Abroncs Kereskedőház Kft.
Hungary, Retail

STABLE

BB-

Key metrics

			Scope estimates	
Scope credit ratios	2021	2022	2023E	2024E
Scope-adjusted EBITDA interest cover	8.1x	10.2x	8.2x	8.0x
Scope-adjusted debt/EBITDA	3.7x	2.1x	3.6x	2.9x
Scope-adjusted funds from operations/debt	23%	42%	24%	29%
Scope-adjusted free operating cash flow/debt	15%	6%	-15%	14%

Rating rationale

The rating downgrade reflects our view that the unfavourable market trend, leading to weaker than expected profitability in 2023, combined with increased external financing, will keep credit metrics under pressure in the medium term.

The business risk profile benefits from strong positioning in the domestic market as one of two market leaders, thanks to solid brand recognition and long-term relationships with international manufacturers. The cyclical nature of the products AKH offers limits the business risk profile, but service integration and an extensive offering partially compensate for this limitation. In addition to standard tire replacement, the offering includes minor repairs and maintenance plus a presence in the lubricants sector. The business risk profile is constrained by the weak geographical outreach, with most covered countries subject to similar economic trends; nonetheless we note an improvement following the acquisition of ARS in Slovakia, which accounted for 19% of AKH's total sales at year-end 2022 (vs 5% in 2021). The business risk profile is also constrained by the issuer’s small size and low profitability.

The comparatively strong financial risk profile remains the major rating driver. However, we hint at the high volatility of the net working capital with peaks twice during the year, which could put further pressure on the leverage.

Outlook and rating-change drivers

The Outlook for AKH is Stable. It reflects our expectations that following the credit metrics deterioration in 2023, these will remain stable as no significant debt issuance is expected and profitability should gradually increase.

A negative rating action could occur if the Scope-adjusted debt/EBITDA ratio increased above 4x on a sustained basis. This could be driven by a continuation of the negative market trend combined with continued high inflation, resulting in profitability not recovering as expected.

A positive rating action could be triggered by the Scope-adjusted debt/EBITDA to return to around 2.5x on a sustained basis.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
20 Oct 2023	Downgrade	BB-/Stable
18 Oct 2022	Affirmation	BB/Stable
25 Nov 2021	Affirmation	BB/Stable

Ratings & Outlook

Issuer	BB-/Stable
Senior unsecured debt	BB-

Analyst

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Related Methodologies and Related Research

Corporate Rating Methodology; October 2023

Retail and Wholesale Rating Methodology; April 2023

European retailers: persistent inflation, low consumer confidence threaten demand, squeeze margins; June 2023

Retailing bankruptcy risk grows in Europe: business failures to rise after slowdown in 2021-2022; April 2023

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Bloomberg: RESP SCOP

Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Strong credit metrics • Leading position in the Hungarian market • Good supplier diversification with a good share of exclusive products • Adequate liquidity	• Below-average profitability • Limited size, capped by the Hungarian market • Seasonality of operations

Positive rating-change drivers	Negative rating-change drivers
• Scope adjusted debt/EBITDA returning at around 2.5x on a sustained basis.	• Scope adjusted debt/EBITDA ratio rising above 4x

Corporate profile

Abroncs Kereskedőház Group (AKH) is one of the leading wholesale tyre retailers in Hungary, distributing products from more than 30 well-known tyre manufacturers. It operates in central Europe, including Hungary, Czechia, Romania, Croatia, Slovenia and Slovakia. In addition to tyres, AKH offers lubricants as well as car and tyre services. With around 300 employees, it generated net sales of HUF 44bn and EBITDA of HUF 1.8bn in 2022.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA interest cover	10.1x	8.1x	10.2x	8.2x	8.0x	8.8x
Scope-adjusted debt/EBITDA	1.4x	3.7x	2.1x	3.6x	2.9x	2.5x
Scope-adjusted funds from operations/debt	64%	23%	42%	24%	29%	35%
Scope-adjusted free operating cash flow/debt	46%	15%	6%	-15%	14%	9%
Scope-adjusted EBITDA in HUF m						
EBITDA	1,103	1,284	1,821	1,186	1,455	1,591
Operating lease payments	156	251	649	610	640	672
Scope-adjusted EBITDA	1,259	1,535	2,470	1,796	2,095	2,263
Funds from operations in HUF m						
Scope-adjusted EBITDA	1,259	1,535	2,470	1,796	2,095	2,263
less: (net) cash interest paid	-85	-103	-102	-76	-122	-110
less: cash tax paid per cash flow statement	-27	-34	-101	-59	-67	-81
less: interest component operating leases	-40	-87	-141	-142	-141	-148
Change in provisions	-	3	77	0	-	-
Funds from operations (FFO)	**1,107**	**1,314**	**2,203**	**1,519**	**1,765**	**1,924**
Free operating cash flow in HUF m						
Funds from operations	**1,107**	**1,314**	**2,203**	**1,519**	**1,765**	**1,924**
Change in working capital	275	382	-843	-408	165	-212
Non-operating cash flow	1	2	11	-	-	-
less: capital expenditure (net)	-469	-651	-544	-1,601	-600	-700
less: lease amortisation	-116	-164	-508	-468	-499	-524
Free operating cash flow (FOCF)	**798**	**883**	**319**	**-958**	**831**	**488**
Net cash interest paid in HUF m						
Net cash interest per cash flow statement	85	103	102	76	122	110
add: interest component, operating leases	40	87	141	142	141	148
Net cash interest paid	**125**	**190**	**243**	**218**	**263**	**258**
Scope-adjusted debt in HUF m						
Reported gross financial debt	3,500	3,826	3,131	4,527	4,327	3,872
less: cash and cash equivalents	-1,047	-1,235	-1,158	-1,244	-1,388	-1,353
add: operating lease obligations	777	2,714	2,923	2,744	2,881	3,027
add: bank guarantee	0	405	405	405	284	-
VAT repayment and fair value hedges	-1,500	-	-	-	-	-
Scope-adjusted debt (SaD)	**1,730**	**5,710**	**5,301**	**6,432**	**6,104**	**5,546**

Table of contents

Environmental, social and governance (ESG) profile[1]

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

AKH does not have a dedicated ESG strategy.

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 that 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, AKH is currently expanding into the all-season tyre segment. Lastly, the environmental footprint of any 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. AKH has implemented some energy savings measures over the years (LED lighting, electric forklifts, warm protection door systems), and it organises or takes part in multiple charity events each year.

[1] 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+

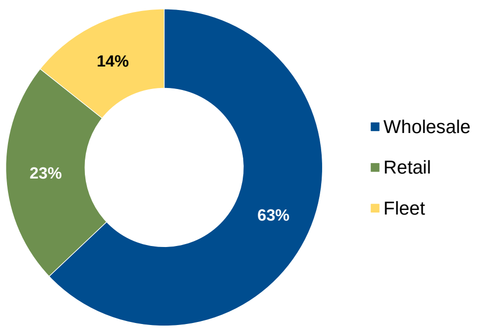
Industry risk profile: BB

AKH's business belongs to the car parts and automotive industry. We classify this industry as discretionary retail, with medium cyclicality, low entry barriers and low substitution risk. The industry risk profile is BB.

Strong market share in the domestic market

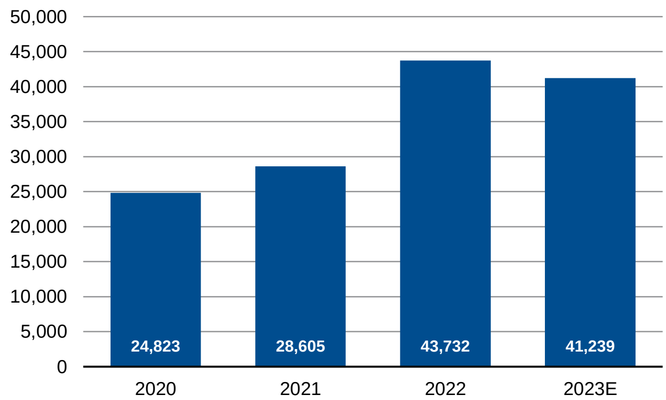
With revenue of HUF 44bn in 2022 (a sharp increase compared to 28.6bn in 2021), AKH is one of the two largest tyre retailers in Hungary and the presence in the lubricants sector further strengthens the issuer's positioning in the domestic market. Nonetheless, the issuer remains a small player when comparing its volume to international retailers, and its growth opportunities are limited by strong competition and limited pricing power.

Figure 1: AKH's revenue split by segment (2022)



Sources: AKH

Figure 2: Revenue evolution over the years (HUF m)



Sources: AKH, Scope estimates

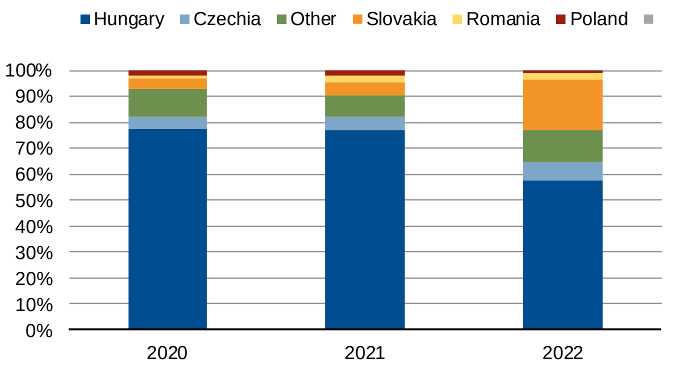
Improved but still limited geographical outreach

We acknowledge that AKH has reduced its dependence on Hungary. 2022 sales confirm that its expansion strategy abroad is evolving in the right direction. Management's expectation following the acquisition of ARS was that it would reach 19% of sales from Slovakia, and it achieved this in 2022 (compared to 5% in 2021). Nonetheless, most of the markets AKH covers follow similar macroeconomic paths and are immediate neighbours.

Weak product diversification …

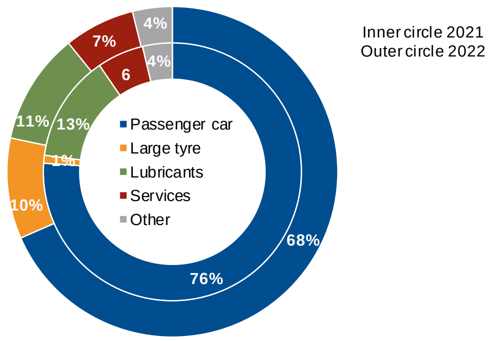
With sales related to only one segment (the automotive industry) and covering only tyres, lubricants and related services, AKH is highly exposed to the cyclicality of its industry. This was clearly demonstrated by the decline in profits during the first half of 2023. Nonetheless, we see service integration as a positive. AKH offers a wide range of services beyond tyre replacement and storage, including minor repairs and maintenance. It also has a solid presence in the lubricants sector. All these factors are less sensitive to an economic downturn.

Figure 3: Geographical diversification (% revenue)



Sources: AKH

Figure 4: Product diversification



Sources: AKH

… but granular suppliers and customer base

AKH has a well-balanced mix of exclusive, semi-exclusive and non-exclusive tyre brands and a history of more than 10 years of collaboration with its main tyre suppliers. In addition, none of the largest suppliers have a particularly high portion of material cost. We deem this credit-positive as it limits dependency risk. Likewise, the customer portfolio is well diversified when corporate customers are included, with the top five customers representing 12.5% of total revenue in 2022.

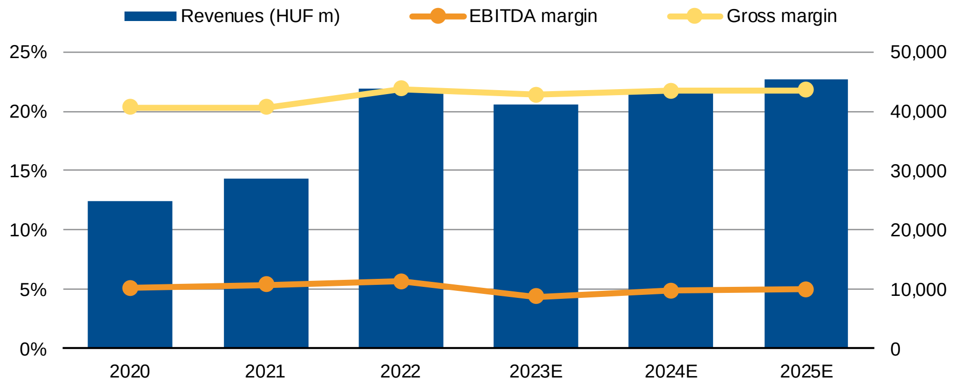
Distribution moving towards omnichannel

We recognise the issuer'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 sales structure inside and outside Hungary.

Below-average profitability

Profitability as measured by the Scope-adjusted EBITDA margin has been volatile over the years. It was at its lowest in 2019 because of: i) a warmer-than-anticipated winter in 2018, leading to higher 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. Its profitability recovered in 2020 and 2021, and the margin rose to 5.6% in 2022 thanks to a strong market and the successful integration of ARS. The trend reverted again in H1 2023, driven by weaker demand combined with persistent inflation, pulling the margin down to 4.4%. We expect profitability to remain low at YE 2023, although a recovery can be anticipated from 2024 following improved market trends and the successful execution of the issuer's cost efficiency strategy. The strategy focuses on: i) keeping personnel costs stable; ii) reducing transportation costs; and iii) a more efficient packaging line.

Figure 5: Profitability



Sources: AKH, Scope estimates

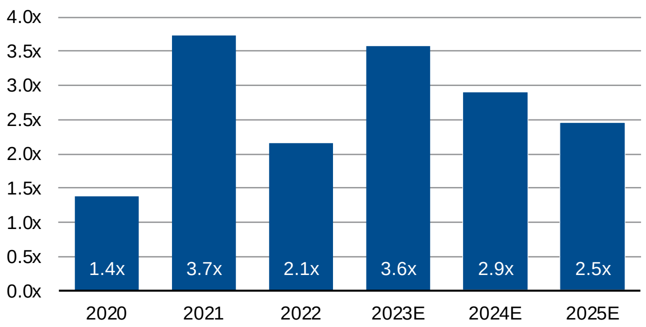
Financial risk profile: BB

The financial risk profile benefited historically from strong credit metrics but has been weakened by the negative profit trend.

Low leverage is exposed to fluctuating EBITDA

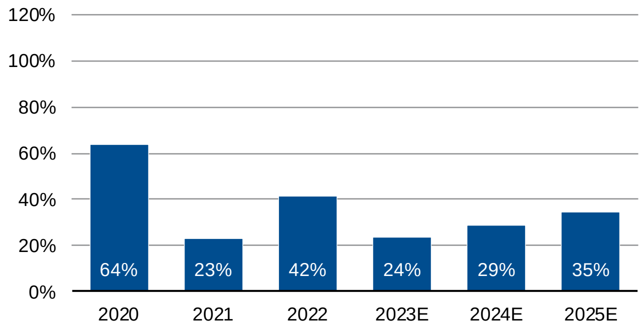
Leverage has been low historically due to a cautious expansion policy and strong liquidity. But the declining EBITDA combined with the debt-financed acquisition of real estate assets and a substantial increase in off-balance sheet debt (operating leases), has put the ratio under pressure. We expect the Scope-adjusted debt/EBITDA to remain above 3.5x in 2023, as profitability will only partially recover and return below 3x going forward because of the improvement in EBITDA. Our assumption is also based on the absence of any significant debt issuance in the medium term. Nonetheless, we highlight the high volatility of leverage, driven by fluctuating EBITDA and the highly seasonal net working capital, which generally peak twice per year.

Figure 6: Scope-adjusted debt/EBITDA



Sources: AKH, Scope estimates

Figure 7: Scope-adjusted FFO/debt



Sources: AKH, Scope estimates

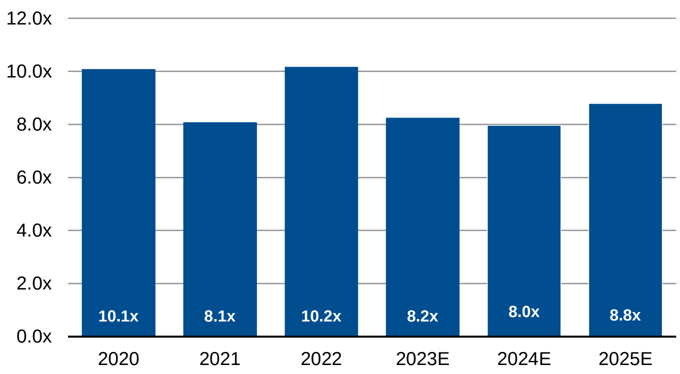
Strong interest cover

The financial risk profile continues to benefit from relatively high interest cover, measured by the Scope-adjusted EBITDA/interest ratio. The newly financed debt and the high interest rate environment led to a deterioration in this ratio and we expect it to range between 8x and 9x for most of the foreseeable future.

Weak cash flow coverage

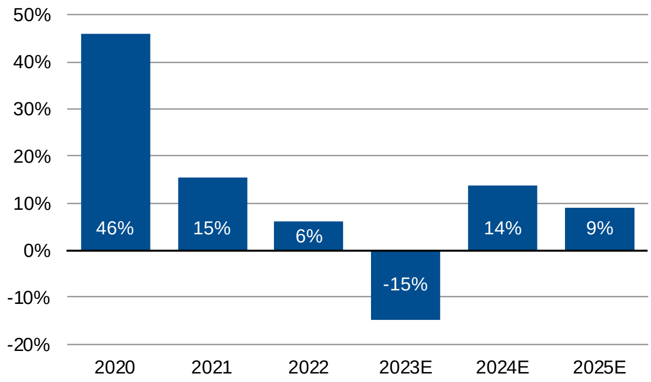
Cash flow cover remains the weakest element in the financial risk profile. The acquisition of ARS and above-average capex during 2021-23 gradually reduced free cash flow generation, which is expected to turn negative in 2023. We expect the Scope-adjusted FOCF/debt ratio to normalise to around 10% from 2024 in view of EBITDA growth and capex returning to near maintenance levels. We note that cash flow is highly volatile throughout the year and can often turn negative during the stocking seasons of Q1 and Q3.

Figure 8: Scope-adjusted EBITDA interest cover



Sources: AKH, Scope estimates

Figure 9: Scope-adjusted FOCF/debt



Sources: AKH, Scope estimates

Strong liquidity

Liquidity is adequate and largely covers short-term debt, even during periods of high working capital consumption.

Balance in HUF m	2022	2023E	2024E
Unrestricted cash (t-1)	4,117	3,859	4,147
Open committed credit lines (t-1)	1,518	1,500	1,500
Free operating cash flow	319	-957	831
Short-term debt (t-1)	719	213	1,018
Coverage	**>200%**	**>200%**	**>200%**

Long-term debt rating

Senior unsecured debt rating: BB-

We have assigned a BB- rating to AKH's senior unsecured debt. Our assessment is based on the issuer's liquidation value following a hypothetical default in 2025, reflecting an above-average recovery. However, given high sensitivity to advance rates, we refrain from up notching the debt rating.

AKH issued a HUF 3.5bn senior unsecured bond (ISIN: HU0000360177) in December 2020 through the Hungarian central bank's Bond Funding for Growth Scheme. The bond proceeds were used for refinancing purposes. The bond has a tenor of 7 years and a fixed coupon of 2.8%. Bond repayment is in four tranches starting from 2021, with 5.7% of the face value payable yearly in 2021, 2022 and 2023, 10% of the face value payable in 2024, 10.7% of the face value payable in 2025, 12% of the face value payable in 2026, and a 50% balloon payment at maturity. Scope notes that AKH's senior unsecured bond issued under the Hungarian central bank's bond scheme has an accelerated repayment clause. The clause requires AKH to repay the nominal amount (HUF 3.5bn) in case of a rating deterioration (two-year cure period for a B/B- rating; repayment within 90 days after the bond rating falls below B-, which could have default implications). Other bond covenants in addition to the rating deterioration covenant include non-payment, insolvency proceedings, cross-default, pari passu, negative pledge, change in control and net debt/EBITDA covenants.

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