1 March 2024

Corporates

Zalaco Sütőipari Zrt.
Hungary, Consumer Products

STABLE

BB-

Key metrics

			Scope estimates	
Scope credit ratios	**2022**	**2023[1]**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	9.9x	21.8x	12.0x	13.5x
Scope-adjusted debt/EBITDA	3.3x	1.4x	2.5x	2.3x
Scope-adjusted funds from operations (FFO)/debt	26%	63%	35%	40%
Scope-adjusted free operating cash flow (FOCF)/debt	-1%	54%	16%	22%

Rating rationale

The issuer rating benefits from low underlying industry risk, solid profitability and low leverage. It is constrained by limited scale and geographical outreach with high customer concentration.

While some of Zalaco's credit metrics may already be strong for the higher financial risk profile assigned, we acknowledge the company's limited scale, which can and has manifested itself in volatile credit metrics. Such was seen in 2021, when the company's performance was impacted by significant increases in utility costs, coupled with the challenge of passing these increased costs on to customers through higher selling prices. In addition, there is limited visibility on the company's financial policy. In recent years, the company has taken a cautious approach, mainly waiting and screening for potential acquisitions. However, this is expected to change and the company is expected to take its first steps in this direction from 2024 onwards.

Outlook and rating-change drivers

The Positive Outlook reflects our expectation that the company will maintain organic growth, while profitability margins will remain stable at historical levels after initiated price reductions, resulting in a Scope-adjusted debt (SaD)/EBITDA ratio of around 2.5x.

A positive rating action is deemed remote in the foreseeable future given the company's limited size and geographical reach. A positive rating action on Zalaco could be considered if the company improves its geographical diversification and size while maintaining its current financial risk profile.

A negative rating action could result from a deterioration in credit metrics, as indicated by a SaD/EBITDA towards 3.5x 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 dividend payments.

Rating history

Date	Rating action	Issuer rating & Outlook
1 Mar 2024	Upgrade	BB-/Stable
2 Mar 2023	Outlook change	B+/Positive
7 Mar 2022	Outlook change	B+/Stable
8 Apr 2021	Outlook change	B+/Positive

[1] Preliminary results - unaudited

Ratings & Outlook

Issuer	BB-/Stable
Senior unsecured debt	BB

Analyst

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Related Methodologies and Related Research

General Corporate Rating Methodology; October 2023

Consumer Products Rating Methodology; November 2023

Sovereign and Public Sector rating report on Hungary; January 2024

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Bloomberg: RESP SCOP

Positive rating drivers	Negative rating drivers
• Operational sustainability following decades of partnerships with international value chains • Vertically integrated value chain and business operations • Relatively high profitability margins	• Limited diversification of the group outside Hungary • The inventory shrinkage and obsolete inventory costs remain at around 2% of sales (ESG factor: credit negative) • Highly concentrated customer base, mainly exposed to Lidl • Small scale compared to international peers

Positive rating-change drivers	Negative rating-change drivers
• Improved geographical outreach or increase in scale	• Scope-adjusted debt/EBITDA towards 3.5x on a sustained basis

Corporate profile

Zalaco Sütőipari Zrt.'s core business is the production of bread and fresh bakery products. The Hungarian company has expanded its sales and production capacity and increased its product portfolio. It currently distributes nearly 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.

Financial overview

				Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023[2]**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	7.4x	9.9x	21.8x	12.0x	13.5x
Scope-adjusted debt/EBITDA	4.6x	3.3x	1.4x	2.5x	2.3x
Scope-adjusted FFO/debt	18%	26%	63%	35%	40%
Scope-adjusted FOCF/debt	1%	-1%	54%	16%	22%
Scope-adjusted EBITDA in HUF m					
EBITDA	1,354	1,956	4,969	2,601	2,889
Other items	155	178	195	205	205
Scope-adjusted EBITDA	**1,509**	**2,134**	**5,164**	**2,806**	**3,094**
FFO in HUF m					
EBITDA	1,354	1,956	4,969	2,601	2,889
less: (net) cash interest paid	-170	-179	-195	-189	-182
less: cash tax paid per cash flow statement	-28	-98	-307	-81	-79
add: depreciation component op leases	122	142	154	161	159
FFO	**1,278**	**1,820**	**4,621**	**2,491**	**2,787**
FOCF in HUF m					
Funds from operations	1,278	1,820	4,621	2,491	2,787
Change in working capital	72	288	-542	66	-316
Non-operating cash flow	134	693	994	220	220
less: capital expenditure (net)	-1,294	-2,696	-1,003	-1,500	-1,000
less: operating lease payments	-122	-142	-154	-161	-159
FOCF	**69**	**-37**	**3,916**	**1,116**	**1,532**
Net cash interest paid in HUF m					
Net cash interest per cash flow statement	170	179	195	189	182
Change in other items	33	36	41	44	46
Net cash interest paid	**203**	**216**	**236**	**233**	**228**
Scope-adjusted debt in HUF m					
Reported gross financial debt	5,437	5,260	5,431	5,231	5,031
less: cash and cash equivalents	-	-	-	-	-
Leasing adjustment	835	1,003	1,003	1,003	1,003
Guarantees	668	791	848	899	951
Scope-adjusted debt	**6,940**	**7,054**	**7,282**	**7,133**	**6,985**

[2] Preliminary results - unaudited

Table of Content

Environmental, social and governance (ESG) profile[3]

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)	Grey leaf
Efficiencies (e.g. in production)	Red leaf	Health and safety (e.g. staff and customers)		Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)	Grey leaf
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)	Grey leaf
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	Grey leaf

Legend
Green leaf (ESG factor: credit positive)
Red leaf (ESG factor: credit negative)
Grey leaf (ESG factor: credit neutral)

Efficiencies

The cost of inventory shrinkage continues to be 2% of sales, leading to a 200-basis point reduction in gross margins. Additionally, the company heavily relies on electricity and gas suppliers, but this dependence may be alleviated with the introduction of a solar panel project that will provide an alternative source of electricity.

[3] 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+

Credit-supportive industry risk profile: A

Zalaco's industry risk profile (assessed at A) continues to benefit from stable demand in the underlying non-discretionary consumer products industry, which has low cyclicality, medium barriers to entry and low substitution risk.

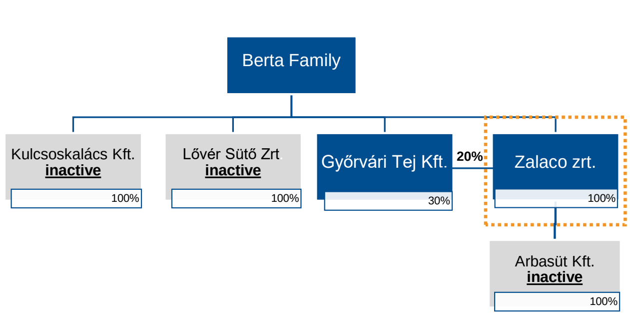
Leading player in Hungarian bakery market and

Zalaco's competitive positioning continues to benefit from its standing as a key national player in the bakery industry.

Limited size

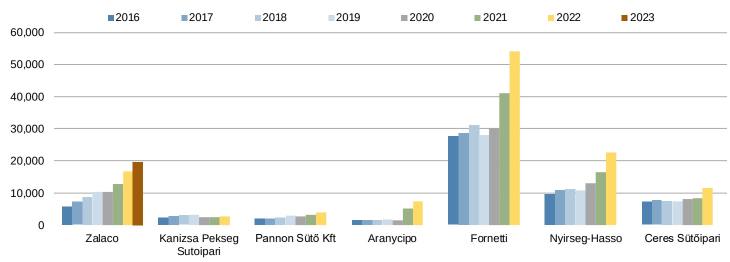
The group's market share is constrained by its small size (HUF 21.1bn in revenue for FY 2023). Although Zalaco's size is significant within Hungary, size remains one of the negative rating drivers of the group's business risk profile.

Figure 1: Organisational structure (as of December 2023)



Sources: Zalaco, Scope

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



Sources: Zalaco, Scope

Regulatory environment

We do not expect quick changes in the regulatory environment for bakery companies and we believe the effect of regulatory action will likely consolidate Zalaco's market share as it will weaken the smaller players.

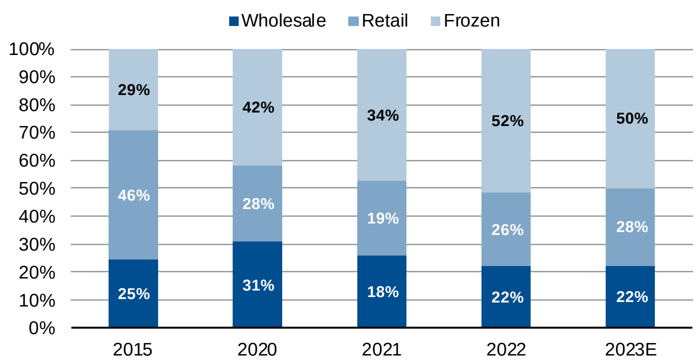
Geographical diversification remains weak

While diversification benefits from a vertically integrated group structure, geographical diversification remains the weak element of the group's business risk profile as it remains heavily dependent on the Hungarian market (macroeconomic vulnerability, see below) in determining input costs.

Country growth outlook and inflation

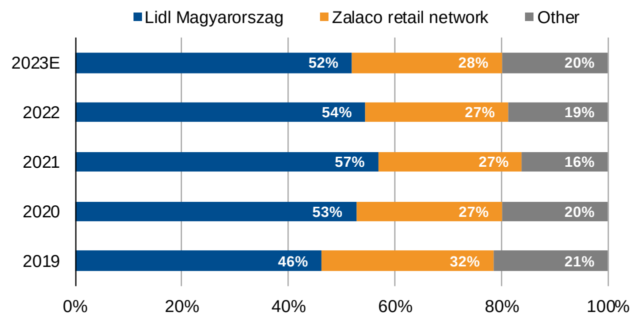
Zalaco is active solely in Hungary and its lack of geographical diversification is a negative rating driver since it leads to vulnerability to macroeconomic risks. Hungary is among the most exposed countries to the fallout from the Ukraine conflict, in view of its high reliance on Russian energy amplified by an economic structure dominated by energy-intensive businesses with complex value chains. Prolonged supply chain disruptions, further inflationary pressures and currency weakness are weighing on the country's growth prospects.

Figure 3: Zalaco's revenue by segment



Sources: Zalaco, Scope estimates

Figure 4: Customer concentration



Sources: Zalaco, Scope estimates

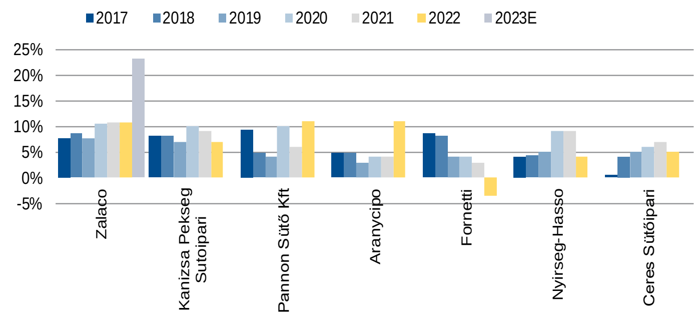
High concentration on Lidl

We regard positively the company's successful transition towards an automated production line which minimises the dependence on the physical workforce and is expected to reduce inventory shrinkage. However, the company's sales remain heavily concentrated on the international retail chain Lidl, which accounted for approximately 52% of its FY 2023 sales (compared to 54% in FY 2022) and is expected to increase further in the medium term as its main customer/partner for frozen product sales. However, the risk of significant sales exposure to Lidl is partially mitigated by Zalaco's ability as a small-cap company to deliver quality-oriented products and maintain sustainable business operations.

Limited export potential

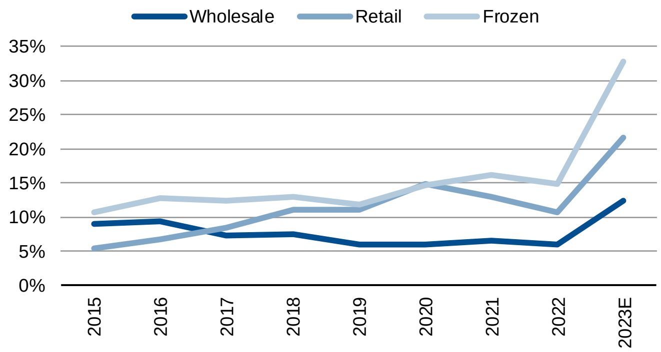
Contrary to our expectations, export sales of frozen products have been delayed. This situation is expected to continue in short to medium term, as international retail chains have postponed commercial negotiations.

Figure 5: Profitability margins compared to domestic and regional peers



Source: Zalaco, Scope estimates

Figure 6: Zalaco's EBITDA by division



Source: Zalaco, Scope estimates

Stable operating profitability margins

The profitability is another major factor that supports the rating (as indicated by relatively high and stable EBITDA margins compared to local competitors). The notable absolute EBITDA growth in 2023 was mainly driven by significant price increases at the beginning of the year and a decline in flower prices of around 20%, while utility costs decreased slightly. However, the achieved EBITDA for 2023 is considered to be a one-off and a normalisation is expected with margins reaching around 11% in 2024-2025. This normalisation is attributed to the implementation of partially initiated price reductions in 2023, which will be fully effective in 2024, together with expected further price decreases in each of Zalaco's business lines from the first quarter of 2024.

Short-term hedging of utility costs

In contrast to the past, the company has now adopted a strategy of hedging electricity and gas prices. The current fixed price for 2024, with an option to extend for one year, provides better visibility on the cost base environment.

Relatively high EBITDA margins for frozen products

The inventory shrinkage and obsolete inventory costs remain at around 2% of sales, which decreases gross margins by 200 bp (ESG factor: credit negative). The profitability is additionally supported by the expected full utilisation of the high-margin automated production line for frozen products (14.7% volume increase in 2022 compared to 2021) starting in May 2023.

Financial risk profile: BBB-

Adjustments and assumptions

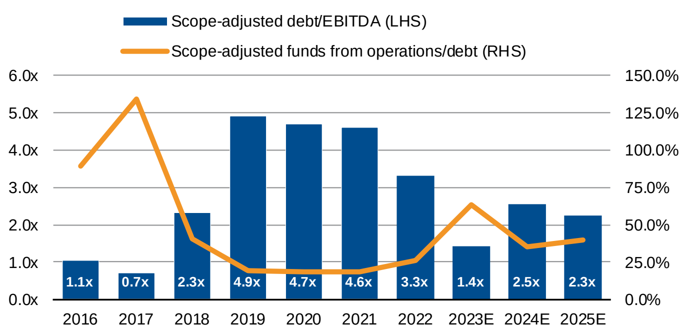
Our adjustments include the following key elements:

- Double-digit percentage top-line growth going forward mainly driven by recovery of sales volumes while sales prices are expected to further decrease from March 2024.
- Expected capex of around HUF 1.0 bn
- Adding-back operating leases for 50 retail stores, which are off-balance sheet debt according to Hungarian GAAP
- Netting of 80% of available cash and cash equivalents for fiscal year 2020 (this amount excluded from 2021)
- Dividend payouts at roughly 25% of last year's net profit, in line with company guidance
- Scope-adjusted EBITDA excludes other income items

Improved leverage

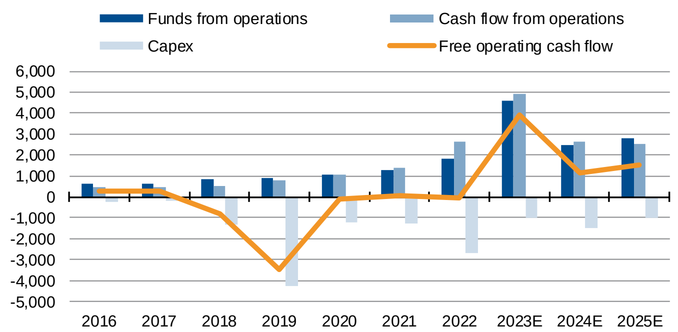
Zalaco's financial risk profile is supported by a solid cash conversion cycle, reflected in substantial cash generation. Significantly lower than expected leverage in 2023 is the result of solid EBITDA performance. Scope-adjusted debt/EBITDA stood at 1.4x at YE 2023 (down 1.9x YoY). However, we expect leverage to move to around 2.5x in 2024-2025 driven by the expected normalization of EBITDA.

Figure 7: Leverage



Sources: Zalaco, Scope estimates

Figure 8: Cash flow (HUF m)



Sources: Zalaco, Scope estimates

Capex phase

We don't expect the heavy investment phase to continue after the completion of the significant investments in machinery in 2022 partially confirmed by positive free operating cash flow in FY2023. However steady demand for frozen produces from international retail chains could push the company into another expansion phase to increase production capacity.

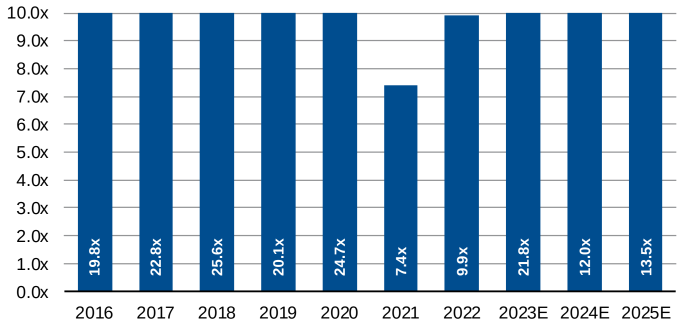
M&A strategy

Alternatively, Zalaco's M&A strategy was initially delayed due to both the Covid pandemic and high inflation rates. However, there is a possibility that Zalaco will now become more active in pursuing its expansion strategy, and acquisitions in the bakery sector could be on the horizon. The company has identified a potential target and management emphasizses that it will consider acquisition EBITDA multiples of up to 5x. Our base case includes around HUF 3.0bn acquisitions in FY2024.

Comfortable cost of debt driven by fixed rate on bond

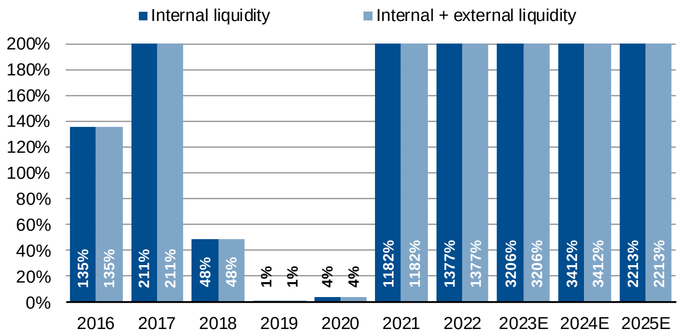
Interest cover is expected to remain at a strong level of above 10x in 2024-25 supported by the fixed interest rate on the issued bond which compromises the majority of interest-bearing debt.

Figure 9: Interest Cover



Sources: Zalaco, Scope estimates

Figure 10: Liquidity



Sources: Zalaco, Scope estimates

Adequate liquidity

Zalaco's liquidity profile is adequate. Despite a lack of committed credit lines, the liquidity profile benefits from the debt structure after all short-term working capital loans (HUF 1.2bn) were refinanced from bond proceeds in FY 2020. The positive expected free operating cash flows starting from YE 2023, and available cash minimises the short-term refinancing risks of company.

Balance in HUF mm	2024 E	2025 E
Unrestricted cash (t-1)	6,038	2,894
Open committed credit lines (t-1)	0	0
FOCF	1,116	1,532
Short-term debt (t-1)	210	200
Coverage	**34.1x**	**22.12x**

Supplementary rating drivers: +/- 0 notches

Credit-neutral supplementary rating drivers

No explicit adjustment for supplementary rating drivers.

Long-term debt rating

Senior unsecured debt rating: BB

We have upgraded Zalaco's senior unsecured debt to BB from BB- including the HUF 4.4bn bond (ISIN HU0000359765). This reflects the upgrade of the issuer rating to BB-/Stable and the expectation of a superior recovery for senior unsecured debt positions in the hypothetical event of a company default.

Operating leases are excluded from debt waterfall

The recovery analysis is based on a hypothetical default scenario in 2025. The debt waterfall includes senior secured loans and guarantees ranked prior to the senior unsecured debt category. The senior unsecured debt of HUF 4.4bn and payables ranked pari passu. As of YE 2023, the loans are constituted of close to 20% of leases, which might stop within short notice time should the situation require it. Our debt waterfall does not take into consideration the recovery of operating leases.

Although the recovery analysis indicates a relatively high recovery rate for senior unsecured debt, we have limited the uplift for the instrument to one notch due to the small scale and the risk that company could raise higher-ranking debt, which would dilute the recovery for senior unsecured debt holders.

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