# Gallfood Kft.
# Hungary, Consumer Goods

SCOPE B+ STABLE

## Corporate profile

Gallfood belongs to the Kövesi Group and – together with other group companies – is part of an integrated turkey manufacturer and processor, with a number two market position in Hungary and Central and Eastern Europe. The company can slaughter and process 2.1 million turkeys, three-quarters of which are bred on its own farms, while the remainder is supplied by third parties. Gallfood sells nearly 20,000 tons of processed meat products, mostly slaughtered poultry.

## Key metrics

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2018** | **2019** | **2020F** | **2021F** |
| EBITDA/interest cover (x) | 3 | 12 | 6 | 8 |
| Scope-adjusted debt (SaD)/EBITDA (x) | 15.9 | 3.4 | 9.9 | 4.5 |
| Scope-adjusted FFO/SaD (%) | 4 | 27 | 7 | 18 |
| FOCF/SaD (%) | 36 | 55 | -70 | -12 |

## Rating rationale

**Scope has assigned a first-time issuer rating of B+/Stable to Hungarian turkey producer and processor Gallfood Kft. as well as a B+ senior unsecured debt rating.**

Gallfood's issuer rating reflects our business risk assessment of B+. This is supported by our view of the company's good market position as the second largest turkey producer and turkey meat processor in Hungary and the Central Eastern European area. Based on about 20,000 tons of meat processed, Gallfood and its related group companies (which are fully owned by Hungarian businessman Otto Kövesi) control about 20% of the total domestic market. The rating is also supported by Gallfood's good geographical diversification, as only about 40% of total sales are generated by domestic customers. Gallfood delivers its products to a number of international wholesalers, meat processors and supermarket chains, which account for the remainder of sales. The latter provide significant growth potential in our view, following new management's strategy to focus more on the consumer segment. This will mean a move away from the company's currently high exposure to the low-margin, cyclical B2B segment (wholesalers and meat processors), which absorbed about two-thirds of 2019 sales.

Gallfood's business risk profile is held back by comparatively low profitability. In 2019, EBITDA was at only 3.4% of sales, mainly reflecting the unfavourable business mix described above. The coronavirus crisis only affected Gallfood to a minor extent in the first half of 2020, namely within the B2B division and specifically in the Horeca segment, as most facilities were closed from March to May. We expect Gallfood's revenues to catch up in the second half of 2020 and to perform as planned overall. This is based on the relaxation of crisis-related restrictions and the fact that the B2C division continued to perform as normal during the first six months of the current year. Management believes that it can generate significant growth in the full year 2020, based on its strategy to create additional B2C business with international supermarkets, even in the short term. Most of the proceeds of the planned HUF 3bn bond under the Hungarian National Bank's Bond Funding for Growth Scheme are earmarked for the expansion and modernisation of production and logistics facilities, mainly to increase B2C business and group profitability.

### Ratings & Outlook

| | |
|---|---|
| Corporate rating | B+/Stable |
| Senior unsecured rating | B+ |


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### Related Methodology

Corporate Rating Methodology, February 2020


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Bloomberg: SCOP

Gallfood's financial risk profile (rated B) is constrained by the company's low and historically volatile operating cash flow levels and substantially increasing debt from 2020. This is due to management's plan to issue a HUF 3bn bond as part of the Hungarian Central Bank's Bond Funding for Growth Scheme. We expect Scope-adjusted debt (SaD) to increase by about HUF 2.5bn in 2020, compared to end-2019 levels, stripping out available cash elements. Most of the cash proceeds – together with about HUF 2bn in government grants to be received over three years, starting in 2020 – will be used to modernise and enlarge production facilities, which will be much more geared towards the B2C segment. This will significantly depress free cash generation via substantially increased capital expenditure up to 2022. At the same time, the hoped-for substantial increase in EBITDA and operating cash flow should materialise, albeit with a certain time lag.

Given the execution risk linked to Gallfood's business transformation, which should eventually bring EBITDA levels to new heights, we based our assessment on 2021 with an EBITDA margin of 4.7%, which appears possible from today's perspective. In this scenario, the company would be able to improve leverage, as expressed by SaD/EBITDA, to about 4.5x (from about 10x in 2020). While this would still be equivalent to the high single B category, it would nevertheless mean a very fast deleveraging compared to expected year-end 2020 levels, mainly supported by a significant rise in operating profit (helped by the low base in 2020). Free operating cash flow/SaD would still remain in negative territory in 2021, and slightly so in the year after, according to our base case.

Gallfood's liquidity is adequate. This is based on annual liquidity (on balance sheet cash plus free committed bank lines) covering short-term debt maturities by a factor of 1.3x in 2021. Coverage over the next few years is not ample but sufficient in our view. It will not be supported by negative free operating cash flows until 2022. We do not expect the current coronavirus crisis to have a meaningful impact on credit metrics in 2020, for the reasons explained in the business risk section.

Gallfood plans to issue a HUF 3bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. The planned bond with an amortising loan structure (20/20/60) has a maturity of eight years and benefits from additional guarantees from other group companies owned by Mr Otto Kövesi (Kövesi Ltd, Pa-Tak Ltd, Tap-Lövö Ltd and Tak Ltd). Proceeds from the bond are mainly earmarked for modernisation and expansion.

Our hypothetical default year is YE 2021, i.e. a scenario in which the company has issued the new senior unsecured bond and proceeds have been used as planned. Our recovery analysis is based on significant asset haircuts reflecting about HUF 4.2bn of asset pledges, mainly for the HUF 1.5bn Exim loan, and indicates average recovery rates (30%-50%) for senior unsecured debt. This translates into no uplift for the instrument relative to the issuer rating. Our assessment assumes a liquidation value of about HUF 5.6bn, after accounting for 10% of liquidation costs. Some of the existing asset pledges for the over-collateralised Exim loan are likely to be released due to the refinancing of the loan at the end of the year. Our calculation also reflects the expected HUF 2bn in state subsidies as senior secured debt, ranking ahead of the bond in a default scenario.

## Outlook

The Outlook is Stable, reflecting our expectation of a significant improvement in profitability from 2021 on. It also includes our assumption of a successful bond placement in 2020 (volume: up to HUF 3bn), which is mainly earmarked for the modernisation and expansion of production facilities.

A positive rating action could be warranted by initial evidence of management's success in markedly improving Gallfood's low profitability to levels of above 5% (EBITDA margin) on a sustained basis. It could also be a consequence of more rapid deleveraging, expressed by SaD/EBITDA of below 4x on a sustained basis. This could be achieved via a faster than expected business transformation with greater B2C exposure.

A negative rating action could be required if SaD/EBITDA does not improve significantly from the very high levels expected for 2020, namely if SaD/EBITDA stays above 4.5x on a sustained basis. This could, in particular, occur if the company does not manage to improve EBITDA margins substantially, thereby improving free cash flow generation.

## Rating drivers

| Positive rating drivers | Negative rating drivers |
|---|---|
| • Second-largest turkey producer in Central and Eastern Europe<br>• Company benefits from stable underlying B2C markets<br>• Supportive geographical diversification<br>• Investment programme aimed at growth realisation and margin enhancement | • Small absolute company size<br>• Highly leveraged financial risk profile<br>• Significant execution risk attached to new strategy |

## Rating-change drivers

| Positive rating-change drivers | Negative rating-change drivers |
|---|---|
| • EBITDA margin of above 5%<br>• SaD/EBITDA below 4x | • SaD/EBITDA of above 4.5x on a sustained basis |

## Financial overview

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2018** | **2019** | **2020F** | **2021F** |
| EBITDA/interest cover (x) | 3x | 12x | 6x | 8x |
| Scope-adjusted debt (SaD)/EBITDA | 15.9x | 3.4x | 9.9x | 4.5x |
| Scope-adjusted funds from operations/SaD | 4% | 27% | 8% | 18% |
| Free operating cash flow/SaD | 36% | 55% | -70% | -12% |
| **Scope-adjusted EBITDA in HUF m** | **2018** | **2019** | **2020F** | **2021F** |
| EBITDA | 172 | 515 | 410 | 900 |
| Operating lease payments in respective year | | 0,6 | 22 | 30 |
| Other | | | | |
| Scope-adjusted EBITDA | 172 | 516 | 432 | 930 |
| **Scope-adjusted funds from operations in HUF m** | **2018** | **2019** | **2020F** | **2021F** |
| EBITDA | 172 | 516 | 432 | 930 |
| less: (net) cash interest as per cash flow statement | -50 | -43 | -68 | -108 |
| less: cash tax paid as per cash flow statement | -12 | 4 | -30 | -65 |
| add: depreciation component, operating leases | 0 | 1 | 19 | 23 |
| Scope-adjusted funds from operations | 109 | 477 | 332 | 751 |
| **Scope-adjusted debt in HUF m** | **2018** | **2019** | **2020F** | **2021F** |
| Reported gross financial debt | 2,732 | 1,799 | 5,038 | 4,620 |
| less: cash and cash equivalents | -109 | -165 | -952 | -672 |
| add: cash not accessible | 100 | 100 | 100 | 100 |
| add: operating lease obligations | 0 | 3 | 112 | 150 |
| Other | 0 | 0 | 0 | 0 |
| Scope-adjusted debt | 2,723 | 1,737 | 4,298 | 4,198 |

## Business risk profile

**Industry risk rated A**

Our business risk assessment takes into account the underlying industry risk as well as the company's competitive positioning in that industry.

We have assigned an industry risk of A based on our business risk assessment, reflecting Gallfood's exposure to consumer goods (the fast-moving-consumer-goods segment/processed meat products). This is supported by our opinion of that segment's low cyclicality and medium entry barriers.

**Competitive position rated B overall**

When assessing a company's competitive position we look at three elements:

- Market shares
- Diversification
- Operating margins.

**…supported by strong market shares**

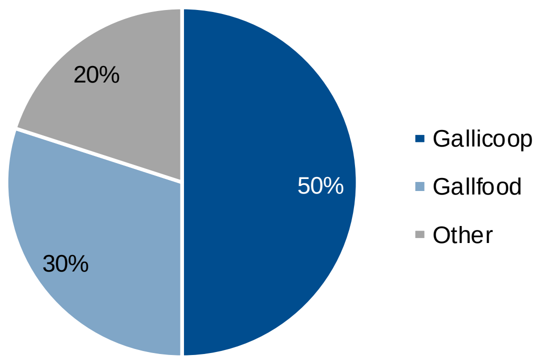
Gallfood's market shares both in turkey production and raw and processed turkey meat products are substantial in Hungary and Central Eastern Europe. Based on the production of about 2 million turkeys per year, the company holds a solid number two position (30% market share) after market leader Gallicoop (50% – see Figure 1 below). However, with about HUF 19bn in revenues (about EUR 70m), Gallfood is still rather small on an absolute scale and also compared to larger international consumer goods producers. Presently, Gallfood's main volumes sold are in the commodity product categories – raw, unprocessed meat sold predominantly to wholesalers, meat processors and the Horeca area. This segment (B2B) still accounts for about two-thirds of Gallfood's business. Management's ambition is, however, to significantly strengthen the company's B2C exposure (processed meat for supermarket chains Aldi, Metro, Auchan, Spar, Metro and Migros).

**…and satisfactory diversification**

Gallfood is well diversified from a geographical point of view. Significantly less than half of revenues are generated by Hungarian customers (see Figure 2 below), and the company has long-standing relationships with sizeable international supermarket operators. This is a benefit with regard to management's new strategy of increasing exposure to the B2C segment. The strategy promises future growth subject to customer requirements with regard to quality and quantities to be supplied in a timely fashion. If successfully executed, the strategy may also significantly improve profitability.

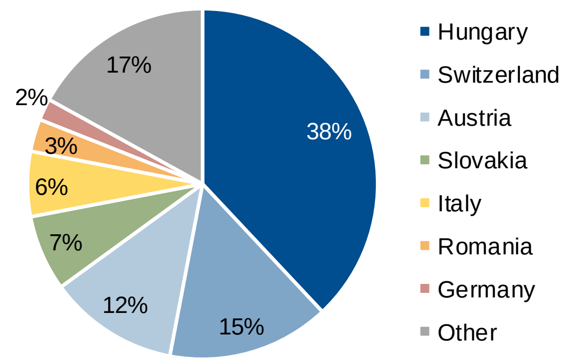
Product diversification does not support the ratings at present because: i) the company is not diversified outside of its main activity; and ii) the present product mix is heavily skewed (about 70% of revenues) towards the B2B business, which has a lower margin and is more cyclical than the provision of processed meat products. In addition, the coronavirus crisis is currently affecting the B2B business more than supermarket-based demand, with a significant decrease in demand from hotels, restaurants and caterers. Gallfood's diversification is further supported by the strong vertical integration of its operations, with about 75% of raw materials supplied by companies within the Kövesi group. Customer diversification is also satisfactory, as Gallfood's top five customers only account for about a third of sales. In total, Gallfood has over 130 customers.

**Figure 1: Market shares, turkey production Hungary**




Source: Gallfood

**Figure 2: Geographical diversification**



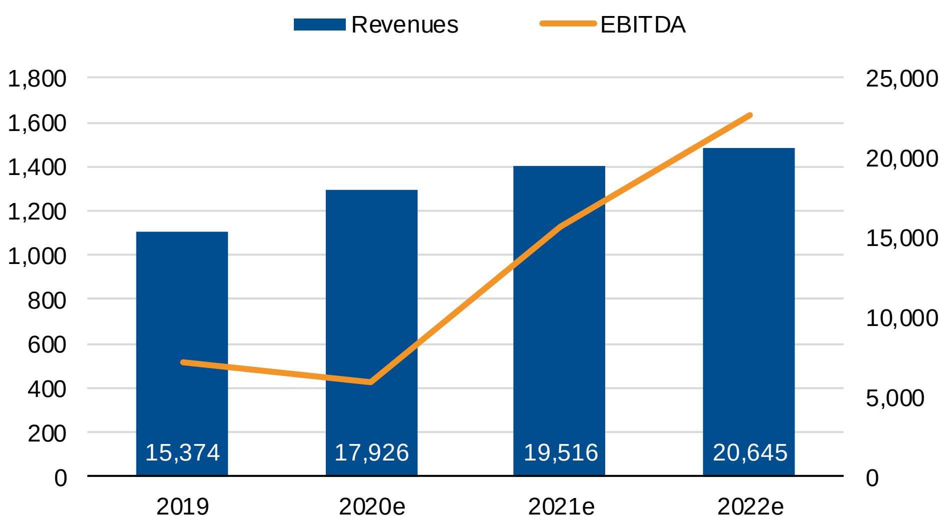

Source: Gallfood

**…while profitability is a drag on the ratings**

Profitability is very low for Gallfood, with an average EBITDA margin of only 2% for the period 2018 to 2020E. EBITDA fell in 2017 due to different strategic priorities followed by the owners. Since then, Mr Kövesi has bought out the second owning family and brought in new management in 2019 in order to execute his strategy focussing on the B2C segment. The company has a track record of generating a large majority of its revenues from the low-margin, cyclical wholesale business. We understand that the B2C segment's profitability is significantly in excess of levels achievable in business with the wholesalers. The execution of the new strategy is likely to be relatively uncomplicated as the large supermarket chains should have an incentive to expand volumes with Gallfood, which should be able to offer products at lower prices than their Western European meat producers.

New management is thus aiming to significantly increase operating profitability over the next years (see Figure 3 below). However, we have still reflected present EBITDA levels in the table below as the base for our profitability assessment in order to reflect the fact that the transformation is still ahead of the company.

**Figure 3: Margins expected to expand significantly**




Source: Scope estimates, Gallfood accounts

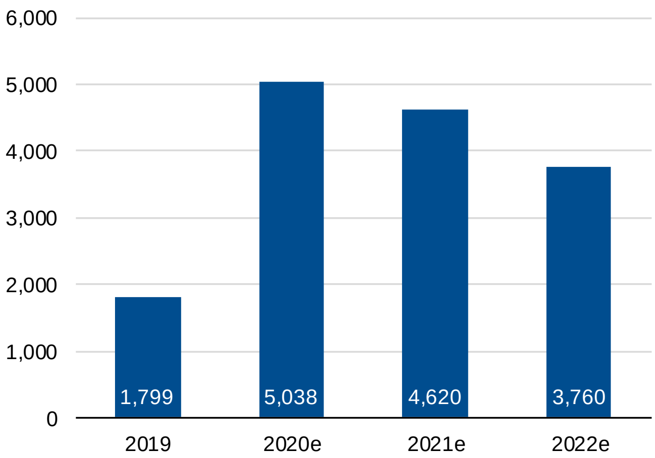
## Financial risk profile

**Recovery in credit metrics depends on transformation progress**

Gallfood's financial risk profile (rated B+) is constrained by the company's low and historically volatile operating cash flow levels and substantially increasing debt from 2020. This is due to management's plan to issue a HUF 3bn bond (maturing in 2028) as part of the Hungarian Central Bank's Bond Funding for Growth Scheme. We expect Scope-adjusted debt (SaD) to increase by about HUF 2.5bn in 2020, compared to end-2019 levels, stripping out available cash elements. Most of the cash proceeds – together with about HUF 2bn in government grants to be received over three years, starting in 2020 – will be used to modernise and enlarge production facilities, which will in future be much more geared towards the B2C segment. This will significantly depress free cash generation via substantially increased capital expenditure up to 2022. At the same time, the hoped-for substantial increase in EBITDA and operating cash flow is expected to materialize, albeit with a certain time lag.

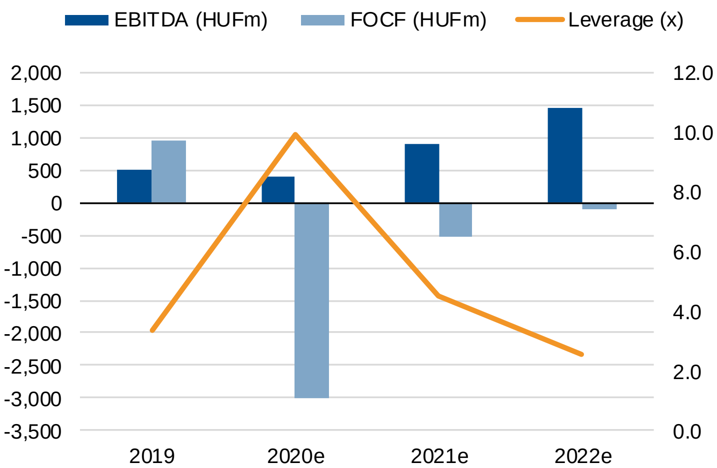
Given the execution risk linked to Gallfood's business transformation, which should eventually bring EBITDA levels to new heights, we based our assessment on 2021 with an EBITDA margin of 4.7%, which appears possible from today's perspective. In this scenario, the company would be able to improve leverage, as expressed by SaD/EBITDA, to about 4.5x (from about 10x in 2020). While this would still be equivalent to the high single B category, it would nevertheless mean a very fast deleveraging compared to expected year-end 2020 levels, mainly supported by a significant rise in operating profit (helped by the low base in 2020). Free operating cash flow/SaD would still remain in negative territory in 2021, and slightly so in the year after, according to our base case

**Figure 4: Planned bond to increase debt levels**




Source: Scope estimates

**Figure 5: Transformation will enable deleveraging**




Source: Scope

**Liquidity is adequate**

Gallfood's liquidity is adequate. Future financial liabilities are likely to be more or less covered by cash at hand and committed credit lines, while expected cash generation for the next few years will be negative, at times considerably so. Gallfood's liquidity is supported by initially high excess balance sheet cash, as the bond proceeds and government grants will not be exhausted in the early years of the expansion programme. In detail, annual liquidity (balance sheet cash plus free committed bank lines) of about HUF 1-2bn is expected to roughly cover expected short-term debt maturities of HUF 1-1.5bn. Coverage over the next few years is not ample but sufficient in our view. It will not be supported by negative free operating cash flows until 2022.

## Recovery

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## Outlook

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