4 August 2022

Corporates

Bayer Construct Zrt. Hungary, Construction

SCOPE B+ NEGATIVE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	18.3x	9.8x	4.1x	2.4x
Scope-adjusted debt/EBITDA	5.8x	6.9x	6.1x	5.6x
Scope-adjusted funds from operations (FFO)/debt	15%	12%	12%	10%
Scope-adjusted free operating cash flow (FOCF)/debt	-57%	14%	-20%	2%

Rating rationale

The rating is driven by Bayer Construct's strong competitive positioning despite its small size and concentration on Hungary, supported by high vertical integration that preserves its market position and profitability thanks to the different underlying demand patterns of its activities.

Main rating constraints include an increase in indebtedness due to its debt-financed growth. Leverage is anticipated to remain volatile and high. The high leverage points to limited access to the external financing needed to tackle unforeseen operational events or a severe decline in the market value of its real estate assets.

Outlook and rating-change drivers

The Negative Outlook reflects the risk of consolidated leverage remaining high after a strong increase in 2021 and volatile due to a concentrated backlog and uneven project pipeline, with a Scope-adjusted debt/EBITDA of above 6x (2021: 6.9x) and Scope-adjusted funds from operations/debt of 10%-15% (12%). The Outlook also reflects the significant development risk and cluster risk for cash flow regarding the Zugló City Centre and Aligaliget (at lake Balaton) projects. The Zugló City Centre will be transferred to an affiliated company, making cash generation from construction work dependent on that company's ability to finance the project, while the Aligaliget project is yet to receive building permits.

A positive rating action (i.e. Outlook back to Stable) could be warranted if consolidated Scope-adjusted debt/EBITDA will decline to below 6x on a sustained basis. This could be due to higher customer-led prefinancing of developments or much lower working capital needs.

We may downgrade the rating if Scope-adjusted debt/EBITDA were sustained above 6x or liquidity worsened. Liquidity could worsen through i) significant delays in customer payments; ii) non-recoverable cost overruns and/or delays in projects; or iii) weaker access to external financing. Leverage might remain elevated if lower investor demand leads to delays on or cancellations of the company's projects.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
4 Aug 2022	Outlook change	B+/Negative
31 Aug 2021	Initial Rating	B+/Stable

Rating & Outlook

Issuer	B+/Negative
Senior unsecured debt	B+

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Related Methodologies

Corporate Rating Methodology; July 2022

Construction and Construction Materials Rating Methodology; January 2022

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Positive rating drivers	Negative rating drivers
• Small size in Hungarian construction industry but market position set to benefit from growth of housing sector supported by the integrated business approach • Wide diversification across segments with different underlying demand patterns • Still high profitability benefiting from vertical integration that also protects against the impending slowdown in Hungarian construction • Interest coverage remains sufficient despite significant increase in leverage and reduced debt protection	• Concentration on domestic construction industry, leaving cash flows vulnerable to expected cooldown • High customer concentration, partially mitigated by order size that obliges the use of construction trustee • Limited cash flow visibility, with order backlog equating to less than two years in revenues, which are predominantly contracts with affiliates • Dependence on external financing due to negative FOCF, i.e., for debt, customer advance payments • Strong increase in leverage caused by large development projects

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted debt/EBITDA sustained below 6x (consolidated)	• Scope-adjusted debt/EBITDA sustained above 6x (consolidated) • Worsening liquidity

Corporate profile

Bayer Construct consists of a group of companies mainly under Hungarian ownership offering complex construction and real estate services. The company is active in Hungary and Romania. Established in 2002, Bayer Construct's initial focus was reinforced concrete construction in Hungary. Today, activities have expanded to full construction projects, general contracting, building material production and real estate development. The issuer benefits from its own industrial site and preparation facilities, new machinery, privately owned construction equipment and highly educated staff with international experience, according to management.

Financial overview

				Scope estimates		
Scope credit ratios	**2019[1]**	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	Net cash interest	18.3x	9.8x	4.1x	2.4x	2.6x
Scope-adjusted debt/EBITDA	4.4x	5.8x	6.9x	6.1x	5.6x	5.5x
Scope-adjusted FFO/debt	22%	15%	12%	12%	10%	11%
Scope-adjusted FOCF/debt	-94%	-57%	14%	-20%	2%	-3%
Scope-adjusted EBITDA in HUF m						
EBITDA	4,616	6,847	8,291	12,257	13,375	13,928
Operating lease payments	104	0	0	0	0	0
Other items	-19	197	-29	0	0	0
Scope-adjusted EBITDA	**4,701**	**7,044**	**8,262**	**12,257**	**13,375**	**13,928**
FFO in HUF m						
Scope-adjusted EBITDA	4,701	7,044	8,262	12,257	13,375	13,928
less: cash interest as per cash flow statement	42	-384	-843	-3,022	-5,604	-5,324
less: interest component operating leases	-37	0	0	0	0	0
less: cash tax paid as per cash flow statement	-349	-571	-624	-594	-260	-355
add: dividends received from shareholdings	126	0	0	0	0	0
FFO	**4,483**	**6,089**	**6,795**	**8,642**	**7,512**	**8,248**
FOCF in HUF m						
FFO	4,483	6,089	6,795	8,642	7,512	8,248
Change in working capital	-6,859	-17,405	12,628	1,196	2,030	-5,192
Non-operating cash flow	-67	0	0	0	0	0
less: capital expenditure (net)	-17,013	-12,071	-11,688	-25,078	-8,402	-5,455
FOCF	**-19,456**	**-23,388**	**7,735**	**-15,240**	**1,140**	**-2,399**
Net cash interest paid in HUF m						
Net cash interest per cash flow statement	-37	0	0	0	0	0
add: interest component, operating leases	42	-384	-843	-3,022	-5,604	-5,324
Net cash interest paid	**5**	**-384**	**-843**	**-3,022**	**-5,604**	**-5,324**
Scope-adjusted debt in HUF m						
Reported gross financial debt	19,867	40,899	57,076	75,120	74,802	77,217
less: cash and cash equivalents	-508	-1,361	-9,481	-1,676	-2,498	-2,514
add: non-accessible cash[2]	508	1,361	9,481	1,676	2,498	2,514
add: operating lease obligations	739	0	0	0	0	0
Scope-adjusted debt (SaD)	**20,607**	**40,899**	**57,076**	**75,120**	**74,802**	**77,217**

[1] 2019 and 2020 have been adjusted based on audited consolidated accounts for the whole group.
[2] Netting of cash: generally, only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible.

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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)		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)

Key person risk

Bayer Construct's management have extensive industry knowledge and years-long company tenures. However, there is key person risk regarding the 60% owner and CEO Attila Balázs as his access to the Romanian workforce enables the company to quickly address increased demand and position itself as a reliable partner/sub-contractor.

No independent board to provide oversight

Bayer Construct plans to publish its first concise ESG report by 2023. Given the extensive environmental impact of the construction industry, we believe the ESG disclosures and the issuer's actions to mitigate climate-related risks in line with the Paris Agreement benefit the group.

The industry is focused on reducing the use of energy and non-renewable materials as well limiting the environmental footprint of construction projects and global operations. The social aspect is also relevant, especially regarding practices that could severely impair reputation and financial performance (e.g. corruption, stakeholder management). Malpractice would also impair the company's ability to win new orders or execute own projects and therefore threaten cash flow.

The following ESG risks are the most relevant for construction companies: i) rising costs and sustainable building materials; ii) efficient technologies; iii) health and safety of employees; and iv) litigation and bribery.

[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+

Industry risk profile: B+

Bayer Construct remains primarily exposed to the construction industry (70% of revenue and 55% of EBITDA in 2021), although we note the growing exposure to real estate development. These two sub-sectors hold an industry risk profile of B (construction) and B/BB (real estate development), thus leading to a weighted industry risk assessment of B+.

Small Hungarian construction company…

Bayer Construct is a small player in European construction but is among Hungary's top-10. As at end-December 2021, revenues were HUF 74.7bn (equivalent to EUR 206m; up 84% YoY) and Scope-adjusted EBITDA was HUF 8.3bn (EUR 23m; up 17% YoY). The company's size affects its ability to achieve economies of scale and obtain large contracts, which can lead to volatile cash flows and a sensitivity to economic cycles.

Revenue growth in 2022 will be constrained by impending headwinds, including higher input prices and a smaller order intake from third parties amid an unsupportive macroeconomic outlook. The company's sole exposure to Hungary and small size also limits its ability to weather the downturn in Hungarian construction anticipated for 2022 with recent growth of the market considered unsustainable. From 2023, the top line is expected to stabilise, supported by increased real estate development activity, which will help to reduce the supply-demand uncertainty in construction and provide better economies of scale along the vertically integrated business.

Figure 1: Bayer and peers (total revenues in FY2021[4] in HUF bn)

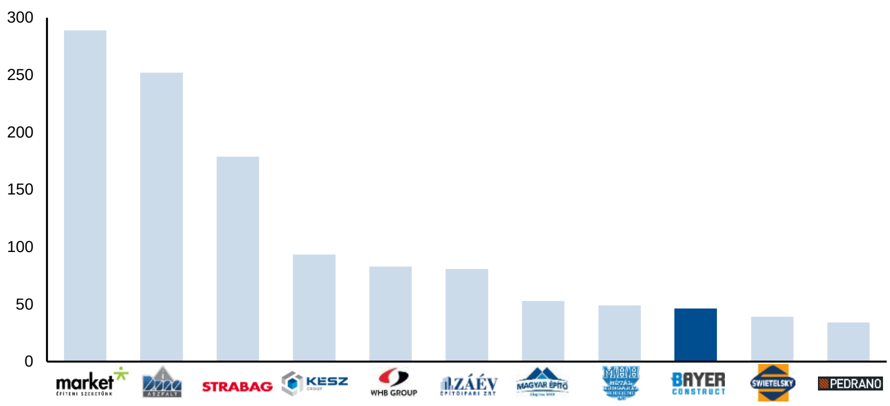
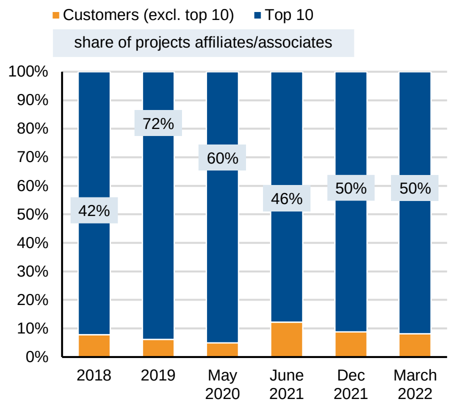


Figure 2: Customer concentration backlog



Sources: Bayer Construct, Scope, public information

.. but high integration …

The group benefits from its highly integrated business with the manufacturer-developer-designer-contractor-sales platform. As such, the company has limited reliance on external parties, at least for its Hungarian operations. In addition, the new structural engineering division since 2021 (comprised of around 40 full-time employees) is adding growth potential in the field of prefabricated structures and benefits own projects by lowering construction delivery times and costs.

…and good access to qualified blue-collar workers

Access to labour remains good, evidenced by the year-on-year headcount increase (up by 327 full-time employees in the 12 months to end-December 2021).

Furthermore, initiatives will help to maintain competitiveness, such as the implementation of the BIM design process into production management and the addition of production facilities for glass and bathtubs.

[4] Revenues of Swietelsky as of end-March 2021 and Pedrano as of end-December 2020; revenue of Bayer Construct (standalone)

Mostly exposure to Hungarian construction…

Geographical diversification is weak as revenues are mostly domestic, with a minor exposure to Romania. In cyclical industries such as construction, low geographical diversification exposes companies to the inherent volatility in the domestic market and constrains opportunities for growth via activities in other regions.

The recent growth in the Hungarian construction market is unsustainable. After a dynamic 2021 with HUF 5,389bn[5] in contracted volume (up 13% from 2020), perspectives are being limited by i) the impact of the Russia-Ukraine war; ii) rising materials costs; iii) labour and building materials shortages; and iv) rising interest rates. EVOSZ expects government orders to decline significantly by around HUF 500bn and the volume of residential works to remain stagnant. A survey[6] conducted by EVOSZ also confirms the industry's negative sentiment/outlook: 83% of respondents indicated a lack of skilled workers and 77% mentioned procurement issues as their main obstacle. Regarding contract portfolios, 47% anticipate a decline and 27% a relatively stable business volume. By 2022, labour costs are expected to rise by 15% on average and nearly 47% of respondents expect weaker profitability. However, the availability of raw and building materials has improved of late, with prices as of July 2022 already below January 2022 levels.

…though to segments with slightly different demand patterns

These developments means Bayer Construct's single exposure to Hungarian construction poses an even greater risk for its operations and cash flow. Despite these challenges, we note that the company secured orders during the first quarter of 2022.

The issuer's segment diversification is strong, benefiting from high vertical integration (mining, construction material, product manufacturing, design and general contracting, real estate development, sales platform). However, construction remains dominant, while less volatile and more predictable income sources (e.g. rental activities) remain very limited.

The issuer aims to increase its outreach, including by expanding its real estate services (real estate agency, funds and management, furnishing) and launching its renewable energy activities (solar panels). This will help safeguard Bayer Construct's business against a prolonged decline in construction demand, especially when end-markets served (construction, real estate, business services) benefit from different demand patterns.

High customer concentration

Customer concentration is high. The top 10 contributed 92% of the backlog on average during 2017-21 (91% at end-March 2022). Risk associated with high customer concentration (bad payment behaviour, customer defaults, loss of contracts) is partially mitigated by 96% of contracts having a value of more than HUF 1.5bn[7] as of end-March 2022 (overall average contract size of HUF 3.2bn) and terms of several years. The backlog also has a high share of associates and/or affiliates (around 60% as of end-March 2022), which improves cost management but does not remove the inherent risks arising from end-customers (with limited visibility) and the potential for project delays/failures. In the absence of disclosures on customer credit quality, we focus on project distribution. The Zugló City Centre is the largest project, with a contract value of HUF 40.9bn and accounting for 25% of the backlog as at end-March 2022 (41% of work outstanding). This multi-year project provides good revenue visibility, although the issuer bears project-related risks until it can sell the project. Overall, project diversification is adequate, with 50 active projects for 40 customers (of which 12 are affiliated).

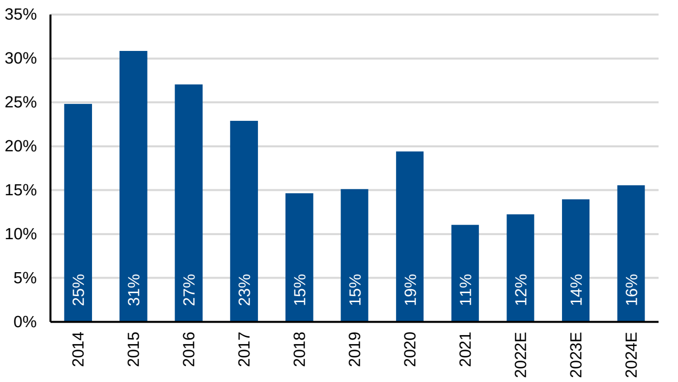
[5] Source: EVOSZ
[6] Survey conducted by EVOSZ with 400 companies about their current market situation and expectations for 2022.
[7] These projects benefit from a law protecting contractors from non-payment or late payment; customers are obliged to pay upfront the costs invoiced by the contractor for the next construction phase on an escrow account.

It is worth mentioning that construction and disposal risks are exaggerated by the effects of rising interest rates and inflation. These have resulted in i) weaker demand and a greater hesitancy among investors/clients to buy due to increasing cost of capital; ii) lower margins due to volatile construction materials prices; and iii) significant construction delays due to supply chains disruptions (labour and material shortages).

High profitability benefiting from vertical integration

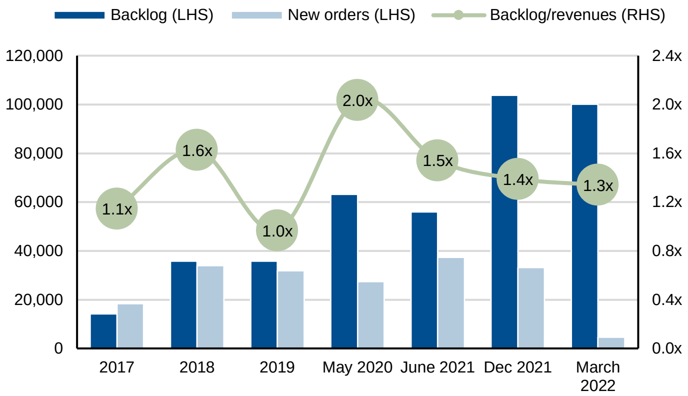
Profitability, as measured by Scope-adjusted EBITDA, dropped by 8.3pp to 11% in 2021, largely due to the higher materials and labour expenses and upfront costs on the new prefabricated structure segment. Investments along the supply chain (production facilities for raw materials, prefabricated modules or real estate developments) help to reduce the supply-demand uncertainty in the construction business and provide better economies of scale. This should provide a cushion against volatility in both profitability and cash flow. Scope-adjusted EBITDA margin is therefore forecasted at above 10%.

Figure 3: Scope-adjusted EBITDA margin



Sources: Bayer Construct, Scope estimates

Figure 4: Backlog and new orders (HUF m) & backlog/revenues



Sources: Bayer Construct, Scope

The high vertical integration reduces the reliance on external providers while improving the ability to manage costs amid rising prices. The extensive use of fixed-priced contracts also limits the impact on profitability. For reference, the company has direct access to raw materials (gravel, sand, quartz) through its mining division, enough to cover its needs for decades and providing cushion against volatility in both profitability and cash flow. In addition, the group is mitigating the impact of rising materials costs and procurement issues by expanding its sourcing to south-east Europe (Serbia) and Turkey (potentially relabelled Russian products).

Adequate cash flow visibility with order backlog exceeding revenues by 1.4x in 2021

The backlog was HUF 103.8bn at end-December 2021, representing 1.4 years of revenues. As of end-March 2022, the backlog stood at HUF 100.2bn, ensuring good cash flow visibility and demonstrating an ability to secure orders (adding HUF 4.6bn during Q1 2022).

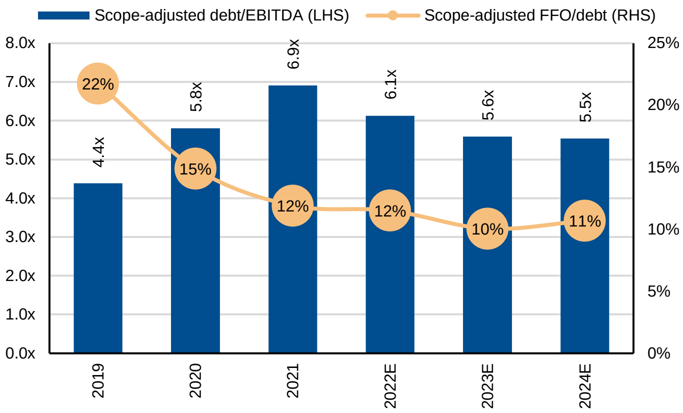
As of end-March 2022, the book-to-bill ratio remains well below 1x, pointing to more muted revenues going forward. Also, much of Bayer Construct's capacity will be tied up in Zugló City Centre in the next few years.

Financial risk profile: B

Negative FOCF suggests reliance on external financing

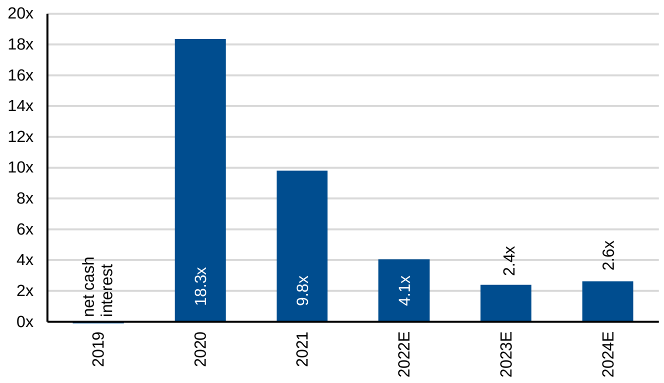
FOCF will remain stretched into the medium term due to the need to finance ambitious capex plans (around HUF 25.1bn projected in FY 2022 excluding discretionary spending). The ramp-up of capex will be mainly driven by the establishment of new production facilities for glass and bathtubs, an increase of production capacities in the mining and prefabricated segments and further investments into Zugló City Centre[8] and Aligaliget[9] projects. FOCF is projected to be negative in FY 2022, necessitating external financing. This will raise Scope-adjusted debt to around HUF 70bn (YE 2021: HUF 47.6bn) and ultimately weigh on debt protection and leverage.

Figure 5: Leverage



Sources: Bayer Construct, Scope estimates

Figure 6: Scope-adjusted EBITDA/interest cover



Sources: Bayer Construct, Scope estimates

Leverage to stabilise after strong increase in past years

Leverage, as measured by Scope-adjusted debt/EBITDA (excluding cash) has increased since FY 2019, reaching 6.9x at December 2021. This level narrows access to external financing, impairing the ability to offset i) cash flow volatility; ii) unforeseen operational disruptions; or iii) a major reduction in real estate market value.

We anticipate a leverage sustained between 5-7x, averaging 5.8x during the forecasted period until FY 2024, driven by the financing needed to cover negative FOCF. We expect deleveraging from FY 2023 once cash flow generation improves thanks to lower capex (following heavy spending in 2020-22, with capex-to-revenues averaging 27%). Higher customer prepayments or a large reduction in working capital (expected by the issuer) in FY 2022 may help ease leverage pressures.

We expect Scope-adjusted FFO/debt (excluding cash) to remain above 10% (end-December 2021: 12%) despite rising interest rates and external financing needs.

Lower debt protection going forward though sufficient to serve interest payments

Until FY 2018, debt protection was high due to the low debt, with Scope-adjusted debt at below HUF 3.0bn. However, indebtedness increased significantly with the addition of HUF 15.2bn loans in FY 2019 and the HUF 30.1bn bond issuance (3.7% coupon) in H2 2021.

Interest cover will come under severe pressure due to the strong increase in leverage coupled with the high share of floating-rate debt, with 43% indexed to BUBOR, which has

[8] The Zugló City Centre project represents a cluster risk for future cash flows. This multi-year project (2022-28, divided into four phases) accounts for 41% of outstanding work. As of July 2022, phase one of construction has only started. The project is also still on the issuer's balance sheet; the aim was to gradually sell plots to external parties before construction started, with most development risks to be carried by the ordering party. This project will be transferred to an affiliated company (no recourse to the group), making cash generation from construction work dependent on that company's ability to finance it.

[9] The Aligaliget project, next to lake Balaton, was acquired for HUF 10.8bn from Appeninn Holding Nyrt (B/Stable). The transaction is financed exclusively through advances and dividends from group companies, even though Bayer Construct is entitled to around HUF 2.6bn of government funds for touristic projects. The company is also far from obtaining a building permit due to public concerns, including regarding the environmental impact.

risen drastically by around 750bp since YE 2021. Scope-adjusted interest cover is forecasted to fall to 2-3x (YE 2021: 9.8x) but will be enough to serve interest payments and provide headroom against cash flow volatility.

Adequate liquidity

Liquidity is adequate despite an anticipated shortfall against short-term debt of HUF 8bn for the 12 months to YE 2022. Our view is based on the unencumbered assets (Aligaliget) to be used to source secured financing and the consistent record of rolling over or repaying debt.

Balance in HUF m	2022E	2023E	2024E
Unrestricted cash (t-1)	9,481	1,676	2,498
Open committed credit lines (t-1)	1,880	0	0
Free operating cash flow	-15,240	1,140	-2,399
Short-term debt (t-1)	4,456	7,818	85
Coverage	**-87%**	**36%**	**116%**

Supplementary rating drivers: +/- 0 notches

Financial policy: neutral

The group has not set a leverage ratio target. Management aims instead to maintain a balance between equity and external financing, taking into account market opportunities and the group's financial position and growth prospects. Other targets are to maintain a cash buffer, sufficient liquidity for operations and the ability to invest in growth opportunities. Dividends are not planned until FY 2024 according to business plan, and distributions, if made, shall not exceed HUF 1.0bn.

Long-term ratings

Senior unsecured debt rating: B+

Bayer Construct issued a HUF 30.1bn senior unsecured corporate bond in H2 2021. Proceeds have been used to refinance working capital loans with the Hungarian Development Bank and invest in own production facilities and development projects. The bond's tenor is 10 years. It will amortise in years 5-9 in equal instalments with a 50% balloon at maturity (21 October 2031). The coupon is fixed (3.7%) and payable yearly.

Our recovery analysis assumes a default in 2023 and is based on Bayer Construct's liquidation value, which assumes the company's parts to be of higher value than the group as a whole. Our view is driven by the high vertical integration among group companies. We therefore expect an 'average recovery' for senior unsecured debt, resulting in a B+ rating for this debt class (in line with that of the issuer).

Appendix: Peer comparison (as at last reporting date)

	Bayer Construct Zrt.	Duna Aszfalt Kft.	Market Építő Zrt.	Masterplast Nyrt.	Metál Hungária Holding Zrt.
	B+/Negative	BB-/Positive	BB-/Stable	BB-/Stable	B+/Positive
Last reporting date	31 Dec 2021	31 Dec 2020	31 Dec 2021	31 Dec 2021	31 Dec 2020
Business risk profile					
Scope-adjusted EBITDA (EUR m)	23	150	105	23	10
Backlog	1.4x	2.0x	1.5x	n/a	1.2x
Scope-adjusted EBITDA margin	11%	22%	14%	12%	9%
Financial risk profile					
Scope-adjusted EBITDA/interest cover	9.8x	67.9x	29.5x	20.7x	27.6x
Scope-adjusted debt/EBITDA	6.9x	0.8x	0.8x	2.5x	3.2x
Scope-adjusted FFO/debt	12%	110%	120%	37%	27%
Scope-adjusted FOCF/debt	14%	Negative FOCF	47%	Negative FOCF	31%

Sources: Public information, Scope

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