25 July 2023 Corporates

GVC George's Venture Capital Zrt.
Hungary, Business Services

STABLE

BB-

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	7.6x	9.0x	12.3x	12.7x
Scope-adjusted debt/EBITDA	3.6x	3.5x	3.1x	2.9x
Scope-adjusted funds from operations (FFO)/debt	23%	23%	27%	29%
Scope-adjusted free operating cash flow (FOCF)/debt	-11%	18%	12%	14%

Rating rationale

GVC's issuer rating benefits from its ability to generate consistent revenue through long-term contracts, which allows it to pass on inflationary costs to customers. Additionally, GVC's operational synergies and efficiency contribute to its comparatively high profitability and potential for organic growth. However, there are certain factors that negatively impact the rating. These include limited diversification in terms of revenue and geographical reach, as well as the company's relatively small size. The issuer rating is constrained by significant cash outflows in the form of other receivables and intercompany loans, which do not provide any economic benefits to the company in the medium term.

Leverage is assessed without netting of cash due to a high cash balance that we expect to be partly used in future instead of serving as a liquidity buffer.

Outlook and rating-change drivers

The Stable Outlook incorporates our expectation that Scope-adjusted debt/EBITDA will remain below 4.0x and continue to gradually decrease.

A positive rating action could follow an improvement in the business risk profile, driven by increasing operating profitability or revenue stream diversification with less exposure to public tenders. A positive rating action could also be warranted if leverage fell below 3.0x. To achieve any rating upgrade, GVC would need to resolve financial policy and/or transparency related concerns.

A negative rating action could result from leverage consistently reaching above 4.0x. Weak financial performance could be triggered by an adverse change in regulations and/or macroeconomic conditions, further increasing input costs and putting operating profitability under pressure.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
25 July 2023	Affirmation	BB-/Stable
28 July 2022	Downgrade	BB-/Stable
28 July 2021	Affirmation	BB/Stable
22 September 2020	New	BB/Stable

Ratings & Outlook

Issuer	BB-/Stable
Senior unsecured debt	BB-

Analyst

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Related Methodology and Related Research

General Corporate Rating Methodology, July 2022

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Bloomberg: RESP SCOP

Positive rating drivers	Negative rating drivers
• Leading position in Hungary's outsourced catering market • Customer retention rate above 90% reflecting a strong record of fulfilling tender requirements • Favourable public contract terms reflected in high EBITDA cash conversion	• Weak diversification with operations only in Hungary and only in one industry • Changeable regulatory framework in terms of food safety requirements • Significant debt-like payments and intercompany loans

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted debt/EBITDA below 3x • Improved financial policy and/or transparency	• Scope-adjusted debt/EBITDA above 4x

Corporate profile

GVC has been operating in the Hungarian catering market (corporate, healthcare, social care and schools) for 20 years. The company offers services in major cities throughout the country, including Budapest, Debrecen, Esztergom, Székesfehérvár, Pécs, Siófok, Sárvár and Győr. It serves around 180,000 consumers daily, has over 300 contractual partners, 50 locations nationwide and about 3,000 employees. GVC is a 100% family-owned company.

Financial overview

				Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	13.2x	7.6x	9.0x	12.3x	12.7x
Scope-adjusted debt/EBITDA	4.1x	3.6x	3.5x	3.1x	2.9x
Scope-adjusted FFO/debt	21%	23%	23%	27%	29%
Scope-adjusted FOCF/debt	19%	-11%	18%	12%	14%
Scope-adjusted EBITDA in HUF m					
EBITDA	2,621	2,722	3,404	4,189	4,589
Operating lease payment in respective year	556	833	979	1,032	1,135
Other items	-253		0	0	0
Scope-adjusted EBITDA	**2,924**	**3,555**	**4,384**	**5,221**	**5,726**
FFO in HUF m					
Scope-adjusted EBITDA	2,924	3,555	4,384	5,221	5,726
less: (net) cash interest paid	-222	-469	-488	-425	-450
less: cash tax paid per cash flow statement	-165	-171	-387	-446	-504
Other items	0	0	0	0	0
FFO	**2,537**	**2,915**	**3,509**	**4,350**	**4,771**
FOCF in HUF m					
FFO	2,537	2,915	3,509	4,350	4,771
Working capital management	1,196	-494	-842	38	-624
Non-operating cash flow	-171	-	-	-	-
less: capital expenditure (net)	-193	-4,331	-658	-2,500	-2,500
Amortisation of leases	-361	-611	-729	-757	-834
FOCF	**2,344**	**-1,416**	**2,851**	**1,850**	**2,271**
Net cash interest paid in HUF m					
Net cash interest per cash flow statement	27	247	238	150	149
Interest component operating leases	195	222	250	275	301
Net cash interest paid	**222**	**469**	**488**	**425**	**450**
Scope-adjusted debt in HUF m					
Reported gross financial debt	7,950	7,999	7,422	7,415	7,306
less: cash and cash equivalents	0	0	0	0	0
add: guarantees	67	67	2,838	2,838	2,838
add: provisions	171	0	0	0	0
add: leasing adjustment	4,117	4,761	5,256	5,737	6,311
Scope-adjusted debt	**12,135**	**12,828**	**15,516**	**15,990**	**16,455**

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)

Corporate structure: A significant amount of intercompany loans has been extended to minority-owned agriculture arm of GVC, namely Zalai Group and Villgroup, which possess cross-ownership characteristics that raise questions about the benefits to the company. In the previous rating action, we highlighted that these investments, deviating from the initially provided development plan, could potentially trigger a breach of the company's soft covenants. Currently, we have observed the provision of additional guarantees and sureties to subsidiaries of the aforementioned groups. Although we have not made explicit adjustments to supplementary rating drivers, we have excluded any potential positive impact from agri business such as cash interest income or dividends received going forward due to limited visibility and lack of structure.

Clarity and transparency: Over the past three years, we have noticed a pattern of shareholder loan payments occurring concurrently with dividend payments. It is essential to note that the company has limitations on dividend payments as outlined in the bond covenants. Treating intercompany transactions with the owner as dividend-like payments would indicate a breach of this covenant. Our view is supported by the fact that none of the downpayments made in the past have been fully repaid. Although we have not made explicit adjustments in the supplementary rating drivers, we reflected transparency issues in conservative assessment of financial risk profile.

Management and supervision: The inability to develop allergen-free meals in the acquired food factory due to unstable supply chain effecting on product development, along with the ongoing switching between the development plan, raises concerns about management and increases execution and integration risks. Although we have not made explicit adjustments to supplementary rating drivers, we have taken this into account by applying a haircut to the company's projections and by overweighting the business risk profile in the overall assessment.

[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: BB-

Credit-neutral Industry risk

The underlying business service industry's medium cyclicality, medium barriers to entry and medium substitution risk are credit-neutral for the business risk profile.

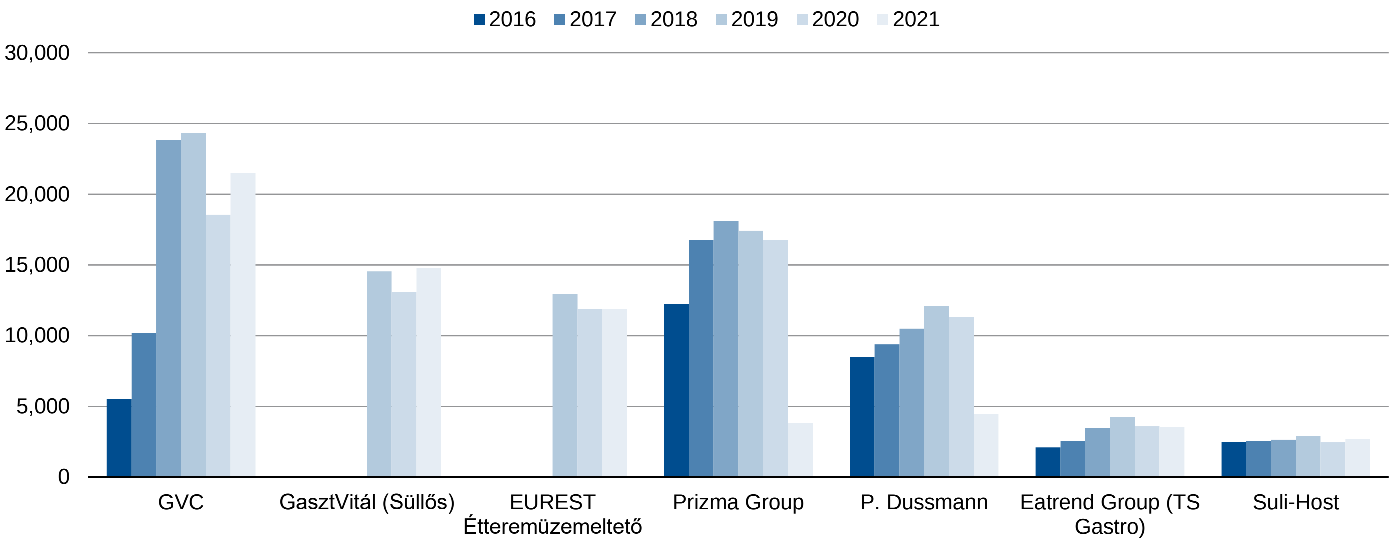
Dominant player in Hungarian outsourced catering market

GVC has maintained a leading position in Hungary's fragmented outsourced catering market. The company had more than a 20% share of the state school catering market and around a 6% share of the corporate catering market by sales in 2022. Its market position remains constrained by a relatively limited addressable market representing under HUF 300bn.

GVC's 2022 performance surpassed our expectations, with significant growth in revenue (up 46% YoY) and EBITDA (up 25%). This can be attributed in part to conservative planning in the previous year, which was a response to weak operating performance in H1 2022. GVC's business model causes delayed effects in an inflationary environment. However, the company demonstrated its ability to successfully pass on the rising costs of raw materials and energy to its customers.

We expect continued growth in revenue for 2023 (up 38% YoY) due to ongoing negotiations on sale prices, aimed at mitigating the impact of rising operational costs such as increased raw material prices and inflation. In H1 2023, the company has provided a comprehensive breakdown of contracts and made necessary price readjustments. Additionally, GVC plans to expand into the hospital catering market, which is expected to generate an additional revenue of HUF 0.8bn in 2023.

Figure 1: Hungarian catering market snapshot (HUF m)



Sources: GVC, Scope

Lack of diversification weakens business risk profile

Geographical diversification remains the weak factor for GVC's business risk profile as the company only operates in one country and one industry. Dependence on public tenders further limits diversification. We do not expect any significant changes in revenue-stream diversification in the medium term.

Sticky market structure could provide additional benefits to GVC in the long term

In addition, inorganic growth opportunities will arise in the medium-to-long term from intermittent, selective consolidation potential in a highly fragmented market. This was the case in the past for the Elamen and Sodexo acquisitions in 2016 and 2017 respectively. The Hungarian state spends a considerable amount of money on public catering, yet food quality continues to deteriorate following its agreements with suppliers. Public institutions cannot withdraw from these contracts for a certain period of time even when suppliers use ingredients of poorer and poorer quality. Our rating case does not incorporate any significant acquisitions in the foreseeable future.

GVC unsuccessfully tried to develop allergen-free food in the acquired food factory (Food Universum), which was mentioned in our last rating action as a potential integration risk of acquired companies. As a result, in December 2022, management terminated the product development and started exploring alternative uses for the food factory.

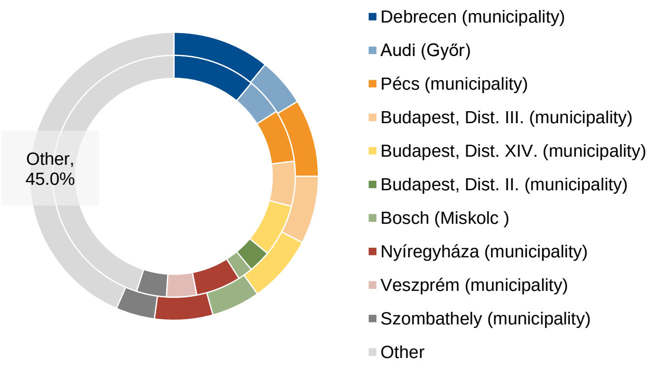
Following the unsuccessful development of allergen-free food products, GVC has made the decision of converting the previously acquired allergen-free food company into an energy-efficient ready-to-eat food factory. In light of these changes, GVC has submitted a proposal to the bond holders to modify the original purpose of the bond proceeds. Instead of investing in allergen-free initiatives dependent on the product development outcome, the funds will be allocated towards financing the transformation of the allergen-free food company into a ready-to-eat food factory. Furthermore, the updated capital expenditure program involves renovating current kitchens serving the public catering segment, with a budget not exceeding HUF 1.5 bn, which is already accounted for in our base case.

Changing regulatory environment

Several regulatory standards have been introduced on the market to improve the quality of public catering. These could give GVC an additional competitive advantage in its fragmented market. We believe that efforts to reform the public catering market in upcoming years will be incremental rather than dramatic. However, we underline continued high dependence on local municipality-funded revenue streams as a significant risk as any changes to reimbursement portfolios or prices could have a significant adverse effect on GVC's business performance.

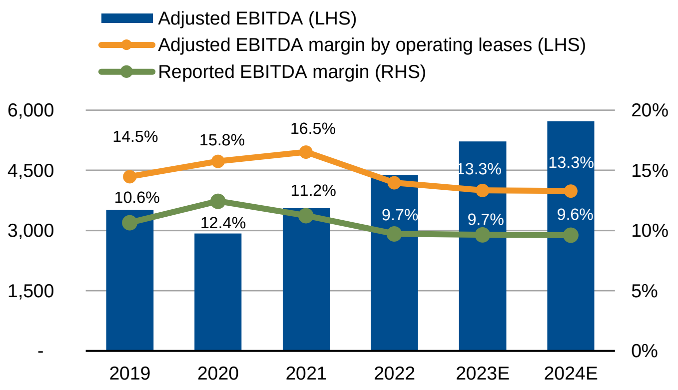
The company managed to maintain EBITDA of HUF 3.4bn and an EBITDA margin above 10%, higher than we anticipated in our last base case. GVC achieved this by reducing salary costs via lay-offs and a gradual improvement of gross margins through supply chain optimisation.

Figure 2: GVC's customer concentration (inner circle = 2021, outer circle = 2022)



Sources: GVC, Scope

Figure 3: GVC's operating performance (HUF m)



Sources: GVC, Scope estimates

A significant portion of other revenue is attributed to discounts on raw materials provided by suppliers, aiming to foster partnership loyalty. These discounts are applicable for raw material purchases over a certain amount. The specific rate and conditions of the discount vary depending on the supplier, with an average rate of 24%. These discounts are deducted from the bills payable to the suppliers. After discussing with the company, it has been determined that these discounts are considered cash-relevant and are included in the calculation of EBITDA.

GVC’s operating profitability is expected to grow steadily, with EBITDA margins remaining at around 10% despite the significantly increased cost base from expected inflation, thanks to its ability to make price adjustments with most of their customers, control salary costs via lay-offs and a gradual improvement of gross margins with optimization of supply chain.

Financial risk profile: BB

Adjustments and assumptions

Our financial projections are mainly based on the following assumptions:

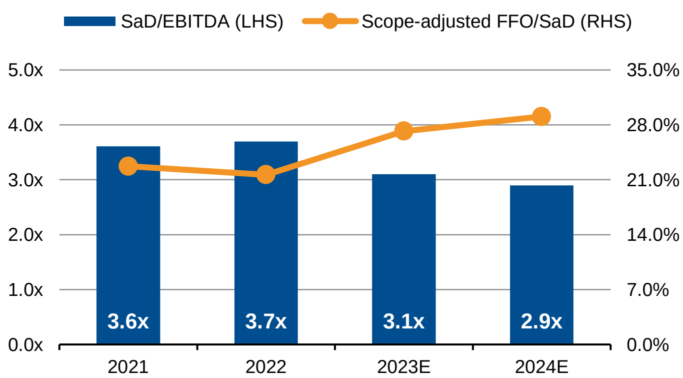
- EBITDA is adjusted by operating leases but includes discounts received from suppliers.
- No expected acquisitions or material disposals.

Financial risk profile affirmed at BB

GVC's financial risk profile is stronger than its business risk profile due to the cash-generating nature of its business. However, the company's deleveraging efforts are constrained by significant off-balance sheet liabilities that emerged in FY 2022, resulting in a leverage ratio of approximately 3.7x. The delayed integration of acquired entities Food Universum and PVK Horog Kft. also limits EBITDA. we anticipate that leverage, as measured by Scope-adjusted debt/EBITDA, will remain below 3.5x in the medium term. The assessment of leverage does not include the netting of cash, as the high cash balance is expected to be partly utilised rather than serve solely as a liquidity buffer.

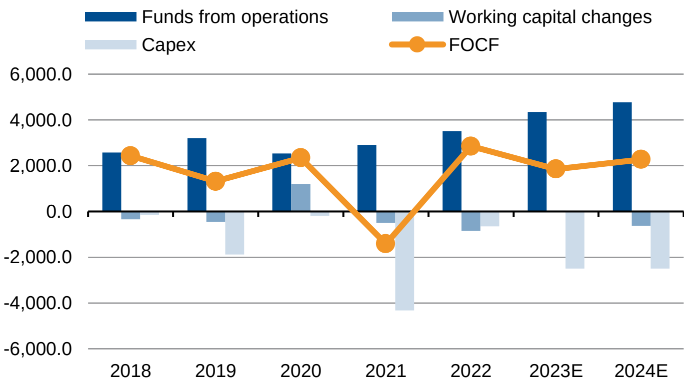
GVC has issued guarantees and made deposits primarily to members of the agribusiness. It is important to note that the performance of the agribusiness does not impact the overall performance of the GVC Group, as these companies are not included in the consolidation of GVC. To prevent double counting, guarantees provided to intragroup members within the consolidation are not included in the calculations.

Figure 4: Leverage



Source: GVC, Scope estimates

Figure 5: Cash flow generation (HUF m)



Source: GVC, Scope estimates

Positive FOCF in the medium term

The favourable receivable collection allows GVC to maintain moderate working capital needs despite expected supply chain bottlenecks.

We believe intercompany loans would have a limited positive impact on GVC’s financial risk profile. Although management communicated 3% interest on intercompany loans without the arm’s length principal, interest could be cumulative and have no cash effect in the short-to-medium term. Thus, potential cash interest income is excluded from our calculations.

We were expecting GVC's heavy capex phase to be over in 2022 but the unsuccessful integration of the allergen-free food company requires the company to invest additional funds into the renovation of existing facilities and convert them into to a ready-to-eat food factory. This will bolster capex in 2023 and probably 2024.

Fixed interest base

We expect EBITA interest cover ratio to remain strong at above 10x in 2023-2024, supported by the fixed interest rate on the issued bond.

Adequate liquidity

GVC's liquidity is adequate. This is driven mainly by a limited short-term debt position and sound EBITDA cash conversion. While an expected increase in maintenance and development capex in upcoming years will turn FOCF close to nil, the significant cash buffer should be sufficient to fully cover financing and refinancing needs.

Supplementary rating drivers: +/- 0 notches

Credit-neutral financial policy

We have not made any explicit adjustments for supplementary rating drivers.

In June 2022, GVC made the strategic decision to merge its group entities with the aim of streamlining the structure of the company. However, during the process of rationalisation, GVC breached the change of control clause in the bond agreement. This occurred when Hungast Vital Management Kft merged into Hungast Vital Kft, resulting in a slight reduction in GVC's indirect ownership from 100% to accommodate the minority owner.

We share the company's view that the change is insignificant and has no economic relevance, nor does it go against the aim of the covenant, since the rationalisation was not a significant sale to a third party.

We acknowledge the general assumption that a maximum decrease of 20% in GVC's ownership share, either in companies impacted by group structure rationalization through merging, or due to management members receiving ownership shares as incentives, would not significantly impact the overall credit quality of the company, as long as GVC retains its majority stake. However, it's important to note that the current bond debt prospectus includes a change of control clause, which requires bondholders' pre-approval for any such change in control. Failure to obtain this approval would result in the acceleration of debt repayment. GVC and its owners are committed to obtaining the necessary approval before implementing any changes to the ownership structure, unless the bond prospectus has been modified accordingly.

Long-term debt rating

Senior unsecured debt rating affirmed at BB-

We have affirmed the debt rating of senior unsecured debt issued by GVC George's Venture Capital Zrt's. at BB-, in line with the issuer rating. This rating is based on a hypothetical liquidation scenario as of end-2024, in which we computed an 'average' recovery for holders of senior unsecured debt based on its assumptions of attainable liquidation values.

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