19 January 2022 Corporates

Communication Technologies Kft.
Hungary, Business Services

B+ STABLE

Corporate profile

Communication Technologies Kft., created in 2002, distributes IT systems (electronic offender monitoring, digital forensics, cybersecurity, artificial intelligence systems, etc.) to national security agencies in Hungary. The company generated HUF 3.1bn in revenues in 2021E with six employees.

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	-1,267.1x	286.0x	22.4x	17.1x
Scope-adjusted debt (SaD)/EBITDA	0.2x	0.2x	1.0x	1.2x
Scope-adjusted funds from operations/SaD	497%	493%	89%	81%
Free operating cash flow (FOCF)/SaD	-14%	13%	159%	49%

Rating rationale

Scope has assigned a first-time corporate rating of B+/Stable to Communication Technologies Kft. along with a first-time senior unsecured debt rating of B+.

The ratings are driven primarily by the company's low leverage and profitability. They are somewhat constrained by its small size, low diversification, and expansion execution risks.

The company's business risk profile is assessed at B+ is restricted by the company's very small size prior to its intended acquisitions.

Its competitive position benefits from good profitability but is constrained due to a relatively small market share in IT security markets (electronic offender monitoring, digital forensics and cybersecurity) and a concentration on one activity in one country.

Communication Technologies' activity is sustained by exclusive contracts to distribute selected security systems in Hungary and well-established customer relations with state agencies, which sometimes involve long-term contracts or maintenance and licence upgrade features. Beyond underlying growth in IT security systems, the company plans to use the issuance of a bond to expand by acquiring companies in related businesses and investing in creating a joint venture for equipment maintenance.

The financial risk profile assessment of A- reflects our expectation that the company will maintain a SaD/EBITDA ratio of around 1.0x (even with no netting of cash) while it moves from a net cash position to low leverage as the bond issuance is executed. Strong profitability and low capital expenditures should enable it to keep FOCF/SaD significantly above 35%.

We place much greater emphasis on the business risk profile due to the company's very small size, execution risks in its growth strategy and acquisitions, the key person risk inherent in a small company (ESG-related driver), risks on the future consolidated balance sheet, and still less committed financial policy. Liquidity is adequate. The company has historically maintained significant levels of cash with relatively low amounts of short-term debt. After the bond is issued, the company will clear all short-term debt while expectedly maintaining a significant amount of cash

Ratings & Outlook

Corporate rating B+/Stable

Senior unsecured rating B+

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Related Methodology

Corporate Rating Methodology: July 2021

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Bloomberg: RESP SCOP

Liquidity is adequate. The company has historically maintained significant levels of cash with relatively low amounts of short-term debt. After the bond is issued, the company will clear all short-term debt while expectedly maintaining a significant amount of cash.

Outlook and rating-change drivers

The Outlook is Stable based on our expectation that the company will implement its plans to grow the business organically and through M&A.

A positive rating action could occur if the company managed to successfully implement its financing plans along with its growth strategy and M&A plans.

A negative rating action could take place if the company was unable to fund its expansion or lost its exclusive status with key suppliers, leading to lower profitability than expected and SaD/EBITDA of above 5.0x.

Long-term rating

We rate the planned senior unsecured debt at B+, in line with the issuer rating. We calculated an 'average' recovery following a hypothetical default in 2023 and therefore have incorporated no notches of uplift in the assigned issuer rating. Communication Technologies plans to issue a HUF 2bn senior unsecured bond under the Bond Funding for Growth Scheme of the Hungarian National Bank (MNB) to finance acquisitions (HUF 1.8bn) and the creation of a maintenance JV (HUF 0.2bn), with an expected tenor of 10 years, with a fixed annual coupon of up to 5% p.a. and 5% amortisation starting in 2025 and in 2026, 10% amortisation in 2027 and 2028, 15% amortisation in 2029, 2030 and 2031, leaving a 25% balloon at maturity.

Rating drivers

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

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Success in financing and growing business organically and through M&A	• Inability to fund expansion, potential loss of exclusive status with key suppliers leading to lower-than-expected profitability and SaD/EBITDA of above 5.0x

Financial overview

			Scope estimates	
Scope credit ratios	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover (x)	-1,267.1x	286.0x	22.4x	17.1x
SaD/EBITDA	0.2x	0.2x	1.x	1.2x
Scope-adjusted funds from operations/SaD	497%	439%	89%	81%
FOCF/SaD	-14%	13%	159%	49%
Scope-adjusted EBITDA in HUF m	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	465	529	2,033	1,709
Operating lease payments in respective year	-	-	-	-
Other	-	-	-	-
Scope-adjusted EBITDA	465	529	2,033	1,709
Scope-adjusted funds from operations in HUF m	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	465	529	2,033	1,709
less: (net) cash interest as per cash flow statement	-3	3	-92	-100
less: cash tax paid as per cash flow statement	-42	-46	-171	-154
add: depreciation component, operating leases	-	-	-	-
Scope-adjusted funds from operations	419	479	1,770	1,670
SaD in HUF m	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	87	109	2,000	2,000
less: hybrid bonds	-	-	-	-
less: cash and cash equivalents	0	0	0	0
add: cash not accessible	-	-	-	-
add: pension adjustment	-	-	-	-
add: operating lease obligations	-	-	-	-
Other	-	-	-	-
SaD	87	109	2,000	2,000

All figures are unconsolidated.

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.

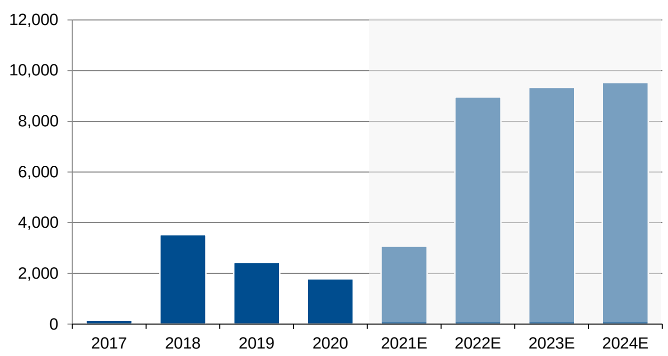
Electronic offender monitoring and digital forensics systems

The main systems sold by Communication Technologies 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, Logicube, Corsight, Viisight), sometimes exclusively for Hungary, and many contracts include contract/licence updates, upgrades and maintenance.

The company's business risk profile is restricted by its very small size prior to its intended acquisitions. The company 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.

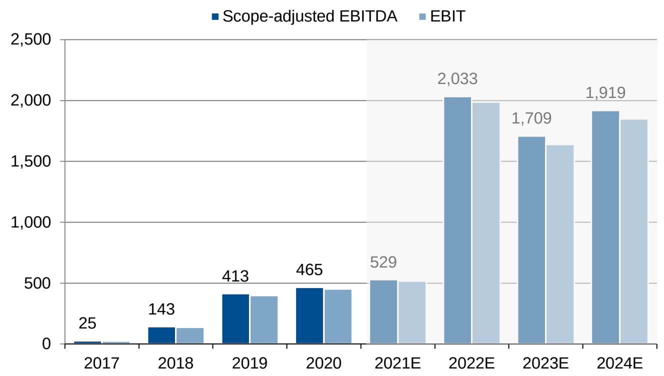
Diversification is also rather weak as the company only operates in Hungary, has a limited number of customers (national security agencies or entities), a limited number of specialised systems and products (security-related), and a small number of international providers.

Figure 1: Revenues, 2017-2024E (HUF m)



Sources: Communication Technologies, Scope estimates

Figure 2: EBITDA and EBIT, 2017-2024E (HUF m)



Sources: Communication Technolgies, Scope estimates

Average EBITDA margin of 18%

During a period of four years (2017-2020), Communication Technologies' reported EBITDA margin ranged between 4% and 26%, for an average of 16%. Its EBITDA margin for 2021 is expected to be around 17%. With some contract renewals and product expansion, we anticipate margins to stand at around 20%. Consequently, profitability sustains the overall business risk profile.

Financial risk profile (A-)

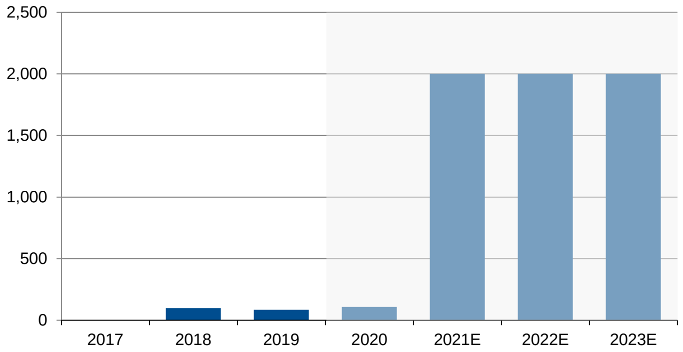
From net cash …

The company has maintained a net cash position over the last five years, with cash and cash equivalents averaging about HUF 450m. It intends to issue a HUF 2bn bond under the Hungarian National Bank's programme to finance investments (about HUF 1.8bn) in companies operating in related businesses, and to create a joint venture offering maintenance of electronic offender equipment (HUF 0.2bn). The bond has an expected tenor of 10 years, with a fixed annual coupon of up to 5% p.a. and 5% amortisation starting in 2025 and in 2026, 10% amortisation in 2027 and 2028, 15% amortisation in 2029, 2030 and 2031, leaving a 25% balloon at maturity.

…to SaD/EBITDA around 1.0x

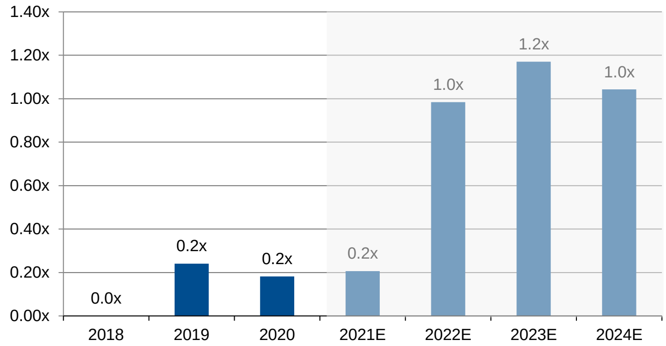
The level of net debt is thus expected to remain rather low, and to decline in the coming years because the company is still expected to maintain a comfortable level of cash. SaD/EBITDA is thus expected to remain around 1.0x (even when SaD excludes cash netting), while funds from operations/SaD is anticipated to remain significantly above 60%.

Figure 3: Scope-adjusted net debt (HUF m)



Source: Scope estimates

Figure 4: Scope-adjusted net debt/EBITDA



Source: Scope

Similarly, interest cover is expected to remain above 10x while FOCF/SaD is anticipated to stay above 35% over the next three years. Liquidity is adequate as the company has historically maintained significant levels of cash with relatively low amounts of short-term debt. After the bond is issued, the company will clear all short-term debt while expectedly maintaining a significant amount of cash during the coming years.

We place much greater emphasis on the company's business risk profile due to its very small size, execution risks in its growth strategy and acquisitions, the key person risk inherent in a firm with only six employees (ESG-related driver), risks on the future consolidated balance sheet, and uncommitted financial policy.

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