Bayer Construct Zrt.
Hungary, Construction

SCOPE B+ STABLE

Corporate profile

Bayer Construct is a group of companies mainly under Hungarian ownership offering complex construction and real estate services. The company is active in Hungary and Romania. When it was established in 2002, Bayer Construct's main profile was reinforced concrete construction in Hungary. Today the issuer deals with complete construction project implementation, 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.

Key metrics

			Scope estimates	
Scope credit ratios	2019[1]	2020[1]	2021E	2022E
Scope-adjusted EBITDA (SaEBITDA) interest cover (x)	96.3x	8.7x	9.1x	14.3x
Scope-adjusted debt (SaD)/EBITDA	4.6x	6.2x	5.3x	3.0x
Scope-adjusted funds from operations (SaFFO)/SaD	20%	14%	15%	34%
Free operating cash flow/SaD	-94%	-33%	-25%	27%

Rating rationale

Scope has assigned Bayer Construct Zrt. a first-time issuer rating of B+/Stable

The rating is driven by the company's vertically integrated business model and relatively high profitability and is constrained by a strong increase in leverage needed to support growth through its own development projects.

The company's business risk profile benefits from a relatively high level of vertical integration, although its main activities are currently focussed on construction. The main contributor after construction is real estate development. A breadth of activities helps to limit cash flow volatility by benefitting from different underlying demand patterns. Moreover, business risk is supported by the company's relatively high profitability, which is above that of peers and is forecasted to stay between 15%-20% (2020: 18% based on pro-forma consolidated results). However, the company's sole exposure to Hungarian construction and its small size lead to relatively high customer concentration, leaving cash flow vulnerable.

The issuer's financial risk profile is mainly supported by its debt protection, with Scope-adjusted interest cover at between 7x-10x (2020: 9x), a level seen as sufficient to enable Bayer Construct to service interest payments. Constraints include an increase in the company's indebtedness as a result of its debt-financed pursuit of growth. Leverage is anticipated to remain volatile yet at elevated levels going forward with SaD/EBITDA broadly between 4x-6x (2020[1]: 6.2x) and SaFFO/SaD between 15%-30% (14%). Relatively high leverage points to the issuer's limited access to external financing needed to tackle any unforeseen operational events or severe declines in the market value of its real estate assets.

[1] Pro-forma consolidated; credit metrics based on audited accounts of Bayer Construct Zrt. are as follows (2019/2020): SaEBITDA interest cover: 17.0x/4.3x; SaD/EBITDA: 2.4x/7.3x; SaFFO/SaD: 38%/9%; FOCF/SaD: -23%/-16%

Ratings & Outlook

Corporate ratings	B+/Stable
Senior unsecured rating	B+

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Related Methodology

Corporate Rating Methodology: July 2021

Rating Methodology: European Construction Corporates January 2021

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Outlook and rating-change drivers

The Outlook is Stable and reflects our view that leverage on a consolidated basis remains at SaD/EBITDA of broadly between 4x-6x (averaging 4.7x in the three years to 2023) and Scope-adjusted funds from operations/SaD of between 15% and 30% (21%). However, credit metrics will remain volatile due to a concentrated backlog and an uneven project pipeline. The Stable Outlook also reflects a successful HUF 27.4bn bond issuance under the Hungarian National Bank's Bond Funding for Growth Scheme.

A positive rating action is seen to be remote but may be warranted if the company manages to keep leverage, as measured by SaD/Scope-adjusted EBITDA, below 4x (consolidated level) on a sustained basis. This could be achieved with a successful ramp-up of construction works for the company's own projects beyond 2022, fee income (success fees, service revenues), or exit proceeds from its own projects that exceed our expectations and are then used to prepay debt.

A negative rating action could occur if liquidity were to worsen or SaD/EBITDA were to increase towards 6x (consolidated). Liquidity could worsen, for example, if: i) customers delay payments significantly, ii) the company becomes exposed to non-recoverable cost overruns and/or delays in its projects or iii) the company does not manage to issue the HUF 27.4bn bond. Leverage might increase if the company's focus on its own projects does not pay off, with limited end-investor demand leading to delays or cancelled projects.

Rating drivers

Positive rating drivers	Negative rating drivers
• Hungarian constructor of limited size, however, future market positioning anticipated to benefit from growth in the state-supported residential real estate sector and an integrated business approach. • Relatively wide segmental diversification enables the issuer to benefit from different underlying demand patterns. • Relatively high profitability benefitting from vertical integration of the group • Despite a significant increase in leverage and reduced debt protection, the latter remains at a sufficient level to service interest payments.	• Weak geographical diversification; exposed to domestic construction industry, leaving cash flows vulnerable • High customer concentration, partially mitigated by order size that calls for obligatory application of construction trustee • Limited visibility on future cash flow with order backlog equal to less than two years of revenues predominantly from contracts with affiliates • Negative Scope-adjusted free operating cash flow (SaFOCF) makes issuer dependent on availability of external financing. • Strong increase in leverage caused by large-scale development project

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/SaEBITDA below 4x on sustained basis	• Worsened liquidity • SaD/SaEBITDA towards 6x

Financial overview

			Scope estimates	
Scope credit ratios	**2019[2]**	**2020[2]**	**2021E**	**2022E**
SaEBITDA interest cover (x)	96.3x	8.7x	9.1x	14.3x
SaD/EBITDA	4.6x	6.2x	5.3x	3.0x
SaFFO/SaD	20%	14%	15%	34%
FOCF/SaD	-94%	-33%	-25%	27%
SaEBITDA in HUF m	**2019[2]**	**2020[2]**	**2021E**	**2022E**
EBITDA	4,351	6,482	11,202	17,039
Operating lease payments in respective year	104	0	0	0
Other[3]	33	254	0	0
SaEBITDA	**4,487**	**6,737**	**11,202**	**17,039**
SaFFO in HUF m	**2019[2]**	**2020[2]**	**2021E**	**2022E**
EBITDA	4,487	6,737	11,202	17,039
less: (net) cash interest as per cash flow statement	-10	-772	-1,228	-1,193
less: interest component operating leases	-37	0	0	0
less: cash tax paid as per cash flow statement	-349	-248	-909	-1,759
add: dividends received from shareholdings	126	0	0	3,585
SaFFO	**4,217**	**5,717**	**9,065**	**17,672**
SaD in HUF m	**2019[2]**	**2020[2]**	**2021E**	**2022E**
Reported gross financial debt	19,867	41,697	59,003	51,349
less: cash and cash equivalents	-508	-1,654	-1,000	-1,000
add: cash not accessible[4]	508	1,654	1,000	1,000
add: operating lease obligations	739	0	0	0
SaD	**20,607**	**41,697**	**59,003**	**51,349**

[2] Pro-forma consolidated; credit metrics based on audited accounts of Bayer Construct Zrt. are as follows (2019/2020): SaEBITDA interest cover: 17.0x/4.3x; SaD/EBITDA: 2.4x/7.3x; SaFFO/SaD: 38%/9%; FOCF/SaD: -23%/-16%
[3] Change in provisions
[4] Netting of cash: generally only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible.

Business risk profile: B+

Industry risk: B

2020 saw a significant shift in Bayer Construct's exposure, away from the construction industry, yet this still remains the dominant sector within the company. At the same time, the group is planning to increase its exposure to real estate development alongside its existing operations in business services (e.g. real estate agent, furnishing of apartments), building materials (rebar-bending and mesh-production facility), as well as in metals and mining (quartz sand). As a result, the forecasted share of construction within Bayer Construct is expected to remain between 60%-70% (by revenues and EBITDA), with other sectors consequently plateauing between 30%-40%. However, each dominant industry's exposure shows the same risk profile of B, leading to an overall industry risk assessment of B.

Hungarian constructor of limited size, yet benefitting from integrated business approach

Bayer Construct is a small player in the construction industry within the European context. Yet the company is among Hungary's top 10 contractors, with revenues of HUF 39.4bn[5] (EUR 112m) and SaEBITDA of HUF 3.2bn (EUR 9m)[6], equating to 1% of the total market share in 2020. Its small size, coupled with limited means to diversify its project portfolio, may lead to volatile cash flows.

The company's sales are expected to significantly increase for two reasons in 2021 and 2022: i) the Hungarian residential real estate industry is heavily subsidised by the government through grants, loans, and favourable VAT rates for prospective buyers; and ii) the creation of a real estate development arm (Bayer Property Zrt.), which is expected to spur demand in excess of that of the market, supporting total output growth in the short term, as Bayer Construct will act as a general contractor for its own projects. We believe that both will positively impact the issuer and that it will be able to increase its market share based on the following competitive advantages over other market participants.

Good access to qualified blue-collar workers

Bayer Construct shows relatively good access to Romanian labour based on the owner's ties to the country. Different measures, such as a workers' hostel, competitive wages and working schedules, plus a free flight home every three weeks, have helped to significantly increase the workforce from 164 full-time employees in 2016 to more than 600 full-time employees today. All of this has made the company the preferred sub-contractor for other relatively large Hungarian contractors, such as Épkar Zrt. (BB-/Stable), West Hungaria Bau Kft. (B+/Stable), Pedrano construction and Colas group (Bouygues).

Relatively high level of integration

The group benefits from a highly integrated business model as Bayer Construct is a manufacturer-developer-designer-contractor-sales platform.

We also believe that measures taken by the issuer, such as implementing building information modelling design processes in production management, will help it to hold on to its competitive advantage over other market players.

However, growth of the sort it has achieved is considered unsustainable, and so we expect output growth to cool down after 2022.

Exposed to domestic construction industry, leaving cash flows vulnerable

Geographical diversification is judged to be weak given that Bayer Construct generates most of its revenue in its domestic market of Hungary and has limited exposure to Romania. Low geographical diversification brings the risk of exposure to the construction cycle of one region. In a cyclical industry such as construction, revenues and earnings are likely to come under pressure if there is a downturn in one region.

[5] HUF 36.6bn in pro forma consolidated group sales
[6] HUF 6.7bn for pro forma consolidated group

Unsustainable growth in Hungarian construction

We view growth in the Hungarian construction market to be unsustainable. Expansion in the overall contract portfolio stopped at the end of 2018 and has been decreasing since March 2019 according to Danube Capital. Signs that the market has peaked and is overheating include: (i) price increases (exceeding inflation) are accelerating; (ii) high capacity utilisation and labour shortages; (iii) significant delays in projects (average of half a year); and (iv) the sector's confidence level began to decline in 2019. These factors were further amplified in 2020 by the impacts of Covid-19, resulting in a 9.1% drop compared to the previous year. On the other hand, the residential sector has been booming. According to the National Federation of Hungarian Building Contractors, the contract portfolio in residential construction expanded in 2020, with 24,000-25,000 residential units sold, and it increased further in 2021. Consequently, we expect that the issuer will benefit from growth in the residential sector in 2021. In the medium-term, however, we believe Bayer Construct's high exposure to Hungary poses a significant risk if construction output declines due to less government-driven stimulus or an economic downturn.

Relatively wide segmental diversification

The issuer's segmental diversification is comparatively strong. It benefits from a relatively high level of vertical integration (manufacturer-developer-designer-contractor-sales platform) although its main activities are focused on construction activity as of now[7]. The issuer aims to increase its outreach with services for operational real estate (real estate agent, furnishing, etc.). We believe this spread of activities will partially dampen the effects of a cooldown in demand, helping to better protect Bayer Construct's business going forward. This is especially true given that its activities do not serve the same end markets (construction, real estate, business services), which brings benefits through different underlying demand patterns.

Figure 1: Geographical distribution by revenues

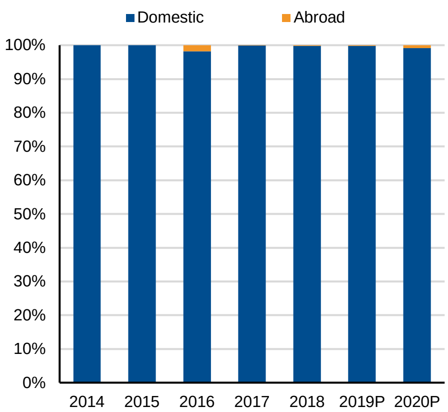


Figure 2: Customer concentration backlog

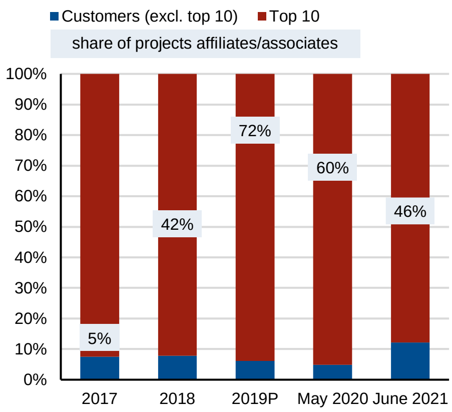
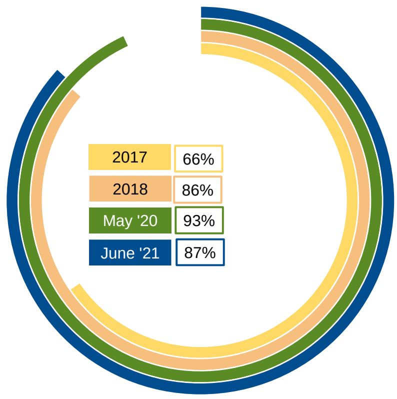


Figure 3: Backlog projects > HUF 1.5bn



Sources: Bayer Construct, Scope, P = pro forma consolidated

High customer concentration

Bayer Construct has a high customer concentration as evidenced by the high backlog contribution from its top 10 customers, which averaged 92% for the period between 2017 and 2021. Risk associated with that high customer concentration (bad payment behaviour or customer defaults) is partially mitigated by the fact that nearly 90% of signed orders, on average, have been exposed to projects in excess of HUF 1.5bn[8]. A large share of the order backlog (approximately 50%) is with associates and/or affiliates, leading to project-related risk with limited visibility of end customers. We expect the share of the internal order backlog to increase in the coming years, as Bayer Construct will most likely be the general contractor that develops the Zugló District Centre (gross development volume of

[7] Around 80% of revenues and 70% of EBITDA by 2023 according to the company's business plan vs. 90% for both in 2019.
[8] These projects benefit from a law enacted to protect contractors from non-payment and late payments. The law requires customers to make upfront payments to an escrow account for costs invoiced by the contractor for the next construction phase.

HUF 145bn). This will help to benefit the issuer's profitability (cost control, contractor margin absorption).

Relatively high profitability benefiting from vertical integration of the group

Bayer Construct's profitability has been above that of most of its competitors (peer profitability ranges between 5-10%). It is forecasted to remain at 15%-20% (2020 pro forma consolidated: 18%) in the coming years as a result of several factors, such as an increase in residential real estate demand and a relatively high level of vertical integration. The latter allows the consolidated group to internalise supplier and distributor margin to a certain extent, yielding higher profits. Furthermore, increased competition for new construction projects beyond 2021/2022 will be partially balanced by the issuer's widening business operations as well as its pole position to become the general contractor and sole service provider for developing the Zugló City Centre (currently partially owned through a joint venture structure). Some pressure on the company's profitability stems from labour and material costs, which are likely to stick at inflated levels.

Limited visibility on future cash flow with order backlog equating to only one year of revenues

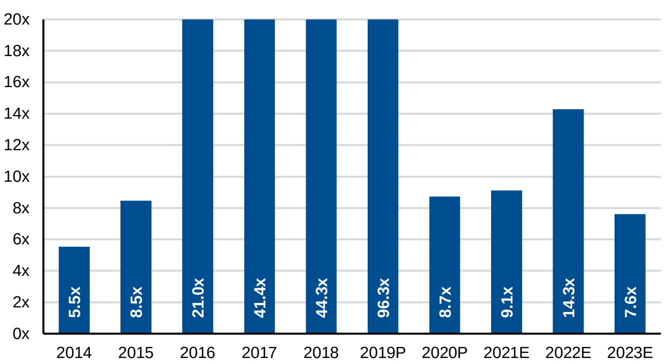
Bayer Construct benefits from an order backlog equating to one and a half years of revenues as at June 2021. This provides some visibility on future revenues development. Its book-to-bill ratio declined to below 1x in June 2021, pointing to more muted, if not negative, revenue growth with externals from 2021 on. However, we believe this to not be credit-negative, as a dominant share of Bayer Construct's capacity will be tied to the Zugló District Centre development project.

Financial risk profile: B+

Dependent on availability of external financing

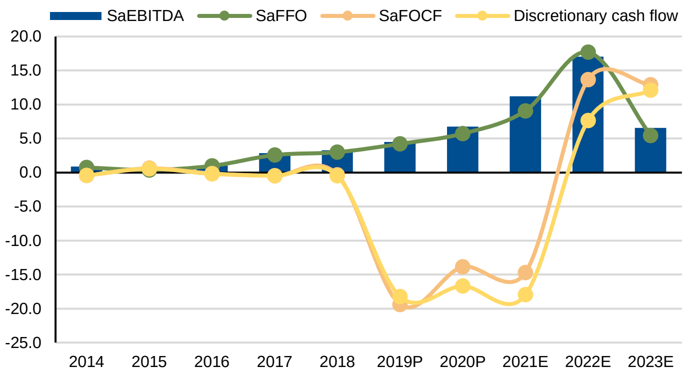
The issuer showed and is likely to show negative SaFOCF, driven by building up working capital or capital expenditure – in line with top line growth historically, and since 2019 driven by the Zugló City Centre development, piling stocks in order to avoid further significant changes in market prices for raw materials and financing of suppliers to ensure flawless operations. Capex are targeted to build up own production facilities for bathroom pods, the company's head quarter as well as a new logistics centre.

Figure 4: SaEBITDA interest cover (x)



Sources: Bayer Construct, Scope estimates; P = pro forma consolidated

Figure 5: Cash flows (HUF bn)



Sources: Bayer Construct, Scope estimates; Sa = Scope-adjusted, P = pro forma consolidated

The Zugló investment represents a cluster risk for the company's future cash flows. However, associated risk is somewhat mitigated as the development site will be divided into ten plots (eight for residential and commercial development and two for access roads), which will be sold to an external party, one by one, in accordance with phasing. Construction works will be ordered and commenced by the external party, which will bear most of the associated development/execution risk.

Negative SaFOCF makes the issuer dependent on external financing. This is anticipated to lift SaD to between HUF 55bn-60bn by YE 2022 (YE 2020: HUF 42bn), burdening debt protection and leverage going forward.

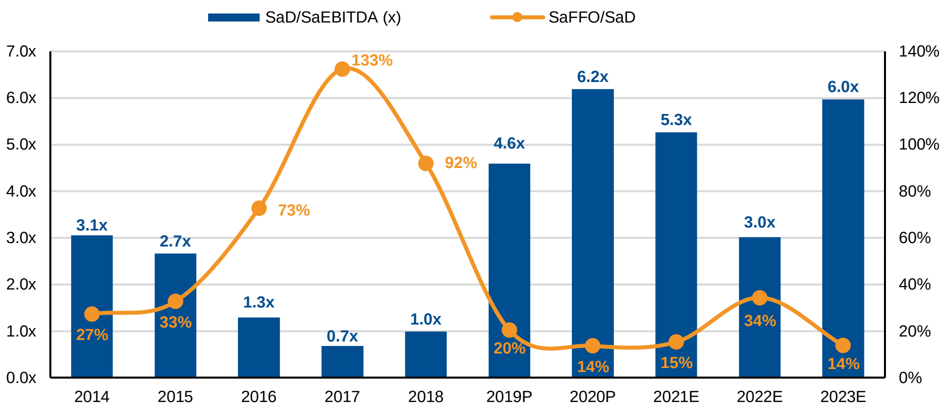
Debt protection at a level sufficient to service interest payments

An increase in indebtedness starting in 2019, when the issuer underwrote HUF 15.2bn in notional loans, and the expected HUF 27.4bn bond issuance assumed for H2 2021 put pressure on debt protection, straining it from levels above 20x to a forecasted level of between 7x-10x – similar to 2020 (9x[9]) – going forward. However, new levels are seen to be sufficient to enable the issuer to service interest payments, even providing some headroom to cover for potential volatility in cash flow driven by high customer concentration.

Strong increase in leverage caused by strong growth via own development projects

The company showed a leverage pattern typical of Hungarian contractors with leverage, as measured by SaD/SaEBITDA, declining as a consequence of increasing results from operations caused by a booming Hungarian construction market. However, with the company's pursuit of growth, leverage increased considerably since 2019 (2020: 6.2x SaD/SaEBITDA; 14% SaFFO/SaD[10]). While the company should show some improvement in 2021 and 2022 versus 2020, we lack visibility regarding future business prospects beyond 2022. This results from the signed backlog and expected projects representing around HUF 120bn (as at June 2021), most of which are to be executed in the next 12-18 months. Thus, we believe leverage will remain volatile going forward, with SaD/EBITDA broadly between 4x-6x (averaging 4.7x in the three years to 2023) and SaFFO/SaD between 15% and 30% (21%). The relatively high leverage forecasted points to the issuer's limited access to external financing needed to tackle any unforeseen operational events or severe declines in the market value of its real estate assets (especially the Zugló City Centre project that is due to be sold to institutional investors in several tranches in the coming years).

Figure 6: Leverage



Sources: Bayer Construct, Scope estimates; Sa = Scope-adjusted; P'= pro forma consolidated

Liquidity is adequate

Liquidity has been below par during the last couple years, mainly driven by consistently high short-term debt, and negative Scope-adjusted free operating cash flow, driven by a build-up of working capital. However, we consider Bayer Construct's liquidity to be adequate as short-term debt repayments for 2021 (HUF 2.2bn) are fully covered by available sources, namely cash (HUF 1.0bn as at YE 2020) and available credit lines (HUF 14.0bn as at YE 2020). Forecasted negative Scope-adjusted free operating cash flow of HUF 14.7bn for FY 2021, mainly driven by the company's capex programme (HUF 15bn for a factory for bathroom pods and HUF 10bn for a new headquarters and

[9] Based on pro-forma consolidation (standalone: 4x)
[10] Based on pro-forma consolidation (standalone: 7.3x SaD/SaEBITDA; 9% SaFFO/SaD)

logistics centre, with spending to be spread across 2021 and 2022), is to be covered by available credit lines as well as additional debt to be issued. Scope believes the latter to be possible as proven in the past by the company's ability to access to external financing to cover negative free operating cash flow. In addition, liquidity is supported by management's decision to not plan any relevant dividend pay-outs – up to HUF 1bn per year – for subsequent years, with the aim of safeguarding the working capital and cash reserve needed for stable operations. However, we highlight the issuer's continuous need to access external financing going forward to pursue further growth.

Key person risk

Bayer Construct's management staff have extensive knowledge of the industry and have been with the company for a number of years. However, we believe the company is exposed to key person risk with regard to its 60%-owner-and-CEO Attila Balázs. From our point of view, Mr Balázs provides the necessary access to the Romanian workforce, enabling the company to quickly address increased demand and position itself as a reliable partner/sub-contractor.

No independent board to provide oversight functions

The company has no independent board in place that provides oversight functions.

The company did not provide consolidated accounts, as there was no regulatory need to do so (due to its small size). However, this will change from FY 2020 onwards, when the issuer is obliged to consolidate all of its holdings. Consolidated accounts for FY 2019 and FY 2020 will be available from September 2021.

Senior unsecured debt: B+

Bayer Construct plans to issue a HUF 27.4bn senior unsecured corporate bond. Proceeds from the bond are earmarked for refinancing of working capital loans with the Hungarian Development Bank. The bond's tenor is ten years, and it will amortise from year five to year nine in equal instalments with a 50% balloon at maturity. The coupon will be fixed and payable on an annual basis.

Our recovery analysis assumes a potential default in 2022 and is based on Bayer Construct's liquidation value, as we assume the sum of the company's parts to be of a higher value than the whole group. Our view is driven by the relatively high level of vertical integration represented by individual companies that form part of the group. Based on the recovery analysis, we expect an 'average recovery' for the company's senior unsecured debt, resulting in a B+ rating for this debt class (in line with that of the issuer).

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