14 December 2022 | Corporates

Sun Group Kft.
Hungary, Business Services

SCOPE B+ STABLE

			Scope estimates	
Scope credit ratios	2020	2021	2022E[1]	2023E
Scope-adjusted EBITDA/interest cover	78.4x	Neg.	4.0x	3.8x
Scope-adjusted debt/EBITDA	2.8x	4.9x	3.0x	3.0x
Scope-adjusted funds from operations/debt	34%	32%	18%	16%
Scope-adjusted free operating cash flow/debt	17%	-4%	10%	9%

Rating rationale

The rating reflects the company's acquisition of the majority stake (80.22%) in the leading HR services provider in Hungary and the related successful senior unsecured HUF 15.4bn bond issuance in Q1 2022 but is constrained by its financial policy including debt-funded acquisitions and dividends.

The issuer rating of the significantly larger Sun Group is mainly driven by the acquisition of Prohumán, which has good cash flow compared to its local HR services peers, low maintenance capex requirements and well-established operations in Hungary and neighbouring countries.

The rating is constrained by the debt-financed acquisition of Prohumán and its high dependence on a single service (temporary staffing), low geographical and revenue diversification and limited transparency coupled with debt structuring at holding level.

Outlook and rating-change drivers

The Outlook is Stable and assumes further development of HR services resulting in a Scope-adjusted debt/EBITDA ratio between 3-4x taking into consideration below inflation revenue growth around yearly 10%, low capex, small acquisitions and moderate shareholder remuneration.

A positive rating action is remote but could be warranted if Sun Group's financial policy becomes more creditor friendly and IFRS consolidation is executed or improved its diversification in the HR services or geographies, including achieving a top-three market share in its countries of operation, with Scope-adjusted debt/EBITDA not exceeding 3x.

A negative rating action could be triggered by events such as supply chain disruptions resulting in a significant downsizing of temporary staff followed by a deterioration in credit metrics, e.g. if Scope-adjusted debt/EBITDA increased and stayed above 4x, or liquidity weakened due to very strong working capital swings or increased shareholder remuneration. Credit metrics could deteriorate because of another large debt-funded acquisition or a major dividend payout in the coming two to three years.

Furthermore senior unsecured bonds issued by Sun Group include a debt acceleration clause triggering early repayment if the rating falls below B+ and is not restored within two years or if the rating falls below B- the debt acceleration becomes immediate.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
14 Dec 2022	Affirmation	B+/Stable
21 Dec 2021	New	B+/Stable

[1] Consolidating Prohumán from 2022

Ratings & Outlook

Issuer	B+/Stable
Senior unsecured debt	B+

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Related Methodology

General Corporate Rating Methodology; July 2022

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Successful acquisition of the majority stake of Prohumán (the leading HR business services provider in Hungary) by the former strategic owners, which has diversified revenue streams and significantly increased the size of the group • Strong regional presence of Prohumán (top three positions in markets it is exposed to) • Prohumán's good standing with 1,000+ customers and a diversified revenue as a one-stop shop for HR business services • High occupancy of the HUF 5bn small real estate portfolio providing recurring cash flow	• Small real estate portfolio, concentrated on a single address, one flagship tenant renting 8,000 sq m out of the 11,000 sq m leasable office space • Acquisition of Prohumán funded by debt, leading to a significant increase in leverage • Disruptive events potentially causing downsizing of temporary staff, which could have immediate effects on the issuer (travel restrictions hindering international placements, supply chain or lower demand induced downsizing) – ESG credit negative • Financing structured on holding level (cash generation on subordinated level), limited but improving transparency (due to recent acquisition-related IFRS consolidation and improving disclosures towards capital markets) coupled with shareholder-friendly financial policy (ESG credit negative)

Positive rating-change drivers	Negative rating-change drivers
• Obtention of top three or market-leading position in its countries of operation and further diversification of services as per revenue share resulting in Scope-adjusted debt/EBITDA below 3.0x on a sustained basis • Improved financial policy	• Scope-adjusted debt/EBITDA sustained over 4.0x • Weakened liquidity

Corporate profile

Sun Group Kft. is a small real estate company managing HUF 5bn of assets consisting mostly of offices and some warehouses. The company is owned by three private individuals: Sándor Zakor, Gyula Kücsön and Róbert Kiss.

In Q1 2022, Sun Group acquired a majority stake (80.22%) in Prohumán 2004 Kft. from a HUF 15.4bn bond issue. Since then, most of the group's cash flow has been arising from HR services.

Prohumán is Hungary's market leader in HR services and has a strong presence in Central and Eastern Europe and the German-speaking countries. The minority share is owned by Hungarian private individuals via Profólió Kft. (19.78%).

Financial overview

			Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022E[2]**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	Net interest income		4.0x	3.8x	4.0x
Scope-adjusted debt/EBITDA	2.8x	4.9x	3.0x	3.0x	2.8x
Scope-adjusted funds from operations/debt	34%	32%	18%	17%	18%
Scope-adjusted free operating cash flow/debt	17%	-4%	10%	10%	11%
Scope-adjusted EBITDA in HUF '000s					
EBITDA	403,667	468,732	5,777,853	5,892,419	6,425,911
Scope-adjusted EBITDA	**403,667**	**468,732**	**5,777,853**	**5,892,419**	**6,425,911**
Funds from operations in HUF '000s					
Scope-adjusted EBITDA	403,667	468,732	5,777,853	5,892,419	6,425,911
less: (net) cash interest paid	1,979	319,549	-1,458,158	-1,533,154	-1,608,150
less: cash tax paid per cash flow statement	-19,352	-52,539	-1,288,350	-1,417,998	-1,523,522
Funds from operations (FFO)	**386,294**	**735,742**	**3,031,345**	**2,941,267**	**3,294,239**
Free operating cash flow in HUF '000s					
Funds from operations	386,294	735,742	3,031,345	2,941,267	3,294,239
Change in working capital	-138,997	-671,138	-212,460	-233,604	-256,856
Non-operating cash flow	-27,367	-	-141,686	-10,306	-9,388
less: capital expenditure (net)	-27,429	-150,000	-1,000,000	-1,000,000	-1,000,000
Free operating cash flow (FOCF)	**192,501**	**-85,396**	**1,677,199**	**1,697,357**	**2,027,995**
Net cash interest paid in HUF '000s					
Net cash interest per cash flow statement	1,979	319,549	-1,458,158	-1,533,154	-1,608,150
Net cash interest paid	**1,979**	**319,549**	**- 1,458,158**	**- 1,533,154**	**- 1,608,150**
Scope-adjusted debt in HUF '000s					
Reported gross financial debt	1,305,882	2,562,555	19,484,066	20,484,066	21,484,066
less: cash and cash equivalents	-167,228	-248,311	-6,529,988	-8,227,345	-10,255,340
add: non-accessible cash			4,309,792	5,430,048	6,768,524
Scope-adjusted debt	**1,138,654**	**2,314,244**	**17,263,870**	**17,686,769**	**17,997,250**

[2] Sun Group Kft. will consolidate Prohumán 2004 Kft. from 2022.

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Environmental, social and governance (ESG) profile[3]

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

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

Sun Group has a low environmental risk profile as it has become a services company after the acquisition of Prohumán.

Labour management compromises the social aspect of the company. Monthly turnover is high (up to 1,000 employees, more than 5% of total employees) and the industry uses hostels or basic accommodation to accommodate workers in the long term. In case of disruptions such as the pandemic or supply chain issues, temporary staff is let go first, with low protection against unemployment and low local state support thereafter. Stricter labour laws may have negative implications on profitability.

The corporate structure has medium complexity with senior secured loans placed on Prohumán (the operating company) and acquisition finance on Sun Group (holding).

Clarity and transparency have been improving with disclosures towards investors after the bond IPO and the group is making efforts to provide consolidated financials under IFRS from FY 2022.

[3] 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: B+

Industry risk profile: BBB

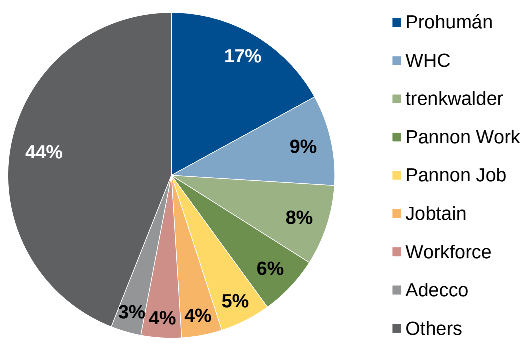
The business risk profile reflects our assessment of the industry in which a company operates and its competitive position within that industry.

We have analysed Sun Group under business services as HR services overtook real estate as Sun Group's primary industry following the acquisition of Prohumán. Real estate now accounts for less than 2% of total revenues and less than 10% of EBITDA.

The overall business services industry has medium cyclicality, entry barriers and substitution risk.

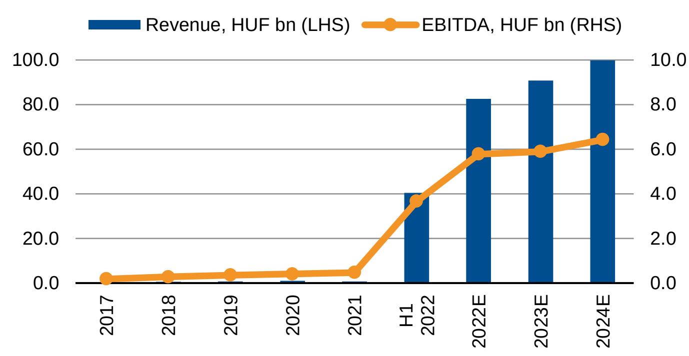
In Hungary, a low unemployment rate (3.6% in October 2022, lower than in 2021) and growing staff shortages in many sectors as a result of large foreign direct investments (such as in automotive/e-mobility, shared service centres) are increasing demand for employment agency services. Fulfilling labour needs is a growing challenge that, given the country's ageing society, is not expected to be resolved without intervention.

Figure 1: Market share of Prohumán in Hungary (2021)



Sources: Sun Group, Scope

Figure 2: Sales and EBITDA evolution



Sources: Sun Group, Scope estimates

Small, stable real estate portfolio

Sun Group's real estate assets are mainly located in Budapest. Assets are highly concentrated on just a few properties, with an office building and a warehouse representing HUF 4bn out of Sun Group's HUF 5bn total assets. The total leasable area is around 12,000 sq m for the office and 7,000 sq m for the warehouse. More than 90% of office space and a third of warehouse space are leased. A small property was sold in 2021. We do not expect any major changes to the portfolio, and we expect a stable EBITDA of HUF 0.4bn yearly.

Market-leading HR services in Hungary with regional presence

Prohumán is Hungary's leading HR services provider, with 17% of the market as of 2021, more than 1,000 clients and 16 offices countrywide. It is also present in the Central and Eastern Europe markets of Romania (13% market share experiencing strong increase) and Slovenia (3%). The fragmented Hungarian (and regional) HR market may see small companies ceasing operations and we expect market consolidation by larger companies such as Prohumán acquiring its smaller competitors.

Prohumán offers a comprehensive range of HR services, allowing clients to cover all their HR needs and gain access to the full labour market (adults, students and pensioners) via one partner.

High exposure to the automotive industry and temporary staffing service

Prohumán has a diversified service offering and client base within HR services and is shifting its focus away from the flagship service of temporary staffing to have a better mix with recruitment, payroll and placements that provide more stable, recurring income.

However, its services are concentrated around one area and there is a high exposure to the automotive industry accounting for 30% of revenue, which contains some large clients. This leads to a low diversification assessment.

Low-profitability flagship service coupled with high-margin add-ons

Prohumán has good profitability compared to local peers, with a Scope-adjusted EBITDA margin of around 7%. However, this is still low as European asset-light business services companies typically operate with margins above 20%. Temporary staffing is the company's flagship service, which comes with low margins (manual workers) and a high administrative burden. Most of its clients work with two to five HR firms, which are sometimes selected by tender, and they do not readily switch service providers. Therefore, Prohumán is more likely to achieve moderate profitability by cross-selling higher-margin services such as outsourcing, recruitment and HR administration.

To tackle low unemployment, two-year contracts are offered as a new service for workers coming from Vietnam, Philippines and Indonesia. The Asian headcount is currently 800, which will increase to 1,000 on the short-term resulting in the group headcount increasing by more than 5%. This provides more stable cash flow compared to temporary staffing jobs filled by locals where the average working contract duration is short term due to the high fluctuation and more seasonal. The additional recurring services (i.e. payroll) complement well the temporary staffing revenue.

Disruptive events resulting in large drop in manual workers

The first wave of the Covid-19 pandemic resulted in a 15% drop in Prohumán's headcount in H1 2020, mainly among Hungarian temporary manual workers. Despite a temporary drop of about 1,000 people, Prohumán significantly increased its overall leased headcount to around 12,500 by the end of 2021 and a further increase may come due to the upcoming influx of Asian workforce. Other disruptive events such as travel restrictions, supply chain issues or decreased demand amid soaring inflation can cause volatility.

Good Hungarian operations, growth driven by Romanian operations

Prohumán's Hungarian revenues decreased by 7.5% in 2020, with its EBITDA comparable to 2019 and 2018 at HUF 1.7bn. Growth is mainly due to the increased need for office workers in Romania, which led to revenue and EBITDA growth of 70% in 2021 compared to 2020. Romanian operations were acquired in 2017 with revenues of HUF 7bn and a margin close to zero. In 2020, revenues grew to over HUF 15bn with an EBITDA contribution of HUF 0.6bn. The strong growth continued in 2021 and as a result, Prohumán increased its market share in Romania from 5% to 13%. Historical EBITDA margin was around 6% for the HR business. We expect group revenue to increase in 2022 below inflation, by around 10% YoY and EBITDA margins to stabilise around 6-7%, albeit with medium volatility due to high fluctuation of temporary staff and possible supply chain disruptions resulting in optimisation of staffing.

Prohumán mainly managed by its founders

Some of Prohumán's founders have been managing the company since its inception in 2004. After the acquisition, Hungarian management did not change significantly.

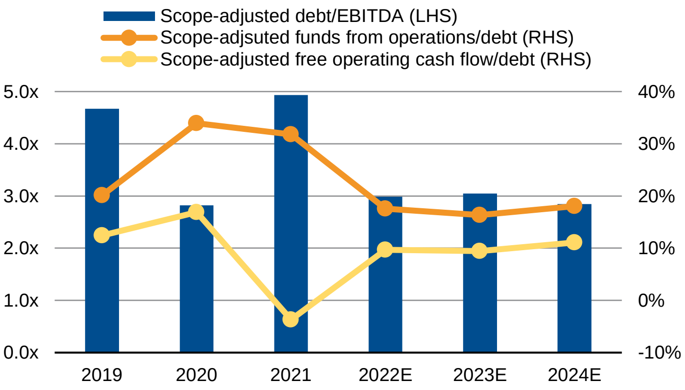
Financial risk profile: BB

Key planning assumptions

Our financial projections are mainly based on the following conservative assumptions:

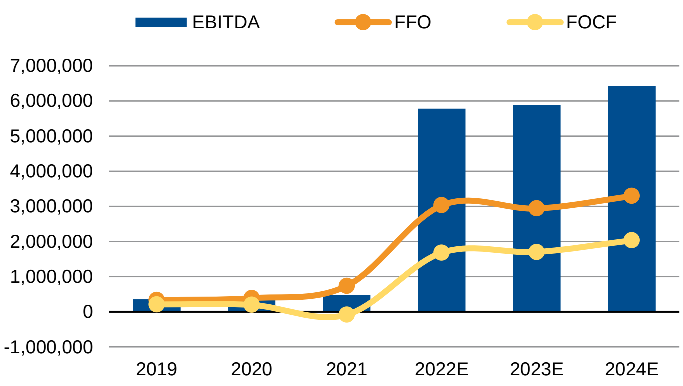
- Successful integration of Prohumán
- 10% in yearly revenue growth mainly driven by i) wage growth (somewhat below as we expect real wages will not match inflation);, (ii) further client acquisitions in Hungary and in the neighboring countries as the HR market consolidates and (iii) further expansion of services in Romania and other countries.
- Scope-adjusted EBITDA margin at around 6.5%-7.0% in line with historical trends
- Effective interest rate increasing to 7.5% because of variable interest rate for HUF denominated working capital lines (especially factoring)
- Stable real estate portfolio, apart from some smaller possible disposals
- No large debt-funded acquisitions planned in the next two to three years
- No large disruptive events (pandemic, supply chains)
- Total shareholder remuneration (cash out of the structure) up to HUF 1bn yearly
- Restricted cash balance relates to voted for but unpaid dividends and other cash items we believe may not be available in the long term for working capital financing

Figure 3: Leverage and cash flow cover



Sources: Sun Group, Scope estimates

Figure 4: Cash flow overview (in HUF '000s)



Sources: Sun Group, Scope estimates

Low leverage and moderate purchase price led to reasonable indebtedness after acquisition

Sun Group has kept leverage low for its small real estate portfolio, with a loan/value ratio of around 35% in 2018-2021.

The cost of the Prohumán acquisition was covered by a senior unsecured bond, resulting in Scope-adjusted debt/EBITDA increasing to around 3.5x for the post-transaction entity in early 2022.

Deleveraging hindered by acquisitions and shareholder remuneration

Sun Group's Scope-adjusted funds from operations/debt of 15-20% is moderate, which shows good cash flow generation while the Scope-adjusted free operating cash flow/debt around 10% show deleveraging potential.

Therefore, we expect gradual deleveraging towards Scope-adjusted debt/EBITDA of 3x which is slowed down by the increase in working capital finance needs due to wage inflation, slower payment from customers (which the company is trying to avoid), small potential acquisitions and moderate shareholder remuneration.

Prohumán maintains a healthy cash balance, with HUF 3bn at H1 2022 in line with our expectation.

There is no upcoming large debt amortisation. We expect all working capital lines (including factoring) to be rolled over as the security behind is often receivables from blue chip companies.

A high share of the cash is likely not available for debt service as we see appetite for acquisitions and the company has a shareholder-friendly dividend policy.

Medium protection against rising interest rates

We estimate an EBITDA/interest cover of around 4x in 2022-2024, with some deterioration due to rising interest rates in Hungarian forint, which heavily impacts the pricing of the group's working capital facilities and hence could impact its cash flow. The acquisition-related bond (ISIN HU0000361225) has a fixed coupon of 5.5% yearly, which protects the acquisition-related debt from increasing rates.

As an asset-light business capex needs are limited, therefore we expect Scope-adjusted free operating cash flow/debt to stay around 10%.

Adequate liquidity

The combined group's liquidity will depend on working capital movements and the fluctuation of temporary workers. We expect liquidity to remain adequate. There is no upcoming large debt amortisation.

Balance in HUF '000s	2022E	2023E	2024E
Unrestricted cash (t-1)	893,677	2,220,196	2,525,297
Open committed credit lines (t-1)	5,000,000	2,500,000	-
Free operating cash flow	1,677,199	1,697,357	2,027,995
Short-term debt (t-1)	1,823,199	2,147,525	3,147,525
Coverage	**>200%**	**>200%**	**145%**

Liquidity could still deteriorate, for example, in the event of very sharp working capital swings due to delayed customer payments, which would be mitigated by the factoring of receivables. We have taken into account the unutilised working capital lines up to the level of the accounts receivables as they are short term.

Supplementary rating drivers: - 1 notch

Sun Group's financial policy is a negative rating driver due to limited transparency (somewhat due the consolidation of the acquisition and related to loose financial planning), with debt structured on holding level and significant dividends in a period of a large acquisition.

The acquisition of Prohumán was performed without equity, financed out of debt issuance and resulted in moderate leverage. Dividend cash upstream from Prohumán to Sun Group entails a leakage of 20% towards the minority investor, the remainder being available at Sun Group level to service the bond issuance.

The rating is further constrained by Sun Group's acquisition appetite for smaller targets, expected to be financed by group cash flows.

Long-term debt ratings

Senior unsecured debt rating: B+

We expect an 'average' recovery for senior unsecured long-term debt including the HUF 15.4bn bond (maturing in 2032), which translates into a B+ rating.

This is based on the asset-light nature of HR services and the debt's ranking behind the senior secured creditors of Sun Group's real estate and the working capital and factoring creditors of Prohumán. The recovery is based on an expected distressed enterprise value as a going concern in a hypothetical default scenario of HUF 17bn in 2023 and a 10% haircut on that value for administrative claims.

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