21 December 2021 Corporates

Sun Group Kft.
Hungary, Business Services

SCOPE | STABLE B+

Corporate profile

Sun Group Kft. is a small real estate company managing HUF 5bn in assets consisting mostly of offices and some warehouses. The company is owned by three private individuals: Sándor Zakor, Gyula Kücsön and Róbert Kiss.

Sun Group plans to acquire a majority stake in Prohumán 2004 Kft. Prohumán is Hungary's market leader in HR services and has a strong presence in Central and Eastern Europe (CEE) and the German-speaking (DACH) countries. It is currently owned by Profólió Kft. (19.78%) and GI Group Poland S.A. (80.22%). The sale and purchase agreement was signed on 16 December 2021. Prohumán's consolidation would result in HR services overtaking real estate as Sun Group's core activity.

Key metrics

	Sun Group Kft.		Sun Group Kft and Prohumán 2004 Kft (consolidated)		
			Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	7.0x	78.4x	67.7x	5.1x	5.5x
Scope-adjusted debt (SaD)/EBITDA	4.7x	2.8x	3.6x	3.3x	2.9x
Scope-adjusted funds from operations/SaD	20%	34%	20%	16%	18%
Free operating cash flow/SaD	12%	17%	17%	13%	15%

Rating rationale

Scope Ratings GmbH (Scope) has today assigned an issuer rating of B+/Stable on Hungarian real estate company Sun Group Kft. Senior unsecured long-term debt has also been rated at B+. Scope's rating case assumes that the Prohumán acquisition will be finalised by the end of 2021 to Q1 2022 at the latest, with Sun Group consolidating Prohumán.

Sun Group's issuer rating reflects our expectation that the post-transaction group will hold a leading position in Hungary's HR services market, bolstered by a strong regional presence.

Sun Group plans to issue a HUF 14.0bn senior unsecured bond under the Bond Funding for Growth Scheme of the Hungarian National Bank (MNB) and accept a 10% oversubscription to finance the purchase price for Prohumán and to provide an intercompany loan to Prohumán. The oversubscription entails some underwriting risk in comparison with raising the initial bond issuance amount.

The sale and purchase agreement was signed recently, and the closing process poses limited execution risk.

Ratings & Outlook

Corporate rating	B+/Stable
Senior unsecured rating	B+

Analyst

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Related Methodology

Corporate Rating Methodology, July 2021

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Bloomberg: RESP SCOP

The bond is expected to have a 10-year tenor, annual fixed coupon of up to 5.5% p.a., and amortisation from year five in equal annual instalments, leaving a 50% balloon at maturity.

The standalone rating of the significantly larger Sun Group is mainly driven by the historically low leverage on its real estate portfolio and its acquisition of Prohumán, which has high profitability, low maintenance capex requirements and well-established operations in Hungary and neighbouring countries. The rating is constrained by the limited scale of Sun Group's operations as well as its geographical and revenue diversification, which we weighted higher in our business risk profile assessment.

The issuer rating, together with supplementary rating drivers, is constrained by Sun Group's intention to finance the Prohumán acquisition purely with debt, while maintaining continuous shareholder remuneration. The credit rating could also deteriorate if there is no significant improvement in the transparency and consistency of information provided by the group.

Outlook and rating change drivers

Stable Outlook

The Outlook is Stable and assumes: i) the successful placement of the bond by the end of Q1 2022; ii) the successful closing of the Prohumán acquisition around the end of 2021 or Q1 2022; and iii) a Scope-adjusted debt (SaD)/EBITDA ratio of around 3.5x for the post-transaction entity.

A negative rating action could be triggered by the cancellation of the Prohumán deal or significant delays in its execution. It could also follow a deterioration in credit metrics, e.g. if SaD/EBITDA increased and stayed above 4x, or liquidity weakened due to very strong working capital swings. Credit metrics could deteriorate as a consequence of another large debt-funded acquisition in the coming two to three years.

A positive rating action is remote but could be warranted if diversification in the HR business improves by services or geographies, including achieving leading or top three market shares in further countries of operation, while SaD/EBITDA stays below 3x on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• High occupancy of real estate portfolio provides visible recurring cash flow (three-year weighted average unexpired lease term) • Acquisition of Hungary's leading HR services provider leading to revenue diversification and increased scale • Strong regional presence (top three market positions) of Prohumán • Prohumán has over 700 customers and diversified revenues as a one-stop shop for HR services	• Small real estate portfolio, concentrated on one flagship tenant renting 8,000 sq m out of 11,000 sq m of leasable office space • Acquisition of Prohumán funded by debt and future cash flow, leading to significant increase in leverage • Disruption of certain services due to pandemic-related travel restrictions, resulting in lower HR services-related revenues for DACH placements • Rather weak transparency • Shareholder-friendly financial policy

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Attainment of top three or market leading position in more countries and further diversification of HR services by share of revenue, resulting in SaD/EBITDA not exceeding 3.0x	• Cancellation of Prohumán acquisition or significant delay in its execution • SaD/EBITDA exceeding 4.0x on a sustained basis • Weakened liquidity • Covenant breach

Financial overview

	Sun Group Kft.		Scope estimates: Sun Group and Prohumán (consolidated)		
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	7.0x	78.4x	67.7x	5.1x	5.5x
SaD/EBITDA	4.7x	2.8x	3.6x	3.3x	2.9x
Scope-adjusted funds from operations/SaD	20%	34%	20%	16%	18%
Free operating cash flow/SaD	12%	17%	17%	13%	15%
Scope-adjusted EBITDA in HUF '000s	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	356,038	403,667	4,404,794	4,743,578	5,067,545
Operating lease payments in respective year			- 236,486	- 243,295	- 247,783
Scope-adjusted EBITDA	356,038	403,667	4,168,308	4,500,283	4,819,762
Scope-adjusted funds from operations in HUF '000s	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	356,038	403,667	4,168,308	4,500,283	4,819,762
less: (net) cash interest as per cash flow statement	- 15,669	1,979	63,470	- 883,381	- 875,482
less: cash tax paid as per cash flow statement	- 5,837	- 19,352	- 1,164,660	- 1,288,350	- 1,417,998
Scope-adjusted funds from operations	334,532	386,294	3,067,117	2,328,552	2,526,281
Scope-adjusted debt in HUF '000s	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	1,781,750	1,305,882	18,210,756	17,649,195	16,937,690
less: cash and cash equivalents	118,190	167,228	4,358,876	6,266,657	6,531,183
add: restricted cash[1]			1,358,876	3,266,657	3,531,183
Scope-adjusted debt	1,663,560	1,138,654	15,210,756	14,649,195	13,937,690

[1] We deem excess cash exceeding HUF 3bn not permanent or accessible as the market is consolidating through M&A and there may be further shareholder remuneration.

Business risk profile: B+

Dominant exposure to business services industry, rated BBB

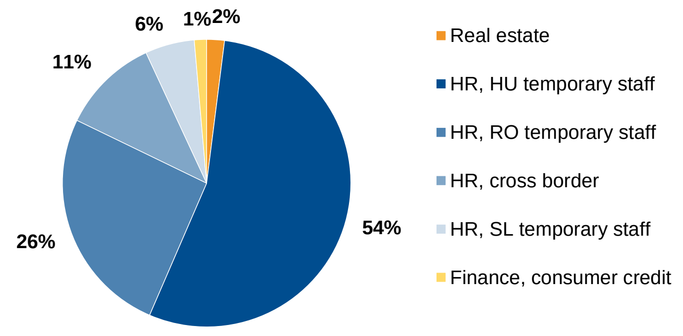
The business risk profile reflects our assessment of the industry in which a company operates and its competitive position within that industry.

We have analysed Sun Group under business services. Our rating case assumes that the Prohumán deal will be successful, which would result in HR services overtaking real estate as Sun Group's primary industry. Real estate would account for less than 2% of total revenues and less than 10% of EBITDA.

We assess the overall business services industry as having medium cyclicality, entry barriers and substitution risk.

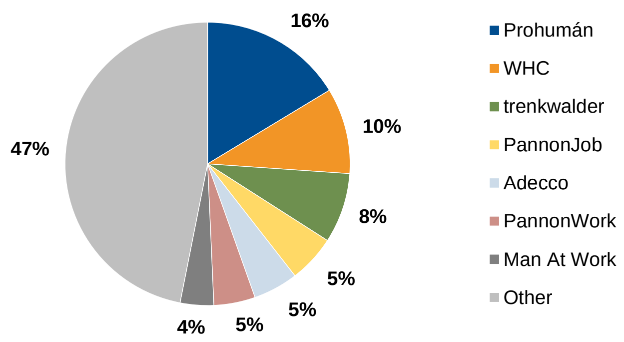
In Hungary, a low unemployment rate (4.5% in February 2021, 3.8% in February 2020) and growing staff shortages in many sectors are increasing demand for employment agency services. Fulfilling labour needs is a growing challenge which, given the country's ageing society, is not expected to be resolved without intervention.

Figure 1: Sales breakdown by business line in 2020



Source: Sun Group, Scope estimates

Figure 2: Market share of Prohumán in Hungary (2019)



Source: Sun Group

Small, stable real estate portfolio

Sun Group's real estate assets are mainly in Budapest. Assets are highly concentrated on one real estate group, with an office building and a warehouse worth HUF 4bn out of Sun Group's HUF 5bn in total assets. The total leasable area is around 12,000 sq m for the office and 7,000 sq m for the warehouse. More than 90% of office space and a third of warehouse space are leased. We do not expect any major changes to the portfolio.

Market-leading HR services in Hungary with regional presence

Prohumán is Hungary's leading HR services provider, with 16% of the market as of 2019, more than 700 clients and 16 offices countrywide. It is also present in the CEE markets of Romania (7% market share) and Slovenia (5%). The fragmented Hungarian HR market may see small companies ceasing operations and we expect market consolidation.

Prohumán offers a comprehensive range of HR services, allowing clients to cover all their HR needs and gain access to the full labour market (adults, students and pensioners) via one partner.

Low-profitability flagship service coupled with high-margin add-ons

Temporary staffing is the company's flagship service, which typically comes with low margins (manual workers) and a high administrative burden. Most of its clients work with two to five HR firms, which are sometimes selected by tender, and they do not switch service providers readily. Therefore, Prohumán can achieve moderate profitability by cross-selling higher-margin services such as outsourcing, recruitment and HR administration.

Large drop in manual workers in 2020 due to Covid restrictions, recovered by early 2021

The first wave of the pandemic resulted in a 15% drop in Prohumán's headcount in March-June 2020, mainly among Hungarian temporary manual workers. Even with Covid-19 measures restricting travel and staff placements to DACH countries, Prohumán significantly increased its overall leased headcount to around 12,000 by the end of 2020. The share in revenues of the top 10 HR clients increased to 44.7% in Q3 2020, from 39.5% in 2019. This was because smaller clients cut back fully on their leased headcount as a result of Covid-19 impacts.

Stable Hungarian EBITDA, growth driven by Romanian operations

Prohumán's Hungarian revenues decreased by 7.5% in 2020, with its EBITDA comparable to 2019 and 2018 levels of HUF 1.7bn. Growth is mainly due to the increased need for office workers in Romania, which led to revenue and EBITDA growth of 70% YoY. Romanian operations were acquired in 2017 with revenues of HUF 7bn and a margin of close to zero. In 2020, revenues grew to over HUF 15bn with an EBITDA contribution of HUF 0.6bn.

Prohumán is mainly managed by its founders and financed on holding level

Some of Prohumán's founders have been managing the company since its inception in 2004. After the acquisition, the Hungarian management will not change significantly. The management team is fairly small, which supports our view that this arrangement will entail some key person risk.

The financing of the acquisition is structured at holding level, which leaves the bondholder one level above the source of repayment. This risk is mitigated by the subsidiary guaranteeing the bond issuance.

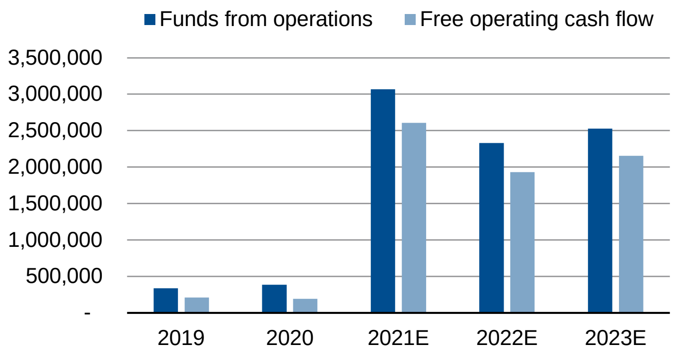
Financial risk profile: BB+

Key planning assumptions

Our financial projections are mainly based on the following conservative assumptions:

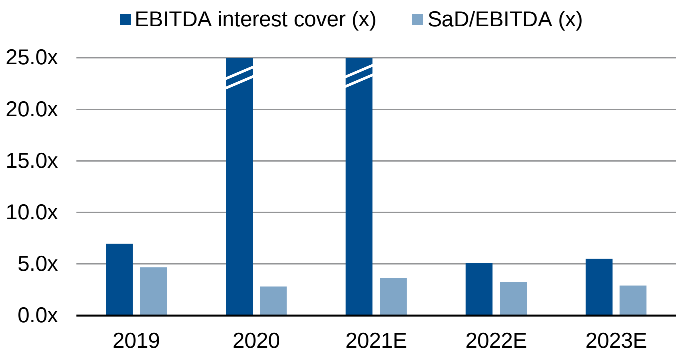
- Successful placement around the end of 2021/Q1 2022 of the HUF 14bn bond + 10% oversubscription under the MNB Bond Funding for Growth Scheme, with proceeds earmarked for the acquisition of 80.22% of Prohumán from GI Group Poland and an intercompany loan provided by Sun Group to Prohumán.
- Purchase price of Prohumán fully covered by the bond and no fresh equity
- 7%-8% in yearly revenue growth mainly driven by further client acquisitions in Hungary as the HR market consolidates, further expansion of services in Romania, and wage growth for personnel
- Scope-adjusted EBITDA margin 1pp lower than the company's guidance, at around 6.5%
- Stable real estate portfolio, apart from some smaller possible disposals
- No large debt-funded acquisitions planned in the next two to three years
- Total shareholder remuneration (cash out of the structure) up to HUF 2bn until 2024
- Restricted cash balance relates to voted for but unpaid dividends and other cash items we believe may not be available in the long term for working capital

Figure 4: Cash flow generation (HUF '000s)



Source: Sun Group, Scope estimates

Figure 5: Leverage and interest cover



Source: Sun Group, Scope estimates

Low leverage and purchase price will enable reasonable indebtedness after acquisition

Sun Group has kept its leverage low, with a loan/value ratio of around 35% in 2018-20.

Prohumán only has working capital loans (loans with a maximum of two years outstanding until maturity, revolving credit facilities, overdrafts and factoring) and some car leases. Historically (2018-2020), it has operated with a net cash position.

The acquisition price will be fully covered by the envisaged bond and future cash flows, resulting in SaD/EBITDA of around 3.5x. However, we expect gradual deleveraging since business services depend less on working capital and capex. No further significant acquisitions are planned. Shareholder remuneration will slow down deleveraging.

Prohumán has maintained a healthy cash balance, which was above HUF 1.3bn at end-2020. We expect it to reach above HUF 3bn in the near future.

Regarding debt maturities, the new bond will start to amortise from the fifth year, enabling the combined entity to have an EBITDA/interest cover of around 5x in 2022-23. Cash flow cover is around 15%-20%, helped by the low capex needs of HR services.

The HR business is expected to grow by around 10% yearly. It has a working capital requirement, but the cash balance will continue to accumulate.

Adequate liquidity going forward

The combined group's liquidity will depend on working capital movements and the fluctuation of temporary workers. We deem liquidity going forward to be adequate.

Balance ('000s)	2021E ('000s)	2022E ('000s)
Unrestricted cash (t-1)	167,228	3,000,000
Open committed credit lines (t-1)	-	-
Scope-adjusted free operating cash flow	2,608,714	1,930,062
Short-term debt (t-1)	1,213,410	1,615,567
Coverage (internal)	**2.3x**	**3.1x**

Nevertheless, liquidity could still deteriorate, for example, in the event of very sharp working capital swings due to delayed customer payments, which would be mitigated by insurance covering non-factored receivables. For 2021, we expect short-term financial debt to be covered more than 2x by a combination of available cash and cash equivalents of about HUF 0.2bn as of YE 2020E for Sun Group (standalone), HUF 1.1bn in cash added through the consolidation of Prohumán, and positive expected free operating cash flows. Our calculation excludes bank financing facilities – such as the HUF 7.5bn factoring line, of which half is not utilised – because they are short term.

Limited headroom under bond covenants

The company is committed to deleveraging and has accepted a net debt/EBITDA covenant of 3.5x for 2022, 3.0x for 2023 and 2.5x afterwards, which leaves a relatively low buffer above the business plan. A covenant breach would constitute an event of default under the bond prospectus, resulting in the early repayment of the bonds. Any breach could trigger refinancing risk and increased finance cost, not linked to the overall issuer rating.

Supplementary rating drivers: -1 notch

Financial policy: -1 notch

We see Sun Group's financial policy as negative due to looser financial planning, with debt structured on holding level and significant dividends in a period of a large acquisition financed purely with debt.

Planned dividends amount to an additional HUF 2bn voted dividend in the next two to three years (to be paid out by YE 2024). This is rather aggressive at a time when M&A are funded purely with debt and the main repayment source for the bond is the acquired company's cash flow. Future dividend payouts are not linked to performance indicators, but rather to the bond's debt service. 20% of dividends from Prohumán will be voted for and ultimately received by the minority shareholder and the other 80% will be used to service debt on Sun Group level. Further dividends out of Sun Group are subject to keeping net debt/EBITDA below 2x.

Senior unsecured debt

Average recovery expectations for senior unsecured debt

We expect an 'average' recovery for senior unsecured long-term debt including the prospective HUF 14bn bond + 10% oversubscription (2021/2031), which translates into a B+ rating. This is based on the asset-light nature of HR services and the debt's ranking behind the senior secured creditors of Sun Group's real estate. The recovery level is based on an expected distressed enterprise value as a going concern of around HUF 8.8bn in a hypothetical default scenario in 2022 and a 10% haircut on that value for administrative claims.

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