Progress Étteremhálózat Zrt.
Hungary, Corporates

SCOPE BB STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	15x	13x	14x	16x
Scope-adjusted debt/EBITDA	2.5x	3.2x	3.2x	2.8x
Scope-adjusted funds from operations/debt	36%	28%	28%	33%
Scope-adjusted free operating cash flow/debt	0%	-14%	2%	13%

Rating rationale

Progress' issuer rating continues to benefit from its position as one of Hungary's largest restaurant operators through its use of the McDonald's brand. The diversification assessment remains low due to the limitation of the development licencee agreement to Hungary and the concentration on one business line. Operating profitability is moderate but under pressure from expansion and inflation.

The financial risk profile is supported by a very strong interest cover due to the low fixed-coupon bond, flat leverage despite soaring inflation and the recovering free operating cash flow to positive as investments are completed.

We assess an above-average recovery for the senior unsecured debt category from 2023 thanks to the tripling of fixed assets since the bond issuance in 2020.

Outlook and rating-change drivers

The Outlook is Stable based on our expectation of expansion being executed as planned and input prices stabilising, resulting in improved cash flow and allowing gradual deleveraging.

A positive rating action could be warranted if the company strengthened Scope-adjusted free operating cash flow/debt to at least 10% on a sustained basis while growing in size.

A downgrade could be warranted if Scope-adjusted debt/EBITDA increased above 4x, possibly as a result of a deterioration in the franchise relationship (development licence) with McDonald's and/or inflationary pressure leading to low cash flow.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
7 Jun 2023	Affirmation	BB/Stable
10 Jun 2022	Affirmation	BB/Stable
13 Jul 2021	Upgrade	BB/Stable
7 Jul 2020	New	BB-/Stable

Ratings & Outlook

Issuer	BB/Stable
Senior unsecured debt	BB+

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Related Methodology

Corporate Rating Methodology; July 2022

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Bloomberg: RESP SCOP

Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Moderate profitability, supported by world-leading quick-service restaurant brand, driven by strong marketing strategy validated by consumer research • Well-defined strategies to preserve its strong market share, including plans for growth in number of new restaurants as well as facelifts for all existing restaurants • Potential for further expansion with drive-through restaurants, which have solid profitability • Robust interest cover ratio	• Heavily dependent on franchise (developmental licencee) with McDonald's • Negative Scope-adjusted free operating cash flow/debt due to intensive capex plan, but we expect the ratio to turn positive by 2024 • Weak diversification

Positive rating-change drivers	Negative rating-change drivers
• Significantly stronger revenue growth • Scope-adjusted free operating cash flow/debt sustained above 10%	• Scope-adjusted debt/EBITDA increasing above 4x • Deterioration in franchise relationship (developmental licencee) with McDonald's • Inflationary pressure resulting in low cash flow

Corporate profile

Progress Étteremhálózat Kft. (Progress) is the McDonald's Corporation developmental licensee in Hungary and one of the largest restaurant operators in the country based on both revenue and profit. Progress operates McDonald's restaurants and uses the trademarks, intellectual property rights and other products under the McDonald's franchise. It is entitled to name itself the 'Developmental Licensee Partner of McDonald's in Hungary'. The company has two primary sources of income: i) revenues generated by own operated restaurants; and ii) franchisee fees from conventional license partners. The company's activities consist solely of operating McDonald's restaurants in Hungary.

The first McDonald's restaurant in Hungary opened in 1988. Progress's former name was McDonalds Hungary Kft. Ownership changed in 2019 when Hungarian entrepreneur Sándor Scheer acquired the full stake from the global McDonald's group through his holding company Leones QSR Kft, whose sole investment is in Progress.

In Hungary, McDonald's has 111 restaurants with system-wide sales of HUF 106bn in 2022. Of these 111 stores, 60% are operated and owned by Progress and roughly 40% are operated by local conventional licensees. Progress plans to further expand its Hungarian restaurant network.

Financial overview

			Scope estimates		
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	15x	13x	14x	16x	19x
Scope-adjusted debt/EBITDA	2,5x	3,2x	3,2x	2,8x	2,4x
Scope-adjusted funds from operations/debt	36%	28%	28%	33%	39%
Scope-adjusted free operating cash flow/debt	0%	-14%	2%	13%	23%
Scope-adjusted EBITDA in HUF 000's					
EBITDA	8,834,279	7,827,429	8,732,384	10,038,865	11,752,471
Operating lease payments	2,173,672	2,753,000	3,242,000	3,522,000	3,721,000
Scope-adjusted EBITDA	**11,007,951**	**10,580,429**	**11,974,384**	**13,560,865**	**15,473,471**
Funds from operations in HUF 000's					
Scope-adjusted EBITDA	11,007,951	10,580,429	11,974,384	13.560,865	15,473,471
less: (net) cash interest paid	-723,672	-832,023	-832,694	-832,694	-832,694
less: cash tax paid per cash flow statement	-574,198	-103,659	-264,233	-251,557	-332,738
Funds from operations	**9,710,081**	**9,644,747**	**10,877,457**	**12,476,613**	**14,308,040**
Free operating cash flow in HUF 000's					
Funds from operations	9,710,081	9,644,747	10,877,457	12,476,613	14,308,040
Change in working capital	-531,912	492,540	-457,718	6,524	160,609
Non-operating cash flow	568,933	1,720,345	1,036,064	535,915	435,411
less: capital expenditure (net)	-9,680,123	-16,747,802	-10,561,000	-8,300,000	-6,500,000
Free operating cash flow	**66,980**	**-4,890,171**	**894,802**	**4,719,052**	**8,404,060**
Net cash interest paid in HUF 000's					
Net cash interest per cash flow statement	723,672	832,023	832,694	832,694	832,694
Net cash interest paid	**723,672**	**832,023**	**832,694**	**832,694**	**832,694**
Scope-adjusted debt in HUF 000's					
Reported gross financial debt	33,000,000	33,693,094	33,000,000	33,000,000	33,000,000
less: cash and cash equivalents	-17,279,600	-9,706,125	-6,665,833	-6,862,885	-7,545,946
add: non-accessible cash[1]	7,201,029	4,853,063	5,450,000	4,250,000	3,650,000
add: operating lease obligations	4,347,344	5,506,000	6,484,000	7,044,000	7,442,000
Scope-adjusted debt	**27,268,773**	**34,346,032**	**38,268,167**	**37,431,115**	**36,546,054**

[1] Includes funds earmarked for capex, cashier money and cash deposit for bank guarantee.

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Environmental, social and governance (ESG) profile

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)

Credit-neutral ESG profile

Progress is working on a dedicated ESG strategy. It strives for cutting its environmental footprint by reducing its general use of packaging (albeit still above the use at à la carte restaurants), offering alternatives to traditional beef burgers (although Hungarian consumers still prefer beef) and modernising its whole infrastructure. As a large employer, Progress has community support programmes and a good focus on gender equity. Ownership and management structures are well separated. The company pays attention to complying with food safety regulations and avoiding regulatory and reputational risks. The Hungarian entity also invests into product innovation. Internal controls and audits from Mc Donald's Corporation provide further assurance. A sustainability report with set targets is also being prepared.

Business risk profile: BB

Small player on global scale; market leader in Hungary

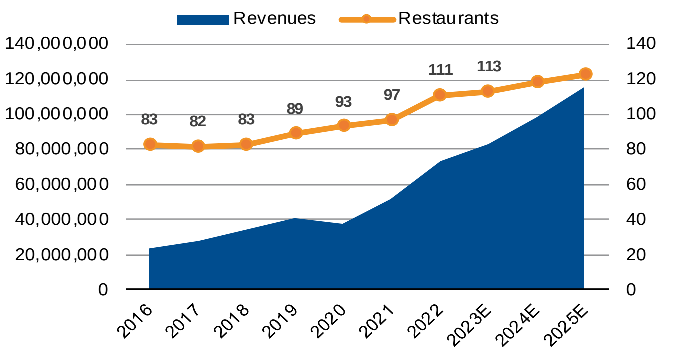
Progress' business risk profile benefits primarily from its position as one of the largest restaurant operators in Hungary through its use of the McDonald's brand. Revenue reached HUF 73.6bn in 2022 (equivalent to EUR 0.2bn and double the amount in 2020), making Progress a medium-sized company.

Progress was able to accomplish significant organic sales and guest count growth in Hungary over 2015-2019 without increasing its number of restaurants. It has since opened 22 new stores (+25% growth) out of which 14 in 2022. At the same time, all existing stores will be modernised by end of 2023.

On an international comparison, however, the number of McDonald's restaurants per capita in Hungary remains half of that in Germany, France or Austria. This can be linked somewhat to the less modern retail space, especially in highly frequented transport hubs, and to the lower purchasing power. We believe Progress' intensive capex plan is strengthening McDonald's market position in Hungary.

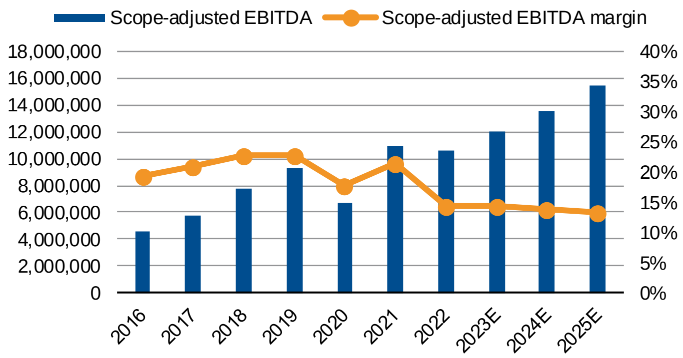
In the medium term, we expect that Progress' moderate EBITDA margins will protect its market share in Hungary from competitors that are willing to sacrifice profitability to gain market share. However, the company's market position assessment is hampered by its dependence on a single country, the Hungarian market's fragmentation and Progress' small scale on a global level.

Figure 1: Evolution of company revenues and network size (in HUF 000's)



Sources: Progress, Scope (estimates)

Figure 2: Operating profitability (in HUF 000's)



Sources: Progress, Scope (estimates)

Restricted product portfolio but supported by diversified distribution channels

Geographical diversification is limited due to the sole exposure to Hungary. McDonald's sales channels are diversified: home delivery is available in around 85% of the restaurants and drive-through access is growing. From the supplier side, we see a strong integration in global supply chains. The company operates with strategic suppliers and has long-term cooperation with its partners. Supplies were not disrupted by the turbulence of recent years, unlike in other sectors or among less powerful companies. Therefore, we see a low concentration of buyers as well as low supply chain risk. We note that McDonald's is pro-actively improving product diversification by increasing menu variety, adding breakfast items, opening McCafé shops, and offering wraps and salads. Ultimately, however, McDonald's product portfolio is still limited to food and beverages.

Moderate margins under inflationary pressure

Historical EBITDA margins range from 13.1% to 17.9% in 2016-2021, averaging 15.6%. The Scope-adjusted EBITDA margin is around 4 pp higher than reported by the company due to adjustments for real estate lease payments received from franchise partners.

Operating profitability is moderate with a Scope-adjusted EBITDA of HUF 10.6bn in 2022 (-3.9% YoY) and a decreasing but solid Scope-adjusted EBITDA margin of 14.4% (down from 21.4% YoY). The Scope-adjusted EBITDA includes HUF 2.75bn of adjustments for real estate leases.

The decrease in margin is due not only to cost inflation but also to the increase in own operated restaurants. This is because own operated restaurants, while having higher revenue, also have higher operating costs than the franchising activity.

The operating environment will remain challenging in 2023. The Hungarian National Bank forecasts inflation at around 15%-20%, well above the EU average of 5.3% forecasted by the ECB. Affordability and economies of scale will therefore be key to remaining competitive. While certain input costs may decrease or at least stabilise compared to 2022 levels, labour costs continue to rise at a double-digit rate. Furthermore, the Hungarian forint has become volatile, which implies partners are applying higher headroom in input prices and hedging is getting more expensive.

The headwinds posed by the rising labour costs in Hungary are, however, being counterbalanced by Progress' pricing power, market growth and productivity-enhancing investment in digitalisation in the years to come. By adding to its number of restaurants, Progress should also continue to benefit from economies of scale.

Financial risk profile: BB

The financial risk profile assessment is unchanged compared to last year. The company was able to navigate the heavy investment phase and soaring inflation in Hungary.

Manageable leverage

Leverage measured by Scope-adjusted debt/EBITDA stood at 3.2x (flat YoY). We expect gradual deleveraging to around 2.5x by YE 2025 through EBITDA growth due to inflation and organic growth and flat gross debt.

The company's debt as at 2022 includes a HUF 33bn senior unsecured bond and HUF 2.45bn in bank guarantees. We expect no major changes in the next three years. Furthermore, we have excluded from cash netting the contracted capex and cashier money totalling HUF 3bn in 2023 and lower amounts in the following years.

Financing at low fixed interest rate contracted ahead of inflation is favourable

Interest cover measured by Scope-adjusted EBITDA/interest expense is very strong, at 13x at YE 2022. The ratio may improve due to the expected EBITDA growth and the bond's low fixed coupon of 3% a year. Such financing is very favourable as the deposit rate in Hungary can be up to 18% a year while subsidised loans in Hungarian forint have fixed interest rates starting at 6% into the medium term.

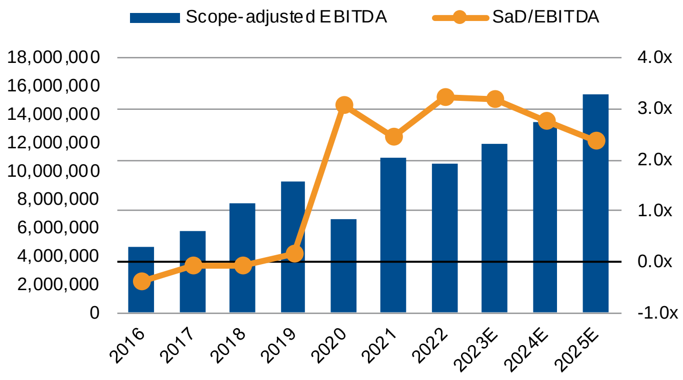
Strong cash flow generation under inflationary pressure

Scope-adjusted funds from operations/debt is moderate at 28% at YE 2022 and points towards healthy cash flow generation. With inflation stabilising, we expect cash flow generation to improve. However, high inflation will apply pressure in 2023, but this will be counterbalanced by the company's firm pricing actions and the normalising energy prices.

Negative free operating cash flow to turn positive

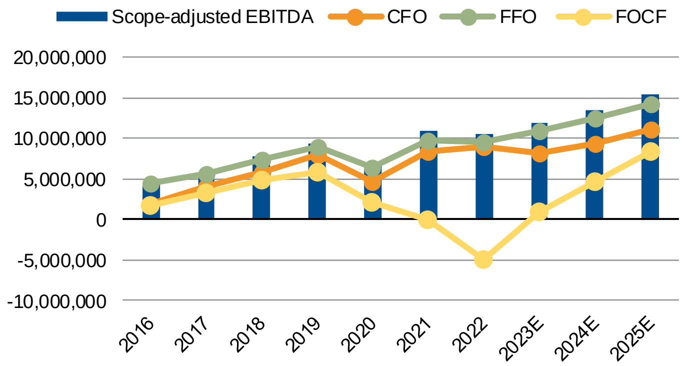
Progress's investment plan for 2019-2025 is roughly 80% completed, with both new store openings and modernisations progressing as scheduled. Subsequent growth plans will therefore be less aggressive and we expect the currently negative Scope-adjusted free operating cash flow/debt to turn positive by 2024. The near completion of the investment plan also means there is no pressure to raise new debt in the current high interest rate environment, which will allow cash to be accumulated for debt service and potential dividend payments.

Figure 3: Leverage evolution with capex deployment (in HUF 000's)



Sources: Progress, Scope (estimates)

Figure 4: Cash flows (in HUF 000's)



Sources: Progress, Scope (estimates)
CFO: cash flow from operations, FFO: funds from operations, FOCF: free operating cash flow

Adequate liquidity

Liquidity is adequate and benefits from the conservative debt maturity profile: no short-term debt has been held historically or is planned in the coming years. The bond will start amortising in 2026 at HUF 4.1bn yearly. Liquidity risk is therefore marginal given the comfortable cash position and positive free operating cash flow expected following the investment phase. We expect this situation to remain for the foreseeable future.

Balance in Scope-adjusted EBITDA in HUF 000's	2023E	2024E
Unrestricted cash (t-1)	4,853,063	3,665,833
Open committed credit lines (t-1)	-	-
Free operating cash flow	894,802	4,719,052
Short-term debt (t-1)	-	-
Coverage	**>200%**	**>200%**

Supplementary rating drivers: +/- 0 notches

No notching was applied for any supplementary rating drivers.

We view Progress' financial policy as appropriate and prudent, with the commitment to a maximum net debt/EBITDA of 3.5x.

No dividends were paid during the investment phase, and company guidance on dividends still allow deleveraging. We assume a HUF 1bn dividend payment in 2024 and HUF 4bn in 2025. The bond prospectus limits dividends to 50% of the previous year's profit after tax, which is protective of debtholders.

Parent support is neutral as we do not expect support from the owner or his holding company.

Governance and structure are credit-neutral, though we view positively the multi-level control mechanisms and decision boards.

Peer group considerations do not warrant a change to the rating.

Long-term debt rating

Senior unsecured debt rating: BB+

We assess above-average recovery from 2023 due to the tripling of fixed assets to HUF 36.8bn at YE 2022 from HUF 13.8bn at YE 2020 as a result of the capex. The company has no senior secured debt and no need to raise any.

The improved recovery rate has resulted in the senior unsecured debt rating being upgraded to one notch above the issuer rating, to BB+ from BB.

In February 2021, Progress issued a HUF 33bn senior unsecured bond (ISIN: HU0000359906) through the Hungarian Central Bank's Bond Funding for Growth Scheme. The bond proceeds were used for capex. The bond has a tenor of 10 years and a fixed coupon of 3.0%. Bond repayment is in four tranches starting from 2026, with 12.5% of the face value payable yearly and a 50% balloon payment at maturity. We note the bond clauses requiring accelerated repayment of the nominal amount (HUF 33bn) in case of rating deterioration (two-year cure period for a B/B- rating; immediate repayment if bond rating falls below B-, which could have default implications). There are also soft bond covenants that relate to, among others, a change of control unless approved by McDonald's Corporation, a net debt/EBITDA of up to 3.5x applicable only if a breach is due to raising new debt, and a dividend payout ratio of up to 50%.

Appendix: Peer comparison

	Progress Étteremhálózat Kft.	NATURTEX Kft.	ZALACO Sütőipari Zrt.	BK Group AG	Aranynektár Kft.
Issuer rating **with supplementary rating drivers**	BB/Stable	B+/Stable	B+/Positive	BB-/Stable	B/Stable
Last reporting date	31 December 2022	31 December 2022P	31 December 2022P	31 December 2022	31 December 2021
Business risk profile	**BB**	**B+**	**B+**	**BB-**	**B+**
Financial risk profile	**BB**	**B+**	**BB-**	**BB-**	**BB+**
Scope-adjusted EBITDA/interest cover	12.7x	34x	15x	34x	30x
Scope-adjusted debt/EBITDA	3.2x	5.9x	3.4x	2.5x	1.1x
Scope-adjusted funds from operations/debt	28%	27%	27%	29%	87%
Scope-adjusted free operating cash flow/debt	Negative	15%	Negative	Negative	65%
Supplementary rating drivers	-	-	-	-	-1 notch

Sources: Public information, Scope

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