Progress Étteremhálózat Kft.
Hungary, Corporates

BB STABLE

Key metrics

			Scope estimates	
Scope credit ratios	2022	2023	2024E	2025E
Scope-adjusted EBITDA/interest cover	12.7x	24.6x	18.7x	17.5x
Scope-adjusted debt/EBITDA	3.2x	3.0x	3.2x	3.0x
Scope-adjusted funds from operations/debt	28%	33%	29%	32%
Scope-adjusted free operating cash flow/debt	-14%	22%	3%	16%

Rating rationale

Progress' issuer rating continues to benefit from its position as one of Hungary's largest restaurant operators through its use of the McDonald's brand. The diversification assessment remains low due to the limitation of the development licensee agreement to Hungary and the concentration on one business line. Operating profitability is good but under pressure from expansion and inflation.

The financial risk profile is supported by a very strong interest cover due to the low fixed-coupon bond, decreasing leverage despite soaring inflation and the recovering free operating cash flow as investment phase is tempered.

We assess an above-average recovery for the senior unsecured debt category from 2023 onwards thanks to the tripling of fixed assets since the bond issuance in 2020.

Outlook and rating-change drivers

The Outlook is Stable, based on our expectation that Scope-adjusted debt/EBITDA will remain well below 3.5x, with no further debt issuance as expansion slows and input prices stabilise, resulting in improved cash flow allowing for gradual deleveraging and dividend payments.

A positive rating action could be warranted if the company strengthened Scope-adjusted free operating cash flow/debt to at least 10% on a sustained basis while growing in size as evidenced by an increased market share.

A downgrade could be warranted if Scope-adjusted debt/EBITDA increased above 4x. This could be a result of a deterioration in the franchise relationship (developmental licensee with McDonald's and/or inflationary pressure leading to low cash flow.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
30 May 2024	Affirmation	BB/Stable
7 Jun 2023	Affirmation	BB/Stable
10 Jun 2022	Affirmation	BB/Stable
13 Jul 2021	Upgrade	BB/Stable
7 Jul 2020	New	BB-/Stable

Ratings & Outlook

Issuer	BB/Stable
Senior unsecured debt	BB+

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Related Methodology

General Corporate Rating Methodology; October 2023

Retail and Wholesale Rating Methodology; April 2024

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Moderate profitability, supported by world-leading quick-service restaurant brand, driven by strong marketing strategy validated by consumer research • Well-defined strategies to preserve its market share, including plans for growth in number of new restaurants as well as facelifts for all existing restaurants • Potential for further expansion with drive-through restaurants, which have solid profitability • Robust interest cover ratio	• Heavily dependent on franchise (developmental licensee) with McDonald's • Volatile Scope-adjusted free operating cash flow/debt due to intensive capex plan • Weak diversification

Positive rating-change drivers	Negative rating-change drivers
• Significantly stronger revenue growth • Scope-adjusted free operating cash flow/debt sustained above 10%	• Scope-adjusted debt/EBITDA increasing above 4x • Deterioration in franchise relationship (developmental licencee) with McDonald's • Inflationary pressure resulting in low cash flow

Corporate profile

Progress Étteremhálózat Kft. (Progress) is the McDonald's Corporation's developmental licensee in Hungary and one of the largest restaurant operators in the country based on both revenue and profit. Progress operates McDonald's restaurants and uses the trademarks, intellectual property rights and other products under the McDonald's franchise. It is entitled to name itself the 'Developmental Licensee Partner of McDonald's in Hungary'. The company has two primary sources of income: i) revenues generated by own operated restaurants; and ii) franchisee fees from conventional lincensee partners. The company's activities consist solely of operating McDonald's restaurants in Hungary.

The first McDonald's restaurant in Hungary opened in 1988. Progress's former name was McDonalds Hungary Kft. Ownership changed in 2019, when Hungarian entrepreneur Sándor Scheer acquired the full stake from the global McDonald's group through his holding company Leones QSR Kft, whose sole investment is in Progress.

In Hungary, McDonald's has 111 restaurants with system-wide sales of HUF 140bn in 2023. Of these 111 stores, 60% are operated and owned by Progress and roughly 40% are operated by local conventional licensees. Progress plans to further expand its Hungarian restaurant network.

Financial overview

			Scope estimates		
Scope credit ratios	**2022**	**2023**	**2024E**	**2025E**	**2026E**
Scope-adjusted EBITDA/interest cover	12.7x	24.6x	18.7x	17.5x	19.4x
Scope-adjusted debt/EBITDA	3.2x	3.0x	3.2x	3.0x	2.6x
Scope-adjusted funds from operations/debt	28%	33%	29%	32%	36%
Scope-adjusted free operating cash flow/debt	-14%	22%	3%	16%	21%
Scope-adjusted EBITDA in HUF m					
EBITDA	7,827	9,632	10,587	11,151	12,261
Operating lease payments	2,753	3,432	3,905	4,125	4,403
Scope-adjusted EBITDA	**10,580**	**13,064**	**14,492**	**15,276**	**16,664**
Funds from operations in HUF m					
Scope-adjusted EBITDA	10,580	13,064	14,492	15,276	16,664
less: (net) cash interest paid	(832)	(531)	(773)	(873)	(859)
less: cash tax paid per cash flow statement	(104)	(122)	(126)	(147)	(203)
Changes in provisions	-	305	-	-	-
Funds from operations	**9,644**	**12,717**	**13,594**	**14,257**	**15,602**
Free operating cash flow in HUF m					
Funds from operations	9,644	12,717	13,594	14,257	15,602
Change in working capital	493	331	164	198	203
Non-operating cash flow	1,721	1,650	-	-	-
less: capital expenditure (net)	(16,748)	(6,071)	(12,500)	(7,000)	(6,500)
Free operating cash flow	**(4,890)**	**8,626**	**1,257**	**7,455**	**9,305**
Net cash interest paid in HUF m					
Net cash interest per cash flow statement	832	531	773	873	859
Net cash interest paid	**832**	**531**	**773**	**873**	**859**
Scope-adjusted debt in HUF m					
Reported gross financial debt	33,693	33,000	33,000	33,000	28,875
less: cash and cash equivalents	(9,706)	(14,438)	(7,671)	(9,000)	(7,777)
add: non-accessible cash[1]	4,853	5,450	4,250	3,650	3,650
add: operating lease obligations	5,506	14,587	16,596	17,533	18,713
Scope-adjusted debt	**34,346**	**38,598**	**46,176**	**45,183**	**43,460**

[1] Includes funds earmarked for capex, cashier money and cash deposit for bank guarantee.

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Environmental, social and governance (ESG) profile

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

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

Credit-neutral ESG profile

Progress is working on a dedicated ESG strategy. It strives for cutting its environmental footprint by reducing its general use of packaging, offering alternatives to traditional beef burgers and modernising its whole infrastructure.

As a large employer, Progress has community support programmes and a good focus on gender equity. Ownership and management structures are well separated. The company pays attention to complying with food safety regulations and avoiding regulatory and reputational risks.

The Hungarian entity also invests into product innovation. Internal controls and audits from Mc Donald's Corporation provide further assurance.

A sustainability report with set targets is also being prepared.

Business risk profile: BB

Small player on global scale; market leader in Hungary

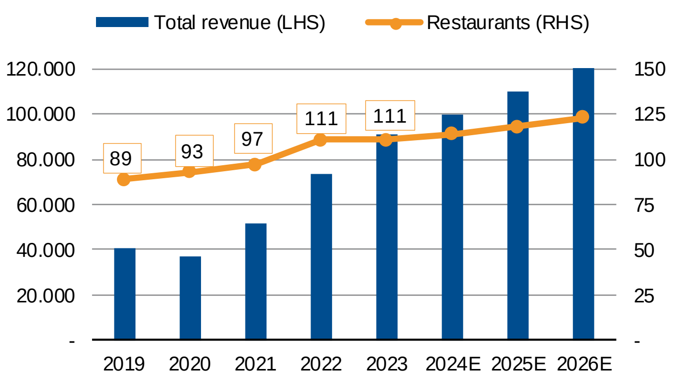
Progress' business risk profile benefits primarily from its position as one of the largest restaurant operators in Hungary through its use of the McDonald's brand. Revenues of Progress reached HUF 91.0bn in 2023 (equivalent to EUR 230m) which is double compared to pre-pandemic levels in 2019.

Progress was able to accomplish significant organic sales and guest count growth in Hungary over 2015-2019 without increasing its number of restaurants. It has since opened 24 new stores (network size up by 25%) out of which 14 in 2022. At the same time, vast majority of existing stores have been modernised, with very little works remaining for 2024.

On an international comparison, however, the number of McDonald's restaurants per capita in Hungary remains half of that in Germany, France or Austria. This can be linked somewhat to the less modern retail space, especially in highly frequented transport hubs, and to the lower purchasing power. We believe Progress' capex plan to open further restaurants is strengthening Progress' market share and overall McDonald's pricing power in Hungary.

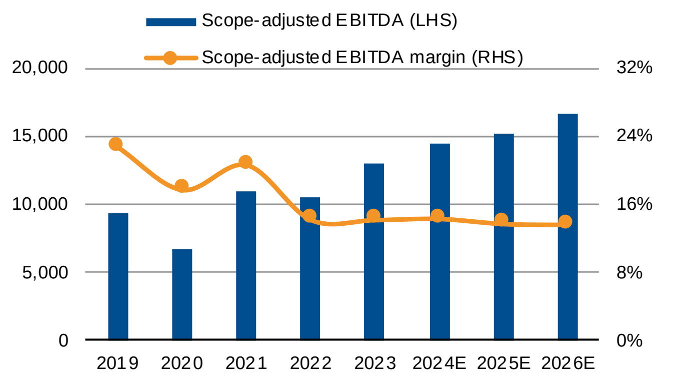
In the medium term, we expect that Progress' good Scope-adjusted EBITDA margins will protect its market share in Hungary from competitors that are willing to sacrifice profitability to gain market share. However, the company's market position assessment is hampered by its dependence on a single country, the Hungarian market's fragmentation and Progress' small scale on a global level.

Figure 1: Evolution of company revenues (in HUF m) and network size



Sources: Progress, Scope estimates

Figure 2: Operating profitability (in HUF m)



Sources: Progress, Scope estimates

Restricted product portfolio but supported by diversified distribution channels

Geographical diversification is limited due to the sole exposure to Hungary. McDonald's sales channels are diversified: home delivery is available in around 85% of the restaurants and drive-through access is growing. From the supplier side, we see a strong integration in global supply chains. The company operates with strategic suppliers and has long-term cooperation with its partners. Supplies were not disrupted by the turbulence of recent years, unlike in other sectors or among less powerful companies. Therefore, we see a low concentration of buyers as well as low supply chain risk. We note that McDonald's is pro-actively improving product diversification by increasing menu variety, adding breakfast items, opening McCafé shops, and offering wraps and salads. Ultimately, however, McDonald's product portfolio is still limited to food and beverages.

Good operating profitability under inflationary pressure

Historical EBITDA margins range from 10.6% to 17.9% in 2016-2021, averaging 14.7%. The Scope-adjusted EBITDA margin is around 4pp higher than reported by the company due to adjustments for real estate lease payments received from franchise partners.

Operating profitability is good with a Scope-adjusted EBITDA of HUF 13.1bn in 2023 (up 23.5% YoY) and a Scope-adjusted EBITDA margin of 14.4% (stable YoY). The Scope-adjusted EBITDA in 2023 includes HUF 3.4bn of adjustments for real estate leases.

The operating environment will remain challenging in 2024. Affordability, digitalisation and economies of scale will therefore be key to remaining competitive. While certain input costs may decrease or at least stabilise compared to 2023 levels, labour costs continue to rise at a double-digit rate. We expect the company to remain resilient to inflationary pressure as proven in 2022-23 and therefore expect stable Scope-adjusted EBITDA margin of 13.5%-14.5% for 2024-26.

Financial risk profile: BB+

The financial risk profile assessment improved compared to last year due to improved leverage metrics. The company was able to navigate the heavy investment phase and operational expenditure inflation and scale up operations which resulted in improved nominal EBITDA exceeding expectations while reported financial debt remained flat and operating lease obligations increased.

Manageable leverage

Leverage measured by Scope-adjusted debt/EBITDA stood at 3.0x at YE 2023 (decreased from 3.2x YoY). We expect Scope-adjusted debt/EBITDA to stay around 3.0x until YE 2025, driven by EBITDA growth due to inflation and additional restaurant openings which is partially offset by increasing operating lease obligations.

The company's debt as at YE 2023 includes a HUF 33.0bn senior unsecured bond and HUF 2.5bn in bank guarantees. We expect no major changes in the next three years. Furthermore, we have excluded from cash netting the contracted capex and cashier money totalling HUF 2.4bn in 2023.

Financing at low fixed interest rate is favourable

Scope-adjusted EBITDA interest cover is very strong, at above 20x at YE 2023. The purely fixed rate debt having a coupon of 3.0% yearly supports debt protection. We expect the metric to stay very strong, above 15x, in the next three years as there is no new financing need and we project nominal EBITDA to increase for reasons mentioned above.

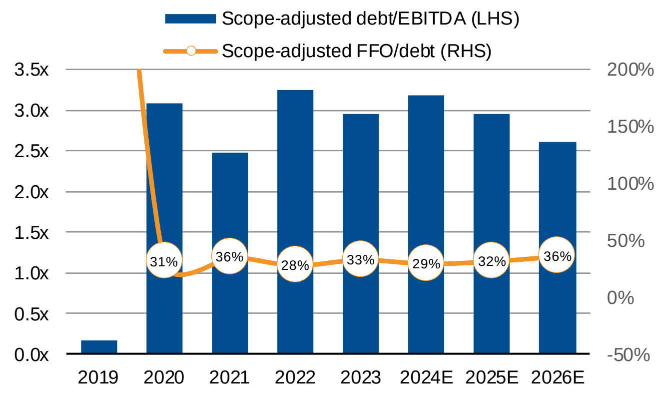
Strong cash flow generation under inflationary pressure

Scope-adjusted funds from operations/debt is good at 33% at YE 2023 (up from 28% in 2022) and points towards healthy cash flow generation. With inflation stabilising, but with some wage pressures and input price volatilities we expect cash flow generation to stabilise above 30%.

Volatile free operating cash flow

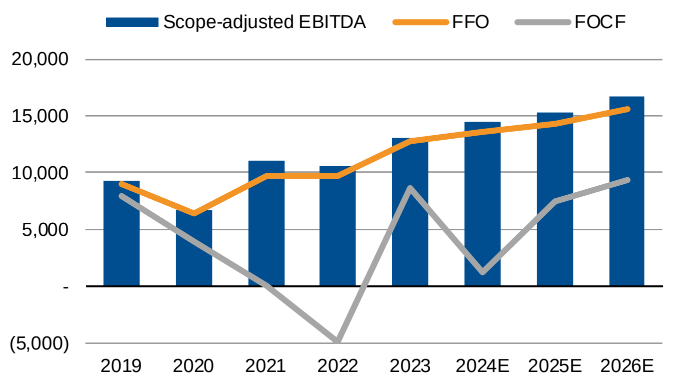
Progress' investment plan from the bond is roughly completed, with new store openings slowing down and modernisations completed. Medium-term growth will therefore be less dynamic allowing FOCF/debt to remain positive in the next three years. This will also result in no pressure to raise new debt in the current high interest rate environment, allowing cash to be accumulated for debt service and dividend payments.

Figure 3: Leverage evolution



Sources: Progress, Scope estimates

Figure 4: Cash flows (in HUF m)



Sources: Progress, Scope estimates
FFO: funds from operations,
FOCF: free operating cash flow

Adequate liquidity

Liquidity is adequate and benefits from the conservative debt maturity profile, with no short-term debt held historically or planned in the coming years. The bond will start amortising in 2026 with HUF 4.1bn yearly which does not seem to pose a liquidity risk given the comfortable cash position and positive free operating cash flow following the investment phase.

We highlight that Progress's senior unsecured bonds issued under the Hungarian National Bank's Bond Funding for Growth Scheme has a covenant requiring the accelerated repayment of the outstanding nominal debt amount (HUF 33bn) if the debt rating of the bonds stays below B+ for more than two years (grace period) or drops below B- (immediate accelerated repayment). Such a development could adversely affect the company's liquidity profile. The rating headroom to entering the grace period is three notches. We therefore see no significant risk of the rating-related covenant being triggered.

In addition to the rating deterioration covenant, bond covenants include list of soft covenants among others (i) change of control unless approved by McDonald's Corporation, (ii) net/Debt EBITDA up to 3.5x applicable only if breach is due to raising new debt, and (iii) dividend restriction up to 50% pay-out ratio.

Balance (in HUF m)	2024E	2025E	2026E
Unrestricted cash (t-1)	8,988	3,421	5,350
Open committed credit lines (t-1)	-	-	-
FOCF	1,257	7,455	9,305
Short-term debt (t-1)	-	-	4,125
Coverage	**>200%**	**>200%**	**>200%**

Supplementary rating drivers: +/- 0 notches

No notching was applied for any supplementary rating drivers.

We view Progress' financial policy as appropriate and prudent, with the commitment to a maximum net debt/EBITDA of 3.5x.

No dividends were paid during the investment phase, and company guidance on dividends still allow deleveraging. We assume a HUF 3.1bn dividend payment in 2024 and HUF 2.0bn yearly thereafter. The bond prospectus limits dividends to 50% of the previous year's profit after tax, which is protective of debtholders.

Parent support is neutral as we do not expect support from the owner or his holding company.

Governance and structure are credit-neutral, though we view positively the multi-level control mechanisms and decision boards.

Peer group considerations do not warrant a change to the rating.

Long-term debt rating

Senior unsecured debt rating: BB+

We assess above-average recovery from 2023 due to the tripling of fixed assets to HUF 36.8bn at YE 2022 from HUF 13.8bn at YE 2020 as a result of the capex. The company has no senior secured debt and no need to raise any.

The improved recovery rate has resulted in the senior unsecured debt rating being upgraded to one notch above the issuer rating, to BB+ from BB.

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