10 June 2022

Corporates

Progress Étteremhálózat Kft. Hungary, Corporates

BB STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	230.5x	15.2x	10.6x	12.3x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	3.1x	2.5x	3.4x	3.1x
Funds from operations/SaD	31%	36%	26%	28%
Free operating cash flow/SaD	19%	0%	-21%	5%

Rating rationale

Scope Ratings affirms the issuer rating Hungary-based Progress Étteremhálózat Kft. at BB/Stable. Senior unsecured debt category is affirmed in line with the issuer rating at BB.

The rating action reflects strong organic growth coupled with new store openings and the modernisation of all existing restaurants while investment cost are fixed and most input costs are protected by robust treasury.

The rating action is based on Progress' good market position in Hungary, solid margins, and significant growth potential. The rating is constrained by low diversification and increasing leverage, as the refurbishment of existing restaurants progresses and new restaurants are opened in the coming years, as well as pressure on medium-term profitability from soaring input costs.

Progress' activities are facilitated by the McDonald's Corporation and its strong brand, which supports the company's market leader position in the informal eating out segment in Hungary and its good profitability. This, in turn, is supported by well-defined global marketing facilities and supplier side capacity. The primary risk to the rating would be a deterioration in Progress' relationship with McDonald's.

The low fixed interest rate bond and fixed investment costs keep leverage under control with strong cash flow generation and adequate liquidity with no large debt amortisation until 2026. The heavy investment pipeline puts pressure on the rating, although the opening of new stores and modernisation of existing restaurants is flexible.

Outlook and rating-change drivers

The Outlook is Stable based on our expectation of expansion being executed as planned, which should result in revenue increasing as new restaurants open. We also assume that the company will not pay dividends to the parent company before 2025.

A positive rating action is a remote scenario but could be warranted if the company strengthened free operating cash flow/Scope-adjusted debt (SaD) of at least 10% on a sustained basis.

A downgrade could be warranted in the event of an increase in SaD/Scope-adjusted EBITDA to above 4x as a result of: i) a deterioration in the franchise relationship (development licence) with McDonald's; ii) a significant delay in or failure to successfully execute expansion plans; and/or iii) a renewed closure of restaurants due to another wave of Covid-19 and/or (iv) inflationary pressure.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
6 Jul 2021	Upgrade	BB/Stable
1 Jul 2020	Initial rating	BB-/Stable

Ratings & Outlook

Issuer	BB/Stable
Senior unsecured debt	BB

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Related Methodology

Corporate Rating Methodology; July 2021

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Bloomberg: RESP SCOP

Positive rating drivers	Negative rating drivers
• Good profitability, supported by world-leading quick-service restaurant brand, driven by strong marketing strategy validated by consumer research • Well-defined strategies to preserve market-leader role, including plans for double-digit new restaurants and facelifts for all existing restaurants • Potential for further expansion with drive-through restaurants, which have solid profitability • Robust interest cover ratio	• Heavily dependent on continued franchise relationship (development licence) with McDonald's • Negative free operating cash flow/SaD due to intensive capex plan • Weak diversification • Increased leverage after issuance of bond, measured by SaD/EBITDA

Positive rating-change drivers	Negative rating-change drivers
• Significantly stronger revenue growth • Free operating cash flow/SaD of at least 10% on a sustained basis	• Increase in SaD/Scope-adjusted EBITDA to above 4x • Deterioration in franchise relationship (development licence) with McDonald's • Significant delay in or inability to execute expansion successfully • Renewed closing of restaurants due to pandemic • Inflationary pressure resulting in low cash flow generation

Corporate profile

Progress Étteremhálózat Kft. (Progress) is the McDonald's Corporation developmental licensee in Hungary and one of the largest restaurant operator in the country, based on both revenue and profit. Progress operates McDonald's restaurants, uses trademarks, intellectual property rights, and other products as part of the franchise business. 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 licence partners.

Progress Étteremhálózat Kft – formerly named McDonalds Hungary Kft – was established in 1988. The ownership changed in 2019 when Hungarian entrepreneur Mr. Sándor Scheer acquired 100% of the company from global McDonald's via Leones QSR Kft. The company does not have any restaurants other than McDonald's restaurants and operations are limited to Hungary. The only investment of Leones QSR is Progress Étteremhálózat Kft. and Leones QSR is the parent of Progress Étteremhálózat Kft.

In Hungary, McDonald's has over 100 restaurants with system-wide sales exceeding HUF 88bn in 2021 and HUF 68bn in 2020. Of these 102 local stores, 62 are operated and owned by Progress and 40 are operated via conventional licence partners in the country. Four new stores were opened in 2021 and over 20 were modernised. Progress plans to expand its Hungarian restaurant network significantly by 2025.

Financial overview

			Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	230.5x	15.2x	10.6x	12.3x	15.4x
SaD/Scope-adjusted EBITDA	3.1x	2.5x	3.4x	3.1x	2.4x
Funds from operations/SaD	31%	36%	26%	28%	37%
Free operating cash flow/SaD	19%	0%	-21%	5%	14%
Scope-adjusted EBITDA in HUF m					
EBITDA	4,899,724	8,834,279	7,724,243	8,710,862	11,484,263
Operating lease payments	1,757,288	2,173,672	2,787,806	3,470,957	3,775,320
Scope-adjusted EBITDA	**6,657,012**	**11,007,951**	**10,512,049**	**12,181,819**	**15,259,583**
Funds from operations in HUF m					
Scope-adjusted EBITDA	6,657,012	11,007,951	10,512,049	12,181,819	15,259,583
less: (net) cash interest paid	-28,884	-723,672	-990,000	-990,000	-990,000
less: cash tax paid per cash flow statement	-174,758	-574,198	-384,990	-384,947	-518,819
Funds from operations[1]	**6,453,370**	**9,710,081**	**9,137,059**	**10,806,872**	**13,750,763**
Free operating cash flow in HUF m					
Funds from operations	6,453,370	9,710,081	9,137,059	10,806,872	13,750,763
Change in working capital	49,584	-531,912	-238,029	-274,620	-125,955
Non-operating cash flow	28,309	568,933	993,179	825,120	905,976
less: capital expenditure (net)	-2,661,296	-9,680,123	-17,500,000	-9,500,000	-9,500,000
Free operating cash flow	**3,869,967**	**66,980**	**-7,607,791**	**1,857,372**	**5,030,784**
Net cash interest paid in HUF m					
Net cash interest per cash flow statement	28,884	723,672	990,000	990,000	990,000
Net cash interest paid	28,884	723,672	990,000	990,000	990,000
Scope-adjusted debt in HUF m					
Reported gross financial debt	34,070,644	33,000,000	33,000,000	33,000,000	33,000,000
less: cash and cash equivalents	-17,687,739	-17,279,600	-6,963,827	-5,472,867	-6,799,123
add: non-accessible cash	674,000	7,201,029	4,033,980	3,892,762	3,000,000
add: operating lease obligations	3,514,576	4,347,344	5,575,612	6,941,914	7,550,640
Scope-adjusted debt	**20,571,481**	**27,268,773**	**35,645,765**	**38,361,809**	**36,751,517**

[1]Analytical changes have been made to FFO and FOCF calculations on lease adjustments, where Scope-adjusted EBITDA was taken into consideration instead of reported EBITDA.

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Environmental, social and governance (ESG) profile[2]

Environment		Social		Governance	
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)	Green leaf	Labour management	Grey leaf	Management and supervision (supervisory boards and key person risk)	Grey leaf
Efficiencies (e.g. in production)	Green leaf	Health and safety (e.g. staff and customers)	Grey leaf	Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)	Green leaf
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)	Grey leaf	Clients and supply chain (geographical/product diversification)		Corporate structure (complexity)	Grey leaf
Physical risks (e.g. business/asset vulnerability, diversification)	Grey leaf	Regulatory and reputational risks	Green leaf	Stakeholder management (shareholder payouts and respect for creditor interests)	Green leaf

Legend
Green leaf (ESG factor: credit positive)
Red leaf (ESG factor: credit negative)
Grey leaf (ESG factor: credit neutral)

ESG profile

Progress is working on a dedicated ESG strategy. It has cut its environmental footprint sharply by reducing packaging in general (albeit still above the use at a la carte restaurants), offering alternatives to traditional beef burgers (although the consumer preference is still beef in Hungary) and modernising its whole infrastructure. As a large employer, Progress has community support programmes in place and has a good focus on gender equality. Ownership and management structures are well separated. The company pays careful attention to compliance with food safety and avoiding regulatory and reputational risks and the Hungarian entity invests above group level in product innovation. The preparation of a sustainability report is underway with set targets.

[2]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

Small player on global scale, market leader in Hungary

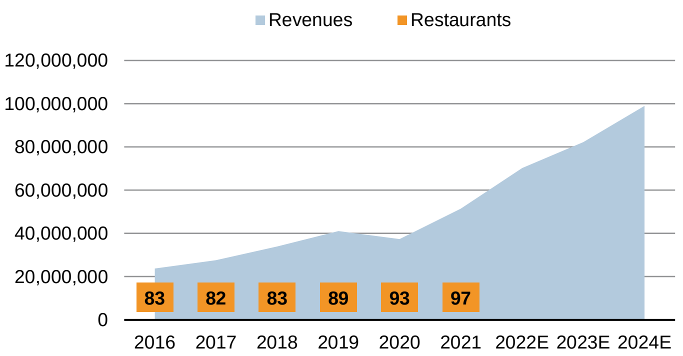
Progress is one of the largest restaurant operator in Hungary, operating the McDonald's brand. Revenues of HUF 41bn in 2019 (roughly EUR 120m), HUF 37.4bn in 2020 and HUF 51bn in 2021 (to above pre-Covid levels) make Progress a small or medium sized B2C company.

Progress was able to accomplish significant organic sales and guest count growth in Hungary over 2015-19 without increasing its number of restaurants. However, in order to maintain its strong market position in the coming years, an increase in the number of restaurants is necessary. This helps to explain Progress' aggressive expansion plans, with new store openings every year until the end of 2025. At the same time, all existing restaurants are being modernised in Hungary until the end of 2023. We believe that this ongoing intensive capex plan will strengthen McDonald's market position. Moderate EBITDA margins will protect the company's market shares if competitors try to win market shares by sacrificing profitability. Our expectation is that Progress will be able to keep its strong market share in Hungary in the medium term. The company's market position is hampered by its dependence on a single country and the fragmentation of the market as well as Progress' small scale on a global level.

Restricted product portfolio but supported by diversified distribution channels

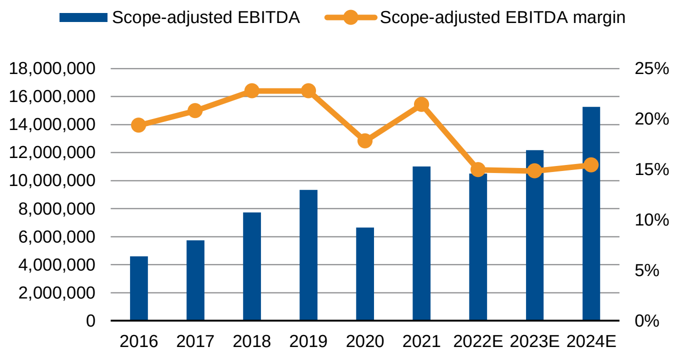
Geographical diversification is limited due to the sole exposure to Hungary. McDonald's sales channels are diversified: home delivery is available in around 85% of the restaurants and drive through access is growing, with McDonald's intention to increase the ratio in the coming years. From the supplier side, we see a strong integration in global supply chains. As the Covid-19 pandemic developed there were no disruptions on the supplier side. Therefore, we see a low degree of concentration as regards both suppliers and buyers. We note that McDonald's is taking pro-active steps to increase product diversification by increasing menu variety, adding breakfast, opening McCafé shops, and offering wraps and salads. Ultimately, however, McDonald's continues to have a product portfolio limited to food and beverages. McDonald's is set to become one of the first companies to integrate decision technology into the customer point of sale.

Figure 1: Evolution of company revenues and network size



Sources: Progress, Scope (estimates)

Figure 2: Operating profitability



Sources: Progress, Scope (estimates)

High margins under inflationary pressure

Historical EBITDA margins range from 13.1% (2016) to 17.9% (2019) and 17.2% (2021) with an average of 15.6% between 2016 and 2021. The Scope-adjusted EBITDA margin is 4pp higher as it is adjusted for the leased real estate portfolio's payments. The margin has recovered to pre-Covid levels and investments in the premium product portfolio have materialised. The better product mix helped Progress regain customers while building up support functions to support growth. All restaurants to be opened under its current strategy will be 'free-standing drive-through', the most resilient format in its restaurant portfolio. Home delivery is made through partners such as WOLT and Foodpanda, making it a volume business that supports market share rather than the margin.

In 2022 margins are under high inflationary pressure. Progress expects its EBITDA margin to fall by more than 5pp, while keeping/increasing its market share and growing its EBITDA in absolute terms.

Progress faces headwinds in terms of rising labour costs in Hungary with double-digit hikes. However, this is counterbalanced by favourable pricing power, market growth, and capex in digitalisation in years to come, which should strongly increase productivity. By adding to its number of restaurants, Progress should also continue to benefit from economies of scale, which has already provided lower material. This is the result of better purchasing conditions due to larger purchasing volumes. Increased general and administrative costs will also flatten as the network expands.

In 2022, we expect no one-off items as seen in previous years, such as the Covid-related wage subsidies or VAT reduction. Pre-election cash incentives for the population will, however, fuel consumption until the end of the year. Affordability and hence economies of scale remain key in light of the soaring inflation environment.

Financial risk profile: BB

Assumptions

We expect pressure on EBITDA margins, down from 17% (2021) to 10%-12% in the next three years due to high inflationary pressure. This will be coupled with strong revenue growth from organic growth due to a better product mix, affordable pricing, continuing investments in the remodeling of existing restaurants and a moderate increase in the number of restaurants.

We assume that significant capex for new restaurants and the redesign of current ones will be in line with management's projections, with most of the construction costs fixed. Furthermore, we assume dividends will only be paid post 2025, after planned investments have been made.

As is the case for other franchise companies, real estate plays an essential role in the finances and the business case of Progress. Long-term sub-franchising agreements entered into by Progress with conventional licence partners include often real estate. We have adjusted EBITDA for these franchise payments.

The company's debt includes a HUF 33bn senior unsecured bond with a 3% fixed coupon and HUF 2.4bn in bank guarantees at the end of 2021, with no major changes expected in the next three years.

We have excluded from cash netting the contracted capex amounts (HUF 4.3bn at the end of 2021) and HUF 500m in cashier money.

Manageable leverage

Despite the ongoing large capex plan and inflationary pressure, leverage remains manageable and well within the BB category. Even after the issuance of the HUF 33bn bond, SaD/EBITDA will stay between 3-3.5x.

In 2020, leverage increased due to the bond issuance but also had low volatility. SaD/EBITDA ranged from 3.1x in 2020 (lower EBITDA due to the economic effects of the Covid-19 pandemic) to 3.4x in 2022 (higher EBITDA due to the opening of numerous restaurants) and inflationary pressure.

Negative free operating cash flow, capex can be phased

Leverage depends heavily on the pace at which capex is deployed. Progress' capex is phased and management has space to manoeuvre, which helps to keep leverage under control.

Strong cash flow generation under inflationary pressure

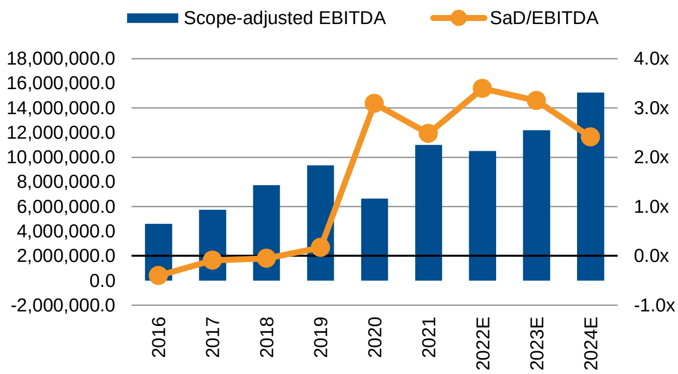
Funds from operations/SaD is very stable and strong, at around 25-35%, reflecting good funds from operations and a limited debt position. High inflation will put pressure on this metric in 2022-23.

Strong interest cover despite acquisition-related loan

Interest cover measured by Scope-adjusted EBITDA/interest expenses is robust. It was extremely high between 2016 and 2019, and we expect it to be above 10x in the next three years.

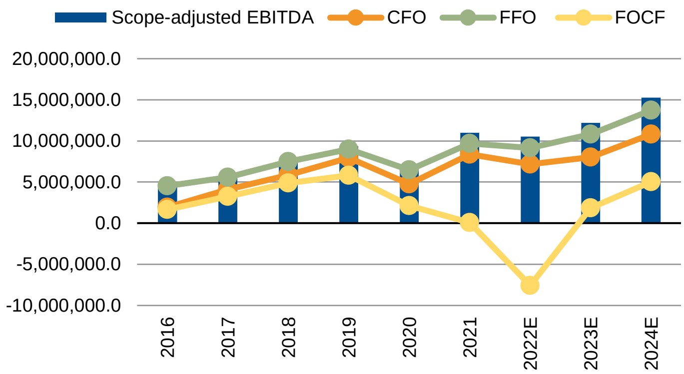
The interest-bearing intercompany loan to Leones QSR is capitalising interest. No cash flow is expected under these terms.

Figure 3: Leverage evolution with capex deployment



Sources: Progress, Scope (estimates)

Figure 4: Cash flows



Sources: Progress, Scope (estimates)

Low fixed interest rate financing provides flexibility

In 2020, Progress issued a senior unsecured HUF 33bn bond under the Bond Funding for Growth Scheme of the Hungarian National Bank (MNB). The bond has a fixed coupon of 3% and will start amortising in 2026 after the capex plan has been completed. The low fixed interest rate bond, fixed investment costs and strong hedges provide an advantage over most competitors.

Adequate liquidity

Liquidity is adequate and benefits from the company's conservative debt maturity profile, with no short-term debt either historically or planned in the coming years. We anticipate that low short-term debt levels will be maintained going forward and be sufficiently covered by available financing sources.

Supplementary rating drivers: +/- 0 notches

We view Progress' financial policy as appropriate and prudent, with the company targeting net debt/EBITDA not exceeding 3.5x. Peer group considerations do not warrant a change to the rating. We view parent support and governance and structure as credit neutral.

Long-term debt ratings

Senior unsecured debt rating: BB

We affirm the senior unsecured debt rating at BB, the same level as the issuer rating.

In our recovery assessment, the increase in assets compared to the YE 2021 level (investments under execution) is heavily discounted and, despite a strong unencumbered asset position, the significant intercompany loan limits the recovery for outstanding senior unsecured debt to 'average' (30%-50%) in a hypothetical default scenario based in 2024. For these reasons, there is no uplift given to the rating for senior unsecured debt category.

Appendix: Peer comparison (as at last reporting date)

	Progress Étteremhálózat Kft.	B+N Referencia Zrt.	Bonafarm Zrt (group)	Baromfi-Coop Kft.	Wellis Magyarország Zrt.
Issuer rating	BB/Stable	BB-/Positive	BB-/Positive	BB-/Stable	BB-/Stable
Last reporting date	31 December 2021	31 December 2020	31 December 2020	31 December 2020	31 December 2020
Business risk profile	BB	BB-	BB+	BB	BB
Financial risk profile	BB	BBB+	B+	BB-	BB -
Scope-adjusted EBITDA/interest cover	15.2x	26.0x	144.5x	17.1x	80.1x
SaD/Scope-adjusted EBITDA	2.5x	1.5x	2.5x	3.6x	1.5x
Funds from operations/SaD	36%	60%	40%	26%	-12%
Free operating cash flow/SaD	0%	189%	-12%	-19%	69%
Supplementary rating drivers	-	+1	+1	-	-

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