7 October 2019

Corporates

# Marso Kft
# Hungary, Retail

BB- STABLE

## Corporate profile

Marso Kft (Marso) is a leading wholesale tyre retailer in Hungary. Marso developed this position through strong relationships with both suppliers and customers, by targeting high market shares at the price of profitability. This aggressive strategy has been successful, with the retailer having closed exclusivity agreements with some of the largest global tyre retailers (Michelin, Bridgestone, Continental, among others) and having increased customer loyalty via different selling networks.

## Key metrics

| | | | Scope estimates | |
|---|---|---|---|---|
| Scope credit ratios | 2017 | 2018 | 2019F | 2020F |
| EBITDA/interest cover (x) | 18.1x | 16.3x | 18.2x | 6.3x |
| Scope-adjusted debt (SaD)/EBITDA | 1.5x | 1.7x | 2.1x | 3.2x |
| Scope-adjusted FFO/SaD | 59% | 52% | 44% | 25% |
| Free operating cash flow (FOCF)/SaD | 2% | -12% | -29% | -39% |

## Rating rationale

**The issuer rating mainly reflects the high market share of the Hungarian wholesaler. We view interest cover as a support to the rating, but consider the low profitability, negative free operating cash flow and weak diversification as negative rating drivers. The senior unsecured debt is rated BB.**

Marso benefits from its dominant position in the niche sector of wholesale tyres, holding close to 25% of the Hungarian market. This is supported by strong, long-term relationships with worldwide suppliers (including Continental, Michelin, Bridgestone) as well as the high amount of exclusive products (close to 50% of total sales), which significantly decreases substitution risk. The wholesaler also has high market recognition via its progressive integration of customers, through franchisee Marsoponts, the Marso partner network, representing close customers benefitting from a wide range of exclusive products, and the Marso online dealer programme, which offers tyres and rims on an online platform. While Marso's market share is well anchored within the country, the relatively small size of its business and low potential for expansion are detrimental to the rating.

Weak diversification is putting pressure on the rating, with Marso active in only one sub-sector (automotive-related). Moreover, despite a large share of sales abroad (20%), the highest country exposure represents a mere 5% of total sales, too small to offset any negative macro developments in its home market of Hungary. On the other hand, Marso's presence in most of the sales channels (online/offline and B2B/B2C) is positive despite their limited ability to generate revenues. Marso management has clearly indicated an aim to maximise market shares at the expense of profitability. This strategy has been evidenced in the company's margins, which are lower than those of rated peers and competitors. Despite the risks posed by relatively high seasonality (winter tyres changed twice yearly), we recognise a positive development of the margins, also helped by the company purchasing stock months in advance to take advantage of forex rate movements. The absence of a clear forex hedging strategy could impact profitability should the macro situation deteriorate for a long period.

### Ratings & Outlook

| | |
|---|---|
| Corporate ratings | BB-/Stable |
| Senior unsecured rating | BB |


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### Related Methodology

Corporate Rating Methodology


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We used a proxy of a factor 4 to calculate the operating lease assessment, as the company reports its financial data under Hungarian GAAP and is not expected to switch to IFRS into the medium term. Operating leases represent the largest part of Scope-adjusted debt (SaD) and refers to rent paid for shops owned by Marso Holding Kft.

Marso's financial risk profile is supported by high interest cover, due to low net interest expenses as a consequence of the high interest received from group entities. We expect interest cover to fall significantly below its historical double-digit level before stabilising at above 6x, due to the upcoming bond issuance. The bond proceeds will be used towards i) repaying the totality of Marso Kft's loans; and ii) building two new warehouses (planned to be operational by 2021). We expect a significant deterioration in leverage until 2020, measured as funds from operations (FFO)/SaD and SaD/Scope-adjusted EBITDA (respectively: 1.7x and 52% in 2018; 2.1x and 43% in 2019; and 3.25x and 25% in 2020). We forecast a slight recovery from YE 2020 onwards once the warehouses are operational and contribute to margins. Lastly, as expected for a company in an investment phase, free operating cash flow (FOCF)/SaD is expected to remain under pressure for the medium term.

While the investment phase will put liquidity under pressure going forward, the repayment of the loans, via the future bond's proceeds, will eliminate short-term payment obligations. The low FOCF generation is expected to put pressure on the liquidity.

The senior unsecured rating takes into consideration Marso Holding Kft, an entity with no equity link to Marso Kft but whose shareholders are the same as the rated entity's. This is justified due to i) the system of cross-guarantees between the two; ii) Marso holding Kft's ownership of the shops operated by the franchisee of Marso Kft. Marso plans to issue an HUF 3.6bn unsecured bond in October/November 2019 under the MNB Bond Funding for Growth Scheme. This instrument will be split into three tranches (nominal HUF 1.2bn each) maturing respectively in 2027, 2028 and 2029. Based on our recovery assessment, liquidation value estimates and a hypothetical default in 2020, we calculate an above average recovery, granting a one notch uplift from the issuer rating.

## Outlook

The Stable Outlook reflects our expectation of i) the prospective bond's successful issuance by YE 2019 and its planned usage of bond proceeds mainly for refinancing of the debt of Marso Kft and for starting the investment phase; and ii) leverage metrics of around 3x for the coming two years.

A positive rating action might be triggered if the SaD/EBITDA fall below 2x on a sustainable basis.

A negative rating action could be triggered if SaD/EBITDA increases to above 4x on a sustainable basis.

## Rating drivers

| Positive rating drivers | Negative rating drivers |
|---|---|
| • Dominant market shares in Hungary | • Low diversification and profitability |
| • High interest cover | • Niche market with limited expansion possibility and high competition |
| • Absence of short-term debt in case of debt issuance | • Execution risk linked to upcoming development of warehouses |
| • High share of exclusive products | • Deterioration of the metrics due to the increase of the leverage due to the bond emission and of the high Capex. |

## Rating-change drivers

| Positive rating-change drivers | Negative rating-change drivers |
|---|---|
| • SaD/EBITDA of below 2x on a sustainable basis | • SaD/EBITDA of above 4x on a sustainable basis |

## Financial overview

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2017** | **2018** | **2019F** | **2020F** |
| EBITDA/interest cover (x) | 18.1x | 16.3x | 14.4x | 6.3x |
| Scope-adjusted debt (SaD)/EBITDA | 1.5x | 1.7x | 2.1x | 3.2x |
| Scope-adjusted funds from operations/SaD | 59.2% | 52.0% | 43.1% | 24.7% |
| Free operating cash flow/SaD | 1.6% | -12.4% | -28.8% | -38.5% |
| **Scope-adjusted EBITDA in HUF m** | **2017** | **2018** | **2019F** | **2020F** |
| EBITDA | 876 | 992 | 1,034 | 1,084 |
| Operating lease payments in respective year | 399 | 448 | 472 | 480 |
| Other items | | | | |
| Scope-adjusted EBITDA | 1,275 | 1,439 | 1,507 | 1,564 |
| **Scope-adjusted funds from operations in HUF m** | **2017** | **2018** | **2019F** | **2020F** |
| EBITDA | 876 | 992 | 1,034 | 1,084 |
| less: (net) cash interest as per cash flow statement | 9 | 1 | -10 | -153 |
| less: cash tax paid as per cash flow statement | -64 | -69 | -66 | -60 |
| add: depreciation component, operating leases | 319 | 358 | 378 | 384 |
| Variation in provisions | 7 | -7 | - | - |
| Scope-adjusted funds from operations | 1,147 | 1,276 | 1,337 | 1,255 |
| **Scope-adjusted debt in HUF m** | **2017** | **2018** | **2019F** | **2020F** |
| Reported gross financial debt | 1,270 | 1,092 | 3,600 | 3,600 |
| less: cash and cash equivalents | - 926 | - 433 | - 2,393 | - 436 |
| add: operating lease obligations (estimated by the annual rental payments with a factor 4) | 1,595 | 1,791 | 1,890 | 1,919 |
| Scope-adjusted debt | 1,939 | 2,451 | 3,098 | 5,084 |

## Business risk profile

Marso's business risk profile is supported by its dominant market position in Hungary. Diversification and profitability are negative rating drivers.

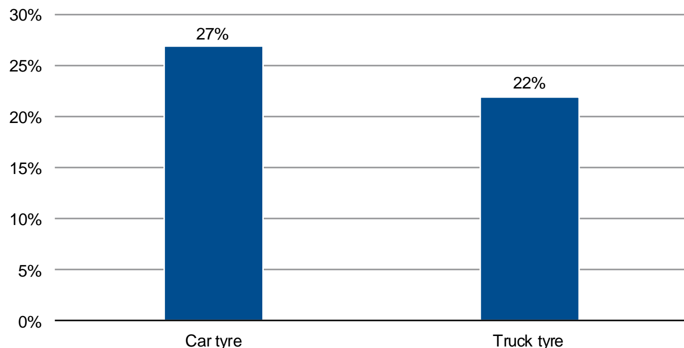
**A strong market share impacted by niche market**

Marso benefits from its market shares for the import of light vehicles and heavy vehicles tyres in Hungary, at 24% and 26%, respectively, which grants the wholesaler a dominant national position. Marso also sells agricultural tyres. The strong market position is mainly due to two factors: strong relationships with suppliers, and a progressive integration of customers into a streamlined process.

Marso has long-term commercial agreements with the most of the large global tyre suppliers, leading to numerous exclusivities (Michelin, Nokian Tyres, Continental, among many others). We consider these relationships to be durable as Marso has developed its strategy with relatively low margins, enhancing the belated market shares of the suppliers. As of 31 December 2018, exclusive products represented close to 50% of total sales.

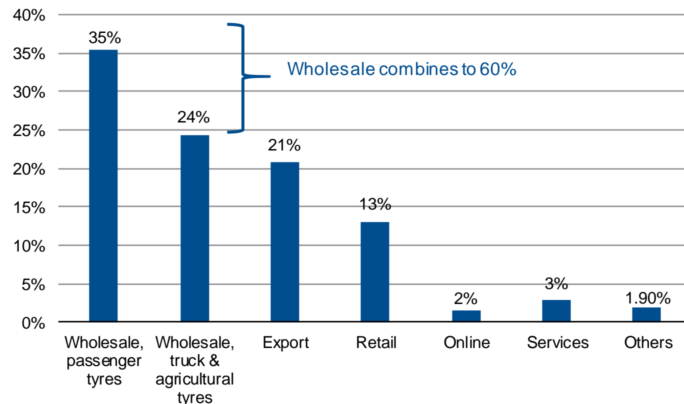
Marso attracts customers through different types of offers. 13-15 shops are operated as franchises (Marsoponts), which obtain the full product range and receive financial support from Marso when needed. The wholesaler has also developed a network of customers under the label 'Marso Network Partner', which receive exclusive products and favourable commercial agreements in exchange for a royalty fee paid to Marso. The two systems are supported by MOND, a webshop platform.

**Figure 1: Domestic market shares in car and truck tyres**




Source: Scope estimates

**Figure 2: Sales diversification**




Source: Scope estimates

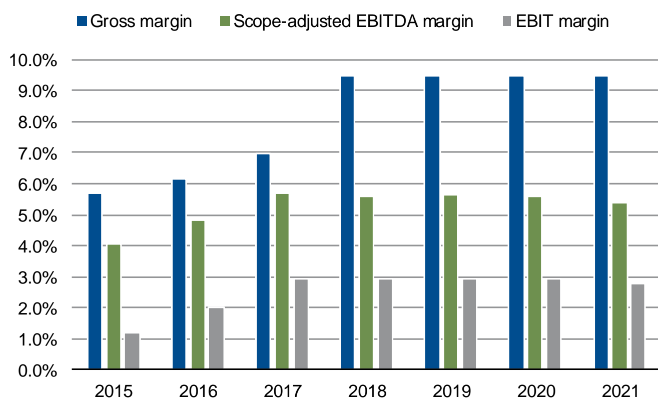
While the high market share is a positive rating driver, Marso remains nonetheless a relatively small retailer due to its niche market. Even so, we forecast increased size in the medium term, through the construction of two warehouses (aimed at streamlining variations in inventory) and planned updates to sales processes. Nevertheless, competition is relatively high on this market, even with the benefits afforded by Marso's exclusivity programme, which result in low overall substitution risks.

Diversification is one of the most negative factors for the business risk profile. Marso is involved in only one category of consumer goods sales (automotive) and in mainly one sales channel (bricks and mortar; 94% of sales). On the other hand, sales to international customers is higher than among rated peers, at around 20% of total sales, which credit-positive.

However, the largest regional exposure, at 25% of international sales, represents only 5% of total sales. This is too low to be offset any negative macro developments in the company's core market of Hungary. We recognise the presence of multiple sales

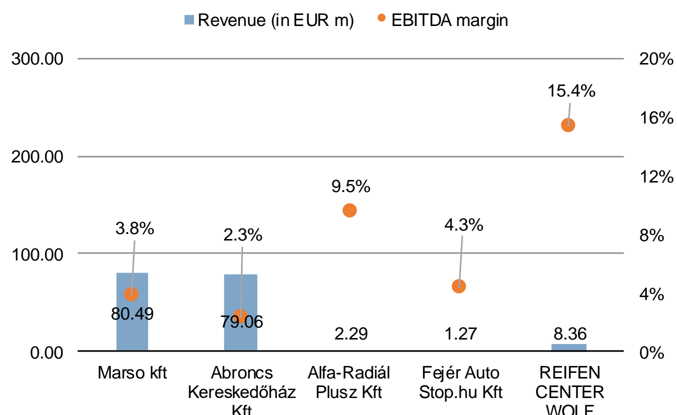
channels (wholesale, retail, online) but the predominance of wholesale does not help to strengthen diversification as Marso appears to be far from establishing an omnichannel sales structure.

**Figure 3: Group profitability**




Source: Scope estimates

**Figure 4: Marso's profitability on reported EBITDA versus peers**




Source: Scope estimates

With a strategy focused on expanding market share at the expense of profitability, the Scope-adjusted EBITDA margin is weaker than that of national and rated peers. We expect a stable margin of around 5.5% going forward, representing the lag before new infrastructure becomes operational and contributes to profitability. The retailer is also exposed to forex risk, given its lack of hedging strategy. Nonetheless, as its orders peak bi-annually, Marso has almost four months to take advantage of the best currency exchange rates.

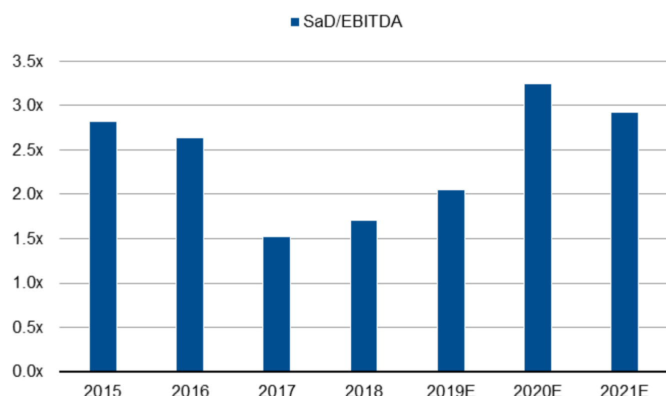
## Financial risk profile

The assumptions regarding the financial risk profile need to include the fact that Marso Kft and Marso Holding Kft hold a cross guarantee system. We assessed the financial metrics of Marso Holding Kft and concluded that a scenario in which only the holding entity falls into bankruptcy is unlikely.

In our financial forecast, we have used much of management's assumptions as they were deemed sufficiently conservative but applied haircuts on revenue growth for each year. We expect slow sales growth and lower profitability for 2019 and 2020, representing some of the company's outdated commercial processes and forex risks. We expect the margin to increase after 2021 once the new warehouses start to generate revenues. These assumptions are conservative as the full capex amount is not planned solely for the warehouses but also for the planned updates to sales processes from 2019. It is therefore likely that the margin will outperform our forecasts.

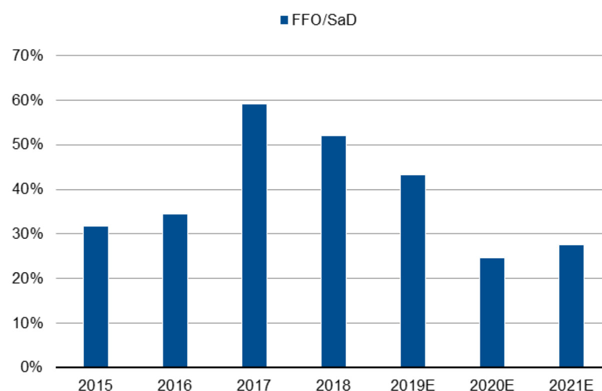
We assume that the repayment of all group loans in October and November 2019 will lead to a large early repayment fee. In terms of capex, Marso plans to invest around HUF 1,700m in 2019 (with roughly HUF 1,400m to purchase land) and around HUF 2,500m in 2020 for building the warehouses.

**Figure 5: Marso's SaD/EBITDA**




Source: Scope estimates

**Figure 6: Marso's FFO/SaD**



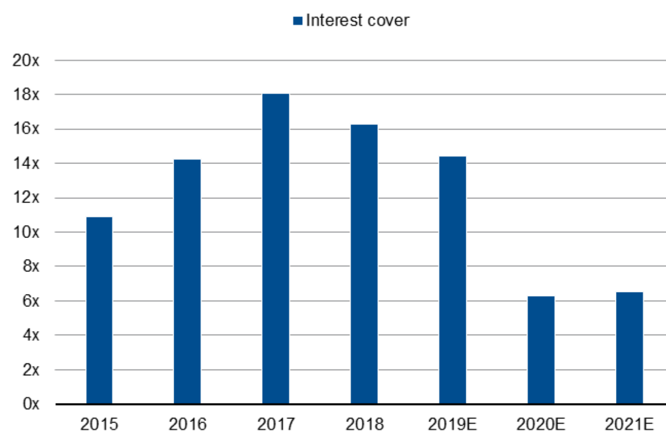

Source: Scope estimates

Marso benefits form a historically low SaD, due to gross debt being partially offset by a regularly high cash balance. The operating lease obligation corresponds mainly to the shops owned by Marso Holding Kft. We estimated operating leases by applying a factor of 4 on rental payments. We found that this balance takes up a large portion of total SaD but should decrease after 2020 as Marso plans to replace the warehouses (currently rented from Marso Holding Kft) with new ones financed by the upcoming bond's proceeds. The latter should result in a slight increase in SaD/EBITDA to above 3x in 2020, because most of the capex will be incurred in 2020. This means the cash balance will remain high in 2019, decreasing the SaD accordingly in that year.

FFO/SaD follows a similar evolution. The ratio corresponded to an investment grade rating category until YE 2018 before deteriorating rapidly until 2020. FFO is expected to absorb well the strong rise in interest payments and should remain at 2018 levels going forward, supported by i) EBITDA growth, and ii) the high share of interest received dampening the full impact of the coupons.

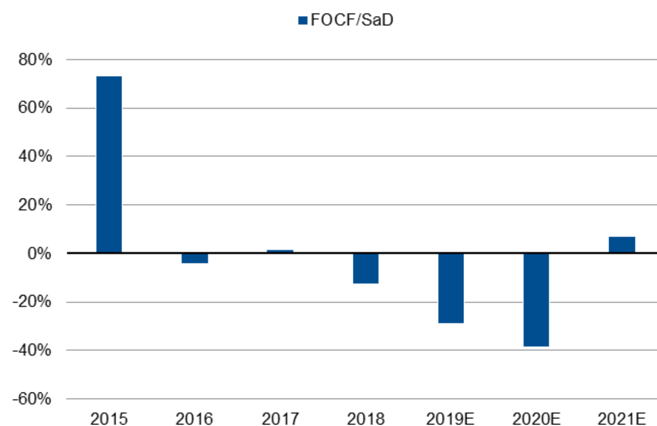
Net interest expense is low, with a high share of interest income countering the level of interest expense. Interest income stems from financial investments by Marso Kft into either a company in its group (including Marso Holding Kft entities) or into its franchisees.

**Figure 7: Marso's interest cover**




Source: Scope estimates

**Figure 8: Marso's FOCF/SaD**




Source: Scope estimates

As is typical for companies in expansion, capex has taken a toll on FOCF, and is expected to remain under pressure during the investment phase. A recovery is possible in 2021 according to our estimates, but we are aware that any delays in construction might lead to additional capex.

While the investment phase will put liquidity under pressure going forward, the repayment of the loans, via the future bond's proceeds, will eliminate short-term payment obligations. The low FOCF generation is expected to put pressure on the liquidity.

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