Abroncs Kereskedőház Kft
Hungary, Retail

SCOPE BB STABLE

Corporate profile

Abroncs Kereskedőház Group (AKH) is one of the leading wholesale retailers of tyres in Hungary. It sells more than 1.3 million tyres annually and distributes the products of more than 30 well-known tyre manufacturers. The group operates in central Europe including in Hungary, Czechia, Romania, Croatia, Slovenia and Slovakia. In addition to tyres, AKH also markets lubricants as well as car and tyre services. The group has around 310 employees. It generated HUF 28bn in net sales and HUF 581m in EBITDA in 2019 (the fiscal year ends on 31 December).

Key metrics

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	7.2x	3.8x	7.7x	8.1x
Scope-adjusted debt (SaD)/EBITDA	3.5x	2.1x	0.8x	0.5x
Scope-adjusted FFO/SaD	23%	32%	100%	173%
FOCF/SaD	(-) FOCF	110%	58%	67%

Rating rationale

Scope Ratings has assigned a first-time issuer rating of BB/Stable to Abroncs Kereskedőház Kft (AKH). The agency has also assigned a first-time rating of BB to senior unsecured debt issued by AKH.

AKH's issuer rating is supported by its leading position in the tyre retail business. The group has a share of over 30% in this market in Hungary. This is due to its strong presence in both the wholesale and retail segments, supported by an extended brand portfolio and a broad footprint in Hungary. The partial integration of the group's business into car service stores and the exclusive partnership with BP lubricants (market share of around 7%) has reduced AKH's exposure to the seasonality inherent in the tyre business. It has also diversified the group's offer, which was previously based on only one type of product. AKH has a good relationship with its suppliers. It has a balanced mix of exclusive and semi-exclusive products (accounting for 74% of sales) and other brands, including worldwide tyre makers (e.g. Continental, Michelin, and Bridgestone). Despite the strong market in Hungary, AKH's business risk profile is limited by its small financial size, fierce industry competition, limited opportunities for the domestic growth of its business and low potential for expansion.

The group's business risk profile is also constrained by weak overall diversification in terms of geography and type of product sold. AKH is clearly focussed on Hungary, which provides 80% of revenues. On the other hand, we view positively its diversified pool of customers (car leasing companies and retailers) and diversified sales channels, with an increasing share of online sales. Low profitability, ranging between 2% and 4%, also puts pressure on the rating. This is driven by seasonality and the large share of wholesale in the revenue mix. The EBITDA margin in 2019 was very weak due to inventory management issues. In response, management's strategy from 2020 onwards has been to maximise profitability in order to recover the 2017 level of around 4% within the next two years.

Ratings & Outlook

Issuer rating	BB/Stable
Senior unsecured rating	BB

Analysts

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Related Methodology

Corporate Rating Methodology, 26 February 2020.

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Bloomberg: RESP SCOP

AKH's financial risk profile clearly supports the rating case, thanks to good credit metrics including high interest cover and investment grade leverage. Liquidity is adequate, with no material short-term debt following the refinancing of the group's bank loans via the Hungarian central bank bond. AKH also has strong free cash flow generation driven by low capex (below 2% of sales). This is, however, highly volatile and sensitive to changes in working capital.

The base case for the ratings incorporates our assumption that proceeds from the upcoming bond will only be used for debt refinancing and not for shareholder remuneration. AKH intends to place a HUF 3.5 bn bond under the Hungarian central bank's Bond Funding for Growth Scheme. The new bond will have an anticipated coupon of 2.5% per annum, a maturity of seven years with amortisation and 50% repayment upon maturity. The amortization schedule is the following: 5,714% per year of the face value for the period 2021-2023, 10% for 2024, 10,714% for 2025 and 12,143% for 2026. The new bond is earmarked solely for the refinancing of all of AKH's debt, with the exception of the overdraft facility, for a total amount of HUF 3.3bn.

Outlook and rating-change drivers

The Outlook is Stable and incorporates our expectation that Scope-adjusted debt (SaD)/EBITDA will remain below 3.0x in addition to the assumption that no dividend payment will be made in the coming years. The Outlook also reflects our expectation of continuing positive performance with a limited impact from the Covid-19 pandemic.

A positive rating action could be warranted by an improvement in AKH's business risk profile. Such an improvement could be achieved via better diversification or a material increase in operating margins.

A negative rating action may be taken if SaD/EBITDA increases towards 3.5x on a sustained basis or in the event of significant shareholder remuneration, contrary to our expectations. An increase in leverage could be triggered by a rise in net debt from larger than anticipated capex and working capital consumption.

Long-term and short-term debt ratings

Senior unsecured debt is issued by Abroncs Kereskedőház Kft. Our recovery assessment is based on a hypothetical default scenario in 2022. Our recovery analysis indicates an 'average recovery' for senior unsecured debt. This expectation translates into a rating of BB for this debt category.

Rating drivers

Positive rating drivers	Negative rating drivers
• Strong but volatile credit metrics driven by overstocking in 2018 and 2019 and by general dependence on working capital management • Good supplier diversification with a good share of exclusive products • Leading position in the wholesale tyre business in Hungary • Strong liquidity	• Below-average profitability • Limited financial size capped by the Hungarian market • Weak diversification with regard to geography, distribution channels and products • Seasonality of operations

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Improvement in business risk profile via an increase in operating margins and better diversification	• SaD/EBITDA above 3.5x on a sustained basis

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
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Scope-adjusted debt (SaD)/EBITDA	3.5x	2.1x	0.8x	0.5x
Scope-adjusted funds from operations/SaD	23%	32%	100%	173%
Free operating cash flow/SaD	(-) FOCF	110%	58%	67%
Scope-adjusted EBITDA in HUFm	**2018**	**2019**	**2020F**	**2021F**
EBITDA	843.4	581.3	870.3	972.4
Operating lease payments in respective year	55.6	56.9	54.4	54.4
Other	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	899.0	638.2	924.7	1,026.8
Scope-adjusted funds from operations in HUF m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	843.4	581.3	870.3	972.4
less: (net) cash interest as per cash flow statement	-84.9	-125.9	-80.5	-88.2
less: cash tax paid as per cash flow statement	-65.2	-27.9	-47.4	-48.7
add: depreciation component, operating leases	15.7	16.7	14.7	15.5
Variations of provisions	0.5	-3.1	0.0	0.0
Scope-adjusted funds from operations	709.5	441.1	757.0	851.1
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020F**	**2021F**
Reported gross financial debt	2,751.4	2,372.4	3,500.0	3,299.8
less: cash and cash equivalents	-395.7	-1,813.3	-3,517.9	-3,585.1
add: operating lease obligations	794.9	812.8	777.1	777.1
Scope-adjusted debt	3,150.6	1,371.9	759.2	491.8

Business risk profile

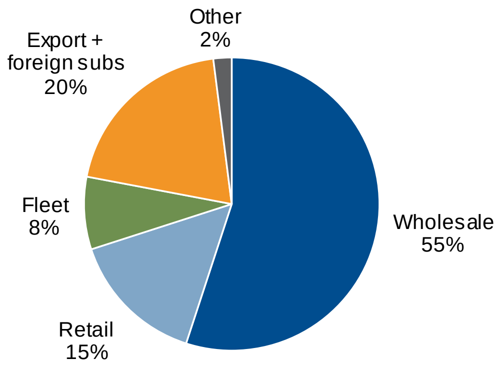
AKH's business risk profile is supported by its market positioning in Hungary, while diversification and profitability are negative rating drivers.

Strong market share offset by small market size

AKH reports having close to 33% of the Hungarian market (based on the number of pieces imported into the country), vs 38% in 2017. After a long period of growth, domestic tyre sales in 2018 and 2019 reached nearly 3 million. The group also sells lubricants, with an exclusive partnership with BP (Castrol, Aral). AKH is the number three player in this business, with a market share of around 7%.

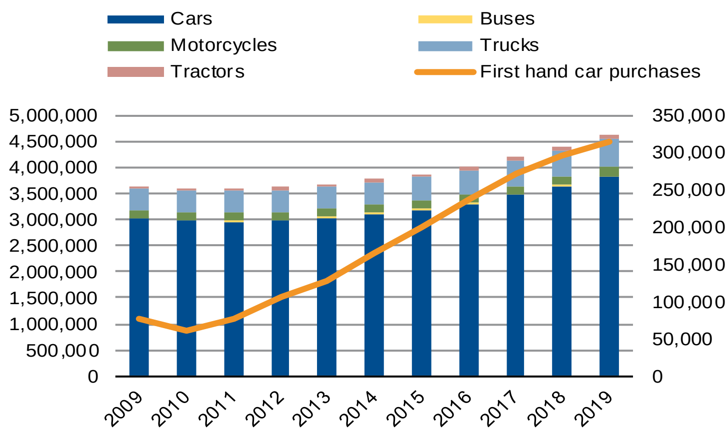
In terms of strategy, AKH intends to improve profitability while maintaining its market share. The strategy is based on: i) increasing the B2C distribution channel by opening additional car services; ii) growing the share of its retail segment and online sales; iii) continuing to reduce the seasonality of its sales through its lubricant and services businesses; iv) maintaining its numerous commercial agreements with most of the largest tyre manufacturers in the world (e.g. Continental, Michelin) for light-vehicle tyres.

Figure 1: AKH revenue split by segment (2019)



Source: AKH

Figure 2: Hungarian fleet by type of vehicle (2009-2019)



Source: KSH

Despite its good market share, AKH is small (EUR 80m in sales). This is due to its core market, restricted growth opportunities, limited pricing power and fierce competition.

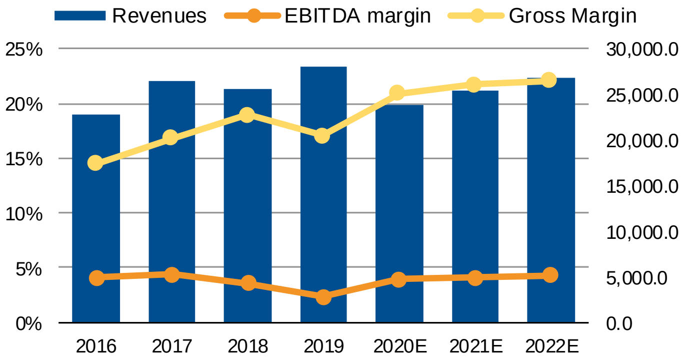
Concentrated product portfolio and limited geographical diversification

Diversification is the main weakness in AKH's business risk profile. With regard to geography, AKH sells 80% of its products in Hungary. Sales realised through exports or its foreign subsidiaries account for 20%, with no country representing a majority share. However, AKH's expansionist strategy abroad may be moving its limited geographical diversification in the right direction.

AKH's product diversification is also weak. Sales are only related to one segment, the automotive industry, and cover all types of tyre (passenger and large tyres for trucks), lubricants and services.

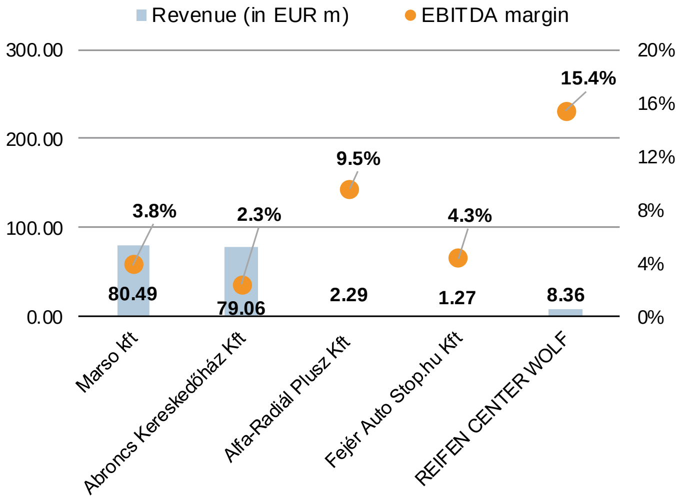
We recognise the group's multiple sales channels (wholesale, retail, online). However, the predominance of wholesale limits diversification as AKH appears to be far from establishing an omnichannel selling structure.

Figure 3: Group profitability



Source: AKH, Scope estimates

Figure 4: AKH's profitability on reported EBITDA versus peers



Source: Scope estimates

Below-average profitability

Between 2016 and 2018, AKH's EBITDA margin ranged from around 3% to 4%. It started to decrease in 2018 and hit 2.3%in 2019. This was a consequence of: i) a warmer than anticipated winter in 2018 leading to a larger inventory; in addition to ii) logistics issues leading to losses in H2 2019. In order to normalise the large stock acquired in 2018, AKH lowered its prices for winter and summer tyres during the first three quarters of 2019.

By successfully reducing its stock level by the end of 2019, the group expects profitability to recover to 2016/2017 levels from 2020 onwards.

Financial risk profile

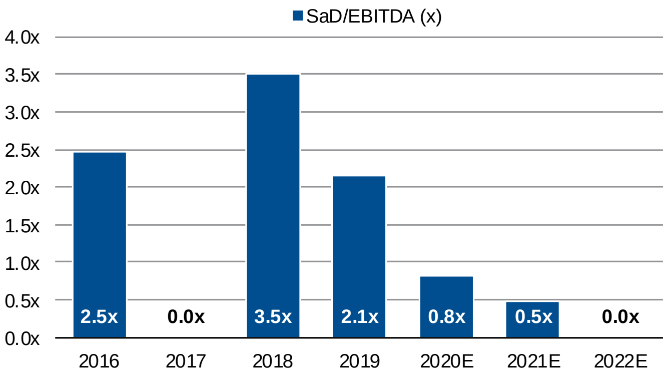
AKH's financial risk profile is clearly supportive of the overall rating case. Our assumptions are in line with the assumptions made by management. We expect the EBITDA margin to increase starting in 2020, given the current favourable pricing environment, the better sales mix (with more sales of premium tyres and exclusive brands), and the increasing share of retail activity.

Investment grade leverage expected to keep improving in future

AKH benefits from a historical leverage in the investment grade category although leverage is volatile due to EBITDA. Our operating lease adjustment represents a large part of SaD, at around 30%. The rest of gross debt is only composed of the upcoming HUF 3.5bn bond used solely to refinance the two loans maturing in 2023 and 2025 for HUF 2.2bn (exposure in August 2020) and the working capital facility of HUF 1.1bn. Only the overdraft facility of HUF 600m will not be refinanced. Nevertheless, the latter is not incorporated into gross debt at year-end as its usage is very seasonable and usually at its lowest at the end of December.

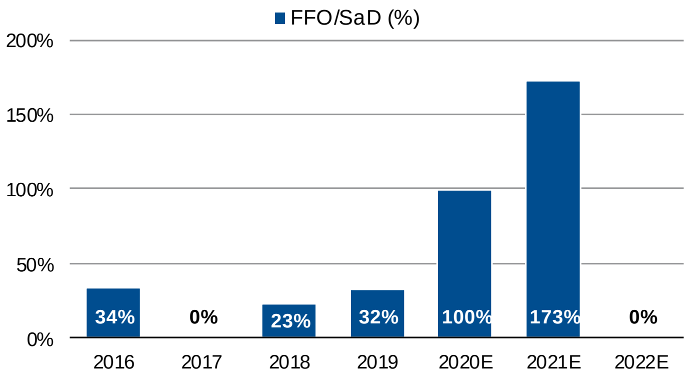
As EBITDA should recover to 2017 levels, both in terms of amount and profitability, we expect SaD/EBITDA to decrease below 2.0x.

Figure 5: AKH’s SaD/EBITDA



Source: Scope estimates

Figure 6: AKH’s funds from operations/SaD

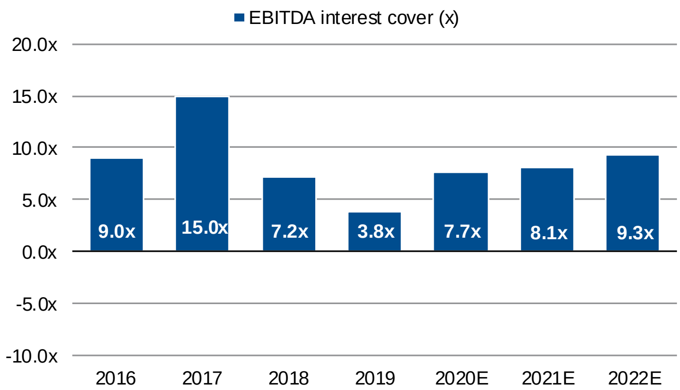


Source: Scope estimates

Funds from operations (FFO)/SaD has developed in a similar way, with the ratio in the BBB category except for at YE 2018. We expect a rapid improvement in the period to 2021. The company is expected to turn net cash in 2022.

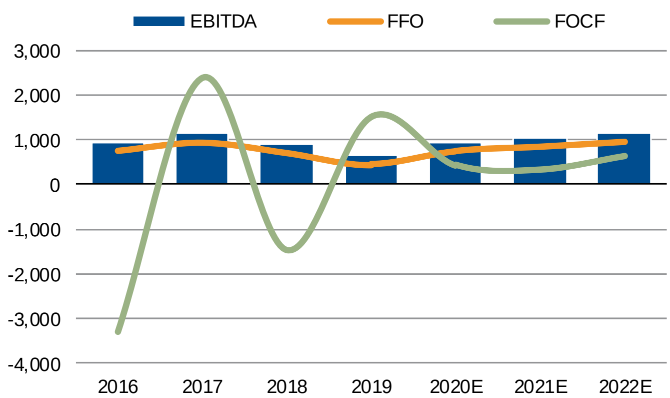
Net interest cover is fairly high. Following the bond issuance, we do not expect the refinancing process to materially impact the cost of debt for the group.

Figure 7: AKH’s interest cover



Source: Scope estimates

Figure 8: AKH’s cash flows (EBITDA, FFO, FOCF)



Source: Scope estimates

The group’s operating cash flow generation is enough to cover capex. Maintenance capex stands at around HUF 230m and upcoming development capex is needed to acquire machinery for new service centres and develop the Navision project. This project to introduce a system to enhance warehouse management will cost a total of nearly HUF 400m by the end of 2021.

However, free cash flow could easily turn negative if there is another material drop in AKH’s working capital consumption. As the ratio could therefore move towards either end of the rating grid, our expectations remain conservative.

Strong liquidity with low level of short-term debt

Liquidity is positive going forward. The group is planning to use the proceeds of the bonds to refinance all of its loans, with the exception of the HUF 600m working capital facility. We have included in short-term debt repayment the amortisation of the bond (around HUF 200m per year) and the fully drawn working capital facility. This is because this short-term debt exposure exists throughout the operating year, and not just at the end of the year, due to the seasonality effect. We view liquidity as adequate.

Figure 9: AKH's liquidity

(in HUF m)	2017	2018	2019	2020	2021E	2022E
Short-term debt (t)	579	92	380	371	801	800
Unrestricted cash (t-1)	165	1,930	396	1,813	3,518	3,585
Open committed credit lines (t)	0	0	0	0	0	0
Free operating cash flow (t)	2,385	-1,476	1,508	438	328	632
Liquidity (internal)	440%	495%	501%	607%	480%	527%
Liquidity (internal + external)	440%	495%	501%	607%	480%	527%

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