Bayer Construct Zrt.
Hungary, Construction

SCOPE B+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	9.8x	15.7x	5.3x	7.6x
Scope-adjusted debt/EBITDA	6.9x	3.0x	3.0x	2.5x
Scope-adjusted funds from operations (FFO)/debt	12%	30%	27%	34%
Scope-adjusted free operating cash flow (FOCF)/debt	14%	24%	2%	10%

Rating rationale

The rating is supported by Bayer Construct's strong competitive position despite its small size and concentration on Hungary, supported by high vertical integration and the sizeable backlog that preserves its market position and profitability. Main constraints arise from the dominant exposure to an unsupportive domestic market and the high customer concentration.

Outlook and rating-change drivers

The Outlook is Stable and reflects our view that Bayer Construct will execute on its order backlog while keeping leverage under control with a Scope-adjusted debt/EBITDA of below 6x. The Stable Outlook also reflects the lower risks associated with the Zugló City Centre project (e.g. disposal, delayed payments or customer defaults) after a purchase agreement was reached for all office buildings on behalf of the Hungarian state.

A negative rating action could be warranted if Scope-adjusted debt/EBITDA exceeded 6x on a sustained basis or liquidity worsened. This could be triggered, for example, by delays in customer payment or project execution, cost overruns, higher working capital requirements or an eroding contract backlog.

A positive rating action is remote but could be warranted if the business risk profile improved. This could be achieved if the company increased its size and improved its diversification, while keeping credit metrics at current levels.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
9 Aug 2023	Outlook change	B+/Stable
4 Aug 2022	Outlook change	B+/Negative
31 Aug 2021	Initial Rating	B+/Stable

Rating & Outlook

Issuer	B+/Stable
Senior unsecured debt	B+

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Related Methodologies and Research

Corporate Rating Methodology; July 2022

Construction and Construction Materials Rating Methodology; January 2023

ESG considerations for the credit ratings of construction and construction-material corporates; December 2022

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Sizeable order backlog of HUF 279bn providing excellent visibility on future revenues • Wide diversification across segments with slightly different underlying demand patterns • High vertical integration limiting reliance on external providers and safeguarding profitability against the acute difficulties in the Hungarian construction market • Adequate debt protection and moderate leverage	• Concentration on domestic construction industry, leaving cash flows vulnerable to the expected contraction • High customer concentration, mitigated by order size that obliges the use of a construction trustee and by the quality of the largest ordering party (i.e. state-owned) • High exposure to floating-rate debt (42% of total debt), indexed to Bubor reference rate • Volatility in cash flow induced by the lumpiness of projects and swings in working capital

Positive rating-change drivers	Negative rating-change drivers
• Increased in size and improvement of diversification leading to an improved business risk profile, with credit metrics at current levels	• Scope-adjusted debt/EBITDA sustained above 6x (consolidated) • Worsening liquidity

Corporate profile

Bayer Construct is a group of companies active in the engineering and construction industry in Hungary and to a smaller extent in Romania. The company deals with the implementation of turnkey projects, general contracting, building material production, mining operations and real estate development. The issuer benefits from its own production and manufacturing facilities, machinery and qualified workforce (537 employees as of end-2022).

Financial overview

				Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	18.3x	9.8x	15.7x	5.3x	7.6x
Scope-adjusted debt/EBITDA	5.8x	6.9x	3.0x	3.0x	2.5x
Scope-adjusted FFO/debt	15%	12%	30%	27%	34%
Scope-adjusted FOCF/debt	-57%	14%	24%	2%	10%
Scope-adjusted EBITDA in HUF m					
EBITDA	6,847	8,303[1]	18,034	17,171	21,181
Operating lease payments	0	0	0	0	0
Other items[2]	197	-29	643	0	0
Scope-adjusted EBITDA	**7,044**	**8,274**	**18,677**	**17,171**	**21,181**
Funds from operations in HUF m					
Scope-adjusted EBITDA	7,044	8,274	18,677	17,171	21,181
less: (net) cash interest paid	-384	-843	-1,192	-3,269	-2,784
less: cash tax paid per cash flow statement	-571	-624	-1,049	-890	-1,166
add: dividends from associates	0	0	0	958	747
Funds from operations (FFO)	**6,089**	**6,807**	**16,436**	**13,970**	**17,978**
Free operating cash flow in HUF m					
FFO	6,089	6,807	16,436	13,970	17,978
Change in working capital	-17,405	12,628	26,638	2,056	-7,020
Non-operating cash flow	0	0	0	0	0
less: capital expenditure (net)	-12,071	-11,688	-29,773	-14,890	-5,815
Free operating cash flow (FOCF)	**-23,388**	**7,747**	**13,301**	**1,135**	**5,144**
Net cash interest paid in HUF m					
Net cash interest per cash flow statement	-384	-843	-1,192	-3,269	-2,784
Change in other items	0	0	0	0	0
Net cash interest paid	**-384**	**-843**	**-1,192**	**-3,269**	**-2,784**
Scope-adjusted debt in HUF m					
Reported gross financial debt	40,899	57,076	55,509	51,226	52,260
less: cash and cash equivalents	-1,361	-9,481	-7,425	-4,277	-8,454
add: non-accessible cash[3]	1,361	9,481	7,425	4,277	8,454
add: operating lease obligations	0	0	0	0	0
Other items	0	0	0	0	0
Scope-adjusted debt	**40,899**	**57,076**	**55,509**	**51,226**	**52,260**

[1] EBITDA in 2021 has been restated to reflect the non-cash nature of impairment losses (previous figure was HUF 8,291m).
[2] Include change in provisions.
[3] Netting of cash is generally only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible.

Table of Content

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)	
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)	
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)	
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	

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

Bayer Construct strengthened its governance by establishing a supervisory board of three members, thus bringing extensive experience and introducing oversight functions that were previously lacking.

As anticipated, the company published its first ESG report, which sets out its objectives to enhance ESG performance. This report provides a reference to monitor future achievements and demonstrates the group's commitment and transparency since most companies in central Europe lack ESG data disclosures. Targets include: i) the reduction of greenhouse gas emissions by 20% by 2025; ii) the recycling of 75% of waste by 2025; and iii) increased energy efficiency by 30% across all operations by 2025.

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.

[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+

Bayer Construct remains primarily exposed to the construction industry (75% of revenue and 59% of EBITDA in 2022), although we note the growing exposure to other sub-sectors (i.e. building materials, mining, services), especially real estate development. The two predominant 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 construction company in the European context but is among Hungary's top 10. As at end-December 2022, revenues were HUF 84.4bn (equivalent to EUR 226m; up 13% YoY) and Scope-adjusted EBITDA was HUF 18.7bn (EUR 50m; up 126% YoY). The company's size affects its ability to achieve economies of scale and undertake multiple large contracts simultaneously, thus implying greater sensitivity to economic downturns and cash flow volatility.

Bayer Construct expects to achieve revenue growth in both 2023 and 2024, mainly driven by the execution of its sizeable order backlog, especially the large-scale Zugló City Centre project. Nonetheless, we do not anticipate substantial growth beyond the existing backlog (HUF 279bn as of end-March 2023) as the Hungarian construction market is facing tremendous difficulties that will lead to a sharp decline of order intakes and construction output in 2023-2024.

Figure 1: Bayer and peers (total revenues in FY 2022[5] in HUF bn)

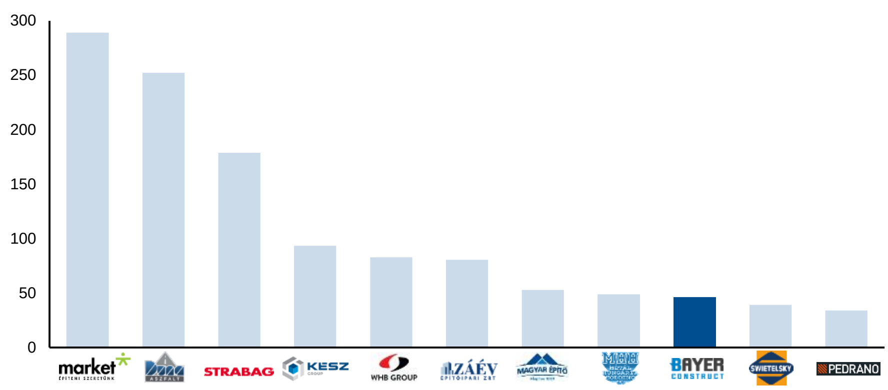
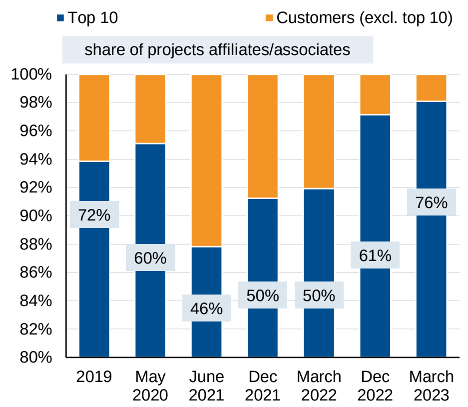


Figure 2: Customer concentration backlog



Sources: Bayer Construct, Scope, public information

Moderate market share in Hungary

The Hungarian construction market is fragmented, comprising a multitude of small, regional or local companies, which is reflected by the top-five contractors accounting for less than 20% of the market. In that context, Bayer Construct sits among the largest construction companies, with a moderate market share estimated at 1%-2%. Going forward, we anticipate the company to strengthen or at least maintain its market shares thanks to its robust backlog, whilst pointing out that shrinking order intakes in the market will likely impact competitors with smaller and uncontracted order books.

High exposure to Hungarian construction…

Geographical diversification is weak as revenues are mostly domestic (89% of revenue in 2022), with some minor exposure to Romania. In cyclical industries such as construction, low geographical diversification exposes companies to the inherent volatility and economic downturn in the domestic market and constrains opportunities for growth via activities in other regions.

[5] Revenues of Swietelsky as of end-March 2022 and Pedrano as of end-December 2021; revenue of Bayer Construct (standalone)

These developments mean Bayer Construct's single exposure to Hungarian construction amplifies the risk for cash flow deterioration in the short term, given the acute difficulties in the domestic market fuelled by uncertainties surrounding the release of EU funds and the budget restrictions in the public sector.

…though to segments with slightly different demand patterns and complementary features

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

High customer concentration

Customer concentration is high. The top 10 contributed 93% of the backlog on average during 2018-2022 (98% at end-March 2023). Risks associated with high customer concentration (bad payment behaviour, customer defaults, loss of contracts) is partially mitigated by most contracts having a value of more than HUF 1.5bn[6] as of end-March 2023 (HUF 8.1bn on average) and terms of several years. The backlog also has a high share of associates and/or affiliates (around 76% as of end-March 2023), which improves cost management but does not remove the inherent risks arising from end-customers (with limited visibility) and the potential for project delays or failures.

Order backlog largely skewed towards Zugló City Centre project

Zugló City Centre is the largest project, accounting for 66% of work outstanding, as at end-March 2023. Despite the significant exposure arising from this large-scale project, we consider project-related risks (e.g. disposal, customer default) to have considerably reduced since a purchase agreement of HUF 244bn for all office buildings (86% of the project) was reached with MNV Zrt[7] on behalf of the Hungarian state, aiming to relocate the majority of federal ministries and ministerial departments to the location. This multi-year project (delivery by March 2026 at the latest) provides good visibility on future revenues for Bayer Construct as general contractor, especially given that Hungarian construction activity is expected to shrink in 2023-2024.

High profitability benefitting from vertical integration

Profitability, as measured by Scope-adjusted EBITDA, rose to 22% in 2022 (up 11.1 pp), driven by the reduced unit cost of construction and upward price adjustments on some contracting works. Investments made in prior years have begun to bear fruit: the integration of prefabricated modules is shortening construction periods and therefore supporting profitability. Bayer Construct's integrated model is enabling some economies of scale, which is expected to be further strengthened by the ramp-up of mining operations and the roll-out of prefabricated elements across projects.

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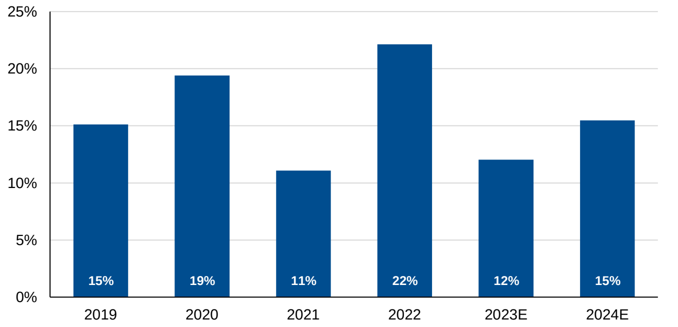
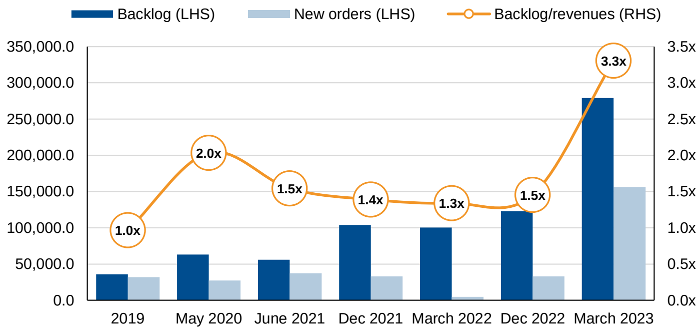
[6] These projects benefit from a law protecting contractors from non-payment or late payment; customers are obliged to pay upfront the costs invoiced by the contractor for the next construction phase on an escrow account.
[7] Magyar Nemzeti Vagyonkezelö

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 company's high vertical integration and sound procurement capacities reduces its reliance on external providers, thus improving its ability to manage costs. For reference, the company sources 60%-70% of raw materials used for buildings directly from its own production facilities. This should provide a cushion against volatility in both profitability and cash flow, and the Scope-adjusted EBITDA margin is therefore forecasted to remain above 12%.

Adequate cash flow visibility with order backlog exceeding revenues by 1.5x in 2022

As of end-2022, the backlog stood at HUF 122.8bn, representing 1.5 years of revenues. As of end-March 2023, the backlog reached a record of HUF 279 bn, which ensures good cash flow visibility and demonstrates an ability to secure orders (adding HUF 156bn during Q1 2023 or HUF 38bn excluding Zugló City Centre).

As of end-March 2023, the book-to-bill ratio exceeded 5x (end-2022: 1.6x), pointing to the Zugló City Centre project as the main revenue driver going forward. Also, much of Bayer Construct's capacity will be tied up in this mega-project, suggesting an efficient use of resources.

Financial risk profile: B+

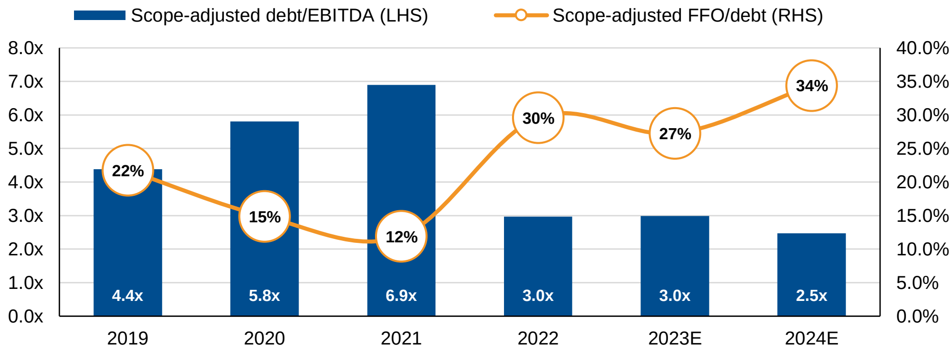
Improved FOCF generation limiting reliance on external financing

The improved profitability coupled with the reduction of working capital has allowed Bayer Construct to generate robust cash flow, covering intensive capex incurred during 2022 (HUF 28.6bn; compared to HUF 15.9bn in 2021). In detail, FFO rose to HUF 16.4bn (2021: HUF 6.8bn) and FOCF stood at HUF 13.3bn (2021: HUF 7.7bn).

Following a dynamic investment phase to boost production capacities (with capex-to-revenues averaging 36% in 2020-2022), capex is expected to gradually ease (projected at HUF 14.9bn in 2023 and HUF 5.8bn in 2024), which should support cash flow.

Further, Zugló City Centre no longer represents a cluster risk for cash flow after the pre-sale agreement was concluded, thus reducing the project's speculative nature. Bayer Construct shifted its risk exposure by acting as general contractor, although it must fulfil contractual obligations, including the handover of office buildings by March 2026. From now on, the issuer only bears development and disposal risks for the residential (commercialisation will start in August 2023) and retail parts of the mega-project (168 units and 11,000 sq m of retail spaces). The positive developments from this project will enhance Bayer Construct's cash flow profile with regular and scheduled inflows for the next two years at least.

Figure 5: Leverage



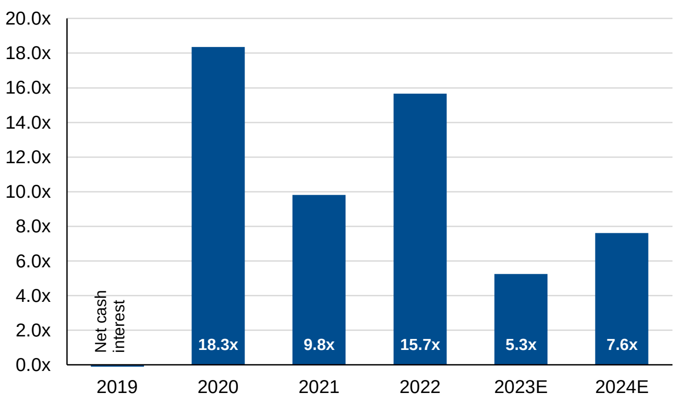
Sources: Bayer Construct, Scope estimates

Easing leverage after strong increase in past years

Leverage, as measured by Scope-adjusted debt/EBITDA (excluding cash), ended its upward trend and returned to 3x as at end-2022 (2021: 6.9x). This reflects improved cash flow and efforts to limit indebtedness in response to the rising interest rates. The current leverage remains adequate and safeguards the issuer's access to external financing to offset potential volatility or unforeseen operational disruptions.

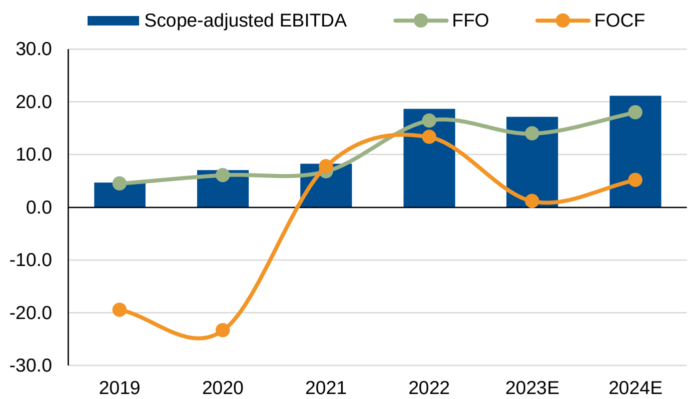
We anticipate the leverage to remain moderate at below 5x as we do not expect major debt to be raised, with ongoing projects being mostly funded by customer advances and existing credit limits (HUF 2.9bn undrawn and available until end-2023). Altogether, we expect indebtedness to remain broadly stable, with Scope-adjusted debt not expected to exceed HUF 60bn. We believe Scope-adjusted FFO/debt (excluding cash) will be sustained above 15% (end-December 2022: 30%) despite the rising cost of borrowings.

Figure 6: Scope-adjusted EBITDA/interest cover



Sources: Bayer Construct, Scope estimates

Figure 7: Cash flow (HUF m)



Sources: Bayer Construct, Scope estimates

Adequate debt protection enough to serve interest payments

Bayer Construct's debt protection is adequate, with Scope-adjusted EBITDA/interest standing at 15.7x as of end-December 2022 (2021: 9.8x). This was largely supported by the improved profitability, while indebtedness has remained stable (interest-bearing debt down 2.7% YoY to HUF 55.5bn at end-2022). The interest cover level is enough to serve current and future interest payments, while providing some headroom against a potential volatility in earnings, which commonly affects construction activities.

The company's debt, entirely denominated in Hungarian forint, comprises numerous bank facilities (mostly investment and working capital loans) and a HUF 30.1bn bond issued under the Hungarian National Bank's Bond Funding for Growth Scheme. As such, the company is exposed to interest rate risks, having a large share (42%) of its debt at floating rates indexed to the Bubor reference rate, which has risen drastically throughout

2022 (i.e. the three-month Bubor was 14.2% as of end-July 2023 compared to 6.5% as of end-March 2022). However, the actual impact on interest expenses has been counterbalanced by interest income received.

Going forward, we anticipate interest cover to remain above 4x, which considers the higher interest burden from floating-rate loans and the refinancing of maturing facilities to fund potential working capital gaps.

Adequate liquidity

Liquidity is adequate based on our expectation that sources of cash will cover uses by more than 1x in the 12 months to end-December 2023. We consider liquidity and refinancing risks manageable, which is supported by the lack of major debt maturities in the short term and unencumbered assets (e.g. Aligaliget at Lake Balaton) that can be sourced to access secured financing.

Balance in HUF m	2022	2023E	2024E
Unrestricted cash (t-1)	9,481	7,425	4,277
Open committed credit lines (t-1)	1,880	2,918	0
Free operating cash flow	13,301	1,135	5,144
Short-term debt (t-1)	4,456	8,783	5,966
Coverage	**>200%**	**131%**	**158%**

Long-term debt rating

Senior unsecured debt rating: B+

Bayer Construct issued a HUF 30.1bn senior unsecured corporate bond in H2 2021. Proceeds have been primarily used to refinance working capital loans and fund investments in own production facilities as well as development projects. The 10-year bond 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 annually.

Our recovery analysis assumes a default in 2024 and is based on Bayer Construct's liquidation value, which assumes the company's parts to be worth more than the group as a whole. Our view is driven by the high vertical integration among the 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).

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