Szabó Fogaskerékgyártó Kft.
Hungary, Capital Goods

SCOPE B STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	97.8x	Net interest positive	Net interest positive	13.2x
Scope-adjusted debt/EBITDA	1.7x	4.7x	2.3x	2.3x
Scope-adjusted funds from operations/debt	55%	23%	42%	39%
Scope-adjusted free operating cash flow (FOCF)/debt	-51%	-11%	10%	-43%

Rating rationale

The issuer rating of B is based on our business risk profile assessment of B- and our financial risk profile assessment of BB+. The business risk profile is constrained by the company's size, low product and customer diversification as well as Szabó Fogaskerékgyártó's business nature: a very low share of recurring revenue (mainly project business) and a lack of aftermarket activities, which usually provide for lower volatility. Good profitability compared to peers is the main driver of the business risk profile. Profitability also supports leverage ratios, which ultimately lead to a financial risk profile assessed as moderate.

Outlook and rating-change drivers

The Stable Outlook reflects the faster-than-expected improvement in Szabó Fogaskerékgyártó's profitability, supported by the normalisation in commodity markets and the higher prices agreed in Q4 2022, which has led us to revise upwards our expectation for the Scope-adjusted EBITDA margin to above 25% in 2023-2024. It also reflects our anticipation of higher revenue in 2023-2024, which, together with better profitability, should lead to improved leverage as measured by Scope-adjusted debt/EBITDA of around 2.5x in 2023-24.

A rating upgrade is remote at this stage but would be possible if the company improved its diversification, particularly with regard to customers and/or grew while keeping its leverage low.

A negative rating action could result from Scope-adjusted debt/EBITDA staying at around 4x, e.g. caused by EBITDA margin pressure from rising material or personnel costs or increased financial debt. It could also result from weaker liquidity or the loss of a major customer.

Rating history

Date	Rating action	Issuer rating & Outlook
22 Dec 2023	Outlook change	B/Stable
21 Dec 2022	Outlook change	B/Negative
31 Jan 2022	New	B/Stable

Ratings & Outlook

Issuer	B/Stable
Senior unsecured debt	B+

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Related Methodology and Related Research

General Corporate Rating Methodology; October 2023

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Good operating profitability (EBITDA) compared to peers • Solid liquidity after significant cash inflows in 2022 • Long relationships with largest customers	• Very small niche player in the European capital goods market with a revenue of HUF 2.4bn (roughly EUR 6m) in 2022 • Weak diversification with regard to products and customers, more than 90% of revenue from only two customers • Szabó Fogaskerékgyártó's business nature entails a very low share of recurring revenue (mainly project business) and lack of aftermarket activities, which usually provide for lower volatility • Weak Scope-adjusted FOCF in 2022-2024 due to lower Scope-adjusted EBITDA and investment cycle • Key person risk (ESG factor) as the entire management of the company rests with the current CEO Ferenc Szabo (the sole owner of Szabó Fogaskerékgyártó Kft.) and his son Krisztian Szabo, the executive vice president

Positive rating-change drivers	Negative rating-change drivers
• A rating upgrade is remote at this stage but it would be possible if the company improved diversification and/or grew while keeping its leverage low	• Scope-adjusted debt/EBITDA staying above 4x • Deterioration in liquidity, loss of a major customer

Corporate profile

Founded in 1976, Szabó Fogaskerékgyártó Kft. is a gear manufacturer based in Kaposvár, Hungary. It is a family-operated business and Ferenc Szabó is the sole owner.

Szabó Fogaskerékgyártó Kft. specialises in gear manufacturing. The company's activities include computer numerical control (CNC) hobbing, CNC milling, gear shaping, CNC turning, contact surface testing heat treatment, CNC gear grinding, broaching, and 3D CNC measuring. The main product lines are spur gears, helical gears, worm gears, planetary gears, spline shafts, straight bevel gears and geared axes.

In 2022, Szabó Fogaskerékgyártó Kft. Reported a revenue of around HUF 2.4bn (EUR 6m) with a Scope-adjusted EBITDA margin of 22%. Szabó Fogaskerékgyártó Kft. has a 3,500 sq m production facility located in Kaposvár and employs more than 50 people. The site Szabó Fogaskerékgyártó currently operates in is owned by its 100%-owned subsidiary Szabó Hajtástechnológia. Szabó Hajtástechnológia's total revenue in 2022 were HUF 32m (2021: HUF 31m), consisting mainly of rental income from the parent company.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	>20x	>20x	Net interest positive	Net interest positive	13.2x	13.7x
Scope-adjusted debt/EBITDA	0.7x	1.7x	4.7x	2.3x	2.3x	1.9x
Scope-adjusted funds from operations/debt	129%	55%	23%	42%	39%	48%
Scope-adjusted FOCF/debt	58%	-51%	-11%	10%	-43%	21%
Scope-adjusted EBITDA in HUF m						
EBITDA	797.6	611.7	526.8	958.9	853.9	927.3
less: capitalised development costs	0.0	0.0	0.0	0.0	0.0	0.0
add: share-based compensation expense	0.0	0.0	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	**797.6**	**611.7**	**526.8**	**958.9**	**853.9**	**927.3**
Funds from operations in HUF m						
EBITDA	797.6	611.7	526.8	958.9	853.9	927.3
less: (net) cash interest paid	-1.8	-6.3	66.4	24.8	-64.7	-67.5
less: cash tax paid per cash flow statement	-55.5	-31.1	-38.7	-51.6	-30.5	-36.8
less: pension interest	0.0	0.0	0.0	0.0	0.0	0.0
less: capitalised development costs	0.0	0.0	0.0	0.0	0.0	0.0
Profit/loss on disposals	0.0	0.0	0.0	0.0	0.0	0.0
Funds from operations	**740.3**	**574.3**	**554.5**	**932.2**	**758.7**	**823.0**
Free operating cash flow in HUF m						
Funds from operations	740.3	574.3	554.5	932.2	758.7	823.0
Change in working capital	-213.1	-83.0	234.5	-121.9	-38.4	-55.8
Non-operating cash flow	-589.1	399.2	944.5	15.4	5.0	5.0
less: capital expenditure (net)	-52.4	-1,067.1	-959.2	-594.4	-1,545.8	-415.6
add/less: special items[1]	449.7	-352.3	-1,038.1	0.0	0.0	0.0
Free operating cash flow	**335.4**	**-528.9**	**-263.9**	**231.2**	**-820.5**	**356.7**
Net cash interest paid in HUF m						
Net cash interest per cash flow statement	1.8	6.3	-66.4	-24.8	64.7	67.5
add: interest component, pension	0.0	0.0	0.0	0.0	0.0	0.0
Net cash interest paid	**1.8**	**6.3**	**-66.4**	**-24.8**	**64.7**	**67.5**
Scope-adjusted debt in HUF m						
Reported gross financial debt	549.3	1,016.2	2,432.3	2,177.8	1,902.1	1,727.2
less: cash and cash equivalents	0.0	0.0	0.0	0.0	0.0	0.0
add: non-accessible cash	0.0	0.0	0.0	0.0	0.0	0.0
Other	25.0	25.0	25.0	25.0	25.0	0.0
Scope-adjusted debt	**574.3**	**1,041.2**	**2,457.3**	**2,202.8**	**1,927.1**	**1,727.2**

[1] In 2020-2021: granting and repayment of loans to the shareholder and the subsidiary; in 2022: adjustment for the state subsidy

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Long-term debt rating: B+ 12

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)

Key person risk

There is a key person risk (ESG factor) as the entire management of the company rests with the CEO Ferenc Szabo, the 100% owner of Szabó Fogaskerékgyártó Kft. and his son Krisztian Szabo, the executive vice president. Ferenc Szabo and Krisztian Szabo entered into an official agreement on the joint management of the company in February 2022, whereby Krisztián Szabó became the managing director of the company alongside his father and was given independent signing authority. Ferenc Szabo is responsible for strategic decisions, which are always made in consensus with Krisztian Szabo. Szabo senior also has the representative tasks of the company, trains the mechanical engineers, and takes an active role in formulating pricing and other policies. Krisztian Szabo is responsible for the operative managerial tasks, taking an active role in production planning either directly or through engineer colleagues and the ERP system. Financial planning and accounting are his responsibility. He is also in charge of R&D and the first line of contact with international business partners. Our rating therefore reflects the improved financial risk profile to a lesser extent than the weak business risk profile, as the company could prove vulnerable to structural changes in management on top of external factors.

[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: BBB

As a manufacturer of gears, Szabó Fogaskerékgyártó is exposed to the capital goods industry. This industry has medium cyclicality, medium barriers to entry and medium substitution risk, and we assess its industry risk at BBB.

Very small niche player in the European capital goods market

With sales of around HUF 2.4bn (EUR 6m), Szabó Fogaskerékgyártó is a small niche player in the European capital goods market with relatively weak market positioning. The company specialises in gear manufacturing, the production of geared parts, and machining.

Figure 1: **Examples of products**

Source: Scope

Business risk profile rated B-

In addition to its size, Szabó Fogaskerékgyártó's business risk profile continues to be constrained by the company's weak diversification both with regard to products and customers.

Diversification is main constraint

The key constraints regarding diversification are:

i) Szabó Fogaskerékgyártó's highly concentrated product portfolio as indicated by its relatively low revenue (around EUR 6m). The company's turnover is 99% gear and gearbox production, with waste management and heat treatment providing 1% of total turnover.

ii) High dependence on certain strategic customers, as the top two customers (German and Canadian-Hungarian agricultural machinery manufacturers) account for more than 90% of total revenue. We note positively that relationships with those two clients go back 20-30 years. Szabó Fogaskerékgyártó not only manufactures gears for its customers, but it is also involved in product development and testing, which promote customer loyalty. Customer loyalty is also promoted by the fact that Szabó Fogaskerékgyártó does not produce high volume parts with a high level of standardisation, but rather small to mid-size batches (10-500 pieces per order) from its portfolio of over 1,000 different gear types.

iii) High end-market concentration: while the company has little exposure to highly cyclical end-markets like automotive, lorries, and consumer products, around 90% of its revenues are generated from companies in the agricultural machinery sector.

iv) Low geographical diversification and high currency risk: exports account for 56% of the company's total net sales and Germany accounts for around 90% of total export sales. Although 44% of revenue is generated in Hungary, the share of EUR-based revenue is much higher at around 95%, as a large part of domestic revenue is also EUR-based. However, as Szabó Fogaskerékgyártó's manufacturing capacity is located only in Hungary, more than 30% of the costs, mainly personnel and some material costs, are incurred in HUF. The currency risk is not hedged.

Further constraint: very low share of recurring revenue and lack of aftermarket activities

The business risk profile is also constrained by Szabó Fogaskerékgyártó's business nature entails a very low share of recurring revenue (mainly project orders with a short lead time of one to six months) and lack of aftermarket activities, which usually leads to low volatility.

Profitability is the main support for the business risk profile

Profitability, as measured by the scope-adjusted EBITDA margin, remains the main pillar of the company's business risk profile in the context of the peer group.

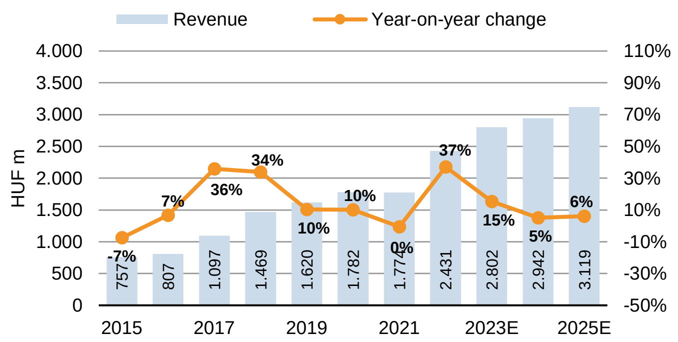
Drop in Scope-adjusted EBITDA margin in 2022

The Scope-adjusted EBITDA margin declined from 34.5% in 2021 to 21.7% in 2022, driven by the sharp increase in material costs and the late conclusion of price negotiations to pass on higher material prices to customers in Q4 2022. An increase in staff costs by around 37% YoY also weighed on profitability. Revenue increased by about 37% in 2022, reaching HUF 2.4bn compared to HUF 1.8bn in 2021 but could not offset the lower Scope-adjusted EBITDA margin, resulting in a decline of Scope-adjusted EBITDA to HUF 527m in 2022 from HUF 612m in 2021.

Decline in Scope-adjusted EBITDA

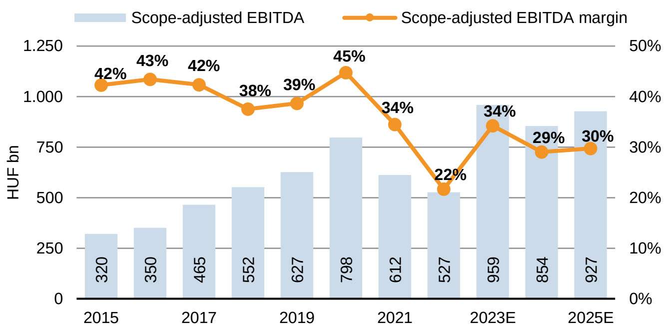
We attribute the revenue increase in 2022 to three main factors: i) higher sales volumes due to efforts to reduce pandemic backlogs for end-customers and replenish inventories following the collapse of supply chains during the Covid-19 period; ii) the depreciation of the forint against the euro as around 95% of the company's revenue are EUR-denominated; and iii) an average price increase of 23% for its main customers to offset rising raw materials and energy costs, which came into force in November 2022.

Figure 2: Revenue, 2015 to 2025E



Sources: Szabó Fogaskerékgyártó, Scope (estimates)

Figure 3: Scope-adjusted EBITDA margin, 2015 to 2025E



Sources: Szabó Fogaskerékgyártó, Scope (estimates)

Strong improvement in profitability after 9M 2023; jump in reported EBITDA

Based on unaudited figures, Szabó Fogaskerékgyártó's revenue increased by 27% YoY to HUF 2.1bn at 9M 2023 compared to HUF 1.7bn at 9M 2022. This was mainly driven by higher volumes (up 13% YoY) and price increases implemented in Q4 2022. This jump in volume is largely due to one-off effects such as the loss of Ukrainian suppliers. In contrast, the depreciation of the forint against the euro had a negative impact. EBITDA (unaudited) of HUF 773m after 9M 2023 were above HUF 276m after 9M 2022. In addition to higher revenue, EBITDA were supported by the improved gross profit margin (51.7% in 9M 2023 versus 32.1% after 9M 2022) thanks to the price increase implemented in Q4 2022 and the normalisation on the energy and raw materials markets. As a consequence, the reported EBITDA margin improved from 17% at 9M 2022 to 37% at 9M 2023.

Revenue expected to be 15% YoY higher in 2023

For the full year 2023, we expect revenue of around HUF 2.8bn (up 15% YoY), which is in line with the company's forecast.

Price risk directs downwards

Szabó Fogaskerékgyártó communicated that there will be no price increase in 2023, no increases are planned for 2024-2025, and growth should come from higher volumes and new customers. There is a risk of downward price adjustments due to falling raw materials prices and energy costs under the contractual agreements. We learnt from its discussions with the company that downward price adjustments are not an issue at this stage.

Order backlog offers only limited visibility for 2024

Szabó Fogaskerékgyártó’s current order backlog for 2024 of EUR 3.3bn (around 55% of 2022 full year revenue) offers only limited visibility for 2024 due to Szabó Fogaskerékgyártó’s business model (project orders) based on relatively short lead times (one to six months).

Revenue to increase by 5% YoY in 2024

The company has shown that it is relatively resilient to economic downturns, which we believe is due to its exposure to the less cyclical agricultural sector. Overall, we have factored in a 5% YoY increase in revenue to around HUF 2.9bn for 2024.

Revised expectation for Scope-adjusted EBITDA margin

In 2023, Szabó Fogaskerékgyártó further increased its wages and salaries by an average of 15%, increasing the ratio of personnel cost to revenue to 15.5% after 9M 2023 from 14% in 2022. Nevertheless, in view of the stronger-than-expected improvement in the gross profit margin as indicated by 9M 2023 figures, we are revising our expectation for the Scope-adjusted EBITDA margin for 2023 upwards from 21% to around 31%. This translates into Scope-adjusted EBITDA of around HUF 960m in 2023. We have factored in a relatively stable gross profit margin of around 51% in 2024 compared to around 52% assumed for 2023 (around 52% after 9M 2023). We assume that personnel costs will continue to rise in 2024. However, Szabó Fogaskerékgyártó benefits from its relatively low ratio of personnel expenses to revenue, which is why the expected continued wage inflation will have relatively little impact on the company's overall profitability.

Moving to the new location in summer 2024 will impact profitability

Szabó Fogaskerékgyártó plans to move into the new location in summer 2024. We expect the costs associated with the move to impact profitability this year. Overall, we have factored in a Scope-adjusted EBITDA margin of around 29% for 2024, resulting in a Scope-adjusted EBITDA of around HUF 855m.

Strategic opening for customers from the automotive industry negative for margins

Szabó Fogaskerékgyártó has indicated that it also wants to open up as a supplier to the automotive industry. According to Szabó Fogaskerékgyártó, the company is in advanced negotiations with automotive suppliers. While this strategic decision could boost revenue, it poses risks to the company's EBITDA margin in the long term, as the automotive industry is characterised by standardised mass production and fierce price competition.

Financial risk profile: BB+

Financial risk profile up to BB+

The issuer rating benefits from a financial risk profile which has been revised to BB+ from BB-. The two-notch uplift reflects the better-than-expected credit metrics in 2022 and the anticipated improvement in credit metrics following our raised expectation for Scope-adjusted EBITDA over the next few years. It is also supported by Szabó Fogaskerékgyártó's unchanged debt reduction plans, which aim to reduce financial debt by around HUF 480m by end-2024.

Reported debt of HUF 2.4bn at end-2022

Szabó Fogaskerékgyártó’s reported debt was HUF 2.5bn at end-2022 compared to HUF 1.0bn at end-2021. The debt mainly comprises a corporate bond (HUF 1.5bn), bank loans (HUF 534m) and financial leases (HUF 354m).

No financial covenants

According to Szabó Fogaskerékgyártó, its bank debt has no financial covenants.

We have made an adjustment for an EU investment grant of HUF 25m (part of accrued liabilities), which will terminate in 2025.

HUF 1bn subsidy not considered due to low probability of repayment

In 2022, Szabó Fogaskerékgyártó received a HUF 1bn subsidy to finance its investments under the Economic Development and Innovation Operational Programme Plus. This subsidy is not included in Scope-adjusted debt as we deem the probability of repayment to be low. Repayment is only required if Szabó Fogaskerékgyártó fails to comply with a conditionality scheme consisting of the following three main factors:

i) The growth rate of gross value added compared to GDP growth.

ii) Growth of the entrepreneurial knowledge base. This can be fulfilled if Szabó Fogaskerékgyártó participates in one of the government's enterprise development knowledge programmes.

iii) Effective project fulfilment: n the basis of the subsidy agreement, Szabó Fogaskerékgyártó can only request up to three changes to its submitted investment plan.

Possible date for repayment of the subsidies is 2026

Underachievement on milestones would lead to a pro-rated repayment rather than a full repayment

The first phase is the implementation of the project (purchase of machinery and construction of facilities). There is a milestone in this phase, which was passed in August 2023. There are no further milestones until the end of the project (the deadline for submitting the final settlement is 9 January 2025). The compliance period (second phase), which is subject to a measurement linked to GDP growth, will start after the completion of the project. The measurement year for maintenance is therefore 2025 and the reference year for the monitoring period is 2019. The possible date for repayment of the subsidies is 2026. Underachievement on the milestones would lead to a pro-rated repayment of subsidies rather than a full repayment of the subsidies received.

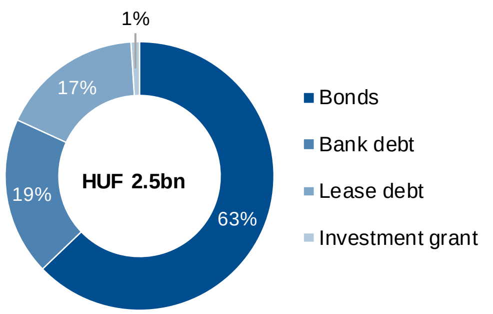
Increase in Scope-adjusted debt to HUF 2.5bn at end-2022

Based on these adjustments, we calculate a Scope-adjusted debt of HUF 2.5bn at end-2022. The increase compared to HUF 1.0bn at end-2021 is due to the bond issuance of HUF 1.5bn under the Hungarian National Bank's Bond Funding for Growth Scheme for investments in capacity expansion in February 2022. This bond has a maturity of 10 years, an annual redemption of the nominal value by 10% in 2027-2031 with a bullet redemption of 50% in 2032 and a fixed-interest coupon of 5.5% payable annually.

Szabó Fogaskerékgyártó plans to reduce its financial debt by HUF 480m by 2024

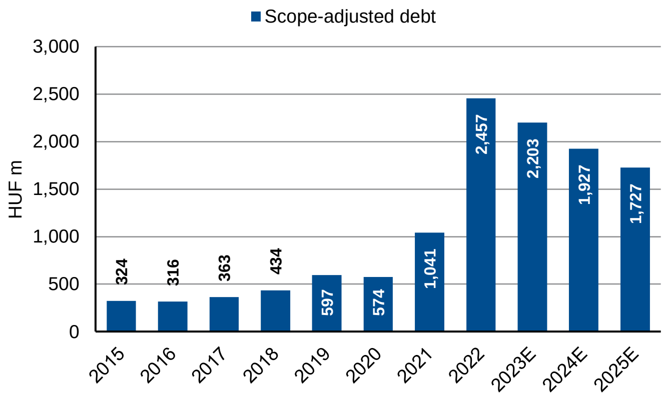
Szabó Fogaskerékgyártó intends to reduce its financial debt by around HUF 530m by the end of 2024. Based on these deleveraging plans, we expect a decrease in Scope-adjusted debt to around HUF 2.2bn by end-2023 and around HUF 1.9bn by end-2024.

Figure 4: Funding structure at end-2022



Sources: Szabó Fogaskerékgyártó, Scope

Figure 5: Trend in Scope-adjusted debt, 2015 to 2025E



Sources: Szabó Fogaskerékgyártó, Scope (estimates)

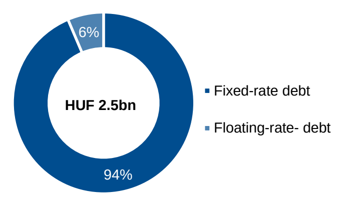
We expect leverage to improve to around 2.5x in 2023-2024

Leverage as measured by Scope-adjusted debt/EBITDA deteriorated to 4.7x in 2022 from 1.7x in 2021, driven by the increase in Scope-adjusted debt following the issuance of a HUF 1.5bn bond and the decline in Scope-adjusted EBITDA, as the higher revenue could not offset the sharp decline in the margin. Based on our upwardly revised expectations for Scope-adjusted EBITDA and the company's deleveraging plans, we see the Scope-adjusted debt/EBITDA ratio improving to around 2.5x in 2023-2024.

Strong interest cover

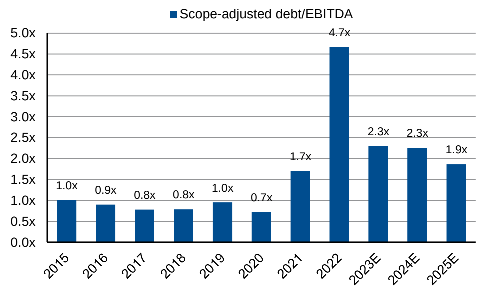
The interest result was positive in 2022, supported by high interest income from the investments of the high cash income in short-term bank deposits and short-term government bonds, and the fact that the payment of interest on the bond started in 2023. As Szabó Fogaskerékgyártó plans to hold the securities on its balance sheet for some time, we expect the company to continue to generate substantial interest income. Szabó Fogaskerékgyártó has informed us that the company generated interest income of HUF 125m in 9M 2023 and expects interest income of around HUF 145m for the full year 2023. Overall, we expect that the interest income will overcompensate the interest paid on the bond for the first time in 2023 and that net interest income will remain positive in 2023. We also note positively that the impact of higher interest rates on Szabó Fogaskerékgyártó is limited as around 95% of Szabó Fogaskerékgyártó's total debt was fixed coupon at end-2022. In addition, the company does not have to refinance its upcoming maturities at all due to its very solid liquidity position or can do so at very favourable costs. In 2023, Szabó Fogaskerékgyártó raised a new HUF 149.9m development loan, due in 2028 with an interest rate of 0.0% (Hungarian Development Bank's interest subsidised loan progamme). Overall, we expect a very strong interest cover of over 10x in 2024.

Figure 6: Interest profile of interest-being debt at end-2022



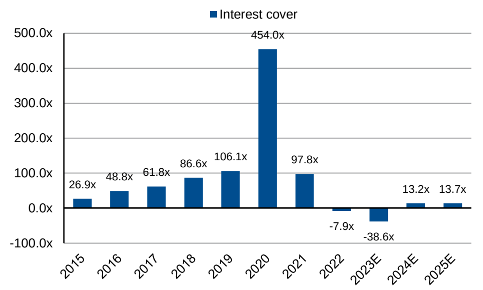
Sources: Szabó Fogaskerékgyártó, Scope

Figure 7: Scope-adjusted debt/EBITDA, 2015 to 2025E



Sources: Szabó Fogaskerékgyártó, Scope (estimates)

Figure 8: Scope-adjusted EBITDA/interest cover, 2015 to 2025E



Sources: Szabó Fogaskerékgyártó, Scope (estimates)

In 2022, Scope-adjusted funds from operations decreased slightly to around HUF 555m from HUF 574m in 2021, as an increase in interest income was unable to offset the lower Scope-adjusted EBITDA. Due to the expected higher Scope-adjusted EBITDA and positive interest result, we anticipate Scope-adjusted funds from operations of around HUF 930m for 2023 as a whole. We expect Scope-adjusted funds from operations to decline to around HUF 760m in 2024 with lower expected Scope-adjusted EBITDA and negative interest result.

Investment cycle started in 2021 weighing on FOCF

Scope-adjusted FOCF remained negative at HUF -264m in 2022 (2021: HUF -529m) due to the impact of high capex in connection with the investments in production capacities initiated in 2021. As part of its investment programme, Szabó Fogaskerékgyártó is investing in a new production hall and a logistics centre as well as in the development of the production structure (automated warehouse structure). Szabó Fogaskerékgyártó plans to build a new 5000 sq m production hall in the industrial park of Kaposvár. This project is supported by the government with a state subsidy of HUF 1bn under the Economic Development and Innovation Operational Programme Plus. After the implementation of the investment programme was delayed in 2022 (weak operating performance and low cash flow) and 2023 (delay in property development), the completion of the programme was postponed by one year to the end of 2024.

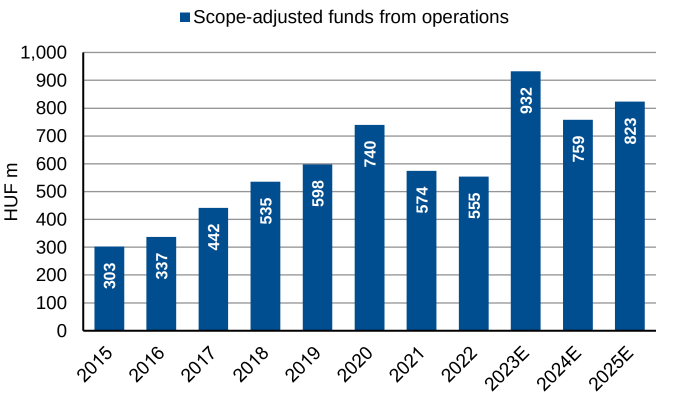
FOCF turned positive after 9M 2023

At 9M 2023, the unaudited FOCF was positive at around HUF 110m (around HUF -210m at 9M 2022, adjusted for the receipt of the subsidy), as higher EBITDA and a positive interest result compensated for the higher outflows of working capital and capex, which however remained below the previous budget due to a delay in property development.

Investment cycle to last until 2024 with strongly negative FOCF expected for 2024

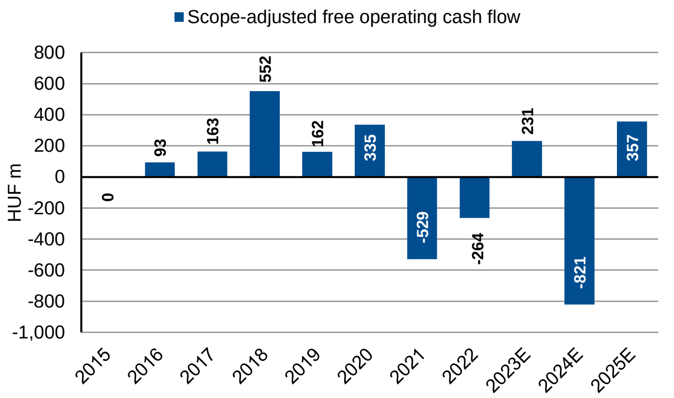
We expect net outflows connected to working capital to reduce the Scope-adjusted FOCF by around HUF 120m in 2023 and around HUF 40m in 2024. The investment programme will last until 2024, thus capex is set to remain high in 2023-2024. Due to the delay in property development in 2023, we have factored in lower capex of around HUF 595m in 2023 and an increase to around HUF 1.5bn in 2024. Overall, we expect a positive Scope-adjusted free operating cash flow of around HUF 230m for 2023 and a negative one of around HUF -820m for 2024.

Figure 9: **Scope-adjusted funds from operations, 2015 to 2025E**



Source: Szabó Fogaskerékgyártó, Scope (estimates)

Figure 10: **Scope-adjusted FOCF, 2015 to 2025E**



Source: Szabó Fogaskerékgyártó, Scope (estimates)

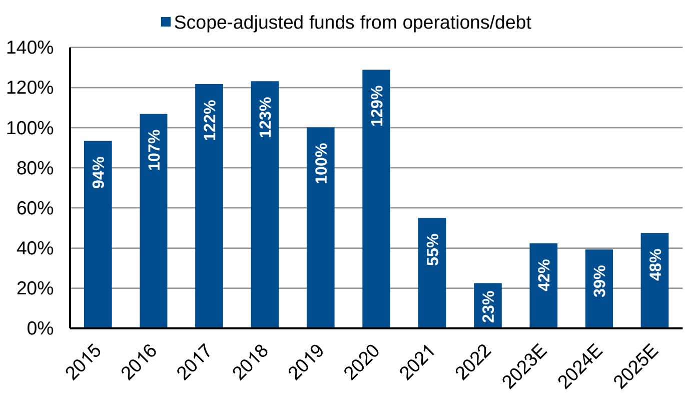
Scope-adjusted funds from operations/debt at above 30% in 2023-2024

The increase in Scope-adjusted debt following the bond issuance has caused the Scope-adjusted funds from operations/debt ratio to fall from 55% in 2021 to 23% in 2022. Based on our upwardly revised expectations for Scope-adjusted EBITDA, we expect Scope-adjusted funds from operations/debt at above 30% in 2023-24.

Volatile cash flow cover during investment cycle

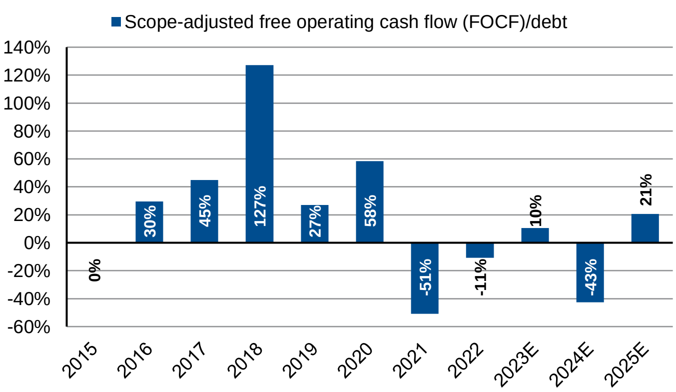
The negative Scope-adjusted FOCF in 2021-2022 led to negative cash flow cover in these years. The investment programme will last until 2024 and will have a negative impact on Scope-adjusted FOCF during this period. We therefore assume that the cash flow cover will be volatile: positive at around 10% in 2023 and negative in 2024.

Figure 11: Scope-adjusted funds from operations/debt, 2015 to 2025E



Sources: Szabó Fogaskerékgyártó, Scope (estimates)

Figure 12: Scope-adjusted FOCF/debt, 2015 to 2025E



Sources: Szabó Fogaskerékgyártó, Scope (estimates)

Dividend stopper in place from 2022 to 2024

With regard to capital allocation, we note that Szabó Fogaskerékgyártó has tended to distribute the entire FOCF as shareholder dividend in recent years. As provided for in the bond prospectus, Szabó Fogaskerékgyártó has committed to reduce the annual dividend to HUF 50m during the investment cycle from 2022 to 2024. We understand that Szabó Fogaskerékgyártó does not want to return to distributing all FOCF after 2024 but wants to use its cash to invest.

No further capital transfer to parent and sister company in 2022-24

We also note that in 2018, Szabó Fogaskerékgyártó started to provide loans to its shareholder and its subsidiary, run by Krisztian Szabo, son of the shareholder of Szabó Fogaskerékgyártó Kft and executive vice president of Szabó Fogaskerékgyártó Kft. Loans provided to the shareholder amounted to HUF 80.5m at end-2022 compared to HUF 73.8 at end-2021. Loans provided to the subsidiary have been largely reimbursed in 2021 (HUF 44.3m at end-2022 versus HUF 411.4m at end-2020) and no further support is planned in the near future. This, however, cannot be fully excluded as there are no binding contractual obligations.

Adequate liquidity

We consider Szabó Fogaskerékgyártó's liquidity and financial flexibility as ‘adequate’ as the significant cash inflows in 2022 led to very high cash reserves and the maturity structure is well stretched.

Balance in HUF m	2023E	2024E	2025E
Unrestricted cash (t-1)	2,463	2,390	1,243
Open committed credit lines (t-1)	0.0	0.0	0.0
Free operating cash flow (t)	231	-821	357
Short-term debt (t-1)	407	181	196
Coverage	**>200%**	**>200%**	**>200%**

Cash sources

Liquidity sources comprise:

i) Cash on balance sheet of HUF 1.9bn at end-2022 (HUF 199m at end-September 2023)

ii) Short-term financial assets (short-term bank deposits as well as short-term government bonds) of HUF 594m at end-2022 (HUF 2.2bn at end-September 2022). In 2022, Szabó Fogaskerékgyártó’s received HUF 1.5bn from the bond issue in February 2022 and HUF 1bn in state subsidies. At end-September 2023, HUF 2.2bn of this was invested in short-term bank deposits and short-term government bonds.

iii) Expected Scope-adjusted funds from operations of around HUF 930m in 2023 and around HUF 760m in 2024

In 2023, Szabó Fogaskerékgyártó raised a new HUF 149.9m development loan, due in 2028 and an interest rate of 0.0% (Hungarian Development Bank interest subsidised loan programme and its GINOP programme).

Cash uses

Expected cash uses include:

i) Net working capital related outflows of around HUF 120m in 2023 and around HUF 40m in 2024

ii) Capex of around HUF 595m in 2023 and HUF 1.5bn in 2024

iii) Dividend payment of around HUF 50m in 2023-24

iv) Debt repayments (net of debt raised) in the amount of around HUF 255m in 2023 and around HUF 275m in 2024

Bond has an accelerated repayment clause

We highlight that Szabó Fogaskerékgyártó'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 1.5bn) if the debt rating of the bond stays below B+ for more than two years (grace period) or drops below B- (accelerated repayment within 10 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 rating headroom, the company must at least maintain its current credit profile to avoid triggering the rating-related covenant.

Long-term debt rating: B+

Senior unsecured debt rating: B+

In line with the issuer rating, we have affirmed the B+ rating for senior unsecured debt, one notch above the issuer rating, based on an 'above average' recovery prospect in the event of a default.

In February 2022, Szabó Fogaskerékgyártó issued a HUF 1.5bn bond under the Hungarian National Bank's Bond Funding for Growth Scheme with a tenor of 10 years, amortisation of the notional amount by 10% annually over 2027-2031 with a 50% bullet repayment in 2032, and a 5.5% fixed interest rate coupon payable annually. Proceeds from the bond were supposed to be used for investments in a new production hall and logistics centre and to develop the production structure with an automated warehouse structure. The remaining debt comprises bank debt and financial leases. Banking loans are secured by pledge on some selected machines, lorries and cars.

We assume that Szabó Fogaskerékgyártó will reduce its bank and lease debt by around HUF 730m by YE 2025 in line with its business plan and the investment programme will be executed as planned with no additional bank debt or other senior-ranking financing ahead of the bond.

In 2022, Szabó Fogaskerékgyártó received a HUF 1bn state subsidy to finance its investments. We have ranked the repayment obligation for subsidies at the simulated point of default senior to the claims on the prospective bond.

We also assume an increase in property, plant and equipment compared to end-2022 due to the ongoing investment programme.

Scope's recovery analysis uses the liquidation value in a hypothetical default in 2025 of HUF 2.4bn. This value is based on a haircut on the assets and reflects liquidation costs of 10%. The haircut also assumes the receivable from the parent, used to refinance the acquisition debt, would become non-recoverable in the event of payment default.

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