Tecnocom, Telecomunicaciones y Energía, S.A. (Tecnocom) Spain, ICT services

BB+ POSITIVE
Corporate Rating

Corporate profile

Spanish-based Tecnocom, Telecomunicaciones y Energía, SA and consolidated companies ('Tecnocom' or 'the group') ranks among the top three providers in the Spanish information and communication technology (ICT) market. Services range from service level agreements for business services such as application management (i.e. software rollout and integration), data and process management (i.e. payment processing with its own developed software) and management of business infrastructure (i.e. efficient workstation management). Such services are provided to a wide range of industries in both the public and the private sector. While Tecnocom remains strongly dependent on Iberia, the company has strongly developed its international outreach to selected markets in North and South America (i.e. Colombia, US, Chile, Peru, Mexico).

Tecnocom has received a takeover offer from Spanish technology company Indra Sistemas, S.A. ('Indra'; not rated by Scope) in November 2016. According to Indra, the bidder has subscribed irrevocable commitments with shareholders, which represent 52.7% of Tecnocom's share capital. The deal has been authorised by the CNMV (Comisión Nacional del Mercado de Valores) on 13 March 2017 and is expected to be closed during Q2 2017.

Rating

Corporate Rating	BB+
Outlook	Positive

Rating rationale

Scope Ratings upgraded the issuer rating of Tecnocom from BB to BB+. The rating outlook remains Positive, thanks to Tecnocom's planned acquisition by Indra Sistemas, SA.

The rating upgrade is primarily driven by the group's strong deleveraging in 2016 (SaD/EBITDA 2016: 0.6x) and the prospects for further deleveraging, with the early redemption of the EUR 35m MARF bond bolstered by further margin improvements and strong free cash flows. The rating, however, remains to some extent constrained by: the cyclicality of ICT, the group's industry; persisting high dependence on economic developments in its core market of Spain; and its limited corporate size.

Scope positively views a takeover by the leading Spanish-based ICT provider Indra, as this can reduce the major credit weaknesses of Tecnocom, such as limited outreach and diversification outside of Spain, without significantly harming the combined financial risk profile of the entity.

Outlook

The Positive Outlook reflects Scope's expectations about the future parent-subsidiary-relationship with Indra, whose creditworthiness is deemed to be stronger than for Tecnocom on a standalone basis.

A rating upgrade could be warranted if the takeover is executed as scheduled without significantly harming the combined financial risk profile of the combined group (SaD/EBITDA remaining below 2.5x; EBITDA/interest coverage remaining above 6.0x).

The Positive Outlook could be lowered if Scope were to expect an increase for the combined group's leverage (SaD/EBITDA) to above 3.0x on a sustainable basis.

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Related Research // Methodology

Scope's Corporate Rating Methodology January 2017

Scope affirms Tecnocom Group's BB Corporate Rating; Outlook changed from Stable to Positive March 2016

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Rating drivers

Positive	Negative
Solid cash flow generation as measured by CFO and positive free cash flow expected to continue in the next few years given the capex-light business model	High industry-inherent risks mainly stemming from the ITC industry's pre-cyclical character (BB rated industry)
Continuously improved financial risk profile • SaD/EBITDA 2016 of 0.6x vs 2.1x in 2015 • EBITDA/cash interest cover 2016 of 6.9x vs 4.1x in 2015 Further improvement of financial risk profile expected due to early debt redemption [MARF bond (2014/19) in 2017]	Remaining high business exposure to the Spanish core market (~80%); slow growth in Latin America
Strong liquidity with limited refinancing needs in 2017-2019 • Even voluntary debt repayment manageable • Strong access to bank financing due to customer footprint with major banks	Limited scale with annual turnover of >EUR 400m
Dominant market position for ICT services with a unique selling point in payment processing for financial institutions and high percentage of recurring revenues (more than 80%) from high-quality customers	ICT business generally a low-margin business
Strongly diversified client portfolio with a large exposure to high-quality blue-chip corporates and governmental authorities	
Positive rating impact from the anticipated acquisition by Indra scheduled in Q2 2017 which reduces Tecnocom's major credit weaknesses without significantly harming the overall financial risk profile • Better geographical outreach • Scaling effects and synergies likely from cross-selling • New dimension of corporate size and outreach	

Rating change drivers

Positive	Negative
Successful integration into Indra with realisation of scaling effects and synergies, especially from the enlarged international outreach with a combined leverage of below 2.5x	Cancellation of deal with Indra or increase of the combined group's leverage (SaD/EBITDA) to above 3.0x on a sustainable basis

Financial overview

		Scope estimates		
Scope key credit metrics	**2015**	**2016**	**2017F**	**2018F**
EBITDA/interest cover (x)	4.1	6.9	6.7	13.9
SaD/EBITDA (x)	2.1	0.6	0.4	0.0
Liquidity	>200%	>200%	>200%	>200%

		Scope estimates		
Scope-adjusted EBITDA in EUR '000s	**2015**	**2016**	**2017F**	**2018F**
Recurring EBITDA	21,852	30,385	29,215	30,037
Operating lease adjustment in respective year	1,113	960	960	960
Scope-adjusted EBITDA	22,965	31,345	30,175	30,997

		Scope estimates		
Scope-adjusted debt in EUR '000s	**2015**	**2016**	**2017F**	**2018F**
Reported gross financial debt	77,515	57,814	17,167	11,772
Deduct: Cash, cash equivalents	-50,434	-58,099	-24,458	-30,369
Cash not accessible	-	-	-	-
Add: Operating lease adjustments	22,251	19,203	19,203	19,203
Scope-adjusted debt (SaD)	49,332	18,918	11,912	606

Business risk profile

High industry-inherent risks partly offset by Tecnocom's operating flexibility

Tecnocom's rating is to some extent constrained by high industry-inherent risks, characterised by the early cyclical patterns of ICT services as well as medium entry barriers. Therefore, the group's cash flows could be negatively impacted once the investment cycle of customers has peaked. However, Scope notes that Tecnocom's robust profitability grants it the flexibility needed to address this potential issue by quickly adjusting its cost base, if required.

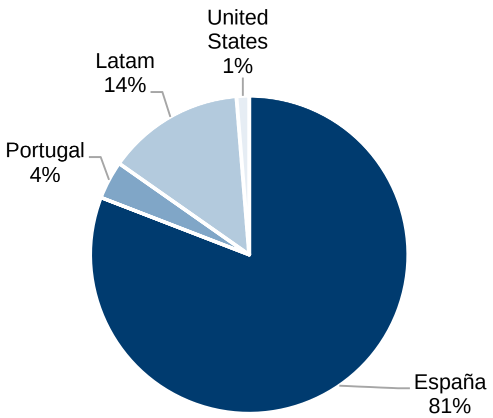
Strong position and long-lasting business relations in core market of Spain

Although Tecnocom is still a relatively small player in terms of revenue (EUR 411m in 2016), Scope regards its market position to be very solid. Ranking among the top three ICT providers in Spain, the group benefits from its niche market position through its methods of payment processing for financial institutions. Scope highlights the group's excellent outreach, not only to large blue-chip customers with a high credit quality (i.e. 22 of the IBEX 35 companies), but also to government authorities. Although the majority of service level agreements must be renegotiated and extended annually, besides some multi-annual agreements, Scope believes the group's expertise and reputation result in a high portion of recurring business with major customers. According to estimates, over 80% of annual revenues come from these long-lasting relations, many of which span more than 10 years. This evidences not only Tecnocom's quality of service and unique selling points, particularly in payment processing, but also the high exit barriers for customers (it is difficult for customers to quickly switch ICT providers or migrate IT systems).

Full coverage of ICT services helps to improve outreach to end-markets

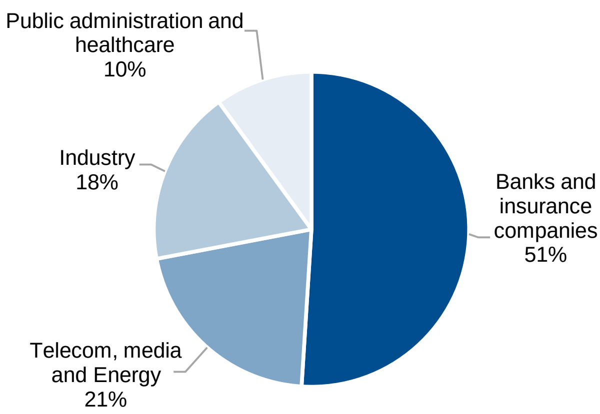
Scope positively views Tecnocom's product portfolio, which encompasses the full spectrum of ICT products and services. This allows the group to address a wide range of industries, including banking and insurance. While Tecnocom has consistently had a high exposure to major financial institutions (51% of revenues in 2016), it has recently increased its footprint in other industries such as telecommunications, media and energy (21% of 2016 revenues), industrials (18%), and public authorities (10%).

Figure 1: Tecnocom's geographical outreach 2016



Source: Tecnocom, Scope

Figure 2: Tecnocom's industry exposure 2016



Source: Tecnocom, Scope

High dependence on core market of Spain constitutes Tecnocom's major credit weakness

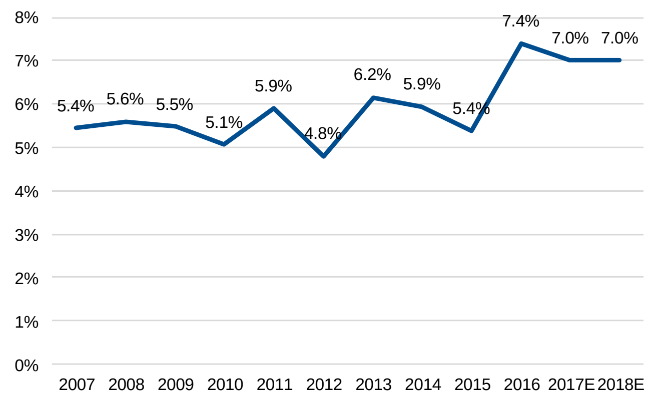
Scope notes that Tecnocom lags behind its own plans regarding its continued diversification outside its core market of Spain. With 81% of 2016 revenues generated in Spain, the group remains vulnerable to shocks in the country's economic recovery, particularly within its banking sector. An accelerated expansion into the Latin American market (14% of 2016 revenues) would therefore enhance its credit strength. Given the stronger growth potential of emerging markets in Latin America, Scope expects

Tecnocom to reduce its dependence on Spain in the coming years. In light of the planned integration into Indra, which already generates about one-quarter of its revenues in Latin America, Scope believes Tecnocom can largely benefit from the cross-selling activities of the future group's salesforce to accelerate its business outreach in this region.

Improving profitability bolstered by increased efficiency

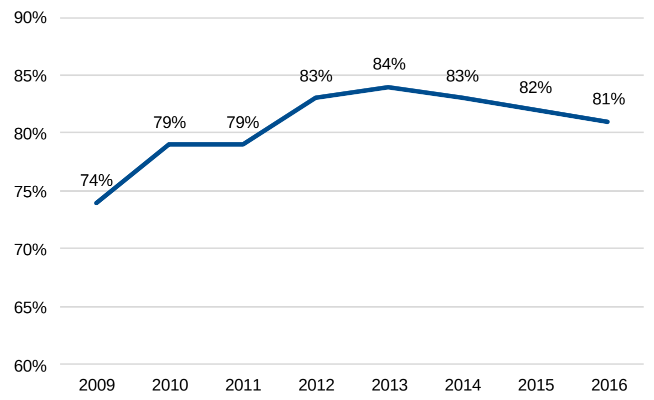
Despite the ICT sector's inherent cyclicality as well as pressures from competitors, Tecnocom's EBITDA margin is regarded as robust. This is a result of the 'capital light' business model, which flexibly adjusts to projected demand. Bolstered by the group's efforts regarding efficiency and the J-curve effect from new contracts, Tecnocom's recurring EBITDA margin reached a new record of 7.8% in 2016 (up from 5.4% in 2015).

Figure 3: Tecnocom's margin development (recurring EBITDA margin)



Source: Tecnocom, Scope

Figure 4: High share of recurring business



Source: Tecnocom, Scope

Tecnocom's credit weaknesses expected to reduce with Indra takeover

Scope positively views the integration of Tecnocom into the larger business of Indra. Scope notes that the combined business risk profile of Indra and Tecnocom is stronger than that of Tecnocom as a standalone entity. This is primarily due to

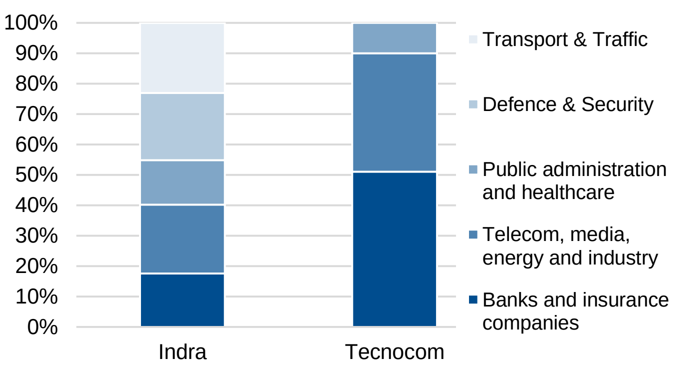
i) the greater corporate size in terms of combined revenues and combined EBITDA;

ii) the stronger exposure to more stable sectors such as governments, healthcare, and traffic/transport, which implies a large share of recurring income and resilience to economic cycles (see figure 5);

iii) higher diversification outside of the Spanish market (see figure 6); and

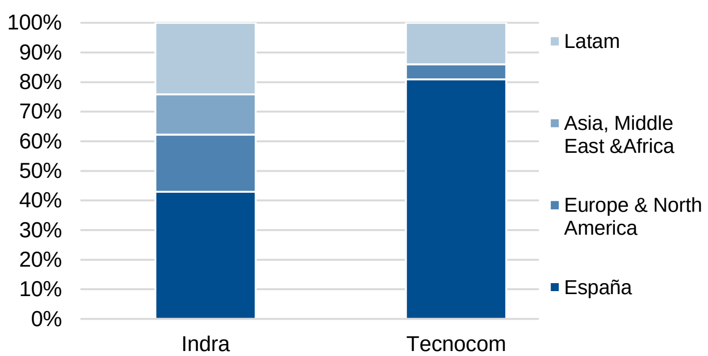
iv) the high likelihood of margin stabilisation with the integration of the complementary businesses, allowing for scaling effects and synergies.

Figure 5: Sector segmentation: Indra vs Tecnocom 2016



Source: Indra, Tecnocom, Scope

Figure 6: Geographical outreach; Indra vs Tecnocom 2016



Source: Indra, Tecnocom, Scope

Financial risk profile

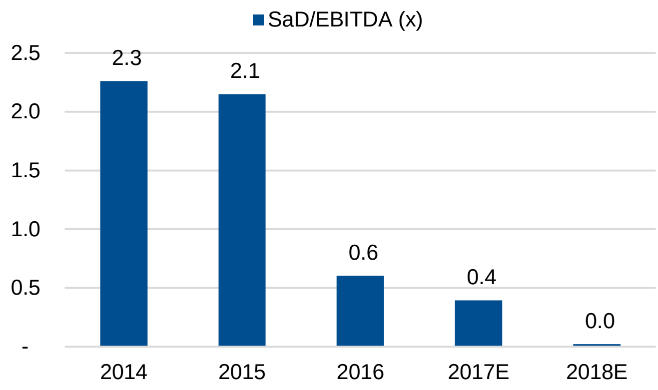
Strong improvement of key credit metrics

Scope highlights the strong improvement of Tecnocom's financial risk profile over the past few years. The group has strongly deleveraged over the past few years, thanks to the group's robust operating cash flows, comparatively low capex, and limited dividend distributions. Tecnocom's leverage (measured as Scope-adjusted debt/EBITDA of 0.6x as of December 2016 against 2.1x at YE 2015) and EBITDA/interest coverage (6.9x in 2016 against 4.1x in 2015) fully justify the rating upgrade.

Early redemption of MARF bond to further improve financial risk profile

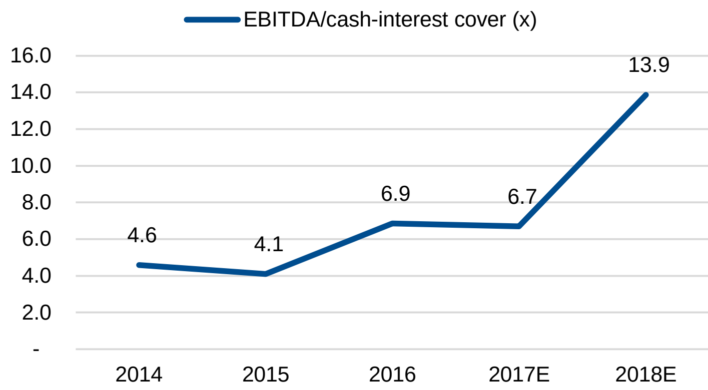
As the group has signalled the early redemption of its EUR 35m MARF bond in H1 2017 – two years ahead of its original maturity – with cash (EUR 58m at YE 2016), Scope expects Tecnocom's financial risk profile to improve further, owing to the annual interest savings of about EUR 2.3m. For 2017, Scope expects Tecnocom's leverage in terms of SaD/EBITDA to remain below 1.0x and its EBITDA/interest coverage to remain above 6.0x. Scope believes Tecnocom will become net cash by YE 2018 on a standalone basis.

Figure 7: Tecnocom: Development of leverage



Source: Tecnocom, Scope

Figure 8: Tecnocom: Development of debt protection



Source: Tecnocom, Scope

Financial risks further mitigated by robust liquidity

Tecnocom's liquidity measures are regarded to be very strong over the next two years, even with the cash-financed redemption of the EUR 35m MARF issue. As liquidity ratios stand well above 200%, refinancing risks are, in Scope's view, very limited. These levels are due to operating cash flows expected at above EUR 20m annually; access to undrawn – mostly rolling – credit and factoring lines of more than EUR 50m; and an unrestricted cash cushion of above EUR 20m at YE 2017. Consequently, Scope believes Tecnocom is in a comfortable position to redeem upcoming debt maturities in 2017 and 2018 (excluding rolling credit lines).

Impact from takeover of Indra on combined financial risk profile

Scope believes that Indra's acquisition of Tecnocom will not significantly harm the combined group's financial risk profile. This is because Indra will

i) integrate Tecnocom, which will almost be net cash at the time of the acquisition; and

ii) finance the takeover through cash and newly issued stock (combination of EUR 2.55 in cash and 0.1727 shares of newly issued Indra stock in exchange for each share of Tecnocom) without issuing new debt.

From Scope's perspective, the group's combined leverage (SaD/EBITDA) will be kept below 2.5x.

Supplementary key rating drivers

Adequate financial policy

Scope deems Tecnocom's financial policy to be risk-averse indicated by i) a strong focus on deleveraging over the past few years, ii) conservative approach on dividends distributions with a current dividend freeze due to the Indra transaction and iii) a strong focus on organic growth without major capex programmes or M&A strategies.

Future parent support from Indra

As outlined above, Tecnocom's credit quality will depend on its future parent company Indra, if the acquisition will be executed as planned. The deal has been authorised by the CNMV (Comisión Nacional del Mercado de Valores) on 13 March 2017 and is expected to be closed during Q2 2017.

Regulatory disclosures

Important information

Information pursuant to Regulation (EC) No 1060/2009 on credit rating agencies, as amended by Regulations (EU) No. 513/2011 and (EU) No. 462/2013

Responsibility

The party responsible for the dissemination of the financial analysis is Scope Ratings AG, Berlin, District Court for Berlin (Charlottenburg) HRB 161306 B, Chief Executive Officer: Torsten Hinrichs, Dr Stefan Bund, Dr Sven Janssen.

Rating prepared by	**Rating committee responsible for approval of the rating**
Sebastian Zank, Lead Analyst	Olaf Tölke, Committee Chair

Rating history

Date	Rating action	Rating
24 March 2016	**Outlook change**	**BB Positive Outlook**
24 March 2015	**Affirmation**	**BB Stable Outlook**
24 March 2014	**Initial rating**	**BB Stable Outlook**

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

Information on interests and conflicts of interest

The rating was prepared independently by Scope Ratings but for a fee based on a mandate of the rated entity. The issuer has participated in the rating process.

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Key sources of information for the rating

☒ Website of the rated entity
☒ Audited annual financial statements of the rated entity
☒ Interim financial statements
☒ Website of the Indra Sistemas SA
☒ Audited annual financial statements of Indra Sistemas SA
☒ Detailed information provided on request
☒ Data provided by external data providers
☒ External market reports
☒ Press reports/other public information

Scope Ratings considers the quality of the available information on the evaluated company to be satisfactory. Scope ensured as far as possible that the sources are reliable before drawing upon them, but did not verify each item of information specified in the sources independently.

Methodology

The methodology applicable for this rating (Corporate Rating Methodology) is available on www.scoperatings.com. The historical default rates of Scope Ratings can be viewed on the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's default rating, definitions of rating notations and further information on the analysis components of a rating can be found in the documents on methodologies on the rating agency's website.

Examination of the rating by the rated entity prior to publication

Prior to publication, the rated entity was given the opportunity to examine the rating and the rating drivers, including the principal grounds on which the credit rating or rating outlook is based. The rated entity was subsequently provided with at least one full working day, to point out any factual errors, or to appeal the rating decision and deliver additional material information. Following that examination, the rating was not modified.

Conditions of use/exclusion of liability

Rating issued by

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