Pannon-Work Zrt.
Hungary, Business Services

SCOPE **B+** STABLE

Corporate profile

Pannon-Work Zrt. is a privately owned human resources service provider founded over 20 years ago. Operations are mainly in Hungary, with core activities in recruitment and workforce leasing. The company acquired ten 0.5MW solar energy production plants in 2021.

Key metrics

			Scope estimates		
Scope credit ratios	2019	2020	2021E	2022E	2023E
EBITDA/interest cover (x)	32.3x	59.0x	8.1x	9.1x	10.2x
Scope-adjusted debt (SaD)/EBITDA	2.5x	5.2x	4.7x	4.3x	4.0x
Scope-adjusted FFO/SaD	39%	18%	18%	19%	21%
FOCF/SaD	-54%	15%	19%	13%	14%

Rating rationale

Scope Ratings has today upgraded Hungary-based Pannon-Work Zrt's issuer rating to B+/Stable from B/Stable. The issued senior unsecured guaranteed bond rating (ISIN: HU0000360052) has been upgraded to BB- from B+.

The rating action reflects the closed acquisition of 5MW solar energy power generation plants with excellent cash flow generation potential, the acquisition of HR-Face Kft. (a payroll provider company) to broaden services and an increasing margin despite the pandemic.

Pannon-Work's business risk profile (assessed at B+) is driven by its position as the fourth largest personnel service provider in Hungary operating in a very fragmented market as well as diversification into payroll services and renewables. The company's business risk profile is constrained by weak geographical and client diversification.

Pannon-Work's financial risk profile is driven by: i) increasing indebtedness following the issuance of a HUF 3.5bn senior unsecured guaranteed bond and additional HUF 700m long-term senior secured loans for capex and acquisitions; ii) weakening but still reasonable credit metrics as a result; iii) investments in recurring cash flow producing assets enabled by bond proceeds and additional debt issued, which will bear fruit in the coming years, supporting EBITDA growth and allowing gradual deleveraging.

Outlook and rating-change drivers

The Outlook for Pannon-Work is Stable and incorporates our view that the business is stable and the company is able to generate cash. The Stable Outlook also reflects our expectation that indebtedness will remain high, at Scope-adjusted debt (SaD)/Scope-adjusted EBITDA of above 4x over the next few years, as a result of the bond issuance and related investments. We expect dividends to the owners of Pannon-Work of up to one-third of profit after tax in the next few years, distribution of dividends to owners is subject to approval of the bank providing the investment loan.

A positive rating action is remote at this stage but could be warranted if Pannon-Work grows significantly in size benefiting the company's diversification, especially regards customers, while SaD/Scope-adjusted EBITDA stays significantly below 4x or if we gain higher visibility on free operating cash flow/SaD exceeding 20%.

Ratings & Outlook

Corporate ratings	B+/Stable

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Related Methodology

Corporate Rating Methodology: July 2021

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Bloomberg: RESP SCOP

This could be achieved by improving profitability, a higher EBITDA contribution from HR services or reduced shareholder remuneration.

A negative rating action could occur if SaD/EBITDA exceeds 6x on a sustained basis or if free operating cash flow/SaD were to fall below 5% on a sustained basis. This could result from lower EBITDA than planned from HR-related services or from its solar energy production assets or further debt-funded capital expenditure or acquisitions.

Rating drivers

Positive rating drivers	Negative rating drivers
• One of the four largest personnel service companies in Hungary	• Impact of the bond issuance and new acquisition/capex loans on financials
• Growth over the years and acquired expertise and market share (recently in payroll services)	• High fragmentation and low entry barriers of the business services industry
• Opportunity to expand into neighbouring countries	• Customer concentration risk and dependence on the domestic market
• Diversification into other sectors – renewables and real estate	• High indebtedness and weak credit metrics

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA moving below 4x on a sustained basis	
• Higher visibility on FOCF/SaD, moving above 20%	• SaD/EBITDA moving above 6x on a sustained basis
• Significant growth in size benefiting the company’s diversification, especially regards customers	• Free operating cash flow/SaD below 5% on a sustained basis

Financial overview

			Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	32.3x	59.0x	8.1x	9.1x	10.2x
Scope-adjusted debt (SaD)/EBITDA[1]	2.5x	5.2x	4.7x	4.3x	4.0x
Scope-adjusted funds from operations/SaD[1]	39%	18%	18%	19%	21%
Free operating cash flow/SaD[1]	-54%	15%	19%	13%	14%
Scope-adjusted EBITDA in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	256	696	926	963	994
Operating lease payments in respective year	-	-	-	-	-
Other	251	61	-	-	-
Scope-adjusted EBITDA	**507**	**757**	**926**	**963**	**994**
Scope-adjusted funds from operations in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	507	757	926	963	994
less: (net) cash interest as per cash flow statement	-16	-13	-114	-106	-98
less: cash tax paid as per cash flow statement	0	-23	-44	-46	-50
add: depreciation component, operating leases	-	-	-	-	-
Scope-adjusted funds from operations	**491**	**720**	**767**	**811**	**847**
Scope-adjusted debt in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	1,249	3,899	4,382	4,181	3,980
less: hybrid bonds	-	-	-	-	-
less: cash and cash equivalents[1]	n/a	n/a	n/a	n/a	n/a
add: cash not accessible	-	-	-	-	-
add: pension adjustment	-	-	-	-	-
add: operating lease obligations	-	-	-	-	-
Other	-	-	-	-	-
Scope-adjusted debt	**1,249**	**3,899**	**4,382**	**4,181**	**3,980**

[1] Netting of cash: generally only applicable to ratings in the BB category or higher, and only if the cash is permanent and accessible.

Business risk profile: B+

Pannon-Work is classified as a personnel services company, which we consider a subsegment of the business services industry. It has also had recent exposure to the renewables energy production market.

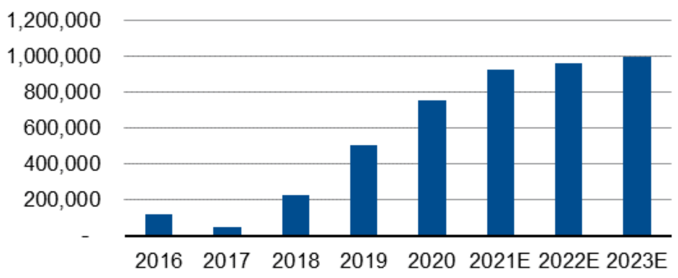
Small-scale player in a fragmented HR services market

Pannon-Work's business risk profile is driven by its position as the fourth largest personnel services provider in Hungary. The Hungarian market is very fragmented, with the top four players holding a market share of around one-third. The industry risk is blended (assessed at BBB+) between business services and renewables (one-fifth of EBITDA from mid-2021).

Volatile cash flow from workforce leasing mitigated by recurring revenues

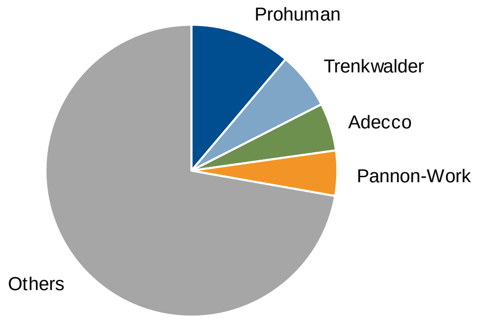
Growth over the years has been driven by the labour shortage in Hungary and companies' need for an intermediary to offer flexibility by leasing out personnel when required. The existing labour shortage and further workforce needs created by large-scale investments in the automotive, retail and consumer goods sectors may continue to be an issue, enabling the leased workforce market to grow. At the same time, clients are continuously tendering out contracts with workforce agencies and the leased workforce is the easiest to let go, as seen in the first wave of the pandemic. The cash flow arising from Pannon-Work's blue collar workforce leasing is therefore volatile and vulnerable.

Figure 1: Pannon-Work Scope-adjusted EBITDA evolution



Source: Pannon-Work, Scope, Data in HUF thousand

Figure 2: Top HR service providers in Hungary



Source: Pannon-Work, Scope

Despite the company's efforts to expand its range of services, it faces concentration risk due to its sole exposure to Hungary, dependence on the Hungarian labour market and low customer diversification. Although the top 10 clients contribute more than 50% of revenues, most of them are bound to Pannon-Work for more than five years. We consider low geographical and client diversification leads to volatile cash flows from Pannon-Work's main activity, as seen in the past as well. Since there are significant large-scale investments in Hungary with need of labour especially in the automotive parts segment, we expect the blue-collar workforce lease market to grow, which may provide additional opportunities for Pannon-Work to grow its client base.

Furthermore, recurring revenues from the recently acquired solar energy production and revenues from outsourced services such as payroll services provided by the recently acquired HR-Face Kft. mitigate this vulnerable cash flow, since clients change service providers less frequently due to the administrative burden.

Resilient to the pandemic but cash flow is volatile

The coronavirus crisis led to the default of one large client, while others decreased their leased worker headcount temporarily between Q1 and Q3 2020. However, clients returned after this period and Pannon-Work successfully secured new, large clients and diversified its service offering by providing payroll services.

Improving profitability, mainly from recurring revenues

The Scope-adjusted EBITDA margin of 4.9% in 2020 has improved despite the pandemic compared to previous year. We expect it to increase to around 6% after Q2 2021 as the ten new 0.5MW solar power generation assets were acquired with a feed-in tariff system fixed for over 14 years[2]. Improved profitability is mainly thanks to recurring revenues and their EBITDA contribution. From 2021 onwards, around 40% of EBITDA will be generated by payroll services and green energy production, which have more protected cash flows than blue collar workforce leasing.

The company faces the challenge of rising operating expenditures due to an increase in wage costs. This is mitigated by decreasing taxes and social security contributions in Hungary since Q3 2020. It is difficult to increase HR services revenues due to the competition.

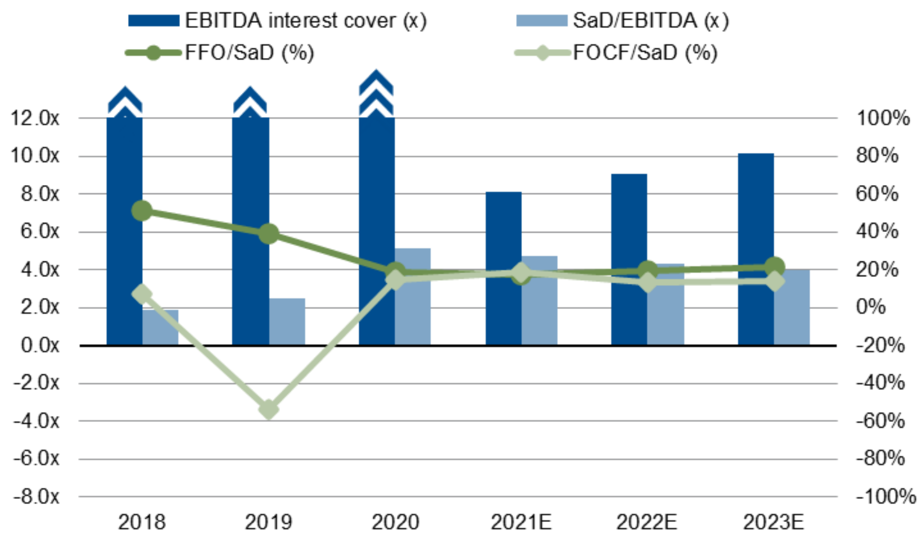
Financial risk profile: B+

Increased leverage due to investments followed by planned deleveraging

Pannon-Work's financial risk profile is driven by: i) increasing indebtedness following the issuance of a HUF 3.5bn senior unsecured guaranteed bond and additional HUF 700m senior secured long-term loans for capex and acquisitions; ii) weakening but still reasonable credit metrics as a result, with SaD/EBITDA increasing to above 5x in 2020 from 2.5x in 2019, FFO/SaD down to slightly below 20% in 2020 from around 40% in 2019; iii) investments recurring in cash flow producing assets enabled by bond proceeds and additional debt issued, which will bear fruit in the coming years, supporting EBITDA growth and allowing gradual deleveraging.

The bond proceeds were used to repay around HUF 1.1bn of Pannon-Work's short-term debts. The remainder was invested in a solar power plants that have been generating cash flow since mid-2021.

Figure 3: Key Scope credit metrics



Source: Scope estimates

We forecast SaD/Scope-adjusted EBITDA of slightly below 5x in 2021, which should follow a decreasing trend towards 4x in the coming years. This will mainly be due to increased profitability and growth of business at 3%-4% p.a. as well as the amortisation of the acquisition/capex loans. EBITDA interest cover is decreasing due to the HUF 4.2bn debt issued between Q3 2020 and Q2 2021, but remains at a good level. The fall to just

[2] The Hungarian Energy and Public Utility Regulatory Authority is the regulatory body for the energy and public utility market, supervising the national economy's sectors of strategic importance. The fixed feed-in tariff system applies for up to 0.5MW solar assets under a KÁT licence, such as the assets acquired in SPVs by Pannon-Work. - http://www.mekh.hu/kotelezo-atveteli-rendszer-villamos-energia

over 8x going forward is supported by increased profitability of HR services and EBITDA generated by HR payroll services and solar energy production. Thus, new levels are seen to be sufficient to enable the issuer to serve interest payments, even providing some headroom to cover for potential volatility in cash flow driven by high customer concentration. Free cash flow has fluctuated in previous years due to the continued expansion and restructuring. However, funds from operations/SaD is forecasted around 20% and free operating cash flow/SaD should stay well above 10% from 2021 going forward.

Historically volatile liquidity is improving

We deem Pannon-Work's liquidity adequate. The internal liquidity ratio should be in the range of 5-13x in the coming two to three years. Part of the bond proceeds were used to repay HUF 1.1bn in interest-bearing short-term debt, while acquisitions and investments are financed via contracted long-term loan facilities. The company also has an available HUF 950m factoring line and HUF 1.05bn working capital facility to help pay any intra-month tax and meet social security payment deadlines. The working capital lines are not extensively used, providing the issuer cash flow headroom.

	2021E (HUF m)	2022E (HUF m)	2023E (HUF m)
Unrestricted cash (t-1)	1,148	1,789	1,979
Open committed credit lines (t-1)	854	854	854
Scope-adjusted free operating cash flow	819	551	564
Short-term debt (t-1)	369	196	196
Coverage (internal)	**5.3x**	**11.9x**	**13.0x**
Coverage (external)	**7.6x**	**16.3x**	**17.3x**

Long-term debt rating

We expect an above-average recovery level in a hypothetical default scenario based on a distressed liquidation value at YE 2022, aided by the high value of the standardised ten 0.5MW solar power plants acquired and insured receivables. We therefore rate the issued senior unsecured bond of Pannon-Work (ISIN: HU0000360052) guaranteed by Gamax Kft. one notch above the issuer rating at BB-. The rating also reflects the bond's junior ranking to the existing senior secured loans (for CAPEX, acquisition and working capital).

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