4iG Nyrt.
Hungary, Business Services

SCOPE BB- STABLE

Corporate profile

4iG Nyrt. is one of the largest players in Hungary's fragmented IT market. The company's main activities include hardware and software sales as well as a range of IT services. 4iG is listed in the premium segment of the Budapest Stock Exchange.

Following a recent change in ownership, the company revised its business strategy and reorganised its activities. As part of a new growth strategy, 4iG intends to acquire a much larger competitor, T-Systems Magyarország Zrt. (TSM), a subsidiary of Magyar Telekom Nyrt. (MT). The parties are still negotiating the purchase price and other contractual conditions. There is no binding agreement yet. The closing of the transaction is expected in 2019.

In the following we refer to the combined entities as 4iG, unless otherwise stated (e.g. 4iG standalone).

Key metrics

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA/interest cover	14.3	44.7	34.7	8.5	10.6
Scope-adjusted debt (SaD)/EBITDA	2.7	2.0	8.7	2.7	2.3
Funds from operations (FFO)/SaD	25%	44%	10%	30%	37%
Free operating cash flow (FOCF)/SaD	82%	-42%	3%	6%	9%

Rating rationale

Scope Ratings assigns an initial issuer rating of BB-/Stable to Hungary-based 4iG Nyrt. Scope also assigns a BB- instrument rating for senior unsecured debt.

The rating case assumes that the acquisition of T-Systems Magyarország Zrt. will be finalised by the end of 2019.

The issuer rating mainly reflects the combined entities' leading position in key segments of the Hungarian IT market. We expect the latter to grow at low single-digit percentage points per year in the medium term, providing sufficient opportunities for the companies in this industry. 4iG's business risk profile further benefits from TSM's fully integrated business model, broad product portfolio and sector expertise.

Challenges include the execution risk related to the TSM acquisition, fierce competition from national and international players, a relatively low share of recurring revenues, weak geographical diversification, strong exposure to public sector customers and relatively low profitability.

4iG's financial risk profile is relatively strong compared to its business risk profile. We expect credit metrics to recover in the next few years following the acquisition of TSM.

Outlook

The Outlook is Stable and reflects: i) the successful placement of a HUF 30bn bond and a significant equity contribution in Q4 2019; ii) the successful closing of the TSM acquisition by the end of 2019; and iii) resilient operating performance and the recovery of credit metrics with Scope-adjusted debt (SaD)/EBITDA of 2x-3x in the next few years.

Ratings & Outlook

Corporate ratings	BB-/Stable
Senior unsecured rating	BB-

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Related Methodology

Corporate Rating Methodology

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A negative rating action could be triggered by a cancellation of the TSM deal or significant delays in its execution. It could also follow a deterioration in credit metrics, e.g. if SaD/EBITDA were to increase and stay above 4x on a sustained basis, or liquidity issues, e.g. very strong working capital swings.

A positive rating action is remote at this stage but could be warranted if SaD/EBITDA were to fall and stay below 2x on a sustained basis subsequent to the successful integration of TSM.

Rating drivers

Positive rating drivers	Negative rating drivers
• The combined entity will become the largest IT service provider in Hungary • Integrated business model and broad product portfolio, supported by the envisaged long-term partnership with MT • Broad sector expertise • Relatively strong credit metrics	• Execution risk related to the TSM acquisition • Fierce competition from national (incl. state-owned) and international players • Relatively low share of recurring revenues • Dominant exposure to Hungarian market • Strong exposure to public sector customers with dependence on spending cycles • Relatively low but improving profitability

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• A SaD/EBITDA of below 2x on a sustained basis subsequent to the successful integration of TSM	• Cancellation of the TSM deal or significant delays in its execution • Deterioration in credit metrics, e.g. a SaD/EBITDA of above 4x on a sustained basis • Liquidity issues

Financial overview

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA/interest cover (x)	14.3	44.7	34.7	8.5	10.6
SaD/EBITDA (x)	2.7	2.0	8.7	2.7	2.3
FFO/SaD (%)	25%	44%	10%	30%	37%
FOCF/SaD (%)	82%	-42%	3%	6%	9%
Scope-adjusted EBITDA in HUF m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA	273	842	3,671	14,071	14,704
add: operating lease payments in respective year (Scope estimates)	134	134	-	-	-
Scope-adjusted EBITDA	407	976	3,671	14,071	14,704
Scope-adjusted FFO in HUF m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA	273	842	3,671	14,071	14,704
deduct: (net) cash interest paid	-18	-11	-106	-1,655	-1,387
deduct: cash tax paid	-104	-117	-512	-815	-1,092
add: depreciation component operating leases (Scope estimates)	123	123	-	-	-
Scope-adjusted FFO	275	838	3,053	11,601	12,225
Scope-adjusted debt in HUF m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Reported gross financial liabilities	1,116	1,763	35,884	35,524	33,844
deduct: available cash & cash equivalents	-323	-176	-4,405	-38	-3,193
add: guarantees	54	54	500	2,600	2,600
add: operating lease obligations (Scope estimates)	265	265	-	-	-
Scope-adjusted debt	1,111	1,906	31,979	38,086	33,251

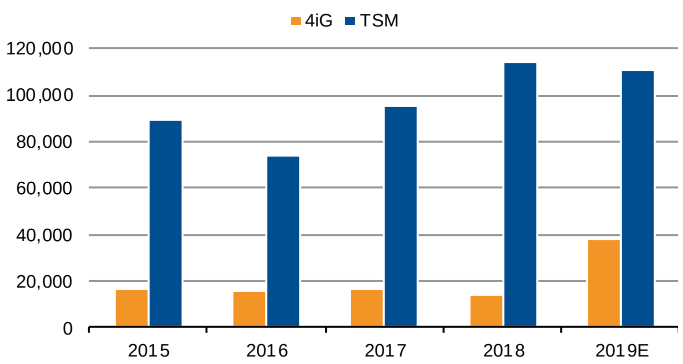
Business risk profile

The business risk profile reflects our assessment of the industry in which the company operates and its competitive position within that industry.

Dominant exposure to business services industry

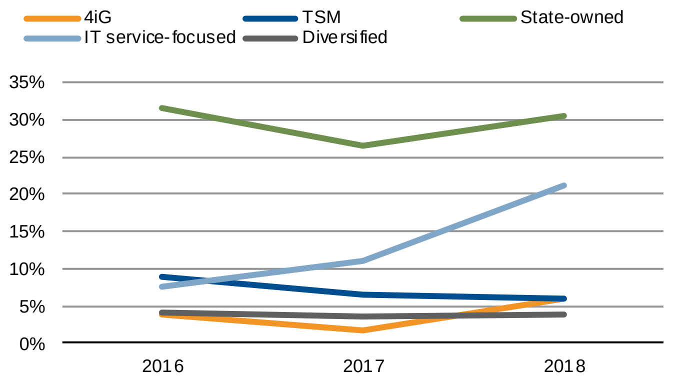
4iG is classified under business services since the company provides IT solutions and services to a broad variety of industries. Companies in this sector support businesses in the performance of their core activities. The concept of business services covers a broad spectrum of activities that are mainly related to business-to-business (B2B) transactions. While cyclicality, entry barriers and substitution risk may be different in various segments of the industry, we assess them as medium on average.

Figure 1: Revenue development: 4iG and TSM (HUF m)



Source: 4iG, MT, Scope

Figure 2: EBITDA margin: 4iG vs local peers



Source: Company reports, Scope

Small market size with moderate growth prospects

The Hungarian IT market (which includes software, hardware and IT services) accounts for less than 0.2% of the global market. We expect the former to grow at low single-digit percentage points per year in the medium term, mainly driven by GDP growth and public and private sector modernisation through investments in IT. This will provide sufficient growth opportunities for the companies in this industry.

Combined entity with leading position in key segments of the market

4iG's competitive position is mainly driven by the combined entities' leading position in key segments of the Hungarian IT market. 4iG and TSM together account for around 15% of the market. The company's scale of activities and expertise will allow it to bid for sizeable, complex projects, although some peers may be at an advantage when it comes to a project's technological needs or other requirements. The combined entities will also be able to execute several large projects at the same time. Assuming dynamic revenue growth ahead of the general industry, we expect 4iG's market share to increase even further.

Fully integrated business model, broad product portfolio and sector expertise

4iG's business risk profile further benefits from TSM's fully integrated business model and broad product portfolio. The combined entity will have long-standing expertise in a number of sectors, such as public administration, healthcare, transportation, financial institutions, manufacturing and professional services.

Execution risk weighs on 4iG's business risk profile

4iG's business risk profile is restricted by execution risk related to the TSM acquisition. Although the company is performing extensive due diligence and is preparing for post-acquisition integration, residual risk cannot be fully ruled out, especially considering the large scale of the transaction.

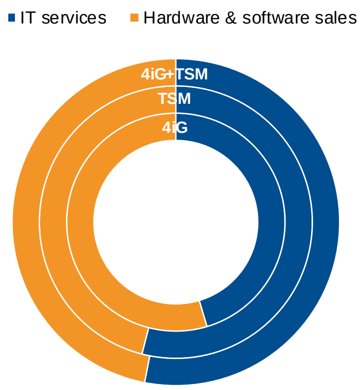
Fierce competition and low share of recurring revenues

The company's market position is further restricted by strong competition from local (including state-owned, e.g. NISZ and MVMI) and international players (e.g. HP, IBM, SAP) as well as a relatively low share of recurring revenues.

Weak geographical diversification

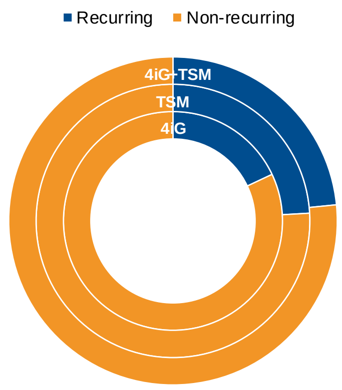
Performance volatility may also arise from weak geographical diversification as more than 90% of revenues are generated in Hungary. Digital transformation is an important IT spending driver under accommodative economic conditions, but in the event of an economic downturn many companies may decide to postpone or even cancel such projects as part of general cost saving programmes. 4iG plans to expand its activities in the CEE region as part of its long-term strategy.

Figure 3: Revenue split by product type (2018)



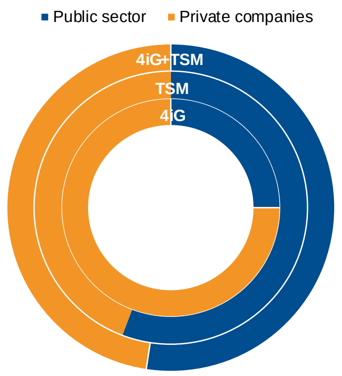
Source: 4iG, MT, Scope

Figure 4: Revenue split by nature (2018)



Source: 4iG, MT, Scope

Figure 5: Revenue split by customer type (2018)



Source: 4iG, MT, Scope

Strong exposure to public sector customers…

4iG and TSM generate more than 50% of their revenues from the public sector (governmental, educational and health care organisations). While this ratio has been relatively stable for TSM, it increased from 25% in 2018 to 61% in H1 2019 for 4iG. Recently, 4iG's board of directors decided to increase the company's revenues from the private sector by continuously expanding the services it offers.

…with dependence on spending cycles

The public sector plays an important role in IT spending in Hungary. We believe that the company is strongly exposed to spending cycles by local and EU authorities. The EU funding cycle has a duration of seven years and EU funds are one of the major drivers of IT spending in Hungary up to 2021. While government spending tends to be anti-cyclical in general, there is no certainty that fiscal policy would be supportive in the event of an economic slowdown (Hungary even has a pro-cyclical fiscal policy[1]) and a strong reliance on a single country does not provide good downturn protection in our view.

Relatively low profitability…

4iG's competitive position is restricted by relatively low profitability (on both a local and global scale). Entry barriers for hardware and software sales are lower than for complex IT services such as system integration or application development, translating into stiffer competition and slimmer margins. This is also evidenced by the EBITDA margins of selective peers.

…is partly offset by revised business strategy and reorganisation

We acknowledge the positive impact of 4iG's revised business strategy and reorganisation following the recent change in ownership. The company has focused on large projects, streamlined sales organisation and made selective acquisitions. As a result, 4iG's H1 2019 revenue exceeded that of FY 2018 with the reported EBITDA margin growing from 6% to 7%.

[1] https://www.scoperatings.com/#search/research/detail/159804EN

Financial risk profile

Key planning assumptions

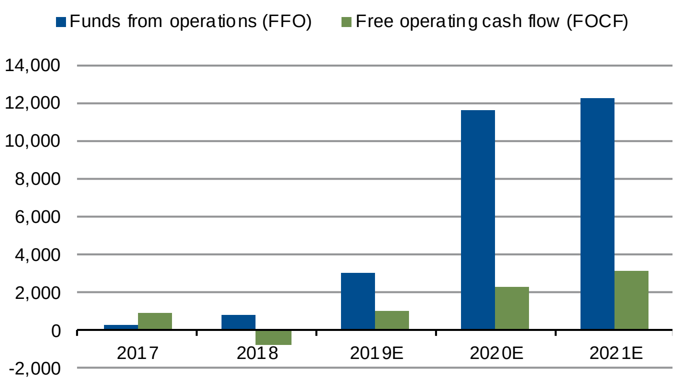
Our financial projections are mainly based on the following assumptions:

- Closing of the TSM acquisition by the end of 2019 and consolidation of TSM activities starting in 2020
- TSM acquisition to be mainly financed by the Hungarian National Bank (MNB) bond of HUF 30bn and a significant equity contribution from the main shareholder, depending on the final purchase price and further liquidity needs
- Very strong revenue growth of the 4iG standalone entity, at more than 2x in 2019, slowing down in 2020/21; moderate growth at TSM
- Scope-adjusted EBITDA margin for combined entities at the average level for the past four years
- Capex growth linked to that of revenues considering relatively asset-light business model of 4iG standalone
- No further material M&A over the next couple of years
- No dividends over the next couple of years

Scope adjustments

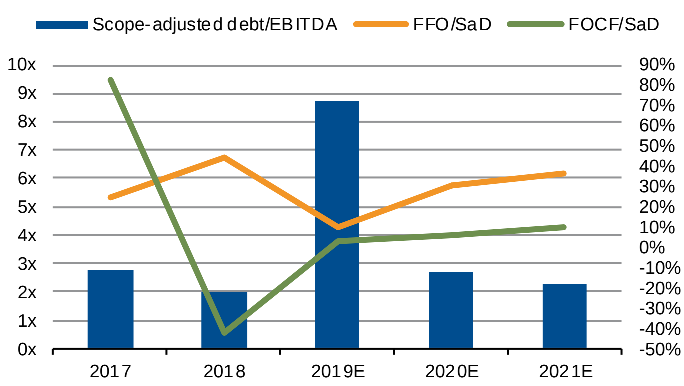
Unless otherwise stated, our calculations are based on reported IFRS numbers for 4iG. TSM financial statements are prepared under Hungarian accounting standards and we applied selective IFRS adjustments based on estimates disclosed by MT. The SaD calculation includes estimated lease obligations.

Figure 6: Cash flow generation (HUF m)



Source: 4iG, Scope

Figure 7: Leverage and cash flow cover



Source: 4iG, Scope

4iG's financial risk profile is supported by the robust interest cover ratio but restricted by weak cash flow cover.

Relatively strong credit metrics also when considering sizeable TSM acquisition

We expect 4iG to have relatively strong credit metrics, with leverage, as measured by SaD/EBITDA, of below 3x going forward. Pressure from acquisition-related bond financing is partly offset by the equity injections from the main shareholder and expected EBITDA growth. The latter is mainly driven by the revised business strategy and the reorganisation mentioned above. Further improvement is limited by conservative growth and margin assumptions.

High capex requirements at TSM burden cash flow cover

FOCF/SaD is expected to remain below 15% in the next two years, mainly driven by relatively high capex requirements at TSM. In addition, FOCF is negatively affected by expected cash outflows for working capital as a result of the growing scale of operations.

Robust interest cover

The company has a comfortable interest cover ratio of above 7x, which is mainly supported by the ongoing low interest rate environment.

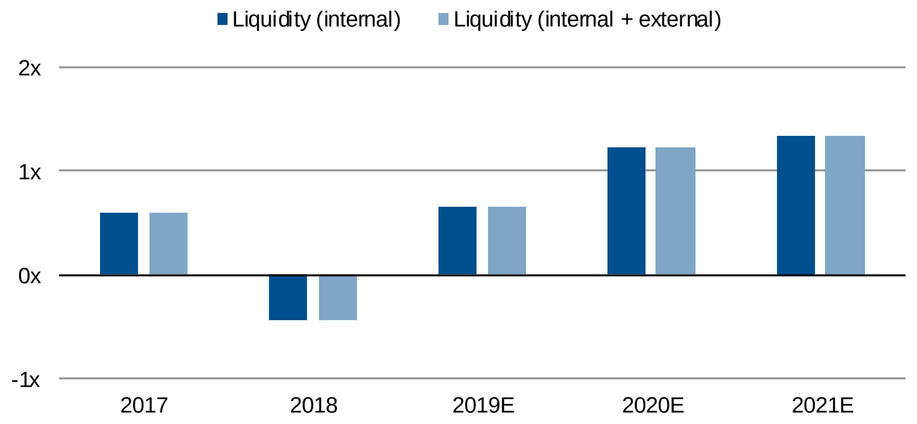
Backloaded maturity profile

4iG's debt maturity is backloaded. Financial liabilities mainly include the MNB bond, bank loans and lease liabilities recognised from 2019.

Adequate liquidity going forward

The company's liquidity is highly dependent on working capital movements. Based on our assumptions, we deem liquidity to be adequate going forward. Nevertheless, it could become an issue, e.g. in the event of very strong working capital swings as a result of delayed payment by customers. For 2020-21, we expect short-term financial debt to be covered more than 1x by a combination of available cash and cash equivalents of about HUF 3.5bn as of H1 2019 and positive expected free operating cash flows. Our calculation excludes bank credit lines because they are uncommitted.

Figure 8: Liquidity



Source: 4iG, Scope

Supplementary rating drivers

Neutral financial policy

We assess 4iG's financial policy as neutral with respect to its issuer rating. Although the acquisition of TSM is sizeable, it will be funded with a combination of debt and equity. Additionally, 4iG's management has stated that there are no plans to distribute any dividends in the short or medium term and no plans for further sizeable acquisitions until TSM has been integrated into the company.

We also understand that the management does not plan any major share buybacks in the near future. According to 4iG, potential share buybacks are primarily focused on improving investor confidence in the company. The shares will only be acquired in very opportunistic cases, in very small amounts and will not be held for the long term.

No impact from shareholder structure

As of 10 September 2019, Mr Gellért Jászai has indirectly controlled around 40% of 4iG's shares through KZF Vagyonkezelő Kft. and MANHATTAN Magántőkealap. As a result of the planned equity contribution, his share is expected to exceed 50%, leading to de-jure control over the company. Mr Jászai also serves as chairman of the board of directors and CEO of the company. Nevertheless, as 4iG is a public company, our assessment of its shareholder structure indicates no impact (either negative or positive) on the issuer rating.

Outlook

Stable Outlook

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Senior unsecured debt

Average recovery expectations for senior unsecured debt

Our recovery analysis indicates an 'average recovery' for senior unsecured debt such as the prospective bond under the MNB Bond Funding for Growth Scheme (HUF 30bn, 2019/2029). This expectation translates into a BB- rating for this debt category. The recovery is based on an expected distressed enterprise value as a going concern in a hypothetical default scenario of around HUF 40bn in 2021, and the application of a 10% haircut on that value for administrative claims.

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