Progress Étteremhálózat Kft. Hungary, Corporates

Corporate profile

Progress Étteremhálózat Kft. (Progress) is the McDonald's Corporation developmental licensee in Hungary and is the largest quick service restaurant operator there, based on both revenue and profit. Progress operates McDonald's restaurants, uses trademarks, IP rights, and other products in the course of the franchise business.

The company has two primary sources of income: i) Revenues generated by own operated restaurants and ii) franchisee fees from conventional licence partners.

Key metrics

		Scope estimates		
Scope credit ratios	2020	2021E	2022E	2023E
EBITDA/interest cover (x)	230.5x	26.1x	25.7x	29.4x
Scope-adjusted debt (SaD)/EBITDA	3.1x	2.6x	2.9x	2.7x
Scope-adjusted FFO/SaD	23%	27%	24%	27%
FOCF/SaD	10%	-24%	-5%	-7%

Rating rationale

Scope Ratings has today upgraded Hungary-based Progress Étteremhálózat Kft.'s issuer rating from BB-/Stable to BB/Stable. Senior unsecured debt is rated BB.

The rating action reflects the reversal of the negative one notch for 'governance and structure' that had reflected concerns regarding the repeated use of intercompany loans (the issuer's parent, Leones QSR, has meanwhile repaid fully its acquisition related bank loan).

The issuer rating of BB is supported by Progress' strong market position in Hungary, high margins and significant growth potential. The rating is constrained by the low diversification and increasing leverage as refurbishment is progressing in existing restaurants and several new restaurants will be opening in coming years.

The competitive position of Progress is constrained by its small size on a global level and its concentration on one geographical area and activity.

Progress' activities are facilitated by the McDonald's brand, which supports the company's strong market position in the informal eating-out market[1] in Hungary and its above-average profitability, which in turn is supported by well-defined global marketing facilities and supplier-side capacity.

This strong market position will be further bolstered by the planned double-digit increase in the number of restaurants by YE 2025. Progress' strategy of focusing on drive-through restaurants is also positive, as it is the most profitable format in the informal eating-out[2] segment and most resilient during the pandemic. The operating environment is currently favourable, and the company is planning to expand strongly to exploit its comparative advantages. The primary risk would entail a deterioration in its relationship with McDonald's.

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[1] The sentence was corrected on 19 July 2021. The text in the original publication was: "dominance in the quick-service restaurant industry".
[2] The sentence was corrected on 19 July 2021. The text in the original publication was: "quick-service restaurant".

Ratings & Outlook

Corporate ratings	BB/Stable
Senior unsecured rating	BB

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Related Methodology

Corporate Rating Methodology, February 2020

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The financial risk profile is rated BB after the increase in leverage caused by the company's issuance of HUF 33bn under the Bond Funding for Growth Scheme of the Hungarian National Bank, including accepting an oversubscription of 10%.

Cash flow generation and cash flow coverage are constrained by ongoing investments. Interest coverage, expressed as the ratio of Scope-adjusted EBITDA (SaEBITDA) to interest expense, is robust; this ratio is expected at above 25x after the bond issuance since Progress achieved a coupon of 3%, lower than assumed.

Liquidity is adequate and benefits from the company's conservative debt maturity profile, with no history of short-term debt or any planned in the coming years. We anticipate low short-term debt levels to be maintained going forward and to be sufficiently covered by available financing sources.

Previous concerns regarding governance and structure resulting in the issuer rating being lowered by one notch are now waived as the issuer's parent, Leones QSR, has fully repaid its acquisition-related bank loan. We do not expect the issuer to provide further intercompany loans to its parent.

Outlook and rating-change drivers

The Outlook is Stable based on our expectation of expansion being executed as planned, which should result in revenue increasing as new restaurants open. We also assume that the company will not pay dividends to the parent company before 2024.

A positive rating action is a remote scenario but would be warranted if the company strengthened free operating cash flow to Scope-adjusted debt to at least 10% on a sustained basis.

A downgrade would be warranted in the event of an increase in SaD/SaEBITDA to above 4x, as a result of i) a deterioration in the franchise relationship (development license) with McDonald's; ii) a significant delay in or failure to successfully execute expansion plans; and/or iii) a renewed closure of restaurants due to another wave of Covid-19.

Rating drivers

Positive rating drivers	Negative rating drivers
• High profitability, supported by world-leading quick-service restaurant brand, driven by strong marketing strategy validated by consumer research • Well-defined strategies to preserve the market-leader role, including plans for double digit new restaurants and facelifts for all existing restaurants • Potential for further expansion with above-average profitable drive-through restaurants • Robust interest cover ratio	• Strongly dependent on continued franchise relationship (development license) with McDonald's • Negative FCF/SaD due to intensive capex plan • Weak diversification • Increased leverage after issuance of bond, measured by SaD/EBITDA

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significantly stronger revenue growth • Free operating cash flow to Scope-adjusted debt at least 10% on a sustained basis	• Increase SaD/SaEBITDA above 4x • Deterioration in franchise relationship (development license) with McDonald's • Significant delay or inability to execute expansion successfully. • Renewed closing of restaurants due to pandemic or other reasons

Financial overview

		Scope estimates		
Scope credit ratios	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	230.5x	26.1x	25.7x	29.4x
Scope-adjusted debt (SaD)/EBITDA (x)	3.1x	2.6x	2.9x	2.7x
Scope-adjusted funds from operations/SaD (%)	23%	27%	24%	27%
Free operating cash flow/SaD (%)	10%	-24%	-5%	-7%
Scope-adjusted EBITDA in HUF (‘000)	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	4,899,724	8,437,408	8,015,710	9,536,648
Operating lease payments in respective year	1,757,288	2,228,032	2,491,446	2,491,446
Other adjustments	0	0	0	0
Scope-adjusted EBITDA	**6,657,012**	**10,665,441**	**10,507,155**	**12,028,094**
Scope-adjusted funds from operations in HUF (‘000)	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	4,899,724	8,437,408	8,015,710	9,536,648
less: (net) cash interest as per cash flow statement	-28,884	-409,000	-409,000	-409,000
less: cash tax paid as per cash flow statement	-174,758	-381,579	-288,200	-334,596
Other adjustments	0	0	0	0
Scope-adjusted funds from operations	**4,696,082**	**7,646,830**	**7,318,510**	**8,793,053**
Scope-adjusted debt in HUF (‘000)	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	34,070,644	34,070,644	34,070,644	34,070,644
less: cash and cash equivalents	-17,687,739	-11,054,417	-9,553,696	-7,231,959
add: cash not accessible	674,000	674,000	674,000	674,000
add: pension adjustment	0	0	0	0
add: operating lease obligations	3,514,576	4,456,065	4,982,892	4,982,892
Other adjustments				
Scope-adjusted debt	**20,571,481**	**28,146,291**	**30,173,839**	**32,495,576**

Business risk profile

Small player on global scale, market leader in Hungary

Progress is the largest fast-food restaurant operator in Hungary, operating the McDonald's brand. Progress was able to accomplish significant organic sales and guest count growth in Hungary in recent years without increasing the number of restaurants. However, to maintain this long-term position as market leader in coming years, an increase in the number of restaurants is necessary. This helps to explain Progress' aggressive expansion plans, with new store openings every year expected to reach double digits, until the end of 2024. We believe that this new intensive capex plan will strengthen McDonald's market position. As its position as market leader was beginning to be challenged in recent years, higher EBITDA margins will protect Progress' market shares if competitors try to win market shares by sacrificing profitability. Our expectation is that Progress will be able to keep its market leading position in Hungary in the medium term. Its market position is hampered by the dependence on a single country and fragmentation of the market, as well as Progress' small scale on a global level.

Restricted product portfolio but supported by diversified distribution channels, and investment in digitalisation

Geographical diversification is limited due to the sole exposure to Hungary. McDonald's sales channels are diversified: home delivery is available in around 85% of the restaurants, with McDonald's intention to increase such ratio in the coming years. From the supplier side, we see a strong integration in global supply chains, and as the Covid-19 pandemic developed there were no disruptions on supplier side. Hence, we assign a low degree of concentration to both suppliers and buyers. We note that McDonald's is taking pro-active steps to increase product diversification by increasing menu variety, adding breakfast, opening McCafé shops, and offering salads. Ultimately, McDonald's continues to have a limited product portfolio. McDonald's is set to be one of the first companies to integrate decision technology into the customer point of sale. Hence, an overall lack of product diversification is partly mitigated by cutting-edge investment in future technology and digitalisation.

High margins

EBITDA margins are strong and best-in-class for Hungarian quick service restaurants, with historical EBITDA margins ranging from 13.1% (2016) to 17.9% (2019) with an average of 16% between 2016 and 2019 and above 13% in pandemic-hit 2020. In 2021, We expect EBITDA margins to recover to 2019 levels as the HORECA sector opened in Hungary and one-off items help the margin (such as 5% VAT instead of 27% for takeaway and wage subsidies). Progress faces headwinds in terms of rising labour costs in Hungary, but this is counterbalanced by favourable pricing power, market growth, and capex in digitalisation in years to come, which should strongly increase productivity. By adding to the number of restaurants, Progress should also continue to benefit from economies of scale, already proven by lower relative material costs in comparison to its competitors. This is the result of better purchasing conditions due to larger purchasing volumes.

According to the company, all restaurants to be opened under its current strategy will be 'free-standing drive-through', the most profitable format in its restaurant portfolio.

Business Risk Profile: BB

We place Progress' business risk profile at BB, constrained by its small size on a global level and its concentration in Hungary.

Financial risk profile

Assumptions

We expect climbing EBITDA margins towards 17% (2021), and 14% (2022), continuing pre-Covid 19 pandemic business profitability. We assume that significant capex for new restaurants and the redesign of current ones will be in line with management's projections. According to the business plan, dividends are to be paid only from 2024, after planned investments are executed.

Leverage

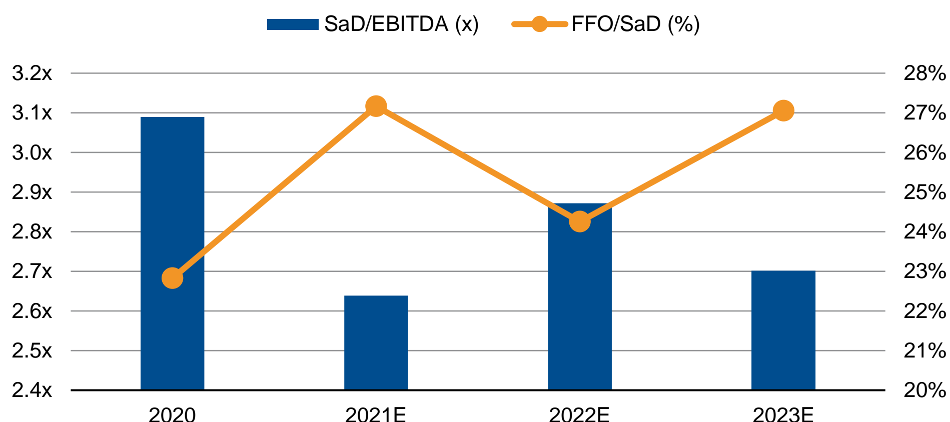
Leverage protection, measured as SaD/EBITDA, reflects a moderately strong EBITDA position, even after the issuance of HUF 33bn of bonds. This metric will be around the BB rating category in the coming years.

The SaD/EBITDA varied between small negative numbers and 0.2x between 2016 and 2019, reflecting the lack of short-term and long-term loans, as the only significant element of SaD was operating lease obligations.

In 2020, leverage increased due to the bond issuance but showed little or no volatility. SaD/EBITDA ranges from 3.1x in 2020 (lower EBITDA due to the economic effects of the Covid-19 pandemic) to 2.9x in 2022 (higher EBITDA due to opening numerous restaurants, however there will be significant capex to refurbish existing restaurants and to open new ones).

Funds from operations/SaD, is very stable, reflecting Progress' strong funds from operations and the limited debt position. While this has been volatile in the past (negative in past years) and moving above 20% from 2020 onwards due to high EBITDA and very low debt levels, the issuance of the bond under the Hungarian National Bank programme places this metric firmly in the BB category, with little movement during the rating period.

Figure 1: Scope-adjusted FFO/SaD and SaD/EBITDA –Base case scenario



Source: Scope

Interest cover

The interest cover ratio of SaEBITDA to interest expenses is robust; it was extremely high between 2016 and 2020; and is expected to be above 25BB after the bond issuance. The interest cover metric is supported by interest revenues that Progress is receiving from the interest-bearing intercompany loan.

Cash flow generation

Free operating cash flow/SaD reflects the negative numbers from 2020 onwards due to significant capex.

Liquidity

Liquidity is adequate, primarily reflecting the lack of significant short-term debt.

Supplementary rating drivers

Supplementary rating drivers have no effect on the rating.

Financial policy

We view the financial policy to be appropriate and prudent.

Peer group

We reviewed Progress relative to its peer group and found no issues that would warrant a change to the rating.

Parent support

We view parent support as credit neutral.

Corporate governance

The rating has been previously lowered by one notch for supplementary rating drivers. This was due to the significant intercompany loan granted by Progress to its parent company, Leones QSR, which raised concerns regarding the company's governance and

structure until the parent had external bank debt. Since the parent does not have external bank debt anymore, which could be technically assigned to the issuer, we do not see any further issues in corporate governance.

Senior unsecured debt

We assign the same rating to the senior unsecured debt as to the issuer.

In our recovery assessment, we recognise that, despite a strong unencumbered asset position, the significant intercompany loan limits recovery to 'average' (30-50%) for outstanding senior unsecured debt in a hypothetical default scenario based in 2023. For these reasons, there is no uplift to the rating for senior unsecured debt as a category.

Outlook

Outlook: Stable

The Outlook is Stable based on our expectation of the expansion being executed as planned, which should result in revenue increasing as new restaurants open. We also assume that the company will not pay dividends to the parent company before 2024. HUF 12,8bn of total proceeds are earmarked for expansion plans, while the remaining refinanced a loan from the parent company via intercompany loan.

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