Market Építő Zrt.
Hungary, Construction

SCOPE BB- STABLE

Key metrics

			Scope estimates	
Scope credit ratios	2021	2022	2023E	2024E
Scope-adjusted EBITDA/interest cover	51.6x	-23.8x[1]	22.8x	9.3x
Scope-adjusted debt/EBITDA	0.8x	0.7x	1.7x	1.7x
Scope-adjusted funds from operations (FFO)/debt	112%	127%	49%	46%
Scope-adjusted free operating cash flow (FOCF)/debt	62%	5%	25%	14%

Rating rationale

Market Építő Zrt's rating is supported by its leading position in Hungarian construction and strong credit metrics, especially low leverage. However, following the deterioration of the EBITDA margin in 2022, we expect profitability to be under pressure from impending headwinds, which include a raw material shortage, volatility of the HUF/EUR exchange rate and wage inflation. The rating benefits from the conservative approach of preserving liquidity to provide a buffer against a downturn in Hungarian construction. The significant capex, including for the ramp-up of Market Asset Management (real estate division), will help to reduce the supply-demand uncertainty in Markets' construction business and provide better economies of scale along the vertically integrated business. The rating is constrained by Market's small size, lack of geographic diversification, and concentration regarding its backlog and business segments (as it is mainly active in buildings[2]).

Outlook and rating-change drivers

The Outlook is Stable and incorporates our expectation of Scope-adjusted debt/EBITDA of 1x-2x. We expect the company to retain its strong liquidity position. The rating Outlook is based on total capex (including organic expansion and acquisition capex) of around HUF 25bn for 2023-2025 and Scope-adjusted EBITDA above HUF 20bn.

A positive rating action could occur if Market's business risk profile improved materially through, for example, improved segment or geographic diversification while credit metrics remained in line with our expectations. However, we do not foresee such an improvement in the short-to-medium term.

A negative rating action could be required if investments under the business plan and in real estate projects weighed on leverage, resulting in Scope-adjusted debt/EBITDA approaching 4x.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
17 Jul 2023	Affirmation	BB-/Stable
26 Jul 2022	Affirmation	BB-/Stable
31 Aug 2021	Outlook change	BB-/Stable

[1] The 2022 interest cover is negative as the company recorded interest received was higher than interest paid.
[2] Buildings is one of the six main segments of construction identified in the Construction and Construction Materials Rating Methodology. The five others are infrastructure and civil engineering; industrial construction; construction-related services; concessions; and construction materials.

Ratings & Outlook

Issuer	BB-/Stable
Senior unsecured debt	BB-

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Related Methodologies

General Corporate Rating Methodology; July 2022

Construction and Construction Materials Rating Methodology; January 2023

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Bloomberg: RESP SCOP

Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Leader in Hungarian construction • Low leverage combined with a conservative approach to cope with a potential downturn in the Hungarian construction market • Significant capex plan to reduce supply/demand uncertainty and diversify activities to improve integration • Good credit metrics supported by low gross debt and strong liquidity	• Small in a European context, with a lack of geographic diversification that limits its ability to offset business cycles • Concentration issues regarding backlog (top five projects account for 54% of backlog, mitigated by investment-grade counterparties) and business segment (mainly buildings) • Adequate profitability hampered by rising materials prices and wages and volatility in operating margin driven by foreign exchange effect

Positive rating-change drivers	Negative rating-change drivers
• Improved business risk profile through significant geographic expansion and development of new segments while credit metrics remain in line with our expectations	• Scope-adjusted debt/EBITDA moving towards 4x

Corporate profile

Market Építő Zrt. (Market), founded in 1996, is Hungary's leading construction company. Its operations are exclusively domestic, it employs about 1,000 people and generated HUF 308bn in turnover in 2022. Its headquarters are in Budapest. Market is owned by GARHART Zrt. (51%), an investment holding company wholly owned by Istvan Garancsi; and Sandor Scheer (49%), Market's CEO and founder. The company is involved in the construction of buildings, industrial facilities and sport facilities. Building projects encompass offices, public facilities, residential buildings and hotels. Growth in the construction segment over the past few years has been driven by high demand for offices and public facilities. Market's industrial projects include logistics centres, auto and tyre production plants and electric battery factories.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	25.0x	51.6x	-23.8x	22.8x	9.3x	10.7x
Scope-adjusted debt/EBITDA	1.7x	0.8x	0.7x	1.7x	1.7x	1.4x
Scope-adjusted FFO/debt	55%	112%	127%	49%	46%	55%
Scope-adjusted FOCF/debt	51%	62%	5%	25%	14%	31%
Scope-adjusted EBITDA in HUF m						
EBITDA	22,239	43,383	26,904	20,036	22,403	24,997
Operating lease payments	241	0	0	0	0	0
Other items	0	0	0	0	0	0
Scope-adjusted EBITDA	**22,480**	**43,383**	**26,904**	**20,036**	**22,403**	**24,997**
FFO in HUF m						
Scope-adjusted EBITDA	22,480	43,383	26,904	20,036	22,403	24,997
less: (net) cash interest paid	-878	-841	1,129	-877	-2,417	-2,331
less: cash tax paid per cash flow statement	-811	-4,618	-4,289	-2,788	-2,993	-3,263
less: interest component, operating lease	-22	0	0	0	0	0
Change in provisions	125	-818	-54	0	0	0
FFO	**20,893**	**37,106**	**23,690**	**16,371**	**16,993**	**19,403**
FOCF in HUF m						
FFO	20,893	37,106	23,690	16,371	16,993	19,403
Change in working capital	20,770	-11,174	-13,850	-1,050	-821	-903
less: capital expenditure (net)	-22,071	-5,204	-8,842	-7,001	-10,853	-7,433
less: operating lease payments	-218	-264	-136	-136	-136	-136
FOCF	**19,374**	**20,464**	**862**	**8,184**	**5,183**	**10,931**
Net cash interest paid in HUF m						
Net cash interest per cash flow statement	878	841	-1,129	877	2,417	2,331
add: interest component, operating leases	22	0	0	0	0	0
Net cash interest paid	**900**	**841**	**-1,129**	**877**	**2,417**	**2,331**
Scope-adjusted debt in HUF m						
Reported gross financial debt	54,321	50,174	53,402	73,886	77,805	76,375
less: cash and cash equivalents	-74,348	-83,702	-83,652	-77,719	-68,349	-76,416
add: non-accessible cash[3]	57,348	66,702	48,852	36,919	27,549	35,616
add: operating lease obligations	447	0	0	0	0	0
Scope-adjusted debt	**37,768**	**33,174**	**18,602**	**33,086**	**37,005**	**35,575**

[3] We expect cash balance to be high going forward but it might be used to cover cash needs related to the Market Asset Management division and fund additional growth (both organic and external) as the issuer declared it would be opportunistic in this regard. Thus, we calculate accessible cash of around HUF 17bn until 2021 (the same as the amount before the company tapped capital markets in 2019), around HUF 34.8bn for 2022 and HUF 40.8bn from 2023 onwards. The increase is based on our expectation of i) liquid funds being more permanent than in the last year as most investments have already been made; and ii) limited opportunistic investments in the medium term due to an expected slowdown in the market for real estate development.

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Environmental, social and governance (ESG) profile[4]

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)		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	Grey leaf	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)

ESG analysis is credit neutral

The construction industry has a large impact on the environment. To date, environmental efforts have largely focused on reducing energy usage and associated emissions. More recently, concerns over supply chain disruptions have left contractors scrambling to find alternative suppliers or paying higher prices for materials. There is no indication that this will improve in the near term. Furthermore, the Covid-19 pandemic heavily impacted the construction industry and construction sites via updated regulations emphasising hygiene and strict safety protocols. This has also increased union influence in projects, potentially increasing costs and time to projects.

Generally, we believe the analytical focus should be on the following main ESG-related risks of relevance for construction companies: i) rising costs and sustainable building materials; ii) efficient technology; iii) employee health and safety; and iv) litigation and bribery.

[4] 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

Market is involved in the construction of buildings, industrial facilities and sport facilities. The company's building projects encompass offices, public facilities, residential buildings and hotels. However, this wide range does not provide adequate diversification as the projects belong to the same operating subsegment according to our methodology (the structures are built on a similar basis; only the end users differ). This segment's growth in recent years has been driven by high demand for offices and public facilities. Industrial projects deal with logistics centres, auto and tyre production plants and electric battery factories. The construction of sport facilities has civil engineering features that require different technical skills. These three types of operations and a lack of risk mitigants (recurring revenues) make the company highly exposed to cyclicality.

Despite the company's recent investment plan, which includes real estate projects, the industry risk profile remains unchanged and is only related to the construction sector. Real estate activities will generate HUF 60bn-62bn of revenue in 2021-2024, a small share of Market's operations (7% of total revenue in the last four years). Market is the main contractor for all these projects.

Low barriers to entry with low-to-medium substitution risk

In line with its strategy, the company does not bid for civil engineering projects (bridges, roads, railways). Its industrial projects in terms of logistics centres are not complicated. This means construction companies from Eastern Europe or Austria can easily participate in tenders. Nevertheless, large structures can be challenging in terms of construction methods and time constraints (e.g. for the stadium and dome of the Budapest Zoo, already completed). Market has won some contracts thanks to its ability to deliver projects quickly. Market does not only build large structures (e.g. stadium, MOL headquarters – the highest building in Hungary) but also large projects, involving dozens of large buildings (e.g. SKI Battery factories, BMW factory).

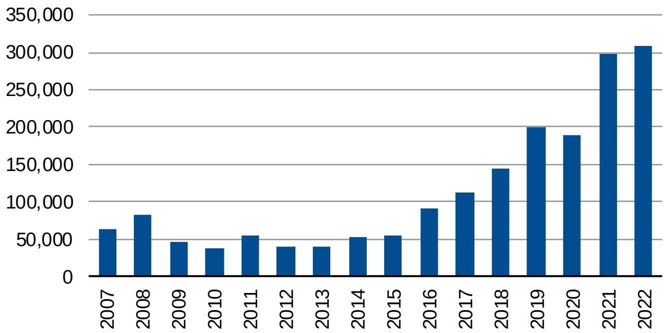
Small, tier three European construction company

The company is small in terms of revenue and EBITDA as it is limited by its core and only exposure is Hungary, a relatively small market. However, the company ranks first domestically with a market share of 5% (9% considering only the building subsegment) thanks to its well-established position in the highly fragmented Hungarian construction sector (26,812 companies in 2020). Market's strategy focuses only on large, visible projects. The company manages between 50 and 60 projects a year, with the main five projects accounting for up to 50% of its full-year revenue.

Leading position in Hungary benefiting from growing domestic market

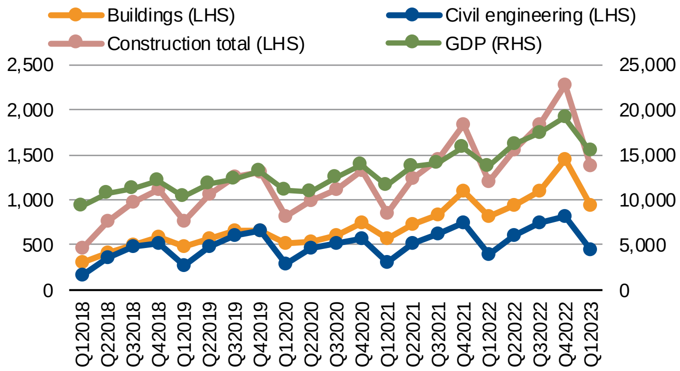
Market is Hungary's leading construction company by far with a turnover of HUF 308bn (EUR 0.7bn) in 2022, significantly more than that of its direct competitors. This building subsegment is larger than the civil engineering segment (60% versus 40%) in Hungary, and it has also been more dynamic than the latter (up 138% since 2018 to 2022 versus 69% for civil engineering projects). Market has a strong footprint in Central Hungary – including the Budapest region, which accounts for almost half of the construction sector of the country – where it derives a large share of its revenue from a sizeable pool of large projects.

Figure 1: Total revenue (HUF m) – 2007 to 2022



Sources: Market, Scope

Figure 2: Hungarian GDP versus Hungarian construction sector output (HUF bn) – 2018 to Q1 2023



Sources: Market, Scope

Weak geographic diversification with no wish to expand abroad; low segment diversification

Hungary has been Market's only exposure since its founding, allowing it to take advantage of the construction sector's strong growth between 2000 and 2008 (up 106% according to KSH, the Hungarian central statistical office). Due to the 2008 financial crisis and a mild recession in 2012, construction output in Hungary declined by 21% during that period, leading to a drop in Market's turnover (see Figure 1). The company could not offset this decline due to a lack of diversification, and it took eight years to regain its 2008 turnover level. Although Market is present in most of Hungary's regions, its footprint is very concentrated. The building segment accounted for 50% of company EBITDA in 2022 while industrial sites represented 45%, although these types of construction are similar.

Slight improvement expected thanks to future side businesses

Market's attempt to diversify into real estate projects is credit positive. The projects include office buildings, hotels, residential buildings and a logistics centre. This large growth plan is funded by a mix of a second bond under the Hungarian National Bank's programme (worth HUF 22bn) and secured bank loans. These projects are implemented in house to support Market's contracting business. Nevertheless, the overall impact on the company's diversification remains limited as they account for less than 10% of Market's revenue over the construction period.

Strong but concentrated backlog mitigated by client quality

The diversification of the backlog (a rough indication of future revenue diversification) is weak, with the top three orders accounting for 54% of the total backlog at end-2022. This concentration is consistent with the company's strategy of focusing on large projects but could lead to a material impairment of revenue and EBITDA. The credit quality of the respective clients mitigates associated risks to a certain extent.

Profitability deteriorated in 2022 due to price inflation for raw materials and wages

On average, the Scope-adjusted EBITDA margin has remained between 4% and 5%, which was at the lower end of the construction industry's range until 2019. This low operating margin was due to: i) the business mix, which prioritises large, visible projects over profitability; and ii) the booming Hungarian construction sector, which has led to shortages in raw materials and qualified staff. Although business conditions remained constrained by raw material and workforce shortages, Market managed to lower costs in 2021 by implementing better sourcing of raw materials, renegotiating contracts with suppliers, reducing intermediaries and improving its in-house material supply with the launch of a concrete manufacturing plant. In 2022, profitability dropped to 8.7% from 14.6% as the consequence of:

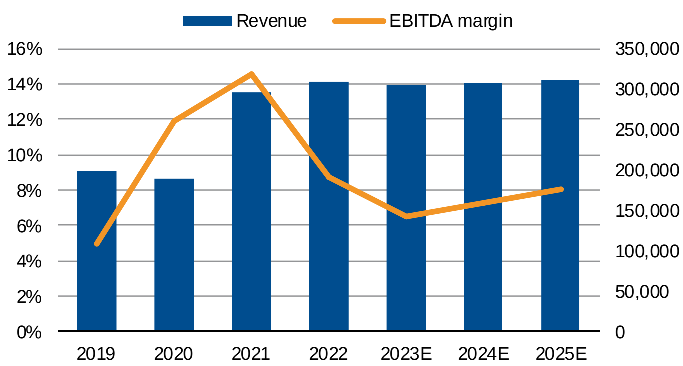
i) A deterioration of the business environment driven by the volatility of the HUF/EUR exchange rate; inflation; and higher interest rates limiting developers' capacity to fund new projects.

ii) The Russia-Ukraine war has led to additional shortages of raw materials (steel, insulation material) and high energy prices. As Market relies heavily on sub-contractors, its capacity to mitigate these increased prices was limited.

iii) Fierce price competition driven by additional capacity from construction companies that were involved in public procurement projects. Since the Hungarian government decided to postpone most public projects, the contractors for these projects started to target private projects, which account for 90% of Market's revenue.

From 2023 onward, we expect profitability to keep on decreasing as 2022 drivers will remain in place: HUF/EUR volatility noting that Market does not implement currency hedge, high subcontracting costs from increased wages, high raw material prices and price pressures from additional competition.

Figure 3: Scope-adjusted EBITDA margin (lhs, in %) and Scope-adjusted EBITDA (rhs, in HUF m)



Sources: Market, Scope estimates

Figure 4: Backlog (lhs, in HUF bn) and book-to-bill ratio (rhs)

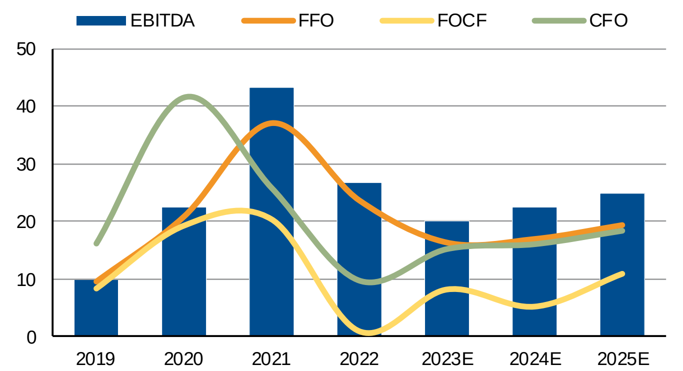
Sources: Market, Scope

Adequate visibility of revenue until 2024 with adequate order backlog

We consider that the order backlog of HUF 629bn as at end-2022 provides some revenue visibility for the next few years. The backlog represents twice the company's 2022 revenue.

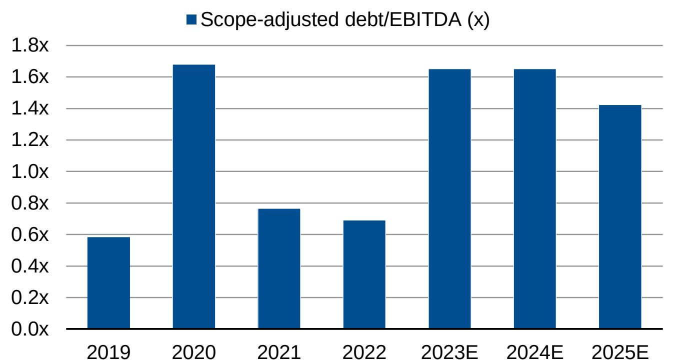
Financial risk profile: BBB+

Figure 5: Cash flows (HUF m)



CFO: Cash flow from operations
Sources: Market, Scope estimates

Figure 6: Scope-adjusted debt/EBITDA



Sources: Market, Scope estimates

Reduced debt protection going forward but sufficient to serve interest payments

EBITDA interest expense cover, while very volatile, has been high at above 20x over 2015-2021. Market recorded a net interest cash income thanks to high interest (above 10%) on its deposit in 2022. The volatility of debt protection arises from the very low level of gross interest costs, with an average cost of debt of 3% and historically low gross debt. We anticipate debt protection to drop to below 10x in 2024, due to a change in future debt from the increase in bank loans to fund Market Asset Management's projects, in particular the Bem project ramping up by around HUF 20bn. Most of these bank loans will be EUR denominated.

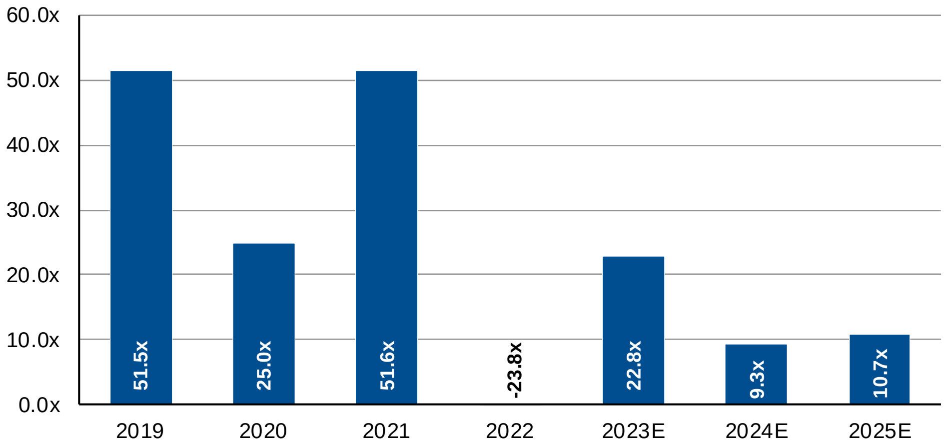
The additional debt booked will impair debt protection, straining it down to a forecasted level of 9x-10x. However, these levels are sufficient to enable the issuer to serve interest payments, even providing some headroom to cover for potential volatility in cash flow driven by high customer concentration.

Volatility of Scope-adjusted FOCF mitigated by low net debt

Historically, the very volatile FOCF has been driven by working capital swings and the gradual increase of capex. Working capital was very positive in 2019 and 2020 to the extent that it offset capex. Going forward, the issuer is likely to keep showing positive FOCF despite building capital expenditures in 2023 including the ramp-up of the real estate investments. Capex targets investments into the BEM palace and the large new contract in BudaPart with six new offices. All these projects aim to maximise Market's capacity as a contractor. Working capital is expected to be a negative contributor to operating cash flow generation in 2023 but to a lower extent (HUF -1.0bn) than in 2022 (HUF -13.8bn).

In 2023, the bulk of investments (HUF 7bn) is in line with previous years, noting that the forecasted working capital negative impact could be higher. All in all, the volatility of the FOCF is mitigated by the low level of net debt.

Figure 7: Scope-adjusted EBITDA/interest cover[5]



Sources: Market, Scope estimates

Slight increase in leverage caused by strong growth of own development projects

Since 2016, the company's consolidated leverage, measured by Scope-adjusted debt/EBITDA and Scope-adjusted FFO/debt, has been negative due to the consistently low gross debt in line with the company's conservative approach – an asset-light strategy combined with small bolt-on acquisitions – helped by recurring positive free cash flow. This strategy has slightly changed reflecting the development of real estate projects while Market was only acting as a contractor. The company has started to increase its leverage. Leverage is expected to increase to 1.7x due the decrease in EBITDA, combined with additional debt booked for the BEM project.

We expect Scope-adjusted debt/EBITDA to increase to around 1.7x in 2023, which is manageable. This is mainly driven by positive FOCF covering discretionary spending

[5] The 2022 interest cover is negative as the company recorded interest received was higher than interest paid.

(mostly dividends), reducing the impact from the lower EBITDA anticipated for 2023. Since Market remains opportunistic regarding its real estate projects and could take on more projects in the near future, we believe most of its cash balance will be spent in 2023-2025, and we have adjusted this part as restricted cash. However, we expect liquid funds to be more permanent than in 2022 as most investments have already been made. We also anticipate limited opportunistic investments in the medium term due to an expected slowdown in the market for real estate development.

Adequate liquidity supported by headroom from unrestricted cash and undrawn credit

Market's liquidity is adequate. This is based on our expectation that liquidity sources will exceed uses by more than 200% in the next 12 months, following consistently high liquidity.

Balance in HUF m	2023E	2024E	2025E
Unrestricted cash (t-1)	34,800	40,800	40,800
Open committed credit lines (t-1)	1,078	878	878
FOCF	8,184	5,183	10,931
Short-term debt (t-1)	2,206	2,206	2,206
Coverage	**>200%**	**>200%**	**>200%**

Long-term debt rating

Senior unsecured debt rating: BB-

We have affirmed Market's senior unsecured debt rating at BB-. This rating is based on a going-concern scenario as of end-2024, in which we computed an average recovery for senior unsecured debt holders.

In October 2019 and November 2020, Market issued two senior unsecured bonds for a total of HUF 42bn (ISIN: HU0000360060/HU0000359237) through the Hungarian Central Bank's Bond Funding for Growth Scheme. All proceeds were used for capex. The bonds have a tenor of respectively 10 and seven years, a fixed coupon of 2.95% and 2.7%, and bullet repayments. We note that Market's senior unsecured bonds issued under the Hungarian scheme have an accelerated repayment clause. The clause requires the company to repay the nominal amount (HUF 42bn) in case of a rating deterioration (two-year cure period for a B rating; repayment within 30 days after the bond rating falls below CCC, which could have default implications). In addition to the rating deterioration covenant, bond covenants include six other covenants.

Appendix: Peer comparison

	Market Építő Zrt.	Duna Aszfalt Kft.	Masterplast Nyrt.	Metál Hungária Holding Zrt.	Bayer Construct Zrt.
	BB-/Stable	BB-/Stable	BB-/Negative	BB-/Stable	B+/Stable
Last reporting date	31 Dec 2022	30 June 2022	31 Dec 2022	31 Dec 2021	31 Dec 2022
Business risk profile					
Scope-adjusted EBITDA (EUR m)	67	5	20	15	46
Backlog/revenues	2.0x	1.4x	n/a	1.2x	1.5x
Scope-adjusted EBITDA margin	9%	15%	10%	9%	22%
Financial risk profile					
Scope-adjusted EBITDA/interest cover	Net interest income	70.4x	14.2x	13.8x	15.7x
Scope-adjusted debt/EBITDA	0.7x	0.9x	3.1x	2.8x	3.0x
Scope-adjusted FFO/debt	127%	103%	18%	30%	30%
Scope-adjusted FOCF/debt	5%	Negative FOCF	Negative FOCF	Negative FOCF	24%

Sources: Public information, Scope

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