Tranzit-Food Kft.
Hungary, Consumer Goods

SCOPE BB STABLE

Corporate profile

The Tranzit group is a Hungarian based poultry company founded in 1990 by the Szabo family. The group employs approximately 1,600 people. Its headquarters are located in Debrecen. Tranzit breeds, slaughters, hatches, processes and sells ducks, geese and chickens. Operations also include crop and feed production. Annual sales amount to HUF 44bn in 2018. The Tranzit group is divided into two subsidiaries: Tranzit-Ker takes care of the agricultural spectrum of the business while the rated entity Tranzit-Food Kft. (Tranzit) focuses on the slaughtering, processing and distribution of poultry (geese, ducks and chickens) under the Goldenfood brand. The company owns two slaughterhouses, dedicated to handling chickens (16m in 2018) and geese & ducks (2m geese and 10m ducks in 2018), respectively. Tranzit also has a secondary processing plant. The shareholding structure changed in 2018, with French group LDC controlling 70% of Tranzit and the Szabo family 30%.

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	110x	121x	126x	27x
Scope-adjusted debt (SaD)/EBITDA	0.3x	0.1x	1.1x	1.9x
Free operating cash flow (FOCF)/SaD	(-) FOCF	457%	(-) FOCF	(-) FOCF
Scope-adjusted FFO/SaD	348%	1059%	84%	47%

Rating rationale

Scope has assigned a first-time issuer credit rating of BB with a Stable Outlook to Hungary-based Tranzit-Food Kft. Senior unsecured debt has been rated at BB.

The credit rating mainly reflects Tranzit's leading market position in the Hungarian goose processing industry, solid profitability (EBITDA margin) and manageable leverage. The rating is held back by the company's small size and rather weak customer and geographical diversification.

The issuer rating is largely supported by Tranzit's leading position in Europe as a goose and duck processor. Tranzit is responsible for 50% of the goose meat supplied in Hungary (the fourth largest producer in the world) and 18% in Europe. For duck, Tranzit's market share in its home country and Europe is 32% and 8% respectively. We view positively the ongoing diversification of Tranzit's poultry meat production. The company has recently started to develop its chicken operations and intends to further increase its output thanks to a planned EUR 50m capex programme. This programme is expected to be partly financed by the issuance of a HUF 9.2bn (EUR 30m) Hungarian National Bank (MNB) bond with seven years maturity, under the MNB Bond Funding for Growth Scheme. This should allow Tranzit to continue benefiting from the growth anticipated for the European chicken sector. The company's creditworthiness is also supported by strong liquidity, a track record of low leverage and a strong operating margin.

Ratings & Outlook

Corporate ratings	BB/Stable
Senior unsecured debt	BB

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Related Methodologies

Corporate Rating Methodology

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Bloomberg: SCOP

The rating is constrained by Tranzit's limited overall size compared to other European players, as well as concentration issues regarding its footprint and customer portfolio (especially for chicken). The low profitability (5%-7%) of the broiler segment combined with the future increase in Tranzit's exposure to chicken is likely to weigh on its overall EBITDA margin, further limiting the rating. We forecast a material increase in leverage from 0.1x in 2018 to 1.9x by 2020. Despite good overall credit metrics, Tranzit's financial risk profile is constrained by forecasted negative free operating cash flow due to massive capex which cannot be self-financed.

Outlook

The Outlook is Stable and incorporates our expectation of stable credit metrics, with net debt/EBITDA below 3.0x and an EBITDA interest coverage of above 7x. The Outlook also includes the expectation that liquidity (currently viewed as adequate) will not deteriorate. Our Outlook is based on annual capex spending (including organic expansion and acquisition capex) of around EUR 50m (HUF 16.5bn) for the 2019-2021 period and an EBITDA margin ranging between 11%-13%.

A positive rating action is likely if SaD/EBITDA remains below 2.0x on sustained basis. A negative rating action could be required if leverage surges above 4.0x on a sustained basis for the next few years.

Rating for unsecured debt

We expect an 'average recovery' for current and future senior unsecured debt. Such recovery expectations translate into a BB rating for the senior unsecured category (equal to the issuer rating). Our expectations are based on a distressed enterprise value under the assumption of a going concern of around HUF 12.1bn at the end of 2020, including a 10% reduction for administrative claims in a liquidation scenario. Existing debt positions are senior unsecured and are expected to rank pari passu to the planned seven-years HUF 9.2bn bond (EUR 30m), under the MNB Bond Funding for Growth Scheme.

Rating drivers

Positive rating drivers	Negative rating drivers
• Market leader in goose production in Europe with 18% market share • Recent entry into the chicken segment providing exposure to a large, growing meat market • Good EBITDA margin (14.7% at YE 2018) despite low profitability of chicken operations • Product diversification with three types of poultry meat	• Small player in the European market • Weak geographical diversification outside of Europe although this is likely to improve; weak customer diversification in the chicken segment • Recurring negative free operating cash flow due to volatile working capital and large capex plan

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA below 2.0x on a sustained basis	• SaD/EBITDA above 4.0x on a sustained basis

Financial overview

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	110x	121x	126x	27x
Scope-adjusted debt (SaD)/EBITDA	0.3x	0.1x	1.1x	1.9x
FOCF/SaD (%)	(-) FOCF	457%	(-) FOCF	(-) FOCF
Scope-adjusted FFO/SaD	348%	1059%	84%	47%
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	4,221	6,084	4,905	5,768
Operating lease payments in respective year	0	0	0	0
Other items	0	0	0	0
Scope-adjusted EBITDA	4,221	6,084	4,905	5,768
Scope-adjusted funds from operations in HUF m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	4,221	6,084	4,905	5,768
less: (net) cash interest as per cash flow statement	-38	-50	-38	-207
less: cash tax paid as per cash flow statement	-24	-17	-284	-325
Other	-50	-35	0	0
Scope-adjusted funds from operations	4,108	6,017	4,581	5,235
Scope-adjusted debt in HUF m	**2017**	**2018**	**2019F**	**2020F**
Reported gross financial debt	6,657	5,633	13,642	15,231
Hybrid bond	0	0	0	0
less: cash and cash equivalents	-5,478	-5,068	-8,163	-4,087
add: cash not accessible	0	0	0	0
add: pension adjustment	0	0	0	0
add: operating lease obligations	0	0	0	0
Other items	0	0	0	0
Scope-adjusted debt	1,179	564	5,478	11,143

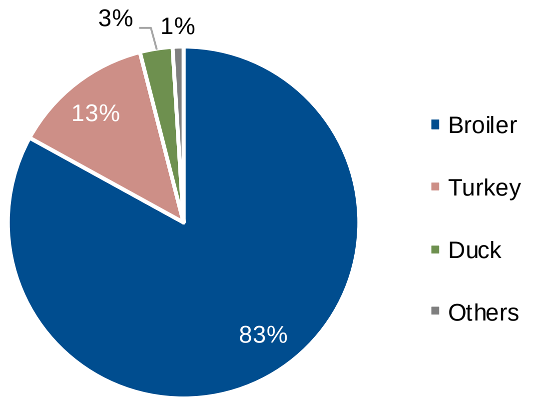
Business risk profile

Small European player constrained by niche market position

The group breeds, slaughters, hatches, processes and sells ducks, geese and chickens.

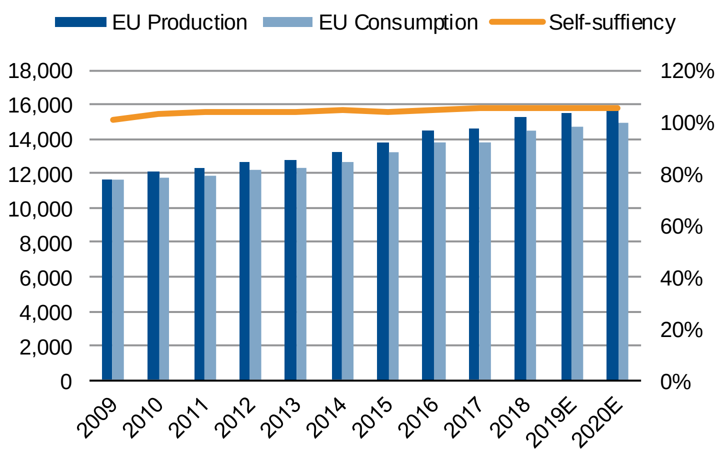
Goose and duck meat production accounts for less than 4% (Figure 1) in the European poultry market, which is widely dominated by the production of broilers (83%). Tranzit is responsible for 50% of the goose meat supply in Hungary and 18% in Europe. The duck meat market in Hungary is three time bigger than the goose meat market (78.77 kt) and Tranzit's market share in its home country and Europe is 32% and 8% respectively. If we include its 40 kt of chicken production, Tranzit produces around 78 kt of poultry meat, which is less than 1% of the 15.2 m tons produced in Europe.

Figure 1: EU Production of poultry meat by type of bird.



Source: European Commission (DG ESTAT, DG AGRI)

Figure 2: EU poultry meat production / consumption.



Source: European Commission (DG ESTAT, DG AGRI)

Recent entry into chicken segment will expose Tranzit to a larger and growing market

Tranzit started its chicken operations in 2017 following an integrated approach already implemented for its goose/duck production, with Tranzit Ker supplying the main share of the poultry slaughtered. Chicken allows Tranzit to benefit from the only meat expected to grow between 2017-2030 both on the consumption (+4.2%) and the production side (+4.6%). Global demand is driven by the comparative advantages of poultry over other meats including affordability, convenience, the absence of religious guidelines and a healthy image. As the EU is self-sufficient (Figure 2), most surplus production is likely to be exported outside of the continent to the Middle East, sub-Saharan Africa and Asia (Vietnam and the Philippines). The EU's main competitor for world demand remains Brazil, which can export at a lower price partly because of its currency devaluation. Due to sustained productivity gains and looser environmental regulation for the building of new farms, the strongest increase in production is expected in Hungary, Poland and Romania.

The sale and production of chicken occurs through the whole year as opposed to goose and duck, which suffer from a seasonal effect. Goose tends to be eaten on particular occasions (such as St. Martin's day in Hungary, Christmas, etc.) with selling contracts running from September to Easter.

Geographical footprint focused on Europe but aim to increase exports outside this region

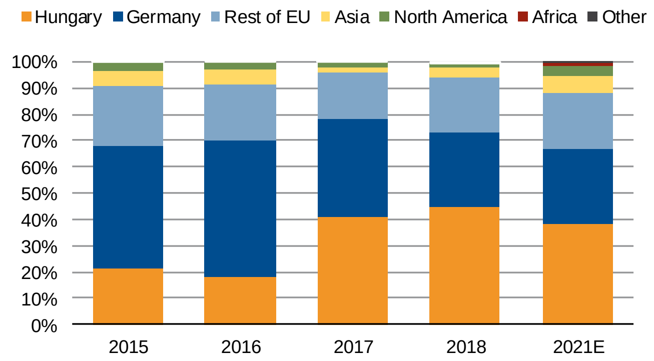
Tranzit's geographical footprint is clearly within Europe. However, this is partially mitigated by the company's strategy to increase its exports outside the region with the expected development of its chicken operations.

At YE 2018, Hungary accounted for 45% of Tranzit sales, while Europe's share stood at 94%. Sales in the rest of Europe are achieved in 20 different countries, mainly Slovakia, Great Britain, Austria and Romania. The remaining exposure is largely dominated by

Japan where Tranzit's goose products enjoy great popularity. On the other hand, Tranzit is less likely to suffer from import restrictions from countries located outside of Europe.

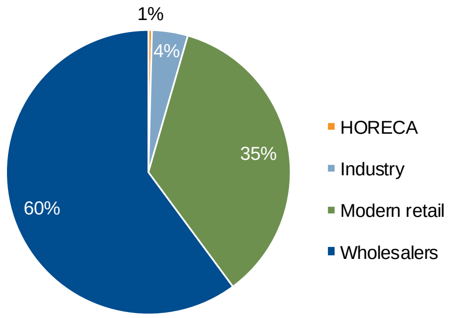
The surge in Hungary' share in revenue generated in 2017 vs 2016 is due to the launch of the chicken segment. Thanks to the latter, management expects to increase its exports outside of Europe from 2019 onwards, with non-European sales reaching 12% by 2021, improving geographical diversification slightly. Tranzit's main customers belong to the wholesale and retailing industries (95% of FY 2018 revenues). At the same time, Tranzit has a diversified portfolio of selling contracts.

Figure 3: Revenue breakdown by region 2015-2021E



Source: Tranzit, Scope

Figure 4: FY2018 revenue breakdown by sales channel



Source: Tranzit, Scope

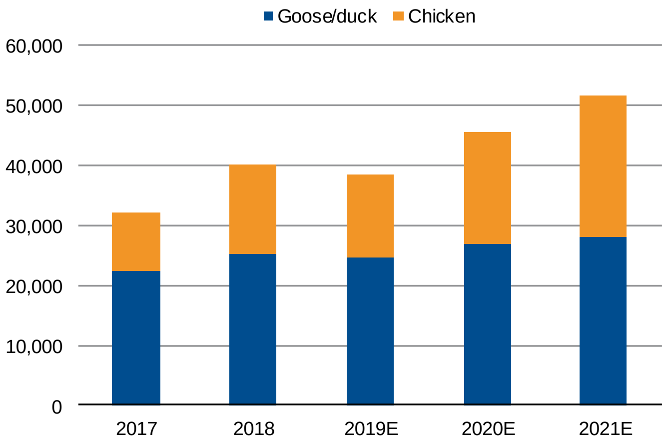
Concentration across products and supply chain, arising from integrated group model

Tranzit markets three types of animal: ducks, geese and chicken. Although they all belong to the 'poultry' category, they are not consumed the same way: while chicken is eaten all year long, duck/goose is bought on special occasions, which makes their market more predictable quantity-wise but also more elastic. Chicken represents 38% of sales and 24% of EBITDA. Product diversification is expected to improve on the top line side, with the contribution from chicken expected to reach 45% by 2021, noting that EBITDA generated from chicken should be lower at 19% (as a consequence of lower anticipated prices).

The three types of bird are sensitive to the avian influenza, which could substantially hamper Tranzit's production in terms of its supply chain. However, this risk is partially mitigated by the fact that visible customers (retailers) impose strict quality controls. Tranzit Ker's strategy is to have breeding farms in various regions, spanning four different counties. This keeps the birds safe because the distance makes hygienic actions more efficient. In addition, Tranzit does not exclusively source its raw materials from its sister company Tranzit Ker:

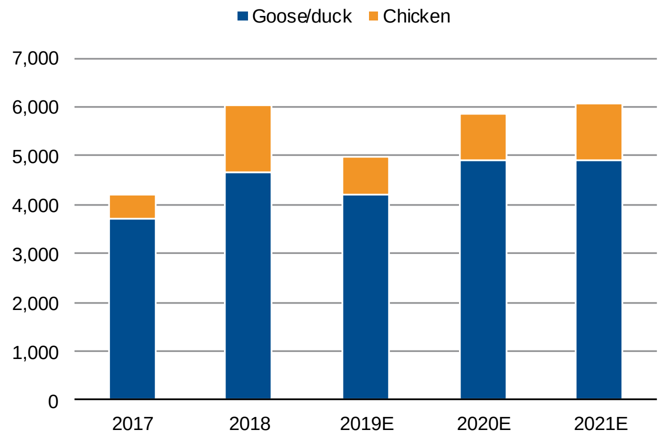
- Goose and duck: a maximum of 65% from Tranzit Ker while the remaining 35% are bought from selected farmers who purchase their feed from Tranzit Ker
- Chicken: 25% from Tranzit Ker while 32.5% are bought from selected farmers who purchase their feed from Tranzit Ker; 32.5% are bought on the free market (with a one-year agreement contract)

Figure 5: Revenue breakdown by type of meat 2017-2021E (HUF m)



Source: Tranzit, Scope

Figure 6: EBITDA breakdown by type of meat 2017-2021E (HUF m)



Source: Tranzit, Scope

Strong profitability forecasted to decrease slightly

Tranzit has strong historical profitability compared to its Hungarian peers, maintaining an operating margin between 9.5% and 14.5%. We expect Tranzit's EBITDA margin to decrease from 2019 onwards due to: i) the larger share of chicken in total revenue as Tranzit ramps up its broiler production with EUR 60m in capex for the next three years. The chicken segment has a substantially lower profitability (5%) than the duck/goose segment (17%-18%); ii) the upcoming downside cycle of the goose/duck segment, which peaked in 2018. We view margin pressures from rising labour costs as limited because they will be offset by greater use of automated processes and the growth of the poultry market. We consider the volatility of profitability to be medium because: i) price pressure risk is mitigated by Tranzit's ability to deliver high quality products (GMO-free and free range) to end-customers with high standards (Japan for example) cementing long-term relationships with buyers; and ii) sales contracts provide visibility on production and pricing power.

Financial risk profile

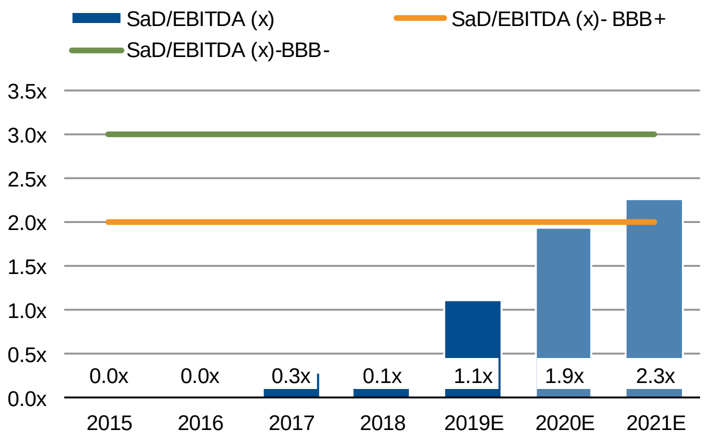
Our main assumptions for Tranzit projections are as follows:

- Revenue decreasing for 2019 then surging in 2020 and 2021 in line with the company's projections with the ramp up of chicken production
- Decreasing margin between 2019 and 2021 due to greater contribution from the low-profitability chicken segment and low environment price for duck and goose, in line with management's forecasts
- Increasing depreciation with two new plants built/acquired in 2019 and 2020 assumed to have a depreciable life of 25 years
- Interest costs to increase, assuming EUR 30m bond issuance (HUF 9,270m) with 3% coupon in 2019 and EUR 22.5m of additional debt (HUF 6,953m) split between 2020 and 2021, partially offset by the EUR 10m intercompany loan (HUF 3,080m) extended to Tranzit Ker with a similar coupon (3%)
- Intercompany loan terms with Tranzit Ker to be aligned with MNB bond: unsecured loan, no guarantee, similar maturity and coupon
- Net capex to increase by EUR 50m between 2019-2021 in addition to EUR 1m maintenance capex per annum: EUR 20m in 2019 financed by MNB bond

(HUF 6,550m), EUR 15m (HUF 5,005m) in 2020 and EUR 15m in 2021. We assumed the financing of 2020 and 2021 capex with 75% of additional debt.

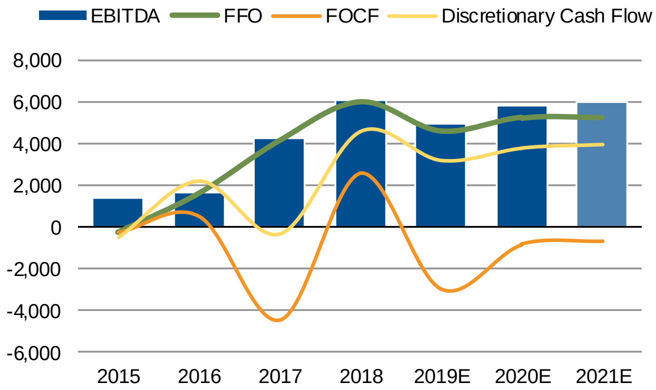
- Dividend payout of 50%. Company policy sets the current payout at 20% but acknowledges that it could be increased.
- No change in provisions, no pensions and no operating leases
- No restricted cash

Figure 7: Leverage – 2015 to 2021E



Source: Tranzit, Scope

Figure 8: Cash flows – 2015 to 2021E



Source: Tranzit, Scope

Historically high EBITDA interest expense cover expected to remain above 7x after the bond issuance

Tranzit had growing and high EBITDA interest expense cover above 80x between 2015 and 2018. This level arose from a very low level of gross interest costs with an average cost of debt below 1%.

We anticipate that debt protection will drop to 14.8x by 2021 due to: i) a significant change in the future debt position with a new EUR 30m bond issued at the end of 2019 for the MNB with a fixed coupon rate set at 3% for the bond and an additional EUR 22.5m of debt booked by 2021 to finance expansion capex; and ii) the intercompany loan of EUR 10m made to Tranzit Ker for the building of a new chicken breeding farm.

Negative FOCF due to massive capex programme despite lower negative working capital impact

If we look at Tranzit's track record, operating cash flow generation has been volatile and insufficient to cover capex. Working capital was negative at the end of 2017 and 2018 because of a sharper decrease in days of purchase outstanding (from 131 days in 2016 to 29 days in 2018) than in days of sale outstanding (from 63 days to 41 days). This is the consequence of Tranzit's new chicken operations, with more external suppliers implying shorter payment delays. We expect free operating cash flow (FOCF)/Scope-adjusted debt (SaD) to remain negative between 2019 and 2021 due to a combination of two factors: i) negative working capital consumption is expected to continue but to a lesser extent because Tranzit Ker will ramp up its chicken production, reducing exposure to external suppliers; ii) EUR 50m in development capex split between 2019 and 2021. Tranzit's financial risk profile is mainly constrained by the company's inability to self-finance its upcoming capex in addition to a potential increase in dividend pay-outs in a high investment phase.

Leverage increasing to 2.3x in 2021 from 0.1x in 2018

Since 2015, Tranzit's consolidated leverage, measured by SaD/EBITDA and funds from operations (FFO)/SaD, has been negative or very low due to the recurring high cash balance level.

We forecast that the company will become much more leveraged, with net debt growing by 207% between 2018 and 2021 from HUF 6.6bn to HUF 17.2bn. This is the consequence of: i) the issuance of the EUR 30m (HUF 9,270m) MNB bond to fund large new investments for EUR 20m at Tranzit Food level and EUR 10m at Tranzit Ker level (through an intercompany loan); ii) the implementation of new credit lines to finance an additional EUR 30m of capex in 2020/2021, management is expecting to finance these through a mix of cash/new debt (we assume 25%/75%); and iii) a reduced negative impact from working capital as mentioned above.

Liquidity supported by headroom from large unrestricted cash balance and undrawn credit facilities

We view Tranzit's liquidity as adequate based on our expectation that sources of liquidity will exceed uses by about 5.3x-4.1x in the next 12 months, following consistently good liquidity in the past.

Figure 9: Tranzit liquidity

	2015	2016	2017	2018	2019E	2020E	2021E
Short-term debt (t)	397	678	2,548	2,124	1,880	1,418	690
Unrestricted cash (t)	5,693	6,017	5,479	5,069	8,164	4,087	3,790
Open committed credit lines (t)	2,500	3,180	4,138	3,478	2,647	2,500	2,500
Free operating cash flow (t+1)	494	-4,491	2,583	-3,000	-868	-719	-719
Liquidity (internal)	15.6	2.3	3.2	1.0	3.9	2.4	4.5
Liquidity (internal+external)	21.9	6.9	4.8	2.6	5.3	4.1	8.1

Source: Tranzit, Scope

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