3 July 2023 | Corporates

Pannon-Work Zrt.
Hungary, Business Services

B+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA interest cover	11.6x	12.3x	4.4x	4.2x
Scope-adjusted debt/EBITDA	4.5x	4.7x	4.4x	4.1x
Scope-adjusted funds from operations/debt	14%	18%	19%	18%
Scope-adjusted free operating cash flow/debt	-7%	5%	7%	9%

Rating rationale

Pannon-Work's ratings are supported by its good market position and increasing leased headcount in Hungary's temporary staffing market. The business services industry's high fragmentation and low barriers to entry temper the company's market position. Customer concentration risk is high, and Pannon-Work strongly depends on its domestic market.

Improvements in the service offering (such as payroll) and diversification into other sectors (such as worker accommodation and solar power generation) are providing higher recurring revenue and hence more stable cash flow.

A HUF 3.5bn bond issuance and new acquisition and working capital facilities during 2020-22 had a negative impact on financials, causing leverage (Scope-adjusted debt/EBITDA) to peak at 5.2x. The leverage ratio decreased moderately to 4.7x by end-2022, although this is still high. Debt protection is good due to the high proportion of fixed rate debt.

Outlook and rating-change drivers

The Outlook for Pannon-Work is Stable and reflects our view that the company can retain its major clients and keep up its strong cash flow generation. The Stable Outlook reflects our expectation that indebtedness will remain high, with a Scope-adjusted debt/EBITDA ratio of 4.0x-4.5x over the next few years as a result of the bond issuance, related investments and additional working capital financing.

A positive rating action is remote at this stage but could be warranted if Pannon-Work strengthened its balance sheet. One way it could do so is by reducing leverage (Scope-adjusted debt/EBITDA) significantly below 4x on a sustained basis. It could achieve this via improved profitability, a higher EBITDA contribution from HR services or reduced shareholder remuneration.

A negative rating action could occur if the Scope-adjusted debt/EBITDA ratio exceeded 6x on a sustained basis or if the Scope-adjusted free operating cash flow/debt ratio dropped below 5% on a sustained basis. This could result from lower-than-expected EBITDA from HR-related services or solar energy production assets or from further large debt-funded capital expenditure or acquisitions.

We note that Pannon-Work's senior unsecured bond issued under the Hungarian central bank's bond scheme has accelerated repayment clauses, including financial covenants and change of control provisions. The clauses require Pannon-Work to repay the nominal amount (HUF 3.48bn) within 15 days if the early repayment clauses are breached, which could have default implications.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
3 Jul 2023	Affirmation	B+/Stable
25 Jul 2022	Affirmation	B+/Stable
11 Aug 2021	Upgrade	B+/Stable

Ratings & Outlook

Issuer	B+/Stable
Senior unsecured bond rating (ISIN: HU0000360052)	B+

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Related Methodology

Corporate Rating Methodology; July 2022

European Utilities Rating Methodology; March 2023

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• One of the four largest personnel services companies in Hungary • Consistent growth over the years paired with growing expertise and market shares (recently in payroll services) • Opportunity to expand into neighbouring countries • Diversification into other sectors – renewables and real estate • Good EBITDA interest cover and cash flow generation	• Impact of the bond issuance and new acquisition/capex loans on financials • Business services industry's high fragmentation and low barriers to entry • Customer concentration risk and dependence on domestic market • High leverage

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted debt/EBITDA ratio significantly below 4x on a sustained basis	• Scope-adjusted debt/EBITDA ratio above 6x on a sustained basis • Scope-adjusted free operating cash flow/debt ratio below 5% on a sustained basis

Corporate profile

Pannon-Work is a privately owned human resources service provider founded over 20 years ago. It mainly operates in Hungary, where its core activities are recruitment and workforce leasing. It bought a large local payroll service provider and a workers' hostel in Komárom in 2021-22. In addition, the company acquired ten 0.5 MW solar energy production plants in 2021 and is in the process of acquiring two more small plants, resulting in 6 MW of total solar power generation capacity.

Financial overview

			Scope estimates		
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA interest cover	11.6x	12.3x	4.4x	4.2x	4.0x
Scope-adjusted debt/EBITDA	4.5x	4.7x	4.4x	4.1x	4.0x
Scope-adjusted funds from operations/debt	14%	18%	19%	18%	18%
Scope-adjusted free operating cash flow/debt	-7%	5%	7%	9%	10%
Scope-adjusted EBITDA in HUF ‘000s					
EBITDA	941,276	1,131,254	1,195,100	1,233,306	1,219,203
Scope-adjusted EBITDA	**941,276**	**1,131,254**	**1,195,100**	**1,233,306**	**1,219,203**
Funds from operations in HUF ‘000s					
Scope-adjusted EBITDA	941,276	1,131,254	1,195,100	1,233,306	1,219,203
less: (net) cash interest paid	-81,250	-92,255	-269,254	-293,684	-307,434
less: cash tax paid per cash flow statement	-19,422	-40,482	-53,577	-53,406	-49,341
Change in provisions and other items	-258,265	-45,757	119,743	17,955	21,225
Funds from operations (FFO)	**582,339**	**952,760**	**992,012**	**904,171**	**883,653**
Free operating cash flow in HUF ‘000s					
Funds from operations	582,339	952,760	992,012	904,171	883,653
Change in working capital	-851,557	-188,116	-392,587	-211,997	-128,376
less: capital expenditure (net)	-18,893	-512,961	-250,000	-250,000	-250,000
Free operating cash flow (FOCF)	**-288,111**	**251,683**	**349,426**	**442,174**	**505,277**
Net cash interest paid in HUF ‘000s					
Net cash interest per cash flow statement	-81,250	-92,255	-269,254	-293,684	-307,434
Net cash interest paid	**-81,250**	**-92,255**	**-269,254**	**-293,684**	**-307,434**
Scope-adjusted debt in HUF ‘000s					
Reported gross financial debt	4,280,783	5,338,701	5,248,492	5,037,090	4,825,687
less: cash and cash equivalents[1]	0	0	**0**	**0**	**0**
Scope-adjusted debt	**4,280,783**	**5,338,701**	**5,248,492**	**5,037,090**	**4,825,687**

[1] No netting of cash was applied.

Table of contents

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

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)

The company has succeeded at digitalising processes related to its core staffing and payroll activities. Gamax (the guarantor) is an IT company that provides know-how in automation, which results in efficiency gains.

The regulatory environment around temporary staffing is socially rather negative as staff can be laid off easily. This may seem to benefit Pannon-Work in the short term but it carries some regulatory risk for the future, hence our view remains credit-neutral for now. New two-year fixed-term contracts to bring Asian workers to Hungary, house them in local hostels and return them to their home country at the end of their term is also socially negative.

Pannon-Work has built up 6 MW of renewable power generation with a strong cash flow, which supports the rating.

[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: B+

Industry risk profile: BBB-

Pannon-Work is classified as a personnel services company, which we consider a subsegment of the business services industry. It also has exposure to the renewable energy production market. The solar energy it produces is currently sold at market prices and is not part of the regulated feed-in tariff schemes available in Hungary. Its industry risk is therefore blended between business services and non-regulated power generation (more than one-fourth of reported EBITDA in 2022).

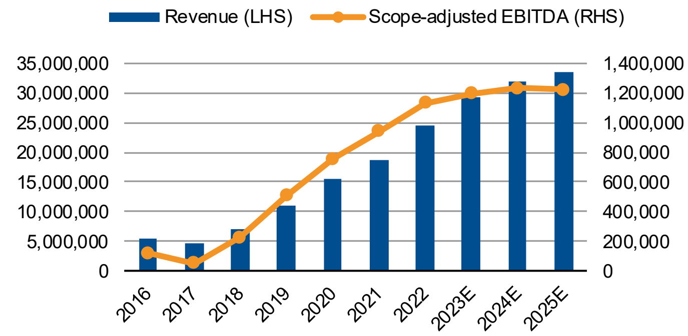
Small-scale player in a fragmented HR services market

Pannon-Work's business risk profile is driven by its position as the third largest personnel services provider in Hungary. The Hungarian market is very fragmented, with the top four players holding a market share of around one quarter.

Volatile cash flow from workforce leasing largely mitigated by recurring revenue

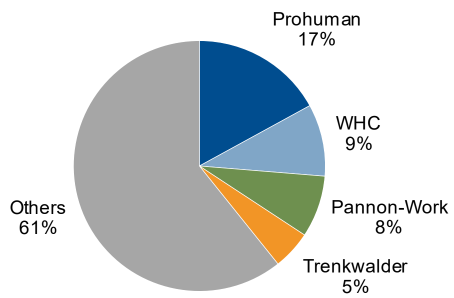
Growth over the years has been driven by a labour shortage in Hungary and companies' need for an intermediary to offer flexibility by leasing out personnel when required. The labour shortage and further workforce needs created by large-scale investments in the EV and automotive, retail and consumer goods sectors may continue to be an issue, enabling the workforce leasing market to grow. At the same time, clients are continually tendering out contracts with workforce agencies, and leased workers are the easiest to let go, as seen during the pandemic and supply chain disruptions. Cash flow from Pannon-Work's blue-collar workforce leasing is therefore volatile and vulnerable. It is difficult to significantly increase HR services revenue due to competition and exclusivity agreements with certain car parts manufacturers.

Figure 1: Pannon-Work's revenue and Scope-adjusted EBITDA evolution (HUF '000s)



Sources: Pannon-Work, Scope

Figure 2: Top HR service providers in Hungary[3]



Sources: 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 and low customer diversification. Low geographical and client diversification has led to volatile cash flow from Pannon-Work's main activity. Its top five clients contribute more than two thirds of revenue, and most of them are bound to Pannon-Work for more than five years. Since there are significant investments in Hungary with a need for labour, especially in the automotive parts segment, we expect the blue-collar workforce leasing market to grow. This is especially true for the electric vehicles market, which may provide additional opportunities for Pannon-Work to grow its client base.

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

[3] Market share in 2022 based on revenues

Improving profitability, mainly from recurring cash flows

The Scope-adjusted EBITDA margin of 4.6% in 2022 is similar to that of previous years, which ranged between 4.5%-5.0%. Improvements in profitability from historical EBITDA margins of 2%-3% are mainly due to recurring revenue and its EBITDA contribution. Since 2022 around one third of EBITDA has come from payroll services, accommodation and green energy production, which have more protected cash flows than blue-collar workforce leasing. The increase in recurring revenues and their EBITDA contribution support the rating.

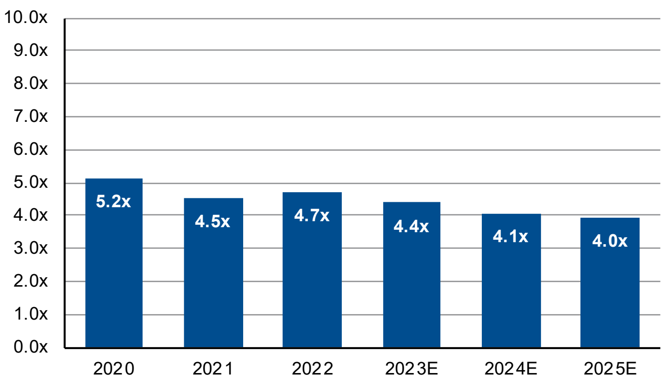
Financial risk profile: BB-

Increased leverage followed by planned deleveraging

Pannon-Work's financial risk profile is driven by high indebtedness caused by debt-financed investments and new working capital financing facilities. Leverage is weak but still reasonable, with a Scope-adjusted debt/EBITDA ratio of 4.7x in 2022 (up from 2.5x in 2019) and a Scope-adjusted FFO/debt ratio of around 15%-20%. Debt is mainly composed of a HUF 3.5bn senior unsecured guaranteed bond, HUF 1bn of senior secured long-term loans for capex and acquisitions, HUF 2bn of short-term working capital facilities and HUF 0.75bn of long-term working capital facilities. Investments in assets generating recurring cash flow support EBITDA growth and allow for gradual deleveraging.

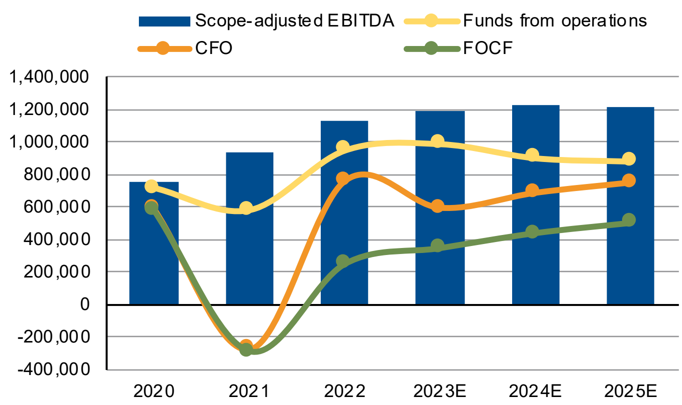
Proceeds from the bond were used to repay around HUF 1.1bn of Pannon-Work's short-term debt. The remainder was invested in solar power plants that have been generating cash flow since mid-2021. Future investments aimed at increasing solar power generation could cause leverage to rise back up to near 5x.

Figure 3: Scope-adjusted leverage (Scope-adjusted debt/EBITDA)



Sources: Pannon-Work, Scope estimates

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



Sources: Pannon-Work, Scope estimates
CFO: Cash flow from operations

Interest cover protected as most debt has low fixed interest rate

Scope-adjusted EBITDA interest cover was strong in 2022 at 12.3x (up from 11.6x in 2021). The 20% YoY EBITDA ramp-up is visible in the expansion of the temporary staffing business, solar power generation and real estate segments. Debt instruments used for investments are long-term and have fixed interest rates of up to 3% per year, which is beneficial in Hungary's current soaring interest rate environment. Working capital facilities have either a 6% fixed rate or a variable rate. The rise in interest rates to above 10% moderately affects Pannon-Work as the company has HUF 2.0bn in variable-rate debt (of which only HUF 0.6bn drawn), and no new, large variable-rate debt financing is planned. We forecast Scope-adjusted EBITDA interest cover will stay above 4x assuming low deposit interest because cash can be spent on investments, which still leads to good debt protection. Interest cover will also deteriorate due to less deposit interest received as interest rates are falling in Hungary.

Adequate liquidity

Pannon-Work refinanced most of its short-term debt to long-term debt in 2020, which significantly improved its liquidity ratio. Its new working capital facility was contracted for three years in 2023, which benefits the liquidity assessment. The overdraft and factoring are not used intensively and are excluded from the assessment as they are short-term. The bond will start amortising in 2026 at HUF 0.7bn yearly, which should be covered by stronger free operating cash flow. Other sources could include accumulated cash, refinancing and sales of solar assets.

Balance in HUF '000s	2023E	2024E	2025E
Unrestricted cash (t-1)	883,382	857,616	745,757
Open committed credit lines (t-1)	500,000	500,000	500,000
Free operating cash flow	349,426	442,174	505,277
Short-term debt (t-1)	1,290,209	1,411,402	1,411,402
Coverage	**134%**	**128%**	**124%**

Supplementary rating drivers: +/- 0 notches

No notching was applied for supplementary rating drivers.

The company distributes reasonable dividends. All acquisitions resulted in acceptable leverage and had low execution risk. The acquired businesses were complementary to the core business or operation, and maintenance has been outsourced in the case of renewables. New businesses provide additional, strong recurring cash flow generation, pointing to successful and fast integration.

Long-term debt rating

Senior unsecured debt rating for specific bond: B+

In October 2020, Pannon-Work issued a HUF 3.48bn senior unsecured bond guaranteed by Gamax Kft. (ISIN: HU0000360052) through the Hungarian central bank's Bond Funding for Growth scheme. The bond proceeds were used to acquire solar power generation companies and for refinancing. The bond has a tenor of 10 years and a fixed coupon of 3.0%. Bond repayment is in five equal tranches starting from 2026, with 20% of the face value payable yearly.

We downgraded Pannon-Work's senior unsecured bond (ISIN: HU0000360052) guaranteed by Gamax Kft. to B+ (in line with the issuer rating) due to average recovery expectations. The lower recovery expectation primarily reflects the bond's ranking below senior secured borrowings (for investments, acquisitions and working capital; up by 9% YoY) and the higher debt in absolute terms (up by 25% YoY), which was not offset by a similar increase in assumed liquidation value.

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