Vöröskő Ltd
Hungary, Retail

SCOPE BB STABLE

Corporate profile

Established in 1996 as a local cooperative purchasing brand, Vöröskő has since developed into one of the main consumer electronics retailers in the Hungarian market. Joining the Euronics purchasing alliance in 2001 increased the group's international branding and gave it better access to international suppliers. With 64 shops in 63 Hungarian cities, the group has the largest number of stores for electronic goods in Hungary, cementing its strong position in that country. The group currently has more than 1,000 employees.

Key metrics

			Scope estimates	
Scope credit ratios	2020	LTM Jun-21[1]	2021/22E	2022/23E
EBITDA/interest cover	9.9x	7.3x	7.0x	5.8x
Scope-adjusted debt (SaD)/EBITDA	0.8x	2.0x	3.1x	3.3x
Scope-adjusted funds from operations/SaD	108%	45%	27%	24%
Free operating cash flow (FOCF)/SaD	71%	-15%	-40%	-18%

Rating rationale

The rating benefits from Vöröskő's solid credit metrics, with operations growth and limited debt issuances in recent years. The business risk profile and profitability (Scope-adjusted EBITDA margin) in particular constrain the rating's potential uplift.

Vöröskő's market positioning is strong within Hungary (where it is the number two in the market) due to high national recognition and its membership in the European procurement alliance Euronics. While the market is competitive, we expect the group to continue to grow in the coming years and widen the gap in market shares versus smaller competitors in the country through strong online sales. While the group is small by international standards, it is only present in Hungary and therefore has its growth potential capped by the national market. Profitability (scope-adjusted EBITDA margin) is low (<5%) despite its membership in Euronics and the recent acquisition of private labels company Dyras Ltd. These factors constitute the main impediments to the business risk profile assessment.

Nonetheless, the absence of significant debt issuance over the last few years counterbalances the group's weak profitability generation and leads to strong credit metrics. While the upcoming bond issuance (a HUF 7bn senior unsecured corporate bond under the Central Bank of Hungary's Bond Funding for Growth Scheme, earmarked for real estate acquisitions and business development) will lead to a deterioration in the financial risk profile, we expect a recovery after YE2022/23, the year the investment phase is set to conclude. Liquidity is adequate, supported by the absence of short-term debt.

[1] In 2021, the group changed its business year to June. We consequently made a proxy on the last twelve months (LTM) at June 2021 to estimate the evolution of the group in 2021.

Ratings & Outlook

Corporate ratings	BB/Stable
Senior unsecured rating	BB

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Related Methodologies

Corporate Rating Methodology: July 2021

Rating Methodology: Retail and Wholesale Corporates March 2021

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Outlook and rating change drivers

The Outlook is Stable and incorporates our expectation that SaD/EBITDA will oscillate between 3.0x and 3.5x in the coming two years while the group maintains Scope-adjusted EBITDA margin between 4.0%-4.5%. Apart from the bond issuance under the Central Bank of Hungary programme, we do not expect any debt issuance or M&A transactions.

A positive rating action could be warranted if SaD/Scope-adjusted EBITDA improved to below 3x on a sustained basis due to stronger Scope-adjusted EBITDA resulting from better cost optimisation. This could stem from ramping up Dyras' private labels or from lower processing costs for online orders thanks to the new automated warehouse and a new web engine.

A negative rating action could be taken if the business risk profile significantly deteriorated or if SaD/Scope-adjusted EBITDA approached 4x on a sustained basis. This could be driven by a deterioration in profitability of scope-adjusted EBITDA margin reaching levels below 3.5% due to tougher competition putting pressure on prices or by a new debt issuance.

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong credit metrics • Absence of short-term debt repayments leading to high liquidity in the short-to-medium term • Strong market positioning within Hungary (number two) • Positive development of online channel during the pandemic	• Low profitability (scope-adjusted EBITDA margin below 5%) • Geographical reach limited to a single country, limiting the size of the group and enhancing the correlation with the Hungarian economy

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA to below 3x	• Deterioration of the business risk profile • SaD/EBITDA increasing to approaching 4x

Financial overview

					Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020**	**LTM Jun-21[2]**	**2021/22E**	**2022/23E**	**2023/24E**
Scope-adjusted EBITDA/interest cover (x)	8.7x	9.1x	9.9x	7.3x	7.0x	5.8x	6.6x
SaD/EBITDA (x)	1.6x	1.8x	0.8x	2.0x	3.1x	3.3x	2.5x
Scope-adjusted funds from operations/SaD (%)	54%	49%	108%	45%	27%	24%	33%
Scope-adjusted FOCF/SaD (%)	4%	-22%	71%	-15%	-40%	-18%	18%
Liquidity (internal+external)	No ST debt	No ST debt	No ST debt	10.9x	No ST debt	No ST debt	No ST debt
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020**	**LTM Jun-21**	**2021/22E**	**2022/23E**	**2023/24E**
Reported EBITDA	969	1,296	1,576	1,873	1,791	2,257	2,746
Operating lease payments in respective year	1,374	1,455	1,592	1,745	1,400	1,300	1,300
Scope-adjusted EBITDA	2,343	2,751	3,168	3,617	3,191	3,557	4,046
Scope-adjusted funds from operations in HUF m	**2018**	**2019**	**2020**	**LTM Jun-21**	**2021/22E**	**2022/23E**	**2023/24E**
Scope-adjusted EBITDA	2,343	2,751	3,168	3,617	3,191	3,557	4,046
less: (net) cash interest as per cash flow statement	6	-12	-2	-1	-176	-353	-353
less: cash tax paid as per cash flow statement	-45	-37	-106	-98	-66	-79	-100
less: leasing adjustment (interest)	-275	-291	-318	-349	-280	-260	-260
Scope-adjusted funds from operations	2,029	2,411	2,743	3,169	2,669	2,866	3,333
Scope-adjusted free operating cash flow in HUF m	**2018**	**2019**	**2020**	**LTM Jun-21**	**2021/22E**	**2022/23E**	**2023/24E**
Scope-adjusted funds from operations	2,029	2,411	2,743	3,169	2,669	2,866	3,333
less: leasing adjustment (depreciation)	-1,099	-1,164	-1,274	-1,396	-1,120	-1,040	-1,040
Net working capital	140	-871	1,774	-1,168	-2,050	-403	600
Net capex	-901	-1,479	-1,436	-1,699	-3,390	-3,559	-1,100
Scope-adjusted FOCF	168	-1,103	1,807	-1,093	-3,892	-2,136	1,793
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020**	**LTM Jun-21**	**2021/22E**	**2022/23E**	**2023/24E**
Reported gross financial debt	16	50	53	457	7,052	7,052	7,052
add: leasing adjustment	5,495	5,820	6,368	6,978	5,600	5,200	5,200
less: cash net from restricted cash	-1,750	-910	-3,871	-323	-2,852	-541	-2,159
Scope-adjusted debt (SaD)	3,761	4,960	2,550	7,112	9,800	11,711	10,093

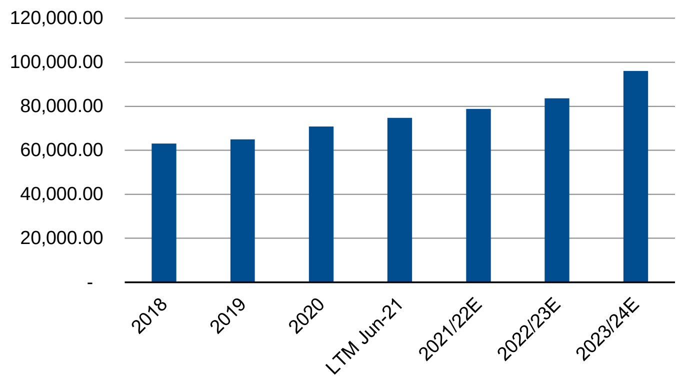
[2] In 2021, the group changed its business year to June. We consequently made a proxy on the last twelve months (LTM) at June 2021 to estimate the evolution of the group in 2021.

Business risk profile (BB-)

Strong local market shares ...

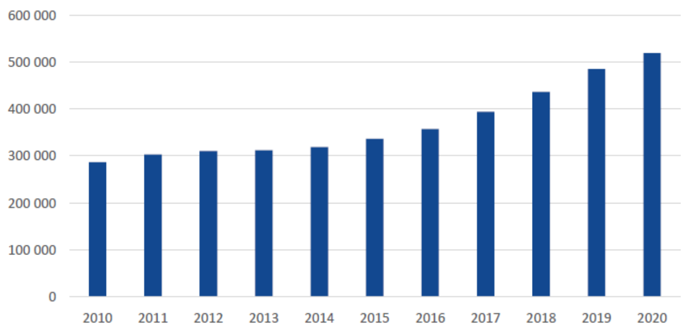
Vöröskő is a strong national player in consumer electronics retailing with close to HUF 71m of revenue at YE 2020. Its management assesses it as the second largest player within Hungary with 17%-19% of total market shares. While the market is fragmented (with numerous smaller players), we consider Vöröskő to be relatively well protected against new entrants as it is present online and in brick-and-mortar format. Entering consumer electronics retailing is relatively complex due to the need for: i) large warehouses and large shops to store and display goods; ii) an effective online channel, as this segment of consumer goods is among the highest in terms of online penetration; and iii) a wide range of suppliers offering sufficient product granularity to meet ever-changing consumer tastes.

Figure 1: Vöröskő's sales growth over the years (in HUF m)



Source: Vöröskő, Scope Ratings

Figure 2: Development of the Hungarian technical consumer goods segment (in HUF m)



Source: Vöröskő

… in a fragmented market

Vöröskö's biggest competitor is the local subsidiary of MediaMarkt (part of Ceconomy, rated BBB-), which is twice as large by revenue and almost four times larger in terms of reported EBITDA. The rest of the competitive environment is highly fragmented, with the third largest player being online-only company Extreme Digital – eMAG (15% smaller than Vöröskö with negative EBITDA). The remaining players are significantly smaller (less than HUF 10m in sales). Vöröskö's size slightly constrains its potential rating, despite its comfortable share of the national market. Its small size is a natural result of the group focusing solely on Hungary; it can only grow as much as the Hungarian market grows

Development plans in line with main retailing trends

The group has developed a relatively large network of shops across Hungary to maintain a strong physical presence (64 shops in 63 cities in December 2021). However, it acknowledges that most of its future growth will be omnichannel, and so it is developing its online sales channels and is not planning to open any new stores. The group increased its online brand strength from Hungary's 12th largest web shop in 2019 to the sixth position in 2020. It is also the only Hungarian company among its competitors. In addition, Vöröskő appears to be keenly aware of consumer buying trends, and it is adjusting its retailing methods accordingly, focusing its strategy on a better shopping experience and easy availability of goods at its locations. In this context, the group gives special attention to its salesclerks, who benefit from regular technical and sales training (the group will receive a subsidy of nearly HUF 1.5bn from the Hungarian government for this purpose) and to revamping its stores for "retail-tainment" and shop-in-shop formats. To increase its top line, the group has also proposed some additional B2B and B2C services (such as financial services).

Although still small in terms of their contribution to overall sales (<10%), these services are seen as supporting the overall market share assessment.

Country retail strength is high-medium

We consider the Hungarian market to be a 'high-medium' market in terms of country retail strength, characterised by big potential for development and consolidation but a certain maturity in terms of retailing activities being reached. With this in mind, we expect online growth to normalise over the next few years.

Reinforcement of online channels expected to support top line and market shares

The bond issuance is expected to increase the group's overall market share. The group aims to use part of the proceeds to merge all its warehouses (located in the vicinity of Üllő) into a larger one and fully automate it, more than doubling the number of goods handled per hour. This investment should increase its ability to serve its customers faster in an environment where customers are putting a greater emphasis on delivery time rather than price (on the assumption that prices remain broadly similar from one online retailer to another). The launch of a reworked web engine, announced for January 2022, should also increase the group's purchase conversion (from optimising the interface and search capabilities, etc.). The group also aims to increase its range of products offered by adding new categories of goods (DIY, gardening, etc.), which should increase its total addressable market.

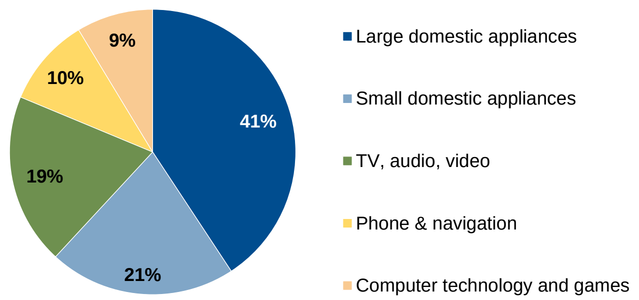
Good product diversification

Product diversification is considered good. While the bulk of sales comes from home appliances (21% from small household appliances and 40.5% from large household appliances), the group also sells other categories of consumer electronics, such as phones, TV, audio, computers and related products. Considered part of the 'cyclical retail consumer goods category' in Scope's retail methodology, these products display a high correlation with intra-year seasonality (Black Friday, Christmas season, summer season), technological change risks and, often, shipping requirements from distant suppliers. The group aims to increase its range of products offered by adding up to 10 or 15 new categories as reported by management. Examples include the recent appearance of electric bicycles and toys at the beginning of the year and the upcoming development of gardening and DIY. We consider the group to be well diversified in this category given a relatively high number of products and suppliers.

However, presence in other activities too small to provide active diversification

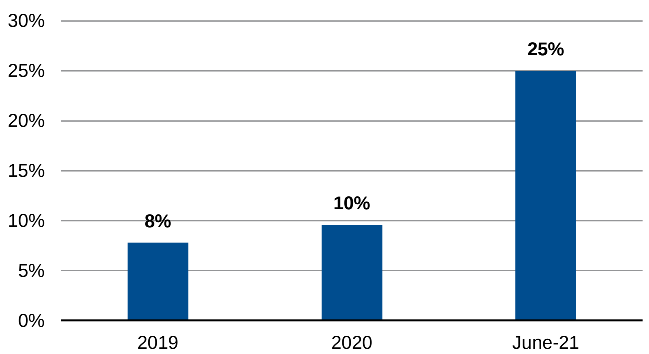
Beyond its B2C retailing activities, the group is also involved in wholesale (0.6% of total sales at YE 2020) and other services (8.8% of total sales at YE 2020). The latter comprises marketing services, warranties, and brokerage commission fees. While none constitute strong diversification away from actual sales, they do consolidate the group's market positioning.

Figure 3: Vöröskő's product diversification (at YE 2020)



Source: Vöröskő, Scope Ratings

Figure 4: Development of online sales



Source: Vöröskő, Scope Ratings

Focus on single country limits diversification potential

The group has a clear focus on Hungary, which caps the diversification assessment. While it has said it is willing to look at entering neighbouring markets using its automated warehouse capacity, the current focus on a single country is seen as negative in our rating. This is because the group would be fully impacted and disadvantaged by a potential downturn in the Hungarian economy (i.e. a devaluation of the Hungarian forint that could ultimately affect the purchasing power of consumers).

Channel diversification fully supported by the pandemic

Channel diversification supports the diversification assessment. Consumer electronics retailers have often been pioneers in online sales due to high customer acceptance, leading to a relatively high total online sales contribution in comparison with other retailers. Vöröskő benefits from a high percentage of online sales (20% in June 2021 versus 10% in 2020), thanks largely to the pandemic. While we expect demand for online sales to recede slightly from this exceptional spike in the coming months, management aims to keep online sales at a similar level, supported by the upcoming automated warehouse and development of the multichannel format. We consequently consider Vöröskő to be well positioned in this segment with limited risks.

Low profitability limits rating ...

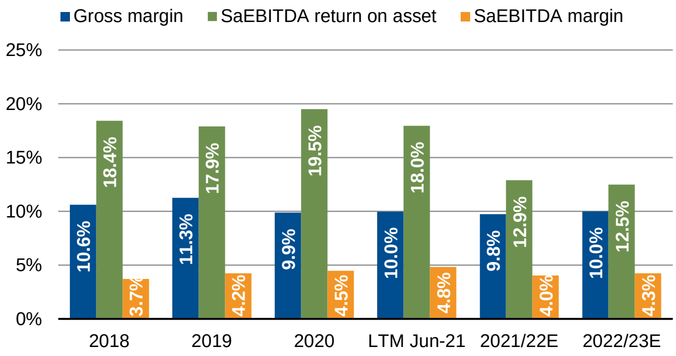
Profitability, defined by the Scope-adjusted EBITDA margin, is detrimental to the group's rating. With a margin of 4.5% on average, the group is significantly below the majority of other retailers.

... despite group's membership in Euronics

Vöröskő is part of the European consumer goods retailing alliance Euronics (8,500 stores spread across 35 countries). Its membership allows it to better negotiate with large manufacturers while also benefitting from side services. Vöröskő estimates that its membership in Euronics contributes up to 1%-2% of its EBITDA. Being part of this alliance also greatly limits forex risks, as it allows the group to buy the vast majority of its goods (97%-98%) in Hungarian forint. In addition, Vöröskő acquired Dyras, an entity manufacturing private labels. While the impact of this acquisition currently remains low (limited number of private labels accounting for close to 250 products), the group expects Dyras to ramp up its offers in the coming year to represent close to 5%-8% of total sales and ultimately act as a non-exclusive supplier.

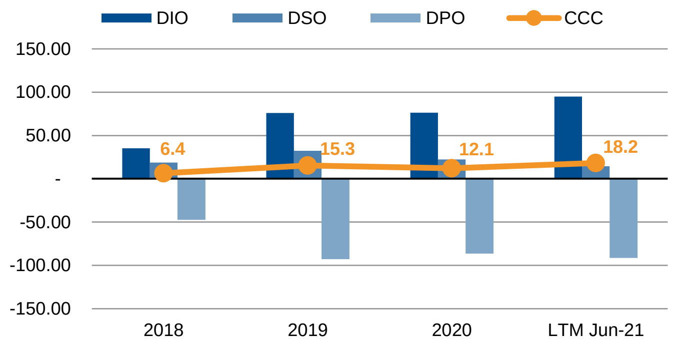
The group's relatively low profitability margins is explained by its low purchasing power overall. Despite the retail alliance and Dyras, the group suffers from a relatively low gross margin. Its cash conversion cycle (CCC) is considered relatively high (close to 13 days) while its Scope-adjusted EBITDA return on assets, which assesses how efficiently assets are used, is close to 18%, both on a four-year average. The cash conversion cycle is slightly higher for Vöröskő than for larger competitors due to: i) tougher competition as well as not having optimised online delivery warehouses, leading to higher days inventories outstanding (DIO); and ii) credits via the integrated financial services that the group provides, which lead to higher days sales outstanding (DSO).

Figure 5: Vöröskő's profitability margins



Source: Vöröskő, Scope Ratings

Figure 6: Development of the cash conversion cycle (CCC) and its components, in number of days



Source: Vöröskő, Scope Ratings

Profitability expected to remain flat

We expect scope-adjusted EBITDA margin to remain stable in the coming years. We do not expect a major improvement in the gross margin in the coming years as we see limited options for raising prices in this competitive market. Positive drivers are the automation of the warehouse and the launch of the new web engine (in January 2022). Its construction is not expected to greatly affect the group's scope-adjusted EBITDA margin as the group expects the project to be accomplished within three months, and the stores have seen an increase in inventories to mitigate. However, the Scope-adjusted EBITDA margin may shrink slightly as a result of our expectation that the group's numerous new initiatives (in terms of revamping existing shops to provide a better shopping experience and launching new products) might temporarily burden the cost of expenditures.

Financial risk profile (BB+)

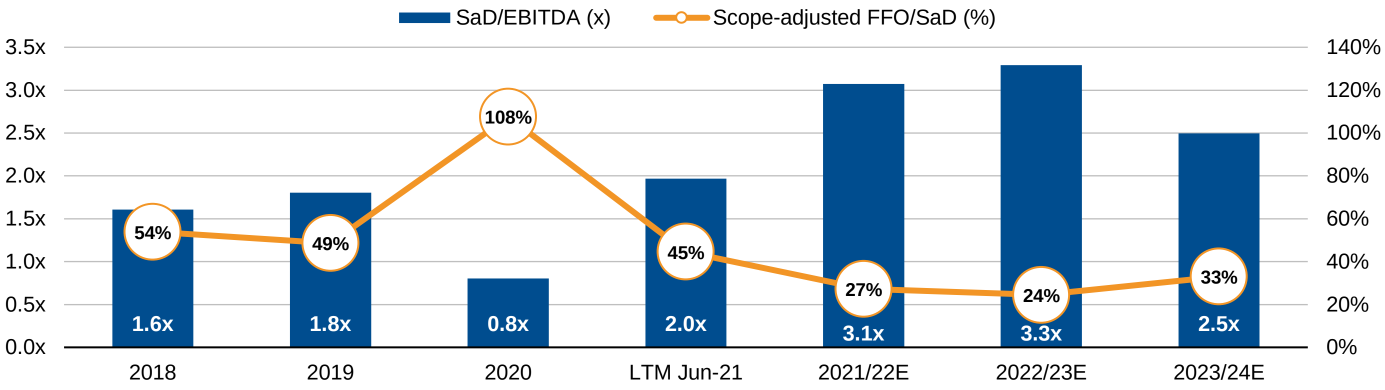
Absence of overall debt prior to bond issuance

While the business risk profile slightly decreases the overall rating, the absence of significant debt leads to a robust financial risk profile. Excluding the upcoming bond issuance, Vöröskő has funded the vast majority of its operations internally, leading to SaD that is mainly comprised of operating leases (above 90% of total gross debt over the last few years). Given that the group aims to buy its rented stores and Budapest office in the next two years, the weight of operating leases is expected to decrease sharply. However, due to relatively low EBITDA, cash flows are expected to remain weak and very sensitive to the evolution of net working capital in the coming years. We expect a reduction in DIO given the upcoming automated warehouse, leading to a gradual reduction in CCC. We expect cash on balance sheet to remain at a comfortable level in the coming years, netting the gross debt 'in the coming years, significantly reducing gross debt. It is worth noting that the group decided to change its business year from December to June to better absorb the winter season.

Metrics expected to be low during capex phase

Leverage metrics (defined by SaD/EBITDA and funds from operations/SaD) are expected to deteriorate in 2022 and 2023 given the group's bond issuance. We expect these metrics to reach a peak of 3.3x and 24% respectively at YE 2022/23 – the end of the capex programme – before improving again in the following years and decreasing to 2.5x and 33%, driven by our assumption of improving cash flow and the absence of new debt issuance.

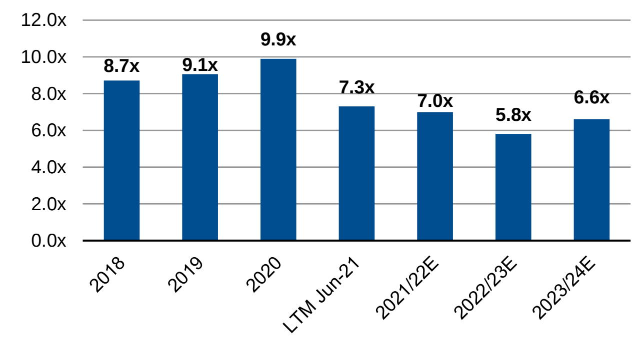
Figure 7: Evolution of leverage metrics



Source: Vörösko, Scope Ratings

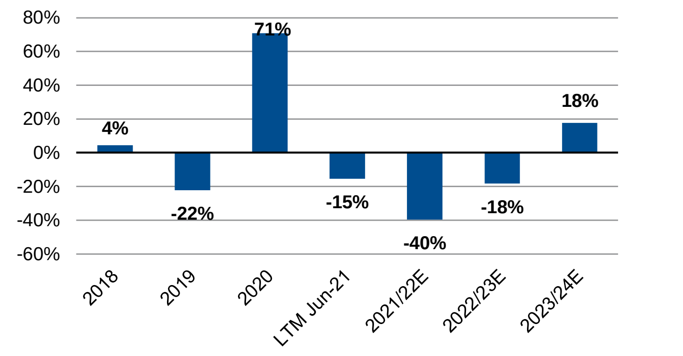
Interest expenses are expected to remain strong despite the bond issuance and a higher interest rate environment, as the group is not expected to issue financial debt. We expect the interest cover to remain stable in a range of 5.5x-6.5x in the coming years. Cash flow cover is expected to remain under pressure for the next two years due to an increase in investments financed by the bond, leading to negative FOCF. We consider the group to be sensitive to variations in net working capital due to its small size. We expect the cash flow cover ratio to recover slightly towards a positive level once the investment programme is completed.

Figure 8: Evolution of the interest cover



Source: Vörösko, Scope Ratings

Figure 9: Evolution of the cash flow cover



Source: Vörösko, Scope Ratings

Liquidity is adequate due to absence of short-term debt

Liquidity is considered adequate, driven by the absence of significant financial debt repayments in the coming years. The first bond repayment is planned for the fifth year. The group benefits additionally from a HUF 5.3bn revolving credit facility, which is intended to be used only for seasonal financing of net working capital.

Long-term debt ratings

The senior unsecured bond is rated based on a recovery calculated on the liquidation value. We calculated an average (31%) recovery under a hypothetical bankruptcy happening in 2023. We have consequently rated the bond at the same level as the issuer.

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