategy.

Rating downside

The Outlook change back to stable from positive could be triggered by a failure to reduce leverage from present levels. A negative rating action could result from a deterioration in credit metrics, as indicated by FFO/SaD of below 10% and SaD/EBITDA of above 5.0x on a sustained basis. An increase in leverage could be triggered by an adverse operational development, leading to reduced profitability or the need for additional external financing for capital expenditure, M&A or unplanned intercompany loans.

Rating drivers

Positive rating drivers	Negative rating drivers
• Relatively high profitability margins • Vertically integrated value chain and business operations • Operational sustainability following decades of partnership with international value chains	• High capex requirements turning FOCF negative • Shortage of workforce • Low scale compared to international peers • High customer concentration risk

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Additional scale and diversification • FFO/SaD above 20% • SaD/EBITDA below 3.5x	• Additional debt-funded acquisitions • FFO/SaD below 10% • SaD/EBITDA above 5x

Financial overview

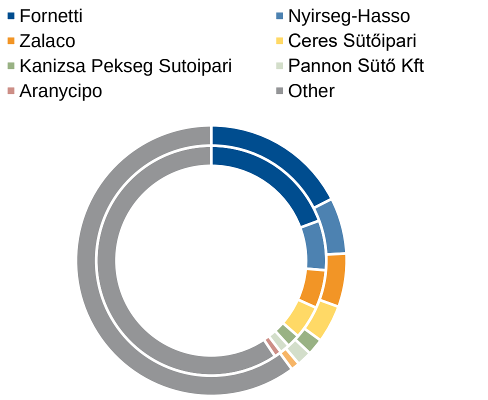
			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover (x)	30.6x	25.2x	10.9x	15.2x
Scope-adjusted debt (SaD)/EBITDA	4.1x	4.3x	3.0x	2.5x
Scope-adjusted funds from operations/SaD	24%	21%	29%	35%
Free operating cash flow/SaD	-80%	-21%	16%	26%
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	887	999	1,259	1,925
Operating lease payments in respective year	162	0	0	0
Other	0	0	0	0
Scope-adjusted EBITDA	999	1,259	1,925	2,213
Scope-adjusted funds from operations in HUF m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	999	1,259	1,925	2,213
less: (net) cash interest as per cash flow statement	-17	-106	-176	-146
less: cash tax paid as per cash flow statement	-18	-35	-96	-127
add: depreciation component, operating leases	0	0	0	0
Scope-adjusted funds from operations	963	1,118	1,653	1,941
Scope-adjusted debt in HUF m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	3,317	6,478	4,878	4,750
less: hybrid bonds	0	0	0	0
less: cash and cash equivalents	-55	-1,958	0	0
add: cash not accessible	0	0	0	0
add: pension adjustment	0	0	0	0
add: operating lease obligations	0	0	0	0
Other	835	835	835	835
Scope-adjusted debt	4,097	5,354	5,713	5,585

Business risk profile (B+)

Business Risk profile affirmed at B+

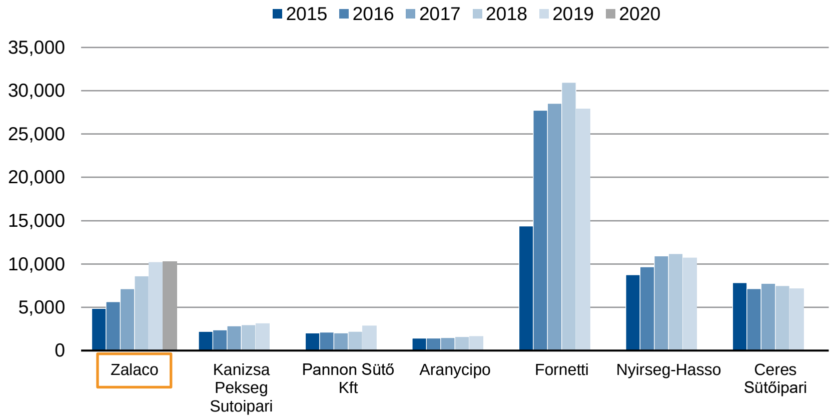
Zalaco's business risk profile continues to benefit from stable demand in the underlying non-durable consumer products industry, which has low cyclicality, medium barriers to entry and low substitution risk.

Figure 1: Hungarian Bakery market shares (2018-2019)



Source: Zalaco, Scope estimates

Figure 2: Top line development of Zalaco's local competitors (HUF m)

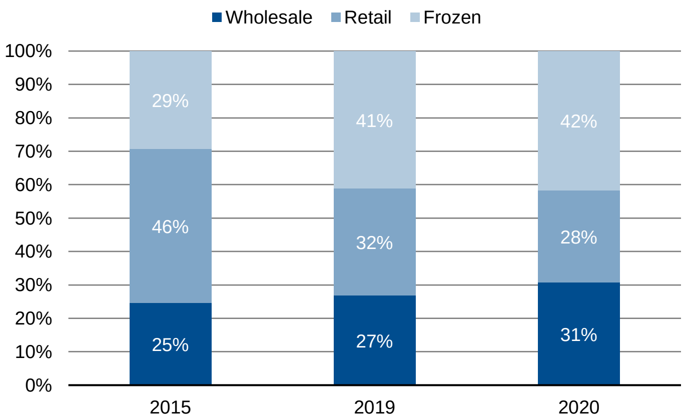


Source: Zalaco, Scope estimates

Pandemic effect on top-line performance of Zalaco

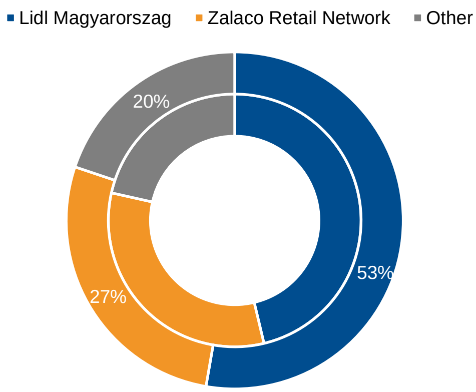
Zalaco's business activities were partially interrupted by the impact of Covid-19 in 2020. The crisis led to delayed implementation of its automated frozen product line, while lockdown regulations strongly affected retails sales, which resulted in lower-than-expected top-line growth (based on preliminary 2020 figures). Nonetheless, we believe the new product portfolio and increased production capacity will help the company achieve double-digit revenue growth and protect cash flow generation in the next few years.

Figure 3: Revenue by division (2015vs2019vs2020)



Source: Zalaco, Scope estimates

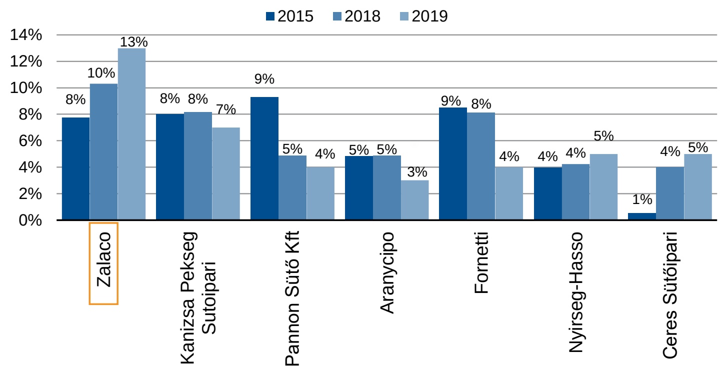
Figure 4: Customer concentration (2019-2020)



Source: Zalaco, Scope estimates

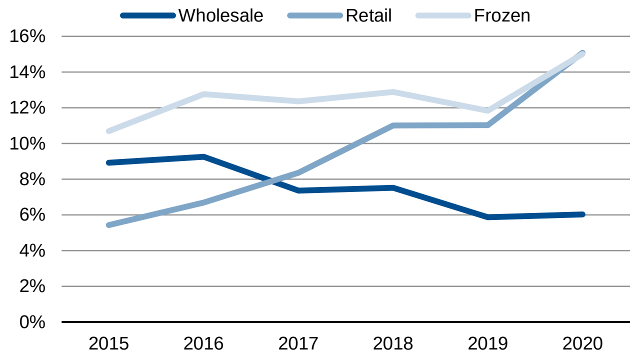
Geographical diversification remains the main constraint on Zalaco's business risk profile, as Covid-19 halted exports of frozen products and limited the company's exposure to one specific region. Furthermore, Zalaco's sales are highly concentrated on international retail chain Lidl, which accounted for 53% of 2020 sales. This is not expected to change in the medium term. The risk of significant sales exposure to Lidl is partially mitigated by the ability of this small-cap company to deliver quality-oriented products and maintain sustainable business operations.

Figure 5: **Profitability margins comparison with domestic and regional peers**



Source: Zalaco, Scope estimates

Figure 6: **Zalaco's EBITDA by division (2-15-2020)**



Source: Zalaco, Scope estimates

The rating is also supported by the company's profitability (relatively high EBITDA margins compared to local peers) which further improved by 2 pp in 2020 thanks to the high-margin nature of its frozen products.

Zalaco does not use its own brand in its wholesale business segment. However, Scope views positively the Zalaco brand value, which is limited to the region in which the company operates. Outstanding local customer loyalty is driven by constantly strengthened product quality and the variety of its product portfolio.

Financial risk profile (B+)

Scope adjustments and assumptions

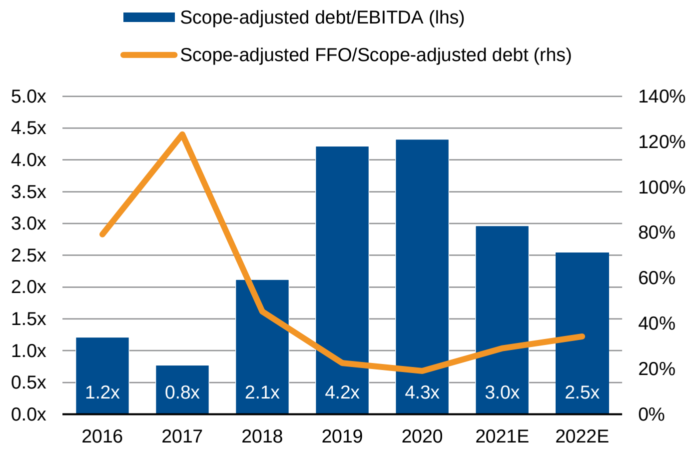
Scope-adjusted debt is adjusted according to our definition, and includes the following key elements:

- Going forward, double-digit percentage growth in revenues despite the adverse short-term impacts of Covid-19.
- Scope-adjusted debt includes the operating leases for existing 50 Zalaco retail stores until FY2019.
- 80% of available cash and cash equivalents are netted for the fiscal year 2020; going forward, this amount of cash is excluded from the Scope-adjusted debt calculation.
- Operating Cash flow has been adjusted by the amount of the bond premium.
- No adjustments for intercompany loans as cash equivalents, since prior to the recent refinancing, these loans where not liquid and there was a significant likelihood of potential write-offs.
- Dividend pay-outs roughly 25% of last year's net profit in line with the company's guidance.
- No M&A effect on top line in base case, which was an option a year ago. Our conservative assumptions on M&A transactions reflect still-limited visibility and execution risk of of the expansion plan.
- Scope adjusted EBITDA incudes adjustments for received government funds.

Financial Risk profile affirmed at B+

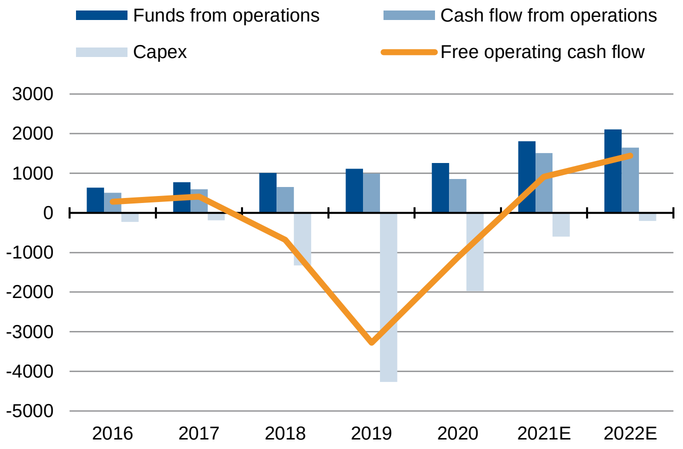
Zalaco's financial risk profile is supported by comfortable operating profitability, reflected in substantial cash flow generation which puts leverage in low BB category. Despite lower-than-expected top line performance, increased EBITDA margins and significant available cash (as confirmed by preliminary FY2020 results) meant that leverage as expressed by Scope-adjusted-debt-to adjusted EBITDA remained in the 4.0x area. Significant expected capital expenditure in 2020 will result in negative free operating cash flow, however. But according to management, the heavy capex phase is over and no material spending should be expected going forward.

Figure 7: Leverage



Source: Scope estimates

Figure 8: Cash flow generation



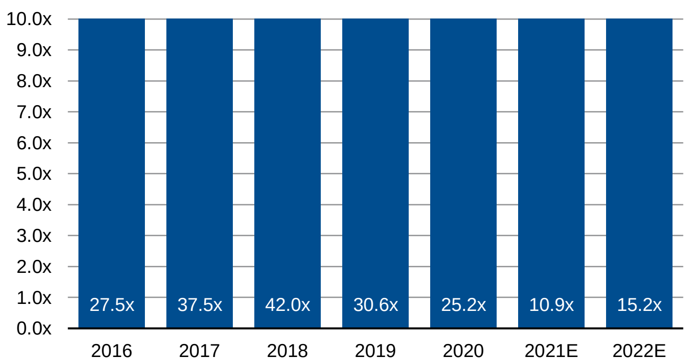
Source: Scope

We expect the company to begin deleveraging from this year, given the high capex phase is over and planned acquisitions have been postponed due to Covid-19. We expect FFO/SaD and SaD/EBITDA to reach 30% and 3.0x respectively in 2021. This is based on our assumption of: i) two ramped-up automated production lines, which will increase annual production capacity of frozen bakery products by 14 tonnes per day; and ii) less severe lockdown regulations in 2021 impacting customer behaviour.

Adequate liquidity profile

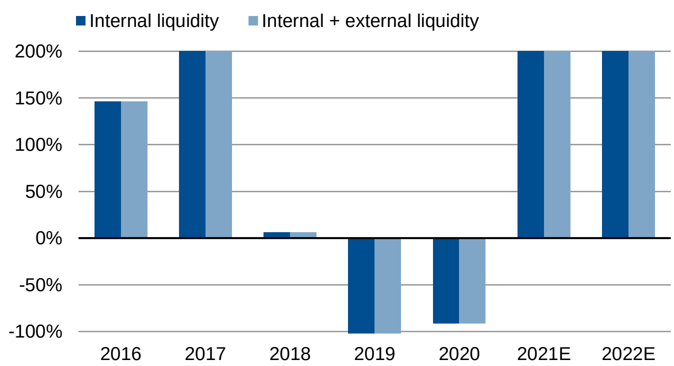
Zalaco's liquidity profile has improved. Despite a lack of committed credit lines, the liquidity profile benefits from its bond repayment structure after refinancing all short-term working capital loans (HUF 1.2bn) in 2020. The positive expected free operating cash flows (above HUF 1.0bn) and material available cash minimises the company's short-term refinancing risks.

Figure 9: EBITDA interest cover



Source: Scope estimates

Figure 10: Liquidity



Source: Scope

Supplementary rating drivers

Credit neutral supplementary rating drivers

There are no explicit adjustments for supplementary rating drivers. Scope deems positively recent changes in Zalaco's organisational structure and asset consolidation with sister companies, which aims to provide outside investors with better transparency and increase operational efficiency. While the owner's commitment and transparency are positive, we also see key person risk.

Long-term debt ratings

Senior unsecured debt rated at B+

The rated entity issued a HUF 4.4bn senior unsecured corporate bond (ISIN HU0000359765) in H2 2020. Our recovery analysis is based on a hypothetical default scenario in 2022, which assumes outstanding senior unsecured debt of HUF 4.4bn in addition to HUF 1.9bn in senior secured loans. Although our recovery analysis indicates a relatively high recovery rate for senior unsecured debt, we have limited the uplift for the instrument to zero notches due to the small scale of the company.

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