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 and has around 1,000 employees. The company is controlled by Gellért Jászai through indirect stakes of 62%. He also serves as chairman of the board of directors and CEO of the company.

Key metrics

			Scope estimates		
Scope credit ratios	2018	2019	2020E	2021E	2022E
EBITDA/interest cover	>20	>20	>20	10.6	12.3
Scope-adjusted debt (SaD)/EBITDA	2.0	Net cash	0.3	2.4	2.3
Funds from operations (FFO)/EBITDA	44%	Net cash	324%	32%	34%
Free operating cash flow (FOCF)/SaD	-42%	Net cash	-28%	16%	18%

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 issuer rating mainly reflects 4iG's solid position in key segments of the Hungarian IT market. Following the ownership change in 2018, the company has grown rapidly both in terms of size and expertise, focusing on public sector contracts. We expect the Hungarian IT market to grow at low single-digit percentage points per year in the medium term, providing sufficient opportunities for the companies in the industry. 4iG's business risk profile further benefits from 4iG's solid product portfolio and sector expertise.

Challenges include fierce competition from national and international players in the fragmented Hungarian IT market as well as a relatively low share of recurring revenues of less than 20% in the past couple of years. Performance volatility may also arise from weak geographical diversification as more than 95% of revenues are generated in Hungary. 4iG is strongly exposed to public sector customers (governmental, educational and healthcare organisations), which account for more than 60% of revenues. While the public sector plays an important role in IT spending in Hungary, we believe that the company is strongly exposed to the spending cycles of local and EU authorities. 4iG's business risk profile is further restricted by the execution risk related to planned acquisitions and relatively low but improving profitability.

4iG's financial risk profile is relatively strong compared to its business risk profile. We expect leverage, as measured by Scope-adjusted debt (SaD)/EBITDA, to increase considerably from below 1x in the recent past but to remain below 3x. This is based on a HUF 15bn bond placement and subsequent business acquisitions in a similar amount. The company has a comfortable interest cover ratio of above 7x, which is mainly supported by the ongoing low interest rate environment. We expect free operating cash flow/SaD to remain below 20% in the next two years, mainly driven by expected cash outflows for working capital as a result of the growing scale of operations.

Ratings & Outlook

Corporate ratings BB-/Stable

Senior unsecured rating BB-

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Related Methodologies

Corporate Rating Methodology (Feb 2020)

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Bloomberg: RESP SCOP

Outlook and rating-change drivers

The Outlook is Stable and reflects: i) the successful placement of a HUF 15bn bond in H1 2021; ii) the execution of the announced M&A strategy; and iii) SaD/EBITDA of below 3x in the next few years.

A positive rating action is remote at this point and would require 4iG to significantly expand in terms of market shares and geographical outreach while maintaining financial metrics in line with our expectations. This could also result from stronger credit metrics with SaD/EBITDA of below 1x on a sustained basis.

A negative rating action could be triggered by a deterioration in credit metrics as indicated by SaD/EBITDA of above 4x on a sustained basis, e.g. due to an inability to generate sufficient new business or if execution risk around targeted acquisitions materialises. A negative rating action could also result from liquidity issues, e.g. caused by very sharp working capital swings.

Rating drivers

Positive rating drivers	Negative rating drivers
• One of the leading players in Hungary's fragmented IT market • Solid product portfolio and sector expertise • Relatively strong credit metrics	• Fierce competition from national 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 • Execution and integration risk related to acquisitions

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significant expansion in terms of market shares and geographical outreach • SaD/EBITDA of below 1x on a sustained basis	• Deterioration in credit metrics, e.g. SaD/EBITDA of above 4x on a sustained basis • Liquidity issues

Financial overview[1]

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EBITDA/interest cover	>20	>20	>20	10.6	12.3
SaD/EBITDA	2.0	Net cash	0.3	2.4	2.3
Funds from operations/SaD	44%	Net cash	324%	32%	34%
Free operating cash flow/SaD	-42%	Net cash	-28%	16%	18%
Scope-adjusted EBITDA in HUF bn					
EBITDA	0.8	4.1	4.5	5.9	6.9
Operating lease payments in respective year	0.1	-	-	-	-
Scope-adjusted EBITDA	1.0	4.1	4.5	5.9	6.9
Scope-adjusted funds from operations in HUF bn					
Scope-adjusted EBITDA	0.8	4.1	4.5	5.9	6.9
deduct: (net) cash interest paid	-0.0	-0.0	-0.1	-0.6	-0.6
deduct: cash tax paid	-0.1	-0.4	-0.7	-0.9	-1.0
add: depreciation component, operating leases	0.1	-	-	-	-
Scope-adjusted funds from operations	0.8	3.6	3.7	4.5	5.3
Scope-adjusted debt in HUF bn					
Reported gross financial debt	1.8	2.2	3.7	18.7	18.7
deduct: available cash & cash equivalents	-0.2	-6.2	-3.1	-5.0	-3.5
add: operating lease obligations	0.3	-	-	-	-
add: guarantees	0.1	0.1	0.5	0.5	0.5
Scope-adjusted debt	1.9	-3.9	1.1	14.2	15.7

[1] Financial projections reflect Scope's view and are based on conservative assumptions.

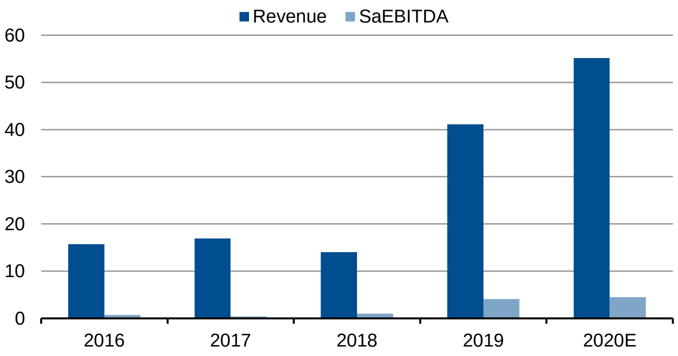
Business risk profile

The business risk profile reflects our assessment of the industry in which a 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 differ across various segments of the industry, we assess them as medium on average.

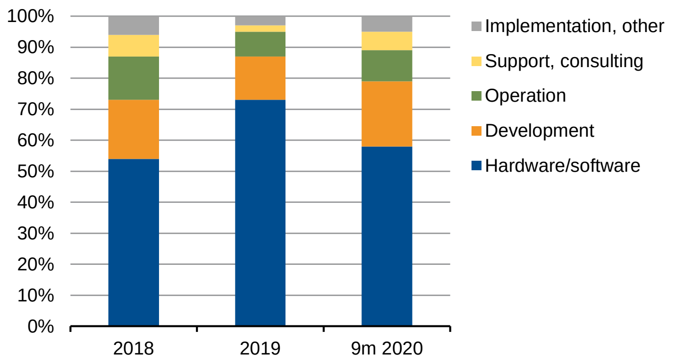
Figure 1: Revenue and EBITDA development (HUF bn)



SaEBITDA = Scope-adjusted EBITDA

Source: 4iG, Scope

Figure 2: Revenue split by product type



Source: 4iG, Scope

Small and fragmented market

The Hungarian IT market (which includes software, hardware and IT services) accounts for less than 0.2% of the global market. The market is highly fragmented, with more than a hundred small niche players and only few companies with critical size and the capability to undertake large and complex projects.

Strong growth following ownership change in 2018

4iG's competitive position is mainly driven by its solid foothold in key segments of the Hungarian IT market. The company has grown rapidly recently, both in terms of size and expertise. Development has been dynamic following the ownership change in 2018, with Gellért Jászai becoming the main shareholder, Chairman of the Board of Directors and subsequently CEO of the company. The new management revised 4iG's business strategy and reshaped its organisational structure. The company has focused on large (primarily public sector) projects, streamlined sales organisation and made selective acquisitions (e.g. Innobyte Informatikai Zrt. or DTSM Kft.). The total number of employees grew from 376 at YE 2018 to around 1,000 at YE 2020.

Impact of Covid-19

After an initial growth slowdown in Q2 2020 triggered by the Covid-19 pandemic, 4iG introduced a number of measures to adapt to the new operating environment and changing clients' needs, which resulted in strong growth rates in H2 2020. We expect the market to grow at low single-digit percentage points per year in the medium term, mainly driven by GDP growth as well as public and private sector modernisation and digitalisation through investments in IT, which has been accelerated by the Covid-19 pandemic. This will provide sufficient growth opportunities for the companies in the IT industry.

Top three market position

As a result, 4iG is now an important player in the Hungarian IT landscape accounting for around 4% of the total IT market in 2019[2]. Following the strong growth in 2020, we expect its market share to exceed 5%. The company's scale of activities and expertise will allow

[2] Based on market assessment by International Data Corporation (IDC).

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.

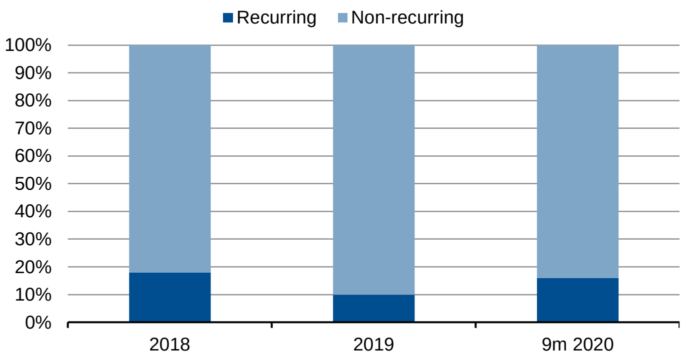
Solid product portfolio and sector expertise

4iG's business risk profile further benefits from its solid product portfolio. In terms of hardware and software sales, it ranges from basic distribution to implementation services such as installation and migration. The company is a certified partner of leading international hardware and software providers and is one of the largest DELL partners in Hungary. In terms of IT services, 4iG develops specialised software products and integrated solutions, e.g. for business intelligence. Further, the company offers remote system operations, support and consulting services including help desk, application, data centre and workstation support, managed security services, compliance, audit and quality assurance. 4iG also has proven expertise in a number of sectors, such as public administration, healthcare, education, transportation, financial institutions, manufacturing, IT and telecommunication.

Fierce competition and low share of recurring revenues

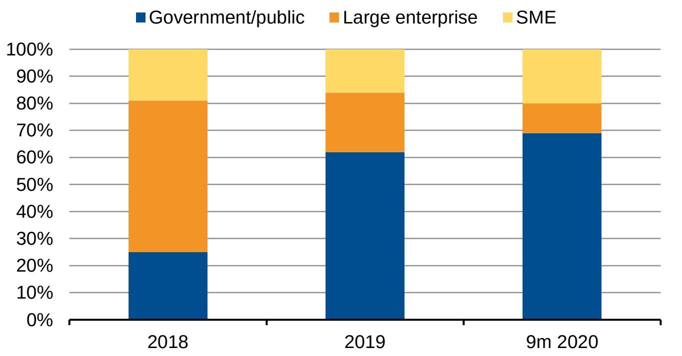
4iG's market position is restricted by stiff competition from local and international players in a fragmented market. It is further negatively affected by a relatively low share of recurring revenues of less than 20% in the past couple of years (16% in 9m 2020). While the company plans to grow significantly, focusing on IT services, the share of recurring revenues is expected to remain low, due primarily to fast growing IT development services, which are usually non-recurring.

Figure 3: Revenue split by nature



Source: 4iG, Scope

Figure 4: Revenue split by customer type



Source: 4iG, Scope

Strong exposure to public sector customers…

4iG generates more than 60% (69% in 9m 2020 up from 62% in 2019) of its revenues from the public sector (governmental, educational and healthcare organisations). The increase is mainly due to the resilience of public sector spending during the Covid-19 pandemic compared to the private sector. In the long term, the company targets a 50/50 split between public and private sector revenues.

…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 the spending cycles of 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. 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 going forward.

Weak geographical diversification

Performance volatility may also arise from weak geographical diversification as more than 95% 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.

Relatively low but improving profitability

4iG's competitive position is further 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. We acknowledge the positive impact of 4iG's growing scale and efficiency as well as its strategy to focus on higher value-added IT services which support profitability. As a result, for 2020 and the next few years 4iG expects an EBITDA margin in the 8%-10% range, compared to 2%-7% in 2016-18.

Execution risk

4iG's business risk profile is restricted by execution and integration risk related to recent and planned acquisitions. This risk is partly mitigated by the relatively small scale of the transactions and management's M&A experience.

Financial risk profile

Key planning assumptions

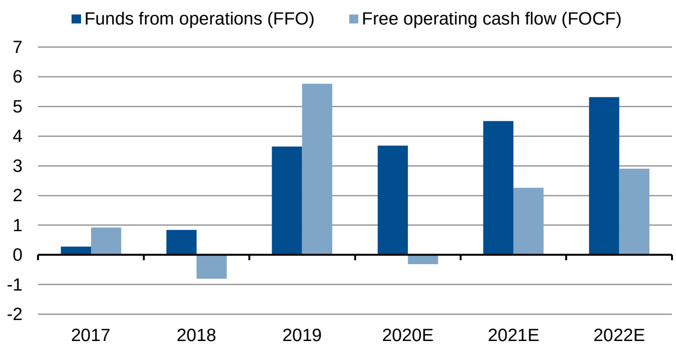
Our financial projections are mainly based on the following conservative assumptions:

- Successful placement in H1 2021 of the HUF 15bn bond under the Hungarian National Bank (MNB) Bond Funding for Growth Scheme with proceeds earmarked for the acquisition of companies primarily in Hungary
- Strong revenue growth mainly driven by recent and planned acquisitions
- Scope-adjusted EBITDA margin at the lower end of company guidance
- Capex growth linked to revenue growth, considering asset-light business model
- Dividends at around 60%-70% of net profits.

Scope adjustments

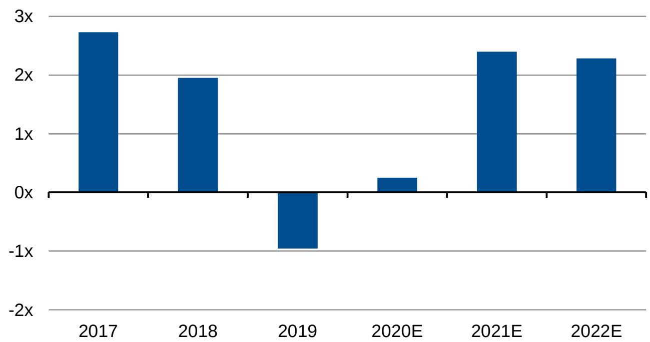
Our calculations are based on reported IFRS numbers. The SaD calculation includes estimated lease obligations before 2019.

Figure 5: Cash flow generation (HUF bn)



Source: 4iG, Scope

Figure 6: SaD/EBITDA leverage



Source: 4iG, Scope

Relatively strong credit metrics

4iG's financial risk profile is relatively strong compared to its business risk profile. It is supported by a robust interest cover ratio but restricted by volatile cash flow cover.

SaD/EBITDA to remain below 3x

We expect leverage, as measured by SaD/EBITDA, to increase considerably from below 1x in the recent past, but to remain below 3x. This is based on the HUF 15bn bond placement and subsequent business acquisitions in a similar amount. Pressure from acquisition-related bond financing is partly offset by expected EBITDA growth. Further improvement is limited by conservative growth and margin assumptions.

Working capital growth weighs on cash flow cover

We expect free operating cash flow/SaD to remain below 20% in the next two years, mainly driven 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.

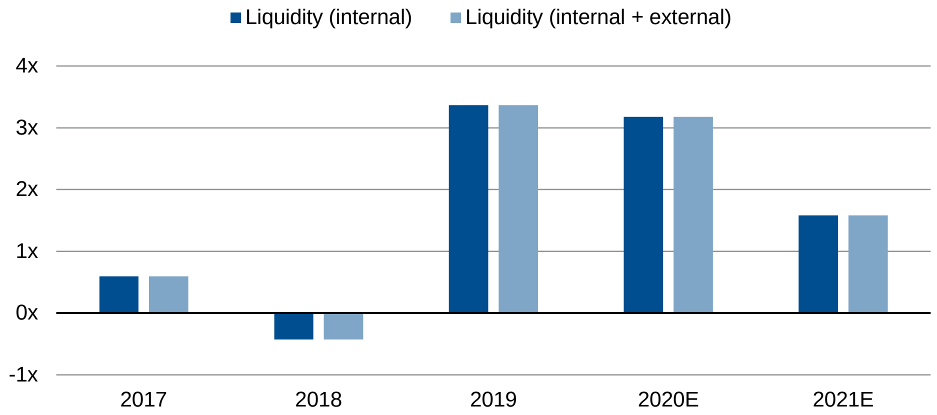
Backend-loaded maturity profile

4iG's debt maturity is backend-loaded. Financial liabilities mainly include the prospective 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. We deem liquidity to be adequate going forward. Nevertheless, it could become an issue, e.g. in the event of very sharp working capital swings as a result of delayed payments from customers. For 2021, we expect short-term financial debt to be covered more than 1x by a combination of available cash and cash equivalents of about HUF 3.1bn as of YE 2020E and positive expected free operating cash flows. Our calculation excludes bank credit lines because they are short term.

Figure 7: Liquidity



Source: 4iG, Scope

Supplementary rating drivers

Neutral financial policy

We assess 4iG's financial policy as neutral with respect to its issuer rating. The company's management has stated that it is aiming for a strong balance sheet with a reported net cash position. 4iG's M&A approach is not overly aggressive, because it is targeting companies with low EV/EBITDA multiples and a short payback period (4-5 years). Acquisitions should also be partly financed via an equity injection (not committed yet and therefore not included in our rating case).

No impact from shareholder structure

As of YE 2020, Mr Gellért Jászai has indirectly controlled around 62% of 4iG's shares through KZF Vagyonkezelő Kft. and MANHATTAN Magántőkealap. Mr Jászai also serves as chairman of the board of directors and CEO of the company. 4iG has stated that the major shareholder is fully committed to the long-term success of the company. Nevertheless, as 4iG is a publicly listed company, our assessment of its shareholder structure indicates no impact (either negative or positive) on the issuer rating.

Senior unsecured debt

Senior unsecured debt at BB-

Our base case financial forecast assumes the successful placement in H1 2021 of a HUF 15bn senior unsecured bond with a fixed annual coupon under the Hungarian National Bank's Bond Funding for Growth Scheme. We expect the bond to have a 10-year tenor, with 10% annual amortisation commencing in 2027 and a 60% bullet maturity in 2031. The proceeds are earmarked for the acquisition of companies.

Our recovery analysis indicates an 'average recovery' for senior unsecured debt such as the prospective bond. 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 in 2023.

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