Progress Étteremhálózat Kft. Hungary, Corporates

SCOPE BB- STABLE

Corporate profile

Progress Étteremhálózat Kft. (Progress) is a McDonald's Corporation developmental licensee and Hungary's largest quick-service restaurant operator by both revenues and profits. Progress operates McDonald's restaurants and uses the trademarks, intellectual property rights and products in the course of its franchise business. This creates two primary sources of income for Progress: i) revenues generated by own-operated restaurants; and ii) franchise fees from conventional licence partners.

Key metrics

		Scope estimates		
Scope credit ratios	**2019**	**2020F**	**2021F**	**2022F**
EBITDA/interest cover (x)	-55.1x	-36.8x	15.7x	19.4x
Scope-adjusted debt (SaD)/EBITDA	0.2x	3.2x	2.9x	2.5x
Scope-adjusted funds from operations (FFO)/SaD	449%	23%	24%	28%
Free operating cash flow/SaD	374%	-5%	-23%	-6%

Rating rationale

Scope Ratings has assigned a first-time issuer rating of BB-/Stable to Progress Étteremhálózat Kft. and a first-time rating of BB- to senior unsecured debt.

The rating of BB- is supported by Progress' strong market position in Hungary, high margins and significant growth potential. The rating is constrained by the low diversification and increasing leverage.

The competitive position of Progress is constrained by its small size on a global level and concentration on one geographical area and activity.

Progress' activities are facilitated by the McDonald's brand, which supports the company's dominance in the quick-service restaurant industry in Hungary and its above-average profitability, which in turn is supported by well-defined global marketing facilities and supplier side capacity.

This strong market position will be further bolstered by the planned double-digit increase in the number of restaurants until end-2025. Progress' strategy of focusing on drive-through restaurants is also positive, as this is the most profitable format in the quick-service restaurant segment. The operating environment is currently favourable, and the company is planning to expand strongly to exploit its comparative advantages. The primary risk would entail a deterioration in its relationship with McDonald's.

Ratings & Outlook

Corporate ratings	BB-/Stable
Senior unsecured rating	BB-

Analyst

Olaf Tölke
+49 69 6677389 11
o.toelke@scoperatings.com

Related Methodology

Corporate Rating Methodology, February 2020

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Tel. +49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

The financial risk profile is rated BB and will not be affected by the anticipated increase in leverage caused by the company's planned issuance under the Bond Funding for Growth Scheme of the Hungarian National Bank (MNB). Cash flow generation and cash flow coverage are constrained by ongoing investments. Interest coverage, expressed as the ratio of Scope-adjusted EBITDA to interest expense, is robust; this ratio was extremely high between 2016 and 2019 and is expected at 15.7-19.4x after the bond issuance. The negative ratio of Scope-adjusted EBITDA to interest expense during 2019-2020 is due to interest income received from the interest-bearing intercompany loan.

Liquidity is adequate and benefits from the company's conservative debt maturity profile, with no short-term debt historically nor planned in the coming years. We anticipate the low short-term debt levels to be maintained going forward and to be sufficiently covered by available financing sources.

The rating is lowered by concerns surrounding the company's governance and structure due to the significant amount of the intercompany loan granted by Progress to its parent company, Leones QSR.

Outlook and rating-change drivers

The Outlook is Stable based on our expectation of expansion plans being executed as planned, which should result in revenues increasing as new restaurants are opened. We also assume that the company will not pay dividends to its parent company before 2024. The Stable Outlook incorporates the successful placement in 2020 of the HUF 30bn MNB bond. HUF 12.8bn of the bond's proceeds are earmarked for expansion plans, while the remaining HUF 17.2bn will refinance a parent company loan via an intercompany loan.

A positive rating action is a remote scenario but would be warranted if the company strengthened its revenue growth significantly while sustaining Scope-adjusted debt (SaD)/EBITDA below 2x.

A downgrade would be warranted in the event of an increase in SaD/Scope-adjusted EBITDA to above 4x, as a result of i) a deterioration in the franchise relationship (development license) with McDonald's; ii) a significant delay in or failure to successfully execute expansion plans; and/or iii) a renewed closure of restaurants due to another wave of the Covid-19 pandemic.

Rating drivers

Positive rating drivers	Negative rating drivers
• High profitability, supported by world's leading quick-service restaurant brand (McDonald's), driven by a strong marketing strategy validated by consumer research • Well-defined strategies to preserve its market leadership, including a double-digit rise in new restaurants in the pipeline • Potential for further expansion via drive-through restaurants, which have above-average profitability • Robust interest-cover ratio	• Strong dependence on franchise relationship (development licence) with McDonald's Corporation • Negative free operating cash flow/SaD ratio due to intensive capex plan • Weak diversification • Increased leverage after bond issuance as measured by SaD/EBITDA

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significantly stronger revenue growth • SaD/Scope-adjusted EBITDA of below 2x on a sustained basis	• SaD/Scope-adjusted EBITDA reaching above 4x • Deterioration in franchise relationship with McDonald's • Significant delay in or failure to execute expansion plans • Renewed closure of restaurants, e.g. due to the pandemic

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020P**	**2021E**	**2022F**
EBITDA/interest cover (x)	-55.1x	-36.8x	15.7x	19.4x
Scope-adjusted debt (SaD)/EBITDA (x)	0.2x	3.2x	2.9x	2.5x
Scope-adjusted funds from operations/SaD (%)	449%	23%	24%	28%
Free operating cash flow/SaD (%)	374%	-5%	-23%	-6%
Scope-adjusted EBITDA in HUF (‘000)	**2019**	**2020P**	**2021E**	**2022F**
EBITDA	7,339,674	4,489,536	7,092,698	9,037,809
Operating lease payments in respective year	2,004,377	1,757,288	2,228,032	2,491,446
Other adjustments	0	0	0	0
Scope-adjusted EBITDA	**9,344,051**	**6,246,824**	**9,320,730**	**11,529,255**
Scope-adjusted funds from operations in HUF (‘000)	**2019**	**2020P**	**2021E**	**2022F**
EBITDA	7,339,674	4,489,536	7,092,698	9,037,809
less: (net) cash interest as per cash flow statement	169,595	169,595	-594,490	-594,490
less: cash tax paid as per cash flow statement	-518,379	-171,558	-154,768	-203,104
Other adjustments	0	0	0	0
Scope-adjusted funds from operations	**6,990,890**	**4,487,573**	**6,343,439**	**8,240,215**
Scope-adjusted debt in HUF (‘000)	**2019**	**2020P**	**2021E**	**2022F**
Reported gross financial debt	1,101,255	31,101,255	31,101,255	31,101,255
less: cash and cash equivalents	-3,804,682	-15,811,130	-9,742,682	-7,993,275
add: cash not accessible	250,000	984,000	984,000	984,000
add: pension adjustment	0	0	0	0
add: operating lease obligations	4,008,754	3,514,576	4,456,065	4,982,892
Other adjustments	0	0	0	0
Scope-adjusted debt	**1,555,327**	**19,788,700**	**26,798,637**	**29,074,871**

Business risk profile

Small player on a global level; market leader in Hungary

Progress is Hungary's largest fast-food restaurant operator and operates under the McDonald's brand. In recent years, Progress accomplished significant growth in terms of both organic sales and guest count without expanding its number of restaurants. However, Progress will only be able to maintain its market leadership in the long term by increasing the number of restaurants. This helps to explain its aggressive expansion plans, with new store openings expected at double-digits every year until the end of 2025. We believe this new intensive capex plan will strengthen McDonald's market position. With Progress' leading position beginning to be challenged in recent years, higher EBITDA margins will protect Progress against competitors seeking to win market share by sacrificing profitability. We expect Progress will keep its market leadership in Hungary in the medium term. Our assessment of Progress' market position is hampered by its dependence on a single country, the fragmentation of its market, and its small scale on a global level.

Restricted product portfolio but supported by diversification by distribution channels and investment in digitalisation

Geographical diversification is limited due to the sole exposure to Hungary. McDonald's sales channels are diversified: home delivery is available in 77 of its 90 restaurants, with McDonald's planning to provide home delivery from all restaurants. From the supplier side, we consider the company's global supply chains to be strongly integrated. Moreover, the Covid-19 pandemic has resulted in no disruptions among its suppliers. Hence, we have determined a low degree of concentration in terms of both suppliers and buyers. We note that McDonald's is pro-actively increasing its product diversification by increasing the variety of menu items, adding breakfast options, opening McCafé shops, and offering salads. However, the product portfolio of McDonald's remains limited. McDonald's will be one of the first companies to integrate decision technology at the point of customer sale. Hence, the overall lack of product diversification is partly mitigated by its investment in cutting-edge technology and digitalisation.

High margins

Progress' EBITDA margins are strong and high relative to other Hungarian quick-service restaurants, ranging from 13.1% to 17.9% during 2016-2019 and averaging 16% during 2016-2019. We expect this margin to reduce in 2020, due to the lower revenues triggered by restaurant closures to contain the Covid-19 pandemic. Progress faces headwinds in terms of rising labour costs in Hungary, but this is counterbalanced by its favourable pricing power, market growth, and capex in digitalisation in the coming years that should increase productivity strongly. The increase in the number of restaurants should also bolster the company's economies of scale, already evident in its low material costs relative to competitors, the result of better purchasing conditions due to larger purchase volumes.

According to the company, all restaurants to be opened under its current strategy will be 'free-standing drive-through', the most profitable format in its restaurant portfolio.

Business risk profile: BB

We place Progress' business risk profile at BB, constrained by its small size on a global level and concentration in Hungary.

Financial risk profile

Assumptions

We expect the EBITDA margin to climb towards 14% in 2021 and 15% in 2022, continuing at pre-Covid 19 levels. We assume significant capex for the construction of new restaurants and the redesign of current ones, in line with projections provided by management. According to the business plan, dividends will be paid only from 2024, after the planned investments are executed.

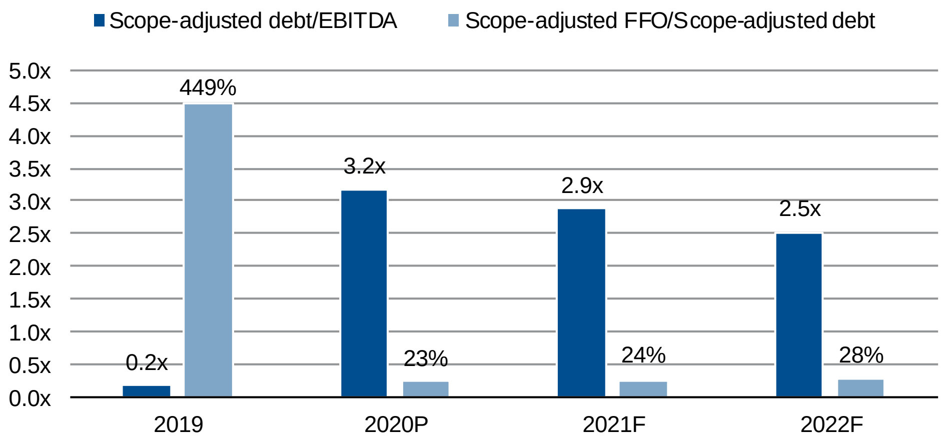
Leverage

SaD/EBITDA in the past varied between slightly negative levels, at 0.2x in 2016-2019, reflecting the lack of short-term and long-term loans as the only significant element of SaD was operating lease obligations.

In 2020, leverage will increase owing to the bond issuance, but with little or no volatility. SaD/EBITDA will range from 3.2x in 2020 (lower EBITDA due to Covid-19 economic effects) and 2.5x in 2022 (higher EBITDA due to the opening of numerous restaurants).

Funds from operations (FFO)/SaD has been historically excellent due to the combination of the high cash position and low debt levels. We expect this ratio to be very stable going forward, and the issuance of the MNB bond will place this metric firmly in the BB category, with little movement during the rating period.

Figure 1: Scope-adjusted FFO/SaD and SaD/EBITDA – base case scenario



Source: Scope

Interest cover

Interest coverage, as a ratio of Scope-adjusted EBITDA to interest expense, is robust. It was extremely high between 2016 and 2019 and is expected at 15.7-19.4x after the bond issuance. We have calculated interest of 3.8%. Progress' interest coverage is supported by interest revenues it will receive from the interest-bearing intercompany loan.

Cash flow generation

The free operating cash flow/SaD ratio reflects negative numbers from 2020 onwards due to the significant capex levels.

Liquidity

Liquidity is adequate, reflecting primarily the lack of significant short-term debt.

Financial risk profile: BB

We place Progress' financial risk profile at BB.

Supplementary rating drivers

The rating has been lowered by one notch for supplementary rating drivers. This is due to the significant amount of the intercompany loan granted by Progress to its parent company, Leones QSR, which raises concerns regarding the company's governance and structure.

Financial policy

The financial policy is appropriate and prudent.

Peer group

We reviewed Progress relative to its peer group and found no issues that would warrant a change to the rating.

Parent support

We view parent support as credit-neutral.

Corporate governance

As mentioned above, corporate governance and structure-related concerns have resulted in the rating being lowered by one notch.

Senior unsecured debt

We have assigned a first-time BB- senior unsecured debt rating.

In our recovery assessment, we recognise that, despite the strong unencumbered asset position, the significant intercompany loan limits recovery to 'average' (30-50%) for outstanding senior unsecured debt in a hypothetical default scenario based in 2022. We have therefore granted no rating uplift for senior unsecured debt as a category.

Outlook

Outlook: Stable

The Outlook is Stable based on our expectation of expansion plans being executed as planned, which should result in revenues increasing as new restaurants are opened. We also assume that the company will not pay any dividend to the parent company before 2024. The Stable Outlook incorporates the successful placement in 2020 of the HUF 30bn MNB bond. HUF 12.8bn of the bond's proceeds are earmarked for expansion plans, while the remaining HUF 17.2bn will refinance a parent company loan via an intercompany loan.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

3rd Floor
111 Buckingham Palace Road
UK-London SW1W 0SR

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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