22 February 2021

Corporates

Gloster Infokommunikációs Nyrt. Hungary, Business Services

B STABLE

Gloster Infokommunikációs Nyrt. (Gloster) has been operating on the Hungarian IT market (networking hardware) for around 20 years. Gloster recently expanded its IT services by acquiring GTMS, Euroway and Cableline. The company has been listed on the Budapest stock exchange Xtend market since June 2020 and has around 50 employees. 64.52% of Gloster's shares are owned by Viktor Szekeres (founder), 24.65% by Széchenyi Fund and 10.83% are free float.

Key metrics

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA/interest cover (x)	29.1x	Net Cash	28.4x	9.5x	10.7x
Scope-adjusted debt (SaD)/EBITDA	1.0x	1.5x	Net Cash	2.7x	2.3x
Scope-adjusted funds from operations/SaD	101%	62%	Net Cash	33%	35%
Free operating cash flow/SaD	-60%	28%	-24%	21%	21%

Rating rationale

The issuer rating of B reflects Gloster's sound financial performance, driven by relatively high profitability and low leverage. The rating is constrained by limited scale and less diversified business services.

Gloster's business risk profile (rated B-) is supported by increased, pent-up demand in the underlying industry, driven by a shift towards wireless adoption, network resilience, and digital transformation requirements. However, the company's limited scale results in negligible market shares (less than 1%) in Hungary's overall IT market, which is one of the main constraints on its business risk profile. Diversification also constrains Gloster's business risk profile due to significant exposure to one supplier (Cisco) in the networking hardware market and a limited geographical presence. Gloster does not compare well with peers rated by Scope due to its smaller scale and range of products/services. However, it has relatively high profitability margins (14% on average) in a local context. We expect EBITDA margins to remain above 10% in 2021-2022, following the gradual integration of target acquisitions.

Gloster's financial risk profile (rated BB) is supported by healthy operating profitability, which translates into a good underlying cash generation capability. Relatively low financial debt on the balance sheet and prudent operating performance have kept Gloster's credit metrics favourable in the past. We expect increased capital through the private placement of an approx. HUF 1.1bn to place Gloster's leverage at net cash.

A major capital investment phase in 2017-2020 (development of IT infrastructure centre CEREBRO and Gloster Managed Service Center) has pushed free operating cash flow close to zero.

Although sound EBITDA cash conversion with limited working capital investments, Gloster's largely short-term debt portfolio structure and significant capex expenditures kept liquidity below 100%. We assume that liquidity will improve further going forward, benefiting from significant cash on balance at the end of 2020 after the issuance of new shares and the assumed debt portfolio structure following the bond placement.

Ratings & Outlook

Corporate rating	B/Stable
Senior unsecured rating	B

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Related Methodology

Corporate Rating Methodology

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Bloomberg: RESP SCOP

Supplementary rating drivers result in a one-notch downgrade due to concerns regarding ambitious M&A strategy linked to execution risk and successful integration of the to be acquired businesses. This is because operating environment standards in the IT services market are rising rapidly and the demands on IT engineers are increasing significantly as technologies change.

Gloster plans to issue a HUF 2.0bn senior unsecured corporate bond. Proceeds from the bond are allocated to expansion via acquisitions. The resulting average recovery expectation translates into the same rating for the proposed senior unsecured debt as the issuer rating.

Outlook and rating-change drivers

Stable Outlook

The Stable Outlook reflects our expectation regards the execution of the issuers targeted M&A strategy financed with proceeds from the successful bond issuance, while Scope-adjusted debt/EBITDA will remain below 3.5x on a sustained basis.

Rating upside

A positive rating action could be warranted by an improved business risk profile, driven by an increase in size, a strengthened market position and a more diversified portfolio of products/services offered, while maintaining credit metrics along Scope’s expectations. This development could be triggered by a successful roll-out of the issuers M&A strategy including smooth integration of the to be acquired businesses.

Rating downside

A negative rating action could result from a deterioration in credit metrics, as indicated by Scope-adjusted debt (SaD)/EBITDA of above 3.5x on a sustained basis. Weak financial performance could be triggered by increased competition in the networking hardware market, putting operating profitability under pressure, or if execution risk around targeted acquisitions materialize.

Rating drivers

Positive rating drivers	Negative rating drivers
• Growing demand in underlying market • High customer retention rate underlines positive track record in fulfilling special expertise requirements • Low leverage • Relatively high profitability margins compared to local peers despite decreasing trend of profitability in hardware sales	• Negligible market share in Hungarian IT market • Project-based nature of business in enterprise hardware market reflected in low recurring revenues • Weak diversification with operations only in Hungary • High exposure to Cisco products • Execution risk posed by transformation of business model from hardware re-seller to IT service provider

Rating-change drivers

Positive rating drivers	Negative rating drivers
• Sustained improvements in business risk profile	• SaD/EBITDA above 3.5x

Financial overview

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA/interest cover (x)	29.1x	Net Cash	28.4x	9.5x	10.7x
SaD/EBITDA	1.0x	1.5x	Net Cash	2.7x	2.3x
Scope-adjusted FFO/SaD	101%	62%	Net Cash	33%	35%
FOCF/SaD	-60%	28%	-24%	21%	21%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA	323	289	354	408	633
Operating lease payments in respective year	0	0	0	0	0
Other	-95	-72	0	0	0
Scope-adjusted EBITDA	228	217	354	408	633
Scope-adjusted funds from operations in HUF m	**2018**	**2019**	**2020F**	**2021F**	**2022F**
EBITDA	228	217	354	408	633
(Net) cash interest as per cash flow statement	-8	1	-10	-43	-59
Cash tax paid as per cash flow statement	0	0	0	0	-50
Other	0	0	0	0	0
Scope FFO	226	217	344	364	524
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020F**	**2021F**	**2022F**
Reported gross financial debt	247	355	355	2,113	2,113
Cash, cash equivalents	-24	-38	-501	-995	-627
Guarantees	0	0	0	0	0
Provisions	0	0	0	0	0
SaD	223	317	-146	1,118	1,486

Business risk profile: B-

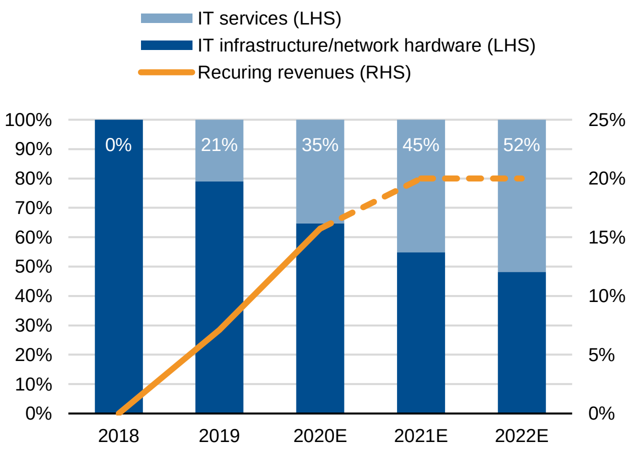
Negligible market shares

Gloster's business risk profile is supported by increased, pent-up demand in the underlying industry, driven by network resilience and digital transformation requirements. However, the company's limited scale results in negligible market shares (less than 1%) in Hungary's overall IT market, which is one of the main constraints on its business risk profile.

Relatively low entry barriers in enterprise networking hardware market

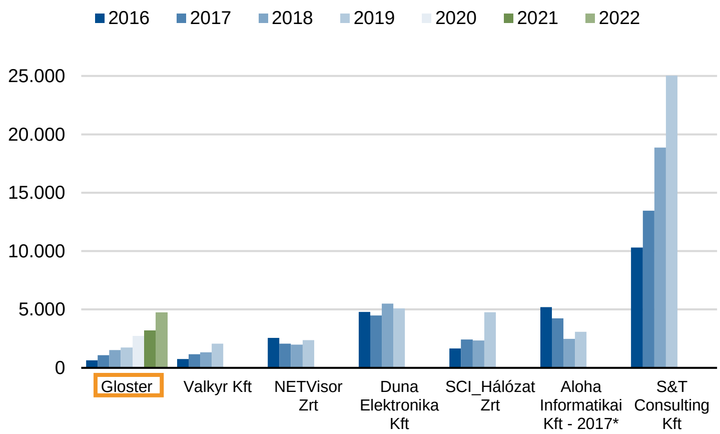
Gloster has high retention rates and positive long-term cooperation experience with customers. However, project-based nature of infrastructure hardware business reflected in low recurring revenues and relatively shorter duration of contracts still raises concern on organic growth and predictability of top line.

Figure 1: Gloster's business model



Source: Gloster, Scope

Figure 2: Gloster's market peers in Hungary (HUFm)



Source: Gloster, Scope

Inorganic growth opportunities on fragmented IT services market increases share of recurring revenues

Inorganic growth opportunities will arise in the short to medium term from concentric merger potential in the highly fragmented Hungarian IT service market. The GTMS, Cableline and Euroway acquisitions in 2019-2020 are cases in point. We see positively gradual increase IT services shares in total shares which proportionally increases recurring revenues. The increase in the adoption of network virtualization across SMEs is another factor contributing significantly to the market growth.

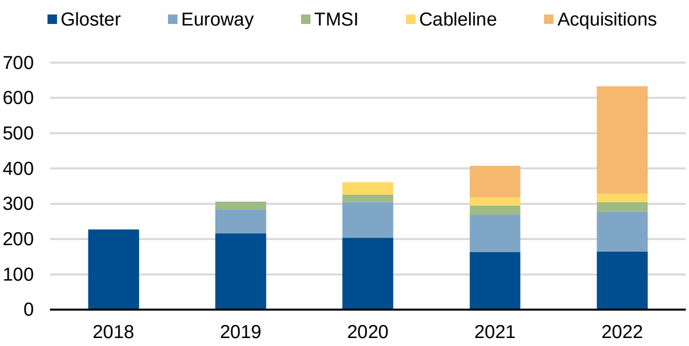
Top-line growth of networking hardware sales constrained by Covid-19 pandemic in short term

We expect Gloster's 2020 top line to have taken a hit from the Covid-19 pandemic, which delayed demand for network equipment. This impact is partially mitigated by accelerated demand IT services for digitalisation. Our current assumptions incorporate a rebound in sales in the short term.

Diversification is weakest component of business risk profile

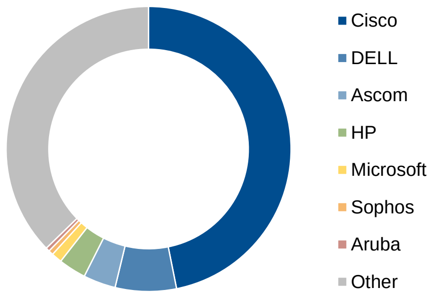
Diversification further constrains Gloster's business risk profile, due to significant exposure to one supplier (Cisco, 47%) in the networking hardware market and a limited geographical presence.

Figure 3: EBITDA split based by business lines (HUFm)



Source: Gloster, Scope

Figure 4: Sales breakdown by vendor (2019)



Source: Gloster, Scope

High dependence on Cisco products

The significant exposure to one supplier (Cisco, 47%) is partially mitigated by global dominance of Cisco in networking hardware market despite recent years trends of shifting from single vendor model to multi-vendor. Gloster has special expertise with different vendors: it is a Cisco Premier Partner, a Balabit Gold Partner; an Aruba MSP partner; and a Fortinet MSP partner). Nevertheless, it is critical for IT companies to diversify their services in order to keep growing their customer portfolios through network effect - increasing competition on the enterprise networking hardware market is pushing players to expand their product portfolios and establish partnerships with different vendors.

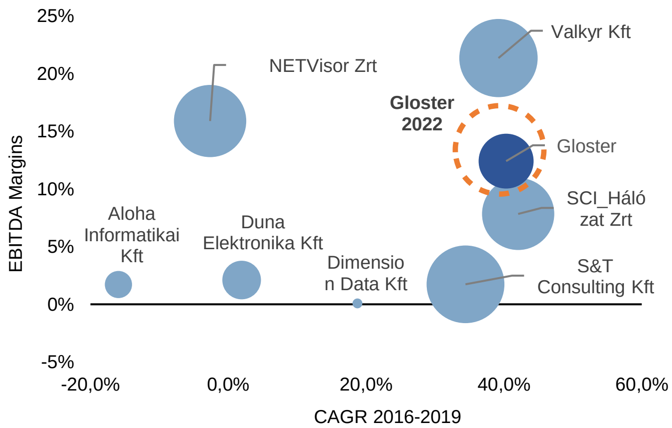
Concentrated customer base

High customer concentration is another factor which constrains diversification. Top ten customers accumulate around 60% of sales in FY 2019.

Potential for service diversification

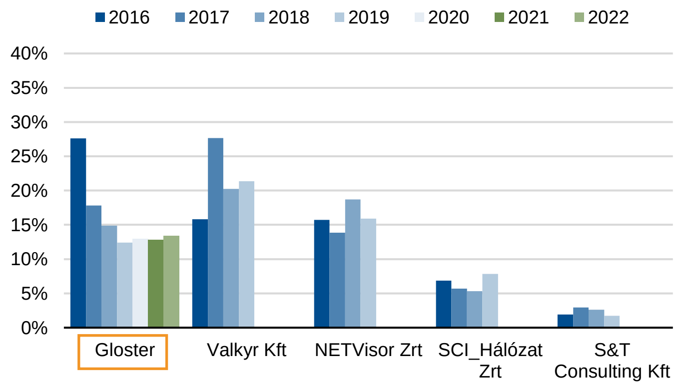
We believe that the company's current expansion plan will help to diversify its range of products/services and allow it to break into the ever-growing niche segment in the IT services market. This will be positive for Gloster's overall business profile, but we cannot give credit for it at the current stage.

Figure 5: Operating performance, Gloster market peers



Source: Gloster, Scope

Figure 6: EBITDA margins vs peers



Source: Gloster, Scope

Relatively high profitability compared to Scope rated peers

Gloster does not compare well with peers rated by Scope due to its smaller scale and range of products/services. However, it has relatively high EBITDA margins (14% on average) in a local context. Gloster's gross margins benefit from: i) flexibility regarding the commercial terms of the partnership agreement with its customers - shifting from single vendor model to multiple which give advantage to company to select supplier based on project requirement of pricing policy; and ii) a presence in an enterprise networking market, where demand is growing stably and which is less price sensitive on the end-market side.

Relatively high margins of IT services mitigate margin pressure on hardware sales

In the short to medium term, Gloster's profitability should be positively affected by an increasing share of IT services. IT services have higher profit margins, which would allow the company to offset margin pressure from the hardware sales unit. Overall, we expect EBITDA margins to remain above 10% in 2021-2022, following the gradual integration of target acquisitions.

Financial risk profile: BB

Our financial projections are mainly based on the following assumptions:

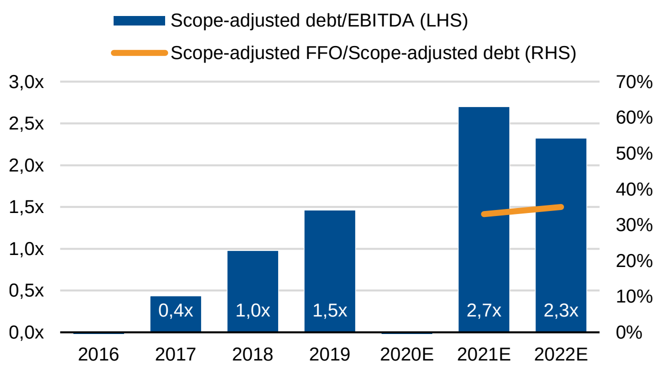
Scope adjustments and assumptions

- Going forward, low single-digit percentage growth in network hardware sales business line despite adverse short-term impact of Covid-19, while increasing competition puts margins under pressure.
- Our conservative assumptions regarding M&A transactions reflect still-limited visibility and execution risk around expansion plan for IT services as well as additional telecommunication-related revenues.
- Scope-adjusted EBITDA incudes adjustments for governmental grants.
- No material income tax till 2022.
- No dividends payments during acquisition phase in line with management guidance.
- The amount of available cash is netted by a 50% haircut in our calculation of SaD.
- No pension adjustments.

Financial risk profile

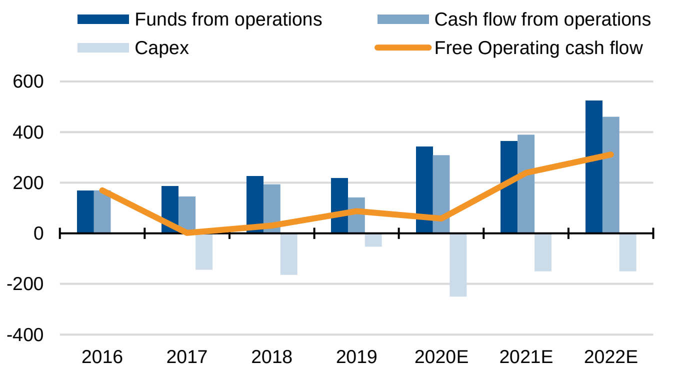
Gloster's financial risk profile is supported by its healthy operating profitability, which translates into a good underlying cash generation capability. Relatively low financial debt on the balance sheet and prudent operating performance have kept Gloster's credit metrics favourable in the past. We expect increased capital through the private placement of an approx. HUF 1.1bn to place Gloster's leverage at net cash.

Figure 7: Leverage



Source: Gloster, Scope estimates

Figure 8: Cash flow generation (HUFm)



Source: Gloster, Scope estimates

Low leverage

Our rating case incorporates the potential issue of HUF 2.0bn in bonds, which will be used for the IT services expansion plan via acquisitions. The substantial bond issuance will cause the company's low leverage to deteriorate but we expect gradual deleveraging after 2021 once potential acquisition targets have been consolidated. We expect leverage, expressed by SaD/EBITDA, to remain in comfortable territory below 3x.

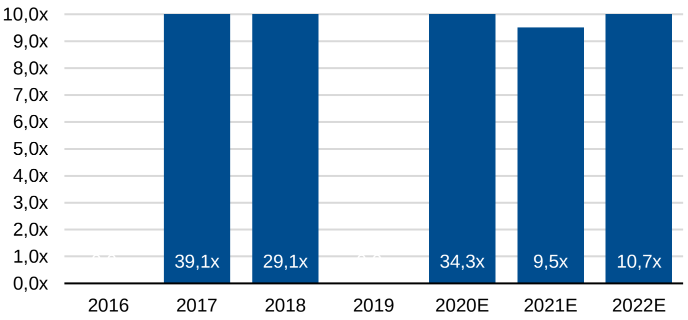
Expected positive free cash flows

A major capital investment phase in 2017-2020 (development of IT infrastructure centre CEREBRO and Gloster Managed Service Center) has pushed free operating cash flow close to zero. Based on no significant swings in working capital and limited capital investments in the future, as confirmed by management, we believe free operating cash flows will stay stable at above HUF 200m in 2021-22.

Sound EBITDA interest cover

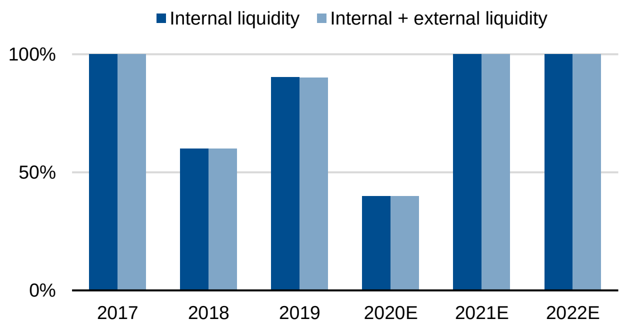
Significantly increased interest expense after the bond issuance will put pressure on Gloster's EBITDA interest coverage. However, this ratio will still remain in the A category in 2021-2022.

Figure 9: EBITDA interest coverage



Source: Gloster, Scope estimates

Figure 10: Liquidity profile



Source: Gloster, Scope estimates

Adequate liquidity profile

Although sound EBITDA cash conversion with limited working capital investments, Gloster's largely short-term debt portfolio structure and significant capex expenditures kept liquidity below 100%. We assume that liquidity will improve further going forward, benefiting from significant cash on balance at the end of 2020 after the issuance of new shares and the assumed debt portfolio structure following the successful bond placement.

In detail:

Position	2020E		2021E	
Unrestricted cash (t-1)	HUF	38.4m	HUF	1,024.8m
Open committed credit lines (t-1)	HUF	0.0m	HUF	0.0m
Free operating cash flow[1]	HUF	58.4m	HUF	239.4m
Short-term debt (t-1)	HUF	230.2m	HUF	241.7m
Coverage		**0.4x**		**5.2x**

Supplementary rating drivers

one-notch downgrade for financial policy

Supplementary rating drivers result in a one-notch downgrade due to concerns regarding ambitious M&A strategy linked to execution risk and successful integration of the to be acquired business. This is because operating environment standards in the IT services market are rising rapidly and the demands on IT engineers are increasing significantly as technologies change. The transformation of business model from networking hardware seller to integrated IT service provider raises concerns about a successful integration of targeted acquisitions in light of the company's current scale and profile.

Although its ownership structure does not fully compare with those of Western public companies, the recent listing on the Budapest stock exchange Xtend market aims to provide outside investors with better transparency. In addition, the owner's long-term commitment is reflected in prudent financial management and a direct involvement in Gloster's operating activities. While the owner's commitment and transparency is positive, we also see key person risk due to heavy dependence on the management/owner despite

[1] Discretionary expansion capex is excluded from the liquidity calculation as these investments are made only if external financing is available.

recent changes in corporate governance of Gloster (The former one-person management was replaced in 2020 by the Board of Directors, the Supervisory Board and the Audit Committee).

On December 15, 2020 National Stock Exchange Development Fund managed by Széchenyi Fund (100% owned by the Hungarian state) publicly announced short term exit strategy on 10% of Gloster's shares which accumulates around 2.5% Gloster's total shares. 22.2% of Gloste's shares will remain under Széchenyi Funds ownership.

Long-term debt ratings

Senior unsecured debt rated same as issuer rating

Gloster plans to issue a HUF 2.0bn senior unsecured corporate bond. Proceeds from the bond are allocated to expansion via acquisitions.

Our hypothetical default year is YE 2022, simulating a scenario in which the company has issued the new, proposed HUF 2.0bn senior unsecured bond and proceeds have been used accordingly. The resulting average recovery expectation translates into the same rating for the proposed senior unsecured debt as the issuer rating.

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