Scope affirms B+ rating of Pannon-Work, with Stable Outlook

The rating action is driven by a growing core business, complemented by recurring revenues from HR services and solar power generation.

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 affirmed Hungary-based Pannon-Work Zrt.'s issuer rating at B+/Stable. The senior unsecured guaranteed bond rating (ISIN: HU0000360052) was downgraded to B+ from BB-.

Rating rationale

The rating action reflects Pannon-Work's good cash flow and increasing headcount from the Hungarian temporary staffing market, complemented by higher recurring revenue provided by HR payroll services, accommodation for workers and 6 MW of solar power generation.

Pannon-Work's business risk profile (assessed at B+) is driven by its position as the third largest personnel service provider in Hungary. The Hungarian market is very fragmented, with the top four players holding a market share of around one quarter. Industry risk is blended (assessed at BBB-) between business services and non-regulated power generation (more than one-fourth of reported EBITDA in 2022).

Growth over the years has been driven by a labour shortage in Hungary and companies' need for an intermediary to offer flexibility by leasing out personnel when required. The labour shortage and further workforce needs created by large-scale investments in the EV and automotive, retail and consumer goods sectors may continue to be an issue, enabling the workforce leasing market to grow.

The strong foreign direct investment pipeline in Hungary's assembly industry provides a good market outlook for the business (examples: battery producers CATL, Samsung, SK Innovation; Audi's new electric engine plant; Mercedes' continual expansion of its plant in Kecskemét; BMW's new EUR 1bn plant in Debrecen, complemented by investments in EV; Flextronics; Lenovo, etc.). The Hungarian government has made it easy for local HR services companies to import Asian workers for a fixed two-year term. Pannon-Work benefits from this programme, as do other market participants such as Prohuman (member of Sun Group). At the same time, clients are continually tendering out contracts with workforce agencies, and leased workers are the easiest to let go, as seen during the pandemic and supply chain disruptions (ESG-factor: credit negative). A steep increase in wages has put pressure on temporary staffing providers' margins as wage increases cannot be passed on immediately. Cash flow from Pannon-Work's blue-collar workforce leasing is therefore volatile and vulnerable. Sluggish economic growth and input-part shortages may force temporary closures of some assembly lines. This could impact Pannon-Work's cash flows as temporary staffing is a margin business based on staffing costs.

Despite the company's efforts to expand its range of services, it faces concentration risk due to its sole exposure to Hungary, dependence on the Hungarian labour market and low customer diversification. Its top five clients contribute more than two thirds of revenue, and most of them are bound to Pannon-Work for more than five years. Low geographical and client diversification has led to volatile cash flow from Pannon-Work's main activity. Since there are significant investments in Hungary with a need for labour, especially in the automotive parts segment, Scope expects the blue-collar workforce leasing market to grow. This is especially true for the electric vehicles market, which may provide additional opportunities for Pannon-Work to grow its client base.

Furthermore, recurring revenue from the company's solar energy production (5 MW acquired, 1 MW under acquisition) largely mitigates vulnerable cash flow. Revenue from recurring services such as payroll services provided by the recently acquired HR-Face Kft. does as well, since clients do not change service providers frequently due to the associated administrative burden.

Profitability as measured by a Scope-adjusted EBITDA margin of 4.6% in 2022 is in the range of previous years' profitability of 4.5%-5.0%. Improvements in profitability from historical EBITDA margins of 2%-3% are mainly due to recurring revenue and its EBITDA contribution. Since 2022 around one third of EBITDA has come from payroll services, accommodation and green energy production, which have more protected cash flows than blue-collar workforce leasing. The increase in recurring revenues and their EBITDA contribution support the rating.

Pannon-Work's financial risk profile (assessed at BB-) is driven by: i) high indebtedness following the issuance of a HUF 3.5bn senior unsecured guaranteed bond and an additional HUF 1bn of senior secured long-term loans for capex and acquisitions and HUF 2.75bn of working capital facilities; ii) resulting weak but still reasonable credit metrics, with a Scope-adjusted debt/EBITDA ratio of 4.7x in 2022 from 5.2x in 2020 and a Scope-adjusted funds from operation/debt ratio of around 20%; iii) investments in assets generating recurring cash flow, enabled by bond proceeds and additional debt issued, which support EBITDA growth and allow for gradual deleveraging; and iv) possible development of existing power generation capacity, putting pressure on the Scope-adjusted free operating cash flow/debt ratio but with only a small increase in the Scope-adjusted debt/EBITDA ratio to 5x.

Scope-adjusted EBITDA interest cover was strong in 2022 at 12.3x (up from 11.6x in 2021). The 20% YoY EBITDA ramp-up is visible in the expansion of the temporary staffing business, solar power generation and real estate segments. Debt instruments used for investments are long-term and have fixed interest rates of up to 3% per year, which is beneficial in Hungary's current soaring interest rate environment. Working capital facilities have either a 6% fixed rate or a variable rate. The rise in interest rates to above 10% moderately affects Pannon-Work as the company has HUF 2.0bn in variable-rate debt (of which only HUF 0.6bn drawn), and no new, large variable-rate debt financing is planned. Scope forecasts Scope-adjusted EBITDA interest cover will stay above 4x assuming low deposit interest because cash can be spent on investments, which still leads to good debt protection.

Scope deems Pannon-Work's liquidity to be adequate. The company refinanced most of its short-term debt to long-term debt in 2020, which significantly improved its liquidity ratio. Its new working capital facility was contracted for three years in 2023, which benefits the liquidity assessment. The overdraft and factoring are not used intensively and are excluded from the assessment as they are short-term.

Outlook and rating-change drivers

The Outlook for Pannon-Work is Stable and reflects Scope's view that the company can retain its major clients and keep up its strong cash flow generation. The Stable Outlook reflects Scope's expectation that indebtedness will remain high, at a Scope-adjusted debt/EBITDA ratio of 4.0x-4.5x over the next few years, as a result of the bond issuance, related investments and additional working capital financing.

A positive rating action is remote at this stage but could be warranted if Pannon-Work strengthened its balance sheet. One way it could do so is by reducing leverage (Scope-adjusted debt/EBITDA) significantly below 4x on a sustained basis. It could achieve this via improved profitability, a higher EBITDA contribution from HR services or reduced shareholder remuneration.

A negative rating action could occur if the Scope-adjusted debt/EBITDA ratio exceeded 6x on a sustained basis or if the Scope-adjusted free operating cash flow/debt ratio dropped below 5% on a sustained basis. This could result from lower-than-expected EBITDA from HR-related services or solar energy production assets or from further large debt-funded capital expenditure or acquisitions.

Scope notes that Pannon-Work's senior unsecured bond issued under the Hungarian central bank's bond scheme has accelerated repayment clauses, including financial covenants and change of control provisions. The financial covenants have sufficient headroom: net debt/equity of max. 2.5x (1.4x at YE 2022), net debt/total liabilities of max. 60% (34% at YE 2022). The clauses require Pannon-Work to repay the nominal amount (HUF 3.48bn) within 15 days if the early repayment clauses are breached, which could have default implications.

Long-term and short-term debt ratings

In October 2020, Pannon-Work issued a HUF 3.48bn senior unsecured bond guaranteed by Gamax Kft. (ISIN: HU0000360052) through the Hungarian central bank's Bond Funding for Growth scheme. The bond proceeds were used to acquire solar power generation companies and for refinancing. The bond has a tenor of 10 years and a fixed coupon of 3.0%. Bond repayment is in five equal tranches starting from 2026, with 20% of the face value payable yearly.

Scope downgraded Pannon-Work's senior unsecured bond (ISIN: HU0000360052) guaranteed by Gamax Kft. to B+ (in line with the issuer rating) due to average recovery expectations. The lower recovery expectation primarily reflects the bond's ranking below senior secured borrowings (for investments, acquisitions and working capital; up by 9% YoY) and the higher debt in absolute terms (up by 25% YoY), which was not offset by a similar increase in assumed liquidation value.