TUESDAY, 30/01/2024 - Scope Ratings GmbH

Scope upgrades Sun Group Kft.'s issuer rating to BB- with Stable Outlook

The upgrade reflects the disciplined acquisition policy and moderate shareholder remuneration.

The latest information on the rating, including rating reports and related methodologies, is available on this LINK.

Rating action

Scope Ratings GmbH (Scope) has today upgraded the issuer rating of the Hungarian HR services company Sun Group Kft. to BB-/Stable from B+/Stable. Further, the long-term debt rating on senior unsecured debt has also been upgraded to BB- from B+. Concurrently, Scope has withdrawn the BB- long-term debt rating on senior unsecured debt and assigned a BB- rating on the senior unsecured bonds issued by Sun Group Kft. and guaranteed by its subsidiary Prohuman Zrt. (ISIN: HU0000361225).

Rating rationale

The upgrade of the issuer rating reflects the removal of the negative one notch on the supplementary rating driver as (i) the minority payouts related to the dividend distribution of Prohuman to Sun Group, which are required to service debt at the issuer level, are not detrimental to creditors; and (ii) Sun Group has demonstrated that it has a disciplined acquisition policy, as evidenced by the recent small bolt-on acquisitions of Cityscope (Serbia) and BRC Services (Hungary) at low transaction multiples, which has allowed the start of deleveraging. Furthermore, transparency towards capital markets and financial planning has improved significantly in 2023 thanks to the full consolidation of the issuer's main subsidiary Prohuman Zrt. under IFRS.

The issuer rating reflects Sun Group's leading position in Hungarian HR services through its majority stake in Prohuman, significant growth of the top line (20% YoY growth expected in 2023) and of the Scope-adjusted EBITDA (15% YoY growth expected in 2023), bolt-on acquisitions in the CEE region with good growth prospects and a moderate financial risk profile which is supported by a deleveraging path to net debt/EBITDA below 2.5x in line with the financial covenants of the bond issued to finance growth into HR service sector.

Sun Group's business risk profile (assessed BB-, revised from B+) is driven by subsidiary Prohuman's moderate regional market shares in CEE in HR services and market leadership in Hungary with revenues expected to exceed HUF 100bn (ca. EUR 260m) in 2023.

The industry risk assessment was changed to BB from BBB following the publication of the applicable sector methodology for European Business and Consumer Services companies. Sun Group is an asset-light company operating with high share of unspecialised workforce as its main service is temporary staffing. Such sub-sector has medium cyclicality, low market entry barriers and medium substitution risk.

The markets are fragmented but show good growth potential: (i) in Hungary Prohuman has one fifth market share and has a strategic partnership with the government which allows import of Asian workforce. A record EUR 13bn foreign direct investments (mainly in electric vehicle and battery manufacturing) were announced in 2023, that require 30,000+ jobs in the next three years while unemployment was as low as 4.1% in October 2023; (ii) in Romania Prohuman has ca.15% market share (3rd largest HR services company) and growth is driven by both white collar placement and blue collar temporary staffing; (iii) in Serbia high growth is expected by non-EU workers legislation which is largely based on the Hungarian legislation; (iv) further bolt-on acquisitions may further boost inorganic growth in other CEE countries and/or by diversification of service offering.

Sun Group's profitability is moderate with a Scope-adjusted EBITDA margin of 7.8% at YE 2022 (first year of consolidating Prohuman) and Scope expects it to stay around 7% in period 2023-25 due to the supportive market conditions. The main service of Prohuman is temporary staffing which is a margin business. This means if wages grow, revenues of Prohuman and its nominal EBITDA will grow as well. The high inflationary environment coupled with labour shortage has had a positive effect in this case on the evolution of nominal EBITDA. The margin effect is visible on the H1 2023 nominal EBITDA of HUF 4.2bn (+13% YoY) as wages are steeply increasing in Hungary. The employees can be let go very easily in Hungary and in CEE *(ESG factor: negative social factor)*, which shields profitability as proven during the pandemic, although stricter labour laws can have negative implications on profitability. Scope-adjusted return on capital employed is good, well above 20% in 2022 and in the following forecasted three years due to the asset-light nature of the business. This highlights the good efficiency of the company generating earnings from assets as it has low capital intensity.

The moderate service strength of the issuer is supported by Prohuman being a well-known brand in Hungary somewhat known in Romania and still very small in other countries of operation that show low-to-medium volatility in customer churn rate as well as medium integration in the customer's business such as payroll, where typical contract length is well above one year. The headcount as of H1 2023 is largely in line with the that as at end-2021 (close to 13,000 employees), but composition changed with signing a new blue chip flagship client. The latter will positively influence the issuer's service strength because large clients usually order more types of services and become sticky if the service is good.

Sun Group's financial risk profile (assessed BB, unchanged) is driven by its decreasing leverage towards 2.5x Scope-adjusted debt/EBITDA at end-2023. For the following two years Scope expects leverage to slightly decrease driven by stable or slightly increasing debt, low amortisation of existing debt and improving EBITDA. Sun Group's Scope-adjusted funds from operations/debt of 20-30% is moderate, which shows good cash flow generation.

Scope-adjusted free operating cash flow/debt was negative in 2022 due to the increase in working capital of HUF 4.2bn YoY. The agency expects Sun Group to require further working capital financing of around HUF 1.8-2.2bn yearly as the business will continue to grow. As an asset-light business, CAPEX needs are limited (HUF 1.0-1.5bn yearly), and working capital swings should normalise, therefore Scope expects cash flow cover to stay in the range of 10-15% in 2023-25.

The agency expects Scope-adjusted EBITDA/interest cover of between 8-10x in 2023-24 (up from

5.1x in 2022). The improvement is driven by the successful refinancing of the partially used HUF 10.0bn variable interest rate factoring line with a much cheaper two-year fixed interest rate HUF 5.1bn working capital facility (6% yearly interest rate compared to above 15% previously). As a result, 90% of the debt has fixed interest rate while interest expense decreased which, together with a further growth of Scope-adjusted EBITDA will result in improved debt protection.

Sun Group's liquidity is adequate, mainly driven by historically good cash flow and the repayment profile of the issued bond which starts amortising only in 2027. The adequate liquidity assessment is based on HUF 2.3bn cash projected for end-2023, HUF 2.0bn unused financing facilities, free operating cash flow exceeding HUF 3.0bn in 2024-25 and that expiring short-term facilities will be refinanced based on good historical track record and improving financials. Liquidity could still deteriorate, for example, in the event of sharp working capital swings due to delayed customer payments, which could be partially mitigated by factoring receivables.

Scope highlights that Sun Group Kft.'s senior unsecured bonds issued under the Hungarian National Bank's Bond Funding for Growth Scheme has covenants requiring the accelerated repayment of the outstanding nominal debt amount (HUF 15.4bn) if the debt rating of the bonds stays below B+ for more than two years (grace period) or drops below B- (accelerated repayment within 5 business days) or in case of breach of net debt/EBITDA ratio (max. 3.0x in 2023 and max. 2.5x afterwards). Such a development could adversely affect the company's liquidity profile. The rating headroom to entering the grace period is 2 notches, where Scope sees no significant risk of the rating related covenant being triggered while net debt/EBITDA covenant has limited headroom of below 0.5x, however it is likely that such potential breach would be waived.

No notching was given for supplementary rating drivers.

One or more key drivers of the credit rating action are considered an ESG factor.

Outlook and rating-change drivers

The Outlook is Stable and assumes that Scope-adjusted debt/EBITDA will be maintained below 3.0x thanks to moderate top-line growth and stable profitability. The Outlook also assumes maintaining full compliance with the financial covenants.

A positive rating action could be warranted if Sun Group improved its diversification in the HR business by services or geographies, including achieving a top-three market share in its countries of operation, with Scope-adjusted debt/EBITDA not exceeding 3.0x and maintaining full compliance with financial covenants.

A negative rating action could be triggered by macroeconomic disruptions resulting in a significant drop in demand for temporary staff followed by a deterioration in credit metrics, e.g. if Scope-adjusted debt/EBITDA increased and stayed above 4.0x. Credit metrics could also deteriorate in the event of another large leveraged acquisition or a large dividend payout in the next two to three years. A negative rating action could also be triggered by weakened liquidity due to very large working capital swings, increased shareholder remuneration or non-compliance with financial covenants.

Long-term debt rating

In January 2022, Sun Group Kft. issued a HUF 15.4bn senior unsecured bond guaranteed by subsidiary Prohuman Zrt. The bond proceeds were used for the acquisition of Prohuman Zrt. The bond has a tenor of 10 years and a fixed coupon of 5.5% yearly. Bond repayment is in five tranches starting from 2027, with 10% of the face value payable yearly, and 50% balloon payment at maturity.

Scope expects an 'average' recovery for the senior unsecured (guaranteed) bond (ISIN: HU0000361225), which translates into a BB- rating in line with that of the issuer.

The average recovery is based on the asset-light nature of HR services and the issued bonds' ranking behind the senior secured creditors of Sun Group and the working capital and factoring creditors of Prohuman. The recovery level is based on an expected distressed enterprise value as a going concern in a hypothetical default scenario of around HUF 18.2bn in 2025 and a 10% haircut on that value for administrative claims.

Stress testing & cash flow analysis

No stress testing was performed. Scope Ratings performed its standard cash flow forecasting for the company.

Methodology

The methodologies used for these Credit Ratings and/or Outlook, (General Corporate Rating Methodology, 16 October 2023; European Business and Consumer Services Rating Methodology, 15 January 2024), are available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. Also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The Rated Entity and/or its Related Third Parties participated in the Credit Rating process.

The following substantially material sources of information were used to prepare the Credit Ratings: public domain, the Rated Entity and Scope Ratings' internal sources.

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Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and/or Outlook and the principal grounds on which the Credit Ratings and/or Outlook are based. Following that review, the Credit Ratings and/or Outlook were not amended before being issued.

Regulatory disclosures

These Credit Ratings and/or Outlook are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and/or Outlook are UK-endorsed.

Lead analyst: Barna Szabolcs Gáspár, Director

Person responsible for approval of the Credit Ratings: Philipp Wass, Managing Director

The Credit Ratings/Outlook were first released by Scope Ratings on 21 December 2021. The Credit Ratings/Outlook were last updated on 25 January 2023.

Potential conflicts

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CONTACT INFO

Barna Szabolcs Gáspár

Analyst

b.gaspar@scoperatings.com

Sebastian Zank

Team leader

s.zank@scoperatings.com

Press contact

press@scopegroup.com

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