Communication Technologies Kft. Hungary, Business Services

SCOPE B+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	149.4x	349.3x	5.7x	25.7x
Scope-adjusted debt/EBITDA	0.2x	0.1x	3.6x	0.7x
Scope-adjusted funds from operations/debt	497%	790%	20%	120%
Scope-adjusted free operating cash flow/debt	-14%	64%	29%	20%

Rating rationale

The rating is restricted by the company's very small size, leading to a low market share in IT security markets (electronic offender monitoring, digital forensics and cybersecurity) and high income concentration due to a focus on Hungary and a single activity. However, profitability is good, supporting strong cash generation that is expected going forward thanks to organic growth in electronic offender monitoring. Consequently, we forecast low leverage and high interest cover in the next years. Beyond its underlying growth in IT security systems, the company plans to invest in acquiring companies in related fields as well as in a joint venture for equipment maintenance. Inorganic growth will be financed by the HUF 2bn in proceeds from the bond issued under the National Bank of Hungary's Bond Funding for Growth Scheme. For the time being, the rating is driven by the issuer's size, the execution risk inherent in its growth strategy and acquisitions, the key person risk that comes with the company's small scale (credit-negative ESG factor) and the absence of a committed financial policy.

Outlook and rating-change drivers

The Outlook is Stable based on our expectation that the company will benefit from the renewal of the police electronic offender monitoring contract and keep Scope-adjusted debt/EBITDA around 1x. positive rating action could occur if the company is successful in executing growth plans through targeted M&A boosting diversification of revenues and clients and keeps Scope-adjusted debt/EBITDA below 1x on a sustained basis.

A negative rating action could occur if the company loses exclusivity status with key suppliers, or non-successful tender for the renewal of the police contract, impairing profitability and subsequently leverage with Scope-adjusted debt/EBITDA of above 5x on a sustained basis.

We note that Communication Technologies Kft.'s senior unsecured bond issued under the Hungarian central bank's bond scheme has an accelerated repayment clause. The clause requires the company to repay the nominal amount (HUF 2.0bn) within 30 days after the bond rating falls below B-, which could have default implications.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
23 Jan 2023	Affirmation	B+/Stable
19 Jan 2022	New	B+/Stable

Ratings & Outlook

Issuer	B+/Stable
Senior unsecured debt	B+

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Related Methodology

Corporate Rating Methodology; July 2022

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Bloomberg: RESP SCOP

Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Strong financial risk profile, with low level of debt • Good profitability • Exclusive distribution contracts for Hungary and established relations with national agencies	• Small market share in the IT services industry • Low diversification (geographic, client, product)

Positive rating-change drivers	Negative rating-change drivers
• Successful execution of growth plan through targeted M&A boosting diversification of revenue and clients, and keeping Scope-adjusted debt/EBITDA below 1x on a sustained basis	• Loss of exclusivity status with key suppliers or non-successful tender for the electronic offender monitoring contract impairing profitability and subsequently leverage with Scope-adjusted debt/EBITDA of above 5x on a sustained basis

Corporate profile

Incorporated in 2002, Communication Technologies Kft. distributes IT systems (electronic offender monitoring, digital forensics, cybersecurity, IA systems, etc.) for national security agencies in Hungary. The company achieved HUF 1.8bn in revenues In 2022E with six employees.

Financial overview

All figures are unconsolidated				Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	514.1x	149.4x	349.3x	5.7x	25.7x	22.2x
Scope-adjusted debt/EBITDA	0.2x	0.2x	0.1x	3.6x	0.7x	0.9x
Scope-adjusted funds from operations/debt	376%	497%	790%	20%	120%	101%
Scope-adjusted free operating cash flow/debt	756%	-14%	64%	29%	20%	100%
Scope-adjusted EBITDA in HUF m						
EBITDA	413	463	826	556	2,722	2,331
Operating lease payments	0	0	0	0	0	0
Other items	0	0	0	0	0	0
Scope-adjusted EBITDA	**413**	**465**	**826**	**556**	**2,722**	**2,331**
Funds from operations in HUF m						
Scope-adjusted EBITDA	413	463	826	556	2,722	2,331
less: (net) cash interest paid	-1	-3	-2	-97	-106	-105
less: cash tax paid per cash flow statement	-38	-42	-73	-62	-230	-200
add: dividends from associates	0	0	0	0	0	0
Change in provisions	0	0	0	0	0	0
Funds from operations (FFO)	**374**	**419**	**751**	**397**	**2,396**	**2,026**
Free operating cash flow in HUF m						
Funds from operations	374	419	751	397	2,396	2,026
Change in working capital	454	-270	-822	194	-1,682	-14
Non-operating cash flow	-73	-160	132	0	0	0
less: capital expenditure (net)	-1	-1	0	-7	-305	-6
less: lease amortisation	0	0	0	0	0	0
Free operating cash flow (FOCF)	**754**	**-12**	**61**	**584**	**409**	**2,005**
Net cash interest paid in HUF m						
Net cash interest per cash flow statement	1	3	2	97	106	105
add: interest component, operating leases	0	0	0	0	0	0
Change in other items	0	0	0	0	0	0
Net cash interest paid	**1**	**3**	**2**	**97**	**106**	**105**
Scope-adjusted debt in HUF m						
Reported gross financial debt	100	84	95	2,000	2,000	2,000
less: subordinated (hybrid) debt	0	0	0	0	0	0
less: cash and cash equivalents (*no cash netting*)	0	0	0	0	0	0
add: non-accessible cash	0	0	0	0	0	0
add: pension adjustment	0	0	0	0	0	0
add: operating lease obligations	0	0	0	0	0	0
Other items	0	0	0	0	0	0
Scope-adjusted debt (SaD)	**100**	**84**	**95**	**2,000**	**2,000**	**2,000**

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Environmental, social and governance (ESG) profile[1]

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)	Red leaf
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)	Grey leaf
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)	Grey leaf
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	Grey leaf

Legend

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

Key person risk

Key person risk is material given that Communication Technologies Kft. is a very small company with only six employees.

[1] 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+

The company was created in 2002 and is based in Budapest. It specialises in distributing IT security systems to Hungarian state agencies (police, justice, intelligence agencies) and, to a lesser extent, corporates.

Electronic offender monitoring and digital forensics systems

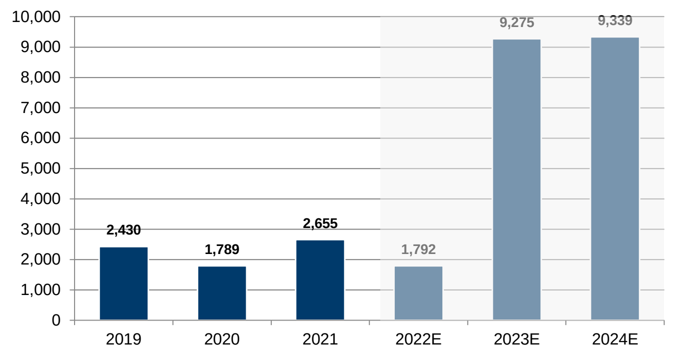
The main systems Communication Technologies sells are electronic offender monitoring systems (GPS bracelets), digital forensics systems (web data collection and analysis, digital data analysis), cybersecurity, and artificial intelligence-based systems (facial and behavioural recognition on video). It has established relations with internationally renowned providers (Attenti, Cobwebs, Cellebrite, Corsight, Viisight), sometimes exclusively for Hungary, and many contracts include contract/licence updates, upgrades and maintenance.

Contract renewal

The company's business risk profile is restricted by its very small size prior to its intended acquisitions. It can only achieve a very small market share because it is mostly active in a niche segment (security systems for national security agencies). This segment usually features repeat business given that changing system providers would mean significant upfront costs (for tailoring the system to local needs) and re-training users and/or supervisors. The company is expected to renew an expanded electronic offender contract with the Hungarian police after a tender that was launched in August 2022. The successful tender is anticipated to lead to strong growth in revenues from 2023 given the fourfold increase in systems served, to 7,000.

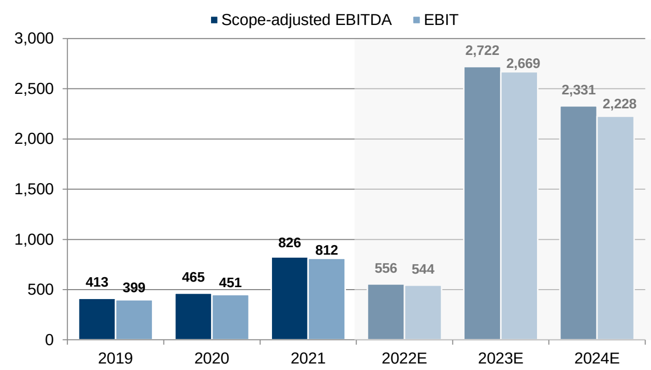
Diversification is also rather weak as the company only operates in Hungary, has a limited number of customers (national security agencies or entities), a limited number of specialised systems and products (security-related) and a small number of international providers. Limited diversification could lead to significant volatility in cash generation if contracts for services provided were not renewed. The risk is manageable, however, because the cost for Communication Technologies customers to change service providers is high.

Figure 1: Revenues 2019-2024 (HUF m)



Sources: Communication Technologies, Scope estimates

Figure 2: EBITDA and EBIT 2019-2024E (HUF m)



Sources: Communication Technologies, Scope estimates

Average EBITDA margin of 25%

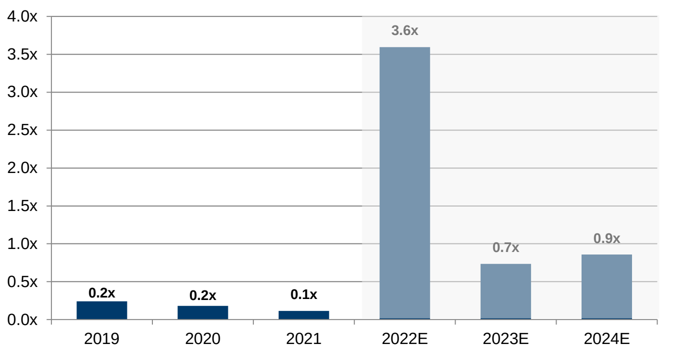
During a period of four years (2019-21), Communication Technologies' Scope-adjusted EBITDA margin ranged between 19% and 31%, for an average of 25%. Its EBITDA margin for 2022 is expected to be around 30%, a similar level to 2021. With some significant contract renewals and product expansion, we anticipate margins will stand at around 27% in upcoming years. Consequently, profitability sustains the overall business risk profile.

Financial risk profile: A-

From net cash …

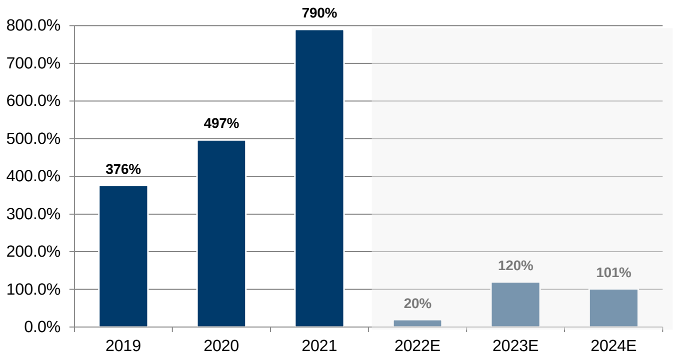
The company has maintained a net cash position over the last six years, with cash and cash equivalents averaging about HUF 450m. January 2022 saw the company issue a HUF 2bn bond under the Hungarian National Bank's Bond Funding for Growth scheme to finance investments (about HUF 2.5bn) in companies operating in related businesses and create a joint venture offering maintenance of electronic offender equipment (HUF 0.3bn). The bond has a tenor of 10 years, with a fixed annual coupon of 5.25% p.a. and 5% amortisation in 2025 and 2026, 10% amortisation in 2027 and 2028, and 15% amortisation in 2029, 2030 and 2031, leaving a 25% balloon at maturity (January 2032).

Figure 3: Scope-adjusted debt/EBITDA, 2019-2024E



Sources: Communication Technologies, Scope estimates

Figure 4: Scope-adjusted FFO/debt, 2019-2024E

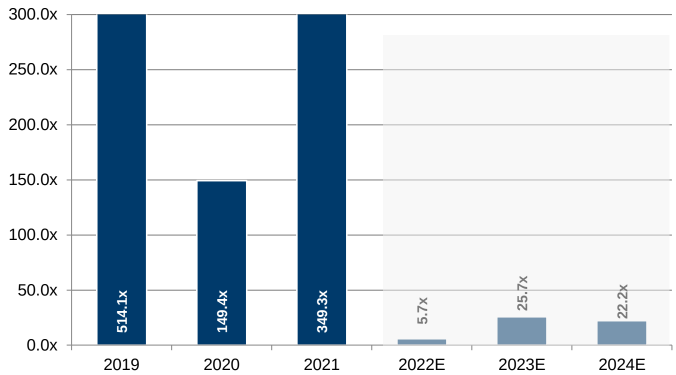


Sources: Communication Technologies, Scope estimates

…to Scope-adjusted debt/EBITDA below 1.0x

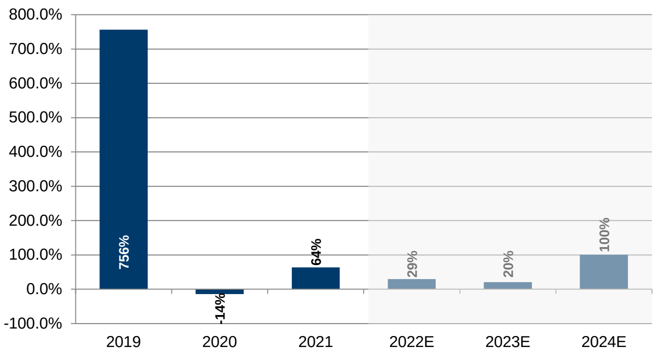
Strong cash generation from the highly profitable specialised services business supports continued low leverage. Net debt is expected to remain low in the coming years as FOCF can more than cover the increased dividend payments going forward, leaving a comfortable cash balance. Scope-adjusted debt/EBITDA is thus expected to remain around 1.0x (even when Scope-adjusted debt excludes cash netting), while Scope-adjusted FFO/ debt is expected to remain significantly above 60% on average. The jump in leverage in 2022 (Scope-adjusted debt/EBITDA: 3.6x; up 3.5x YoY) was due to the increased debt burden that was not matched by an increase in EBITDA. The reason was a delayed tender for the electronic offender monitoring systems in Hungary.

Figure 5: Scope-adjusted EBITDA interest cover, 2019-2024E



Sources: Communication Technologies, Scope estimates

Figure 6: Scope-adjusted FOCF/debt, 2019-2024E



Sources: Communication Technologies, Scope estimates

Similarly, interest cover is expected to remain above 10x in upcoming years. Scope-adjusted FOCF/debt is expected to stay above 35% on average over the next three years as the business requires very limited investment (except in 2023, where investment is needed to develop an in-house maintenance business for its electronic offender equipment).

Adequate liquidity

Liquidity is adequate, with HUF 386m of cash and cash equivalents as at YE 2021 and HUF 584m in forecasted FOCF fully cover short-term debt of HUF 95m. The first bond repayment (HUF 100m) is not due until January 2025.

Balance in HUF m	2022E	2023E	2024E
Unrestricted cash (t-1)	386	2,658	1,058
Open committed credit lines (t-1)	0	0	0
Free operating cash flow	584	409	2,005
Short-term debt (t-1)	95	0	0
Coverage	**>200%**	**>200%**	**>200%**

We place much greater emphasis on the company's business risk profile due to its very small size, the execution risk inherent in its growth strategy and acquisitions, the key person risk associated with having only six employees (ESG-related driver) and no committed financial policy.

Supplementary rating drivers: +/- 0 notches

Key person risk is material due to the very limited size of the company (only six employees), but it is already incorporated in the company's risk profile.

Long-term debt rating

Senior unsecured debt rating: B+

We rate senior unsecured debt at B+, the same level as the issuer rating. We calculated an 'average' recovery following a hypothetical default in 2024 and therefore incorporate no notches of uplift on the assigned issuer rating.

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