Abroncs Kereskedőház Kft.
Hungary, Retail

SCOPE BB STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	9.6x	10.3x	14.5x	13.4x
Scope-adjusted debt (SaD)/EBITDA	1.2x	2.9x	2.2x	2.1x
Scope-adjusted funds from operations/debt	73%	30%	40%	42%
Scope-adjusted free operating cash flow/debt	58%	22%	11%	20%

Rating rationale

The rating is supported by AKH's financial risk profile, driven by good but volatile leverage. In addition to strong EBITDA interest coverage, the company still exhibits an SaD/EBITDA ratio below 3.0x following the acquisition of Slovakian truck tyre retailer ARS. Its resilient business model derives from its leading position in the wholesale and retail tyre business in Hungary and adequate supplier diversification. The latter, strengthened by partnerships with exclusive brands, has allowed the company to cope with the current shortage of supply from Chinese producers. Despite AKH's strong market share, the rating is limited by the overall small size of the company and moderate geographical diversification given a focus on Hungary. Geographical expansion through the acquisition of ARS is credit-positive but exposure to Slovakia remains low. AKH is also limited by its moderate profitability, assessed by the Scope-adjusted EBITDA margin remaining below 5% in the medium term. The operating margin is expected to be weakened by labour market conditions and rising input prices. The company is structurally sensitive to a highly seasonal business, entailing large working capital swings. Consequently, free operating cash flows are repeatedly weak throughout the year, despite low capex requirements, as the company needs to increase its inventory twice a year.

Outlook and rating-change drivers

The Outlook is Stable and incorporates our expectation that the SaD/EBITDA ratio will remain below 3.0x throughout the year, including when working capital seasonality peaks. The Outlook also reflects our expectation of a stable EBITDA margin from the continued recovery of ARS, limited disruption in the supply chain and the capacity to pass on price increases to end customers.

A positive rating action could be warranted either by an improvement in AKH's business risk profile, which could be achieved via better diversification, or by a material increase in operating margins.

A negative rating action could be taken if the SaD/EBITDA ratio increased towards 3.5x on a sustained basis or significant shareholder remuneration was undertaken contrary to Scope's expectations. An increase in leverage could be triggered by a rise in net debt due to larger-than-anticipated capex and working capital consumption.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
18 October 2022	Affirmation	BB/Stable
25 November 2021	Affirmation	BB/Stable
20 November 2020	New	BB/Stable

Ratings & Outlook

Issuer	BB/Stable
Senior unsecured debt	BB

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Related Methodologies

Corporate Rating Methodology; July 2022

Retail and Wholesale Rating Methodology; April 2022

ESG considerations for the credit ratings of retail corporates; November 2021

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Bloomberg: RESP SCOP

Rating drivers and rating-change drivers

Positive rating drivers	Negative rating drivers
• Strong but volatile credit metrics, driven in the past by overstocks in 2018 and 2019 and by general dependence on highly seasonal working capital management • Good supplier diversification with a good share of exclusive products • Leading or significant position in B2B and B2C tyre distribution and tyre services in Hungary • Adequate liquidity	• Below-average profitability • Limited financial size, capped by the Hungarian market • Weak free operating cash flow • Limited but improving diversification by geographies, distribution channels and products • Seasonality of operations

Positive rating-change drivers	Negative rating-change drivers
• Improvement in business risk profile via increased operating margins and better diversification	• SaD/EBITDA ratio above 3.5x on a sustained basis

Corporate profile

Abroncs Kereskedőház Kft. (AKH) is one of the leading B2B and B2C distributors and servicers of tyres in Hungary and Slovakia, with a presence in many neighbouring central and eastern European countries. It sells more than 1.3m tyres annually and distributes products supplied by more than 30 well-known tyre manufacturers. The group operates in countries such as Hungary, the Czech Republic, Romania, Croatia, Slovenia and Slovakia. In addition to tyres, AKH also markets lubricants as well as car and tyre services. The group has around 295 employees. It generated HUF 28bn in net sales and HUF 1.3bn in EBITDA in 2021 (its fiscal year ends on 31 December).

Financial overview

				Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	3.9x	9.6x	10.3x	14.5x	13.4x	15.3x
Scope-adjusted debt/EBITDA	3.7x	1.2x	2.9x	2.2x	2.1x	1.7x
Scope-adjusted funds from operations/debt	19%	73%	30%	40%	42%	52%
Scope-adjusted free operating cash flow/debt	63%	58%	22%	11%	20%	21%
Scope-adjusted EBITDA in HUF m						
EBITDA	581	1,103	1,284	1,825	1,671	1,814
Operating lease payments	57	53	94	125	131	141
Scope-adjusted EBITDA	**638**	**1,156**	**1,378**	**1,950**	**1,802**	**1,955**
Funds from operations Scope-adjusted EBITDA in HUF m						
Scope-adjusted EBITDA	638	1,156	1,378	1,950	1,802	1,955
less: (net) cash interest paid	-126	-85	-103	-97	-91	-81
less: cash tax paid per cash flow statement	-28	-27	-34	-128	-109	-123
less: interest component operating leases	-38	-36	-32	-38	-44	-47
Change in provisions	-3	0	4	0	0	0
Funds from operations (FFO)	**443**	**1,008**	**1,213**	**1,687**	**1,559**	**1,704**
Free operating cash flowScope-adjusted EBITDA in HUF m						
Funds from operations	443	1,008	1,213	1,687	1,559	1,704
Change in working capital	1,557	275	383	-490	-137	-235
less: capital expenditure (net)	-473	-468	-650	-661	-600	-700
less: lease amortisation	-19	-17	-63	-87	-87	-94
Free operating cash flow (FOCF)	**1,508**	**798**	**883**	**449**	**735**	**674**
Net cash interest paid Scope-adjusted EBITDA in HUF m						
Net cash interest per cash flow statement	126	85	103	97	91	81
add: interest component, operating leases	38	36	32	38	44	47
Net cash interest paid	**164**	**121**	**134**	**134**	**135**	**127**
Scope-adjusted debt Scope-adjusted EBITDA in HUF m						
Reported gross financial debt	2,372	3,500	3,826	3,449	3,245	2,895
less: cash and cash equivalents	-1,813	-3,489	-4,117	-4,034	-4,415	-4,468
add: restricted cash[1]	1,005	2,242	3,244	3,565	3,565	3,565
add: operating lease obligations	813	621	650	859	900	971
Other items[2]	0	0	405	405	405	284
Scope-adjusted debt (SaD)	**2,377**	**1,375**	**4,008**	**4,244**	**3,700**	**3,246**

[1] Cash used throughout the calendar year to fund large working capital outflows during Q1 and Q3. Cash assessed as not fully available to AKH.
[2] Financial guarantees linked to EUR 1m payment remaining for the acquisition of ARS, to be paid in 2024 and 2025.

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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)
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)

ESG profile: adequate

Reputational risk is a major criterion for the social aspect of a retailer. For example, product or labour management that has a negative social impact may prompt consumer boycotts, affecting sales, margins and inventory value. However, we believe AKH's position as a national wholesaler reduces this risk substantially. AKH has initiated several social responsibility projects including staff training.

Discretionary goods companies like AKH are also under growing pressure to ensure the sustainability of their products, namely in terms of durability and repairability. A strong commitment in this regard is likely to improve brand value. To this end, the company is currently expanding into the four-season tyre segment.

Lastly, the environmental footprint of a company's brick-and-mortar shops will remain fundamental to its development. AKH is well protected against environmental risks as the number of its stores across the country is low outside of Budapest, given that the network relies on franchises.

[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: BB

The industry risk profile remains rated BB given the medium cyclicality and low barriers to entry in the automotive parts wholesaler segment. AKH's new designation as a 'discretionary' retailer (from 'cyclical' retailer) follows the update of the Retail and Wholesale Rating Methodology; however, it has no effect on the industry risk profile.

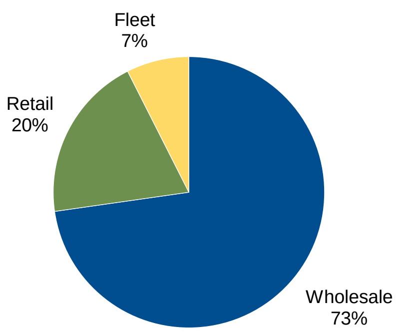
Strong market share offset by small market size

AKH's business risk profile is supported by its market positioning in Hungary, while diversification and profitability are negative rating drivers.

The company reports having close to 30% of the Hungarian market (based on the number of pieces imported into the country) versus 33% in 2019. After a long period of growth, domestic tyre sales reached a volume of nearly 3m pieces in 2018 and 2019. AKH also sells lubricants through an exclusive partnership with BP (Castrol, Aral). The company is the number three player in this business, with a market share of around 7%.

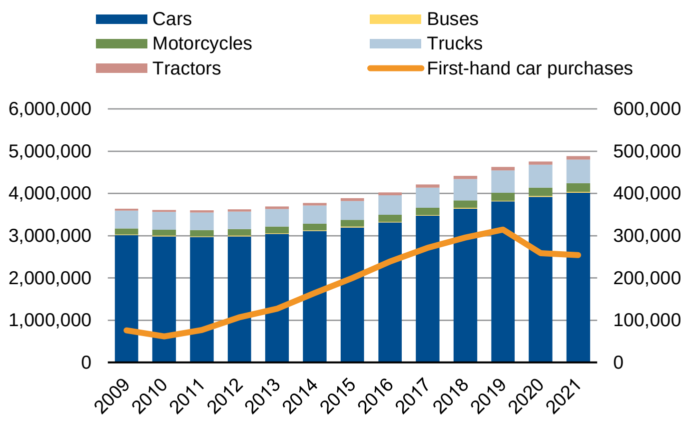
In terms of strategy, AKH intends to improve profitability while maintaining its market share. This strategy is based on: i) growing the distribution channel by opening additional car services centers; ii) growing the share of its retail segment and online sales; iii) continuing to reduce the seasonality of its sales through its lubricant and services businesses; and iv) maintaining its numerous commercial agreements with most of the largest tyre manufacturers in the world (e.g. Continental, Michelin) for light-vehicle tyres.

Figure 1: AKH's revenue split by segment (2021)



Source: AKH

Figure 2: Hungarian fleet by type of vehicle (in numbers of vehicles-LHS) and new car purchases (in numbers of vehicles- RHS) (2009-21)



Source: AKH

Despite its good market share, AKH is small (EUR 80m in sales). This is due to its core market, restricted growth opportunities, limited pricing power and strong competition.

Concentrated product portfolio and limited geographical diversification

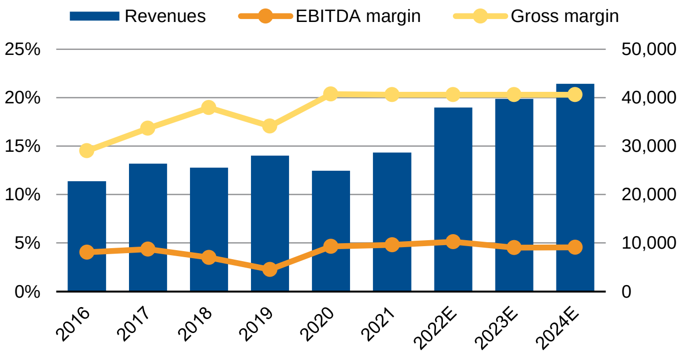
Diversification is the main weakness in the business risk profile. In terms of geography, AKH sells 77% of its products in Hungary. Sales realised through exports or its foreign subsidiaries account for 23%, with no country representing a majority share. That said, AKH's strategy to expand abroad is moving its limited geographical diversification in the right direction. The recent acquisition of ARS is expected to bring the exposure to Slovakia to around 19% of sales in 2022. Nevertheless, we consider this improvement to be too limited to result in a positive re-assessment of the overall diversification factor.

Product diversification is also weak. Sales are only related to one segment, the automotive industry, and they only cover tyres (passenger tyres and large tyres for trucks), lubricants and services.

We recognise the company's multiple sales channels (online B2B distribution, online B2C distribution, brick and mortar retail and fleet servicing). Although the predominance of

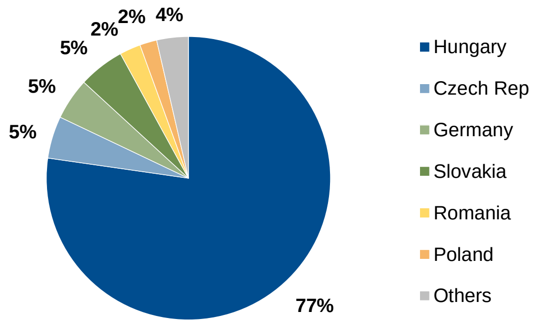
B2B distribution limits diversification, AKH appears to be making progress towards an omnichannel selling structure inside and outside Hungary.

Figure 3: Group profitability: EBITDA margin, Gross margin (in %-LHS) and Revenues (in HUFm-RHS)



Source: AKH, Scope estimates

Figure 4: Geographical diversification (2021 revenues)



Source: Scope estimates

Below-average profitability

Between 2016 and 2018, AKH's EBITDA margin ranged from around 3% to 4%. It started to decrease in 2018 and hit 2.3% in 2019. This was the consequence of: i) a warmer-than-anticipated winter in 2018, leading to a larger inventory; and ii) logistics issues, leading to losses in H2 2019. To normalise the large stock acquired in 2018, AKH lowered its prices for both winter and summer tyres during the first three quarters of 2019. The group recovered its profitability in 2020 and 2021 to above 4% thanks to:

- a better brand mix (focusing on the much more profitable tyre segment, increasing the ratio of exclusive and semi-exclusive brands)
- extending the retail capacity of existing service stations
- an increasing ratio of retail activity (product/service) and exposure to online B2C
- optimised in-house warehousing efficiency

ARS acquisition and price increases expected to have a limited impact on margins

ARS' EBITDA grew from HUF 16m in H1 2021 to HUF 165m in H1 2022. The recovery was driven by a new strategy with the development from a one sales channel/one brand (Bridgestone) company to a model with multiple sales channels and multiple brands. The group's EBITDA, including AKH and ARS, increased by an impressive 95.7% over the same period, rising by HUF 547m, although HUF 200m of this is viewed as a one-off. The EBITDA margin improved from 3.5% in H1 2021 Pro-Forma to 5.4% in H1 2022. Although we view this level as unsustainable and we expect profitability to revert to between 4% and 5%, we do not think ARS will put pressure on the overall EBITDA margin going forward.

Additionally, risks concerning supply shortages, general price increases and negative foreign exchange impacts (AKH buys in EUR and sells in HUF) are limited with regard to operating margins in the short term. We view the company as able to pass on price increases from tyre suppliers and expect HUF to improve versus EUR.

Financial risk profile: BBB-

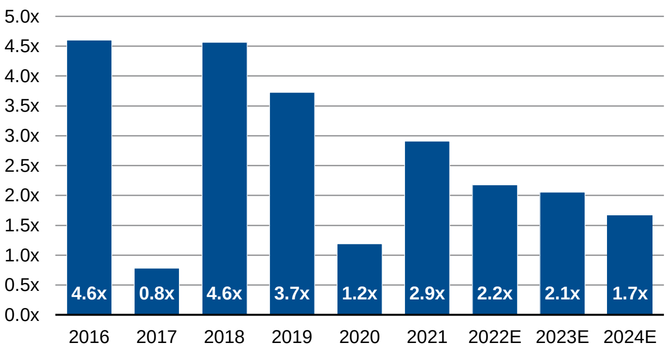
AKH's financial risk profile is clearly supportive of the overall rating case. Our assumptions are mostly in line with the assumptions made by management in terms of sales, EBITDA and capex. We expect the EBITDA margin to remain above 4% given the efforts made to manage costs, the better sales mix (with more sales of premium tyres and exclusive brands) and the increasing share of retail activity.

Good leverage despite ARS acquisition

AKH has benefited from investment-grade leverage. However, leverage is volatile due to the volatility in EBITDA and working capital. Our operating lease adjustment represents a large part of SaD at around 13%. The remainder of gross debt comprises a HUF 3.5bn bond used solely to refinance two loans maturing in 2023 and 2025 for HUF 2.2bn (exposure in August 2020). An overdraft facility of HUF 600m is the only item to have not been refinanced, and it increased to HUF 1bn. Nevertheless, the latter is not incorporated into gross debt at year-end as its usage is highly seasonal and usually at its lowest at the end of December.

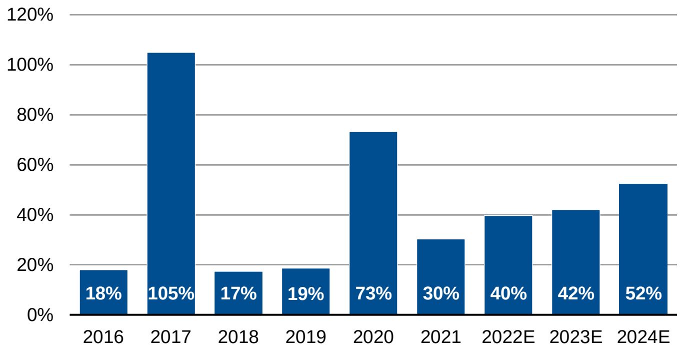
We expect the SaD/EBITDA ratio to remain below 3.0x. Leverage is assessed throughout the fiscal year because working capital consumption is at its lowest at year-end, giving a biased picture of the company's true indebtedness. Working capital is highly seasonal and generally peaks twice a year in Q1 and Q3. Hence, we adjusted part of the cash as restricted, considering it is to be used each year to fund AKH's inventory. In 2021, the SaD/EBITDA ratio reached 2.9x. The acquisition of ARS (consolidated in 2022), the additional capex needed by this new company, and deteriorating working capital are not expected to put leverage under pressure. It now stands at a manageable 2.2x.

Figure 5: AKH's SaD/EBITDA ratio



Source: AKH, Scope estimates

Figure 6: AKH's funds from operations/SaD

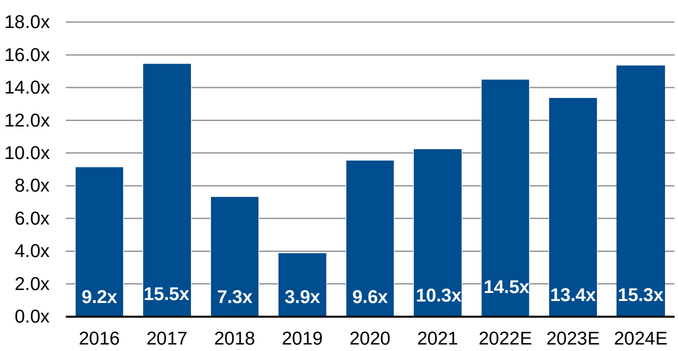


Source: AKH, Scope estimates

The funds from operations/SaD ratio has developed in a similar way. Our assessment of leverage considers the possibility of higher capex and worse-than-expected working capital, in addition to the potential integration risk of the newly acquired company.

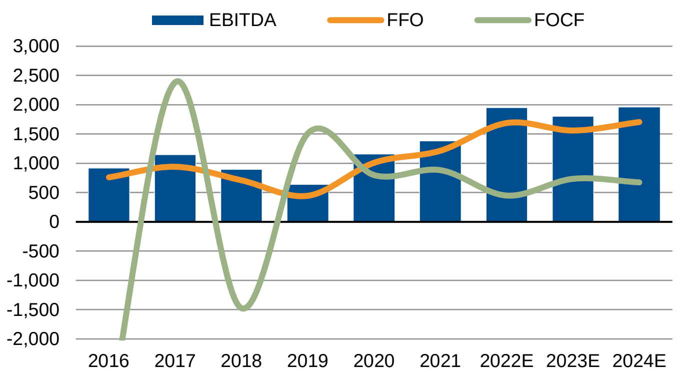
Net interest cover is very strong. Following the bond issuance, the refinancing process has materially impacted the cost of debt.

Figure 7: AKH's interest cover



Source: AKH, Scope estimates

Figure 8: AKH's cash flows (in HUF m)



Source: AKH, Scope estimates

Weak free operating cash flow

Operating cash flow was enough to cover capex in 2021. Maintenance capex stands at around HUF 230m. The upcoming development capex for ARS to acquire machinery and complete digital investments is expected to put pressure on free operating cash flow generation. This project to introduce a system to enhance warehouse management will cost nearly HUF 400m by the end of 2021.

Free operating cash flows are expected to remain very low to negative throughout 2022 and 2023 following large working capital swings. Working capital outflows reached up to HUF 3.2bn in 2021 and HUF 3.5bn in H1 2022. The outflows are expected to be more significant going forward with the consolidation and growth of ARS (additional inventory). Free operating cash flows will remain volatile and be put under pressure by working capital, leading the FOCF/SaD ratio to move towards one or the other end of the rating grid depending on the time of the year. Consequently, our assessment of AKH's capacity to deleverage remains conservative.

Adequate liquidity

Liquidity is considered adequate, despite large negative fluctuations in working capital throughout the year. 2022E will also be temporarily burdened by negative FOCF during a period of inventory stocking linked to the seasonality of the tyre business. However, liquidity is still considered adequate during these periods of large working capital consumption.

BalanceScope-adjusted EBITDA in HUF m	2022E	2023E	2024E
Unrestricted cash (t-1)	4,117	4,034	4,415
Open committed credit lines (t-1)	1,239	1,000	1,000
Free operating cash flow	449	735	674
Short-term debt (t-1)	720	532	678
Coverage	**>200%**	**>200%**	**>200%**

Long-term ratings

Senior unsecured debt rating: BB

All senior unsecured debt is issued by Abroncs Kereskedőház Kft. We affirm a BB debt rating to the senior unsecured debt of AKH. This rating is based on a hypothetical liquidation scenario as of year-end 2024, in which we computed an 'average' recovery for holders of senior unsecured debt based on our assumptions of attainable liquidation values.

Appendix: Peer comparison (as at last reporting date)

	Abroncs Kereskedőház Kft	Marso Kft.	AutoWallis Nyrt.	Unix Auto Kft.
	BB/Stable	BB-/Stable	B+/Stable	BB-/Stable
Last reporting date	31 December 2021	31 December 2021	31 December 2021	31 December 2021
Business risk profile	**B+**	**B+**	**B+**	**BB**
Country retail strength	High-medium	High-medium	High-medium	High-medium
Market position	Strong	Strong	Strong	Strong
Revenue size (EUR bn)	0.1	0.1	0.5	0.3
Consumer goods category	Discretionary	Discretionary	Discretionary	Discretionary
Online diversification	Moderate	Low	Moderate	Moderate
Geographical exposure	Immediate neighbours	Immediate neighbours	Immediate neighbours	Immediate neighbours
Product diversification	Low and cyclical	Low and cyclical	Low and cyclical	Low and cyclical
Profitability assessment	Moderate	Moderate	Moderate	Moderate
Financial risk profile	**BBB-**	**BB**	**B+**	**BB-**
Scope-adjusted EBITDA/interest cover	10.3x	14.1x	9.5x	9.9x
SaD/Scope-adjusted EBITDA	2.9x	3.0x	6.0x	2.7x
Funds from operations/SaD	30%	30%	15%	32%
Free operating cash flow/SaD	58%	-8%	203%	0%

Sources: Public information, Scope

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