TEGETA MOTORS LLC
Georgia, Retail

SCOPE BB- STABLE

Corporate profile

Tegeta Motors LLC (Tegeta) is a Georgian retailer which specialises in the sale of cars, car parts and special vehicles. The group has a large footprint in Georgia with 20 service centres and five retail outlets spread across every region. Thanks to numerous commercial agreements with international leaders in the automotive sector, Tegeta has developed swiftly in most of the retail segments. It is now one of the leading automotive retailers in the Caucasus region with a compound annual sales growth rate of over 20% for the last three years.

Key metrics

			Scope estimates	
Scope credit ratios	2017	2018	2019F	2020F
EBITDA/ interest cover (x)	4	4	5	6
SaD (Scope-adjusted debt)/ EBITDA (x)	2.8	3.0	2.5	2.1
Scope-adjusted FFO/ SaD (%)	28	26	33	40
FOCF/ SaD (5)	2	-7	-10	-3

Rating rationale

Scope Ratings assigns an issuer rating of BB- to Georgia-based Tegeta Motors LLC. The rating Outlook is Stable and the prospective GEL 30m domestic bond is rated BB- on a preliminary basis.

The issuer rating is mainly supported by the company's BB rated financial risk profile, based on its comparatively strong operating profitability, which enables good underlying free cash flow generation, and will continue to do so in future. Tegeta's business risk profile (rated BB-) is supported by its good market position in the profitable Georgian market. The rating is constrained by low geographical diversification and by some execution risk associated with the company's future expansion programme. The rating also reflects our view on the evolving macroeconomic and industrial environment in which the company operates: the risks and opportunities presented by expected industry consolidation and the significant changes likely in the retail segment in the future.

In terms of competitive positioning, we consider Tegeta's market situation in Georgia to be sustainable. The group is the national leader in Georgia's fragmented automotive market, holding an estimated share of 25% for new cars (16% including used cars). Tegeta benefits from commercial agreements with world-leading automotive suppliers such as Toyota, Porsche, Volvo, Shell, Bosch, MAN and JCB. This leading position is reinforced by the expected decline in non-professional markets (bazaars) and by laws requiring car owners to take their vehicles for regular technical inspections. Tegeta's broad presence in Georgia has also helped the company to win significant national bus tenders. We believe that Tegeta will increase its share of public tenders on the back of large infrastructural reforms planned by the Georgian government.

Ratings & Outlook

Corporate ratings	BB-/Stable
Senior unsecured rating	BB-

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Related methodology

Corporate Rating Methodology, March 2019

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We have a negative view of Tegeta's diversification, given its dependency on the Georgian market. However, its strategic expansion into the Caucasus region is expected to support future diversification, as there are no clear market leaders in this region. Product diversification is the main positive rating driver as it distinguishes Tegeta from smaller domestic competitors, which usually offer only one product category. The company is present in vehicle sales (all types), car parts, as well as maintenance and specialised equipment. This broad product range is also complemented by a good split of customer types (40% retail / 35% corporate / 25% wholesale). We view this mix as positive because it balances the risks attached to a single group of customers.

With a Scope-adjusted operating profit margin consistently above 10% (12.5% in YE 2017, defined on an EBITDA basis), Tegeta's profitability is high for a retailer. We consider this high margin to be supported by: i) a profitable after-sales business, accounting for most of current revenues; and ii) significant projected sales growth, allowing for better cost absorption.

With regard to corporate governance, we believe that Tegeta's ownership structure – consisting of Georgian individuals, mainly the Kokhodze family which has 73% – is not comparable to those of public companies in the West. However, current plans include the setting-up of a supervisory board and the creation of greater transparency for outside investors. We therefore have a neutral view of Tegeta's current corporate governance, as structures are expected to improve in the near term and no corporate governance-related concerns were identified during the rating process.

Tegeta's financial risk profile is supported by its high operating profitability, which translates into a good ability to generate underlying cash flow, in particular after 2020 when the present expansion programme will end. Combined with the group's growth potential, this is already likely to lead to significantly improved credit metrics in 2019 – in the middle of the investment programme. This expansion programme centres around Tegeta's involvement in various Georgian infrastructure projects. As a consequence, capital expenditure and working capital are expected to increase markedly by 2020. The expansion in working capital will be driven both by expected sales growth and by Tegeta's strategy to increase product availability (tyres and other spare parts). The planned capex will significantly exceed maintenance levels, meaning it is highly likely that free cash flows will turn negative during this period. However, capex in particular is flexible and could be considerably reduced if necessary. We believe that Tegeta can already improve its credit metrics in 2019 as, despite the spending programme, EBITDA growth is likely to outpace the increase in Scope-adjusted debt.

Tegeta is planning to use a good part of the GEL 30m bond placement, intended for the first half of 2019, to swiftly reduce its traditionally heavy reliance on short-term debt. This will affect liquidity positively (we consider liquidity to be 'adequate' assuming a successful bond placement) as the remaining short-term debt maturities will be fully covered by available liquidity as a result.

Thus, our underlying conservative base case foresees a considerable improvement in key credit metrics in 2019. On the other hand, free cash flows are likely to remain negative. In our view, execution risk for strong sales growth should not be high for Tegeta, as this is largely a function of receiving cars and buses on a timely basis from manufacturers. Assuming a stable EBITDA margin of 9% on a reported basis, and assuming that revenues will reach GEL 600m in 2019, leverage should improve from approximately 3x in 2018 to 2.3x in 2019. Tegeta is likely to generate negative free operating cash flows (FOCF) in 2019 and 2020 and we believe that most of the expected growth in EBITDA is likely to fund working capital expansion. We have therefore focused on the FOCF-to-Scope-adjusted debt (SaD) ratio which we expect will become positive again by 2021.

We have applied a negative one-notch adjustment for supplementary rating factors, primarily encapsulating emerging market risks, currency risk and growth plan execution risks as well as execution risk associated with the prospective bond placement and potential consequences for the company's liquidity policy.

We also examine recovery values for bond holders in a hypothetical case of default. We have calculated a recovery rate of about 40% for the GEL 30m senior unsecured bond using a liquidation approach. Our calculation is based on secured bank loans ranking ahead of the bond, the roll-over of existing bank guarantees, the first liens already held by banks on some of the assets, the possibility that some of Tegata's foreign-currency denominated debt could appreciate relative to local currency, and the risks regarding bankruptcy resolution in the emerging market of Georgia. This results in the same bond rating as the issuer rating, based on our calculated value available at default.

Outlook

The Outlook is Stable and reflects our expectation that Tegeta will successfully place its GEL 30m bond in 2019 thereby allaying current liquidity concerns that would otherwise exist. The Stable Outlook is likewise linked to the positive generation of free operating cash flows after 2020.

A positive rating action could be warranted if the company achieves positive free operating cash flow after 2020 of above 5% in relation to Scope-adjusted debt. A negative rating action could result from sustained negative free operating cash flows.

Rating drivers

Positive rating drivers	Negative rating drivers
• Dominant share of the Georgian market, leading to high profitability • Good overall credit metrics	• Current low geographic diversification with presence limited to Georgia • Investment programme restraining free cash generation

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Positive free operating cash flow after 2020 of above 5% in relation to Scope-adjusted debt	• Sustained negative free operating cash flows

Financial overview

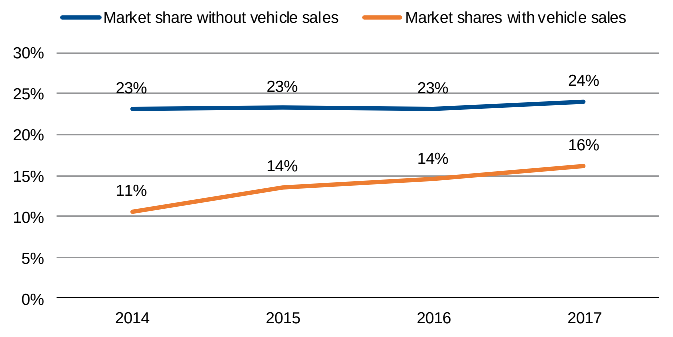
			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	4x	4x	5x	6x
SaD/EBITDA	2.8x	3.0x	2.5x	2.1x
Scope-adjusted FFO/SaD	28%	26%	33%	40%
FOCF/SaD	2%	-7%	-10%	-3%
Scope-adjusted EBITDA in GEL m	**2018**	**2018**	**2019F**	**2020F**
EBITDA	38	38	52	71
Operating lease payment in respective year	4	5	7	9
Scope-adjusted EBITDA	42	43	59	80
Scope funds from operations in GEL m	**2018**	**2018**	**2019F**	**2020F**
EBITDA	38	38	52	71
less: (net) cash interest as per cash flow statement	-9	-10	-11	-12
less: cash tax paid as per cash flow statement	-1	-1	-1	-1
add: depreciation component operating leases	4	6	8	8
Scope funds from operations	32	33	48	67
Scope-adjusted debt in GEL m	**2018**	**2018**	**2019F**	**2020F**
Reported gross financial debt	96	103	112	121
less: cash, cash equivalents	0	0	0	0
add: operating lease obligation	20	25	35	45
Scope-adjusted debt	116	128	147	166

Business risk profile

Tegeta is the market leader in every automotive retail subindustry…

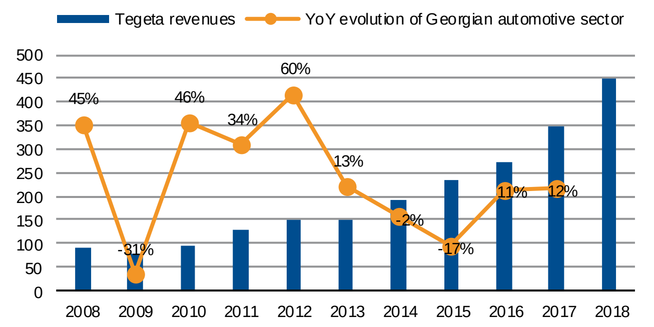
Tegeta is the Georgian national market leader in the automotive retail sector (cars, buses, car parts and specialised vehicles). By simultaneously developing a footprint in the sale of new cars and car parts, the retailer has become the only national player present in each segment, ensuring high market shares and brand recognition. This duality has reinforced the company's top line by decreasing its vulnerability to adverse macroeconomic movements. By reaching a critical size in terms of revenue and national coverage, Tegeta has gained the ability to win national tender offers, such as the last two large bus tender offers won for the city of Tbilisi. The company has managed to achieve significant sales growth over recent years, which we expect to accelerate in the near future. This is due to the bus tenders won, additional licenses contracted, for example from Volvo and Shell, and to successful bids for some Georgian infrastructure programmes to be realised over the coming years (power plants, high roads). Tegeta's specialised vehicle and related divisions should thus develop swiftly and continue to mitigate the company's dependence on new car sales.

Figure 1: Tegeta holds strong market shares



Source: Tegeta

Figure 2: Significant growth in the past



Source: Tegeta

.. leading to high brand recognition

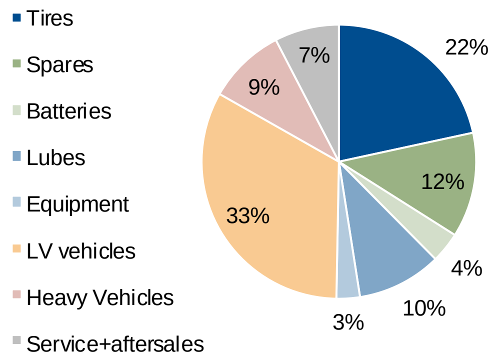
By successfully developing its multi-segment offers, Tegeta has gradually been expanding the number of its international commercial partners in the Caucasus region. The company offers a vast range of products, including but not limited to well-recognised car brands (Toyota, Porsche, Infiniti & Volvo) tyres (Bridgestone, Michelin and Continental) and trucks & specialised equipment (MAN, JCB, Hyundai, Komatsu). It is difficult for most of Tegeta's competitors operating in the Caucasus region to replicate these commercial agreements because of their small size and/or their focus on a single sub product (for example: car dealership only).

Low geographical diversification constrains the rating

We assess Tegeta's geographical diversification as weak due to its heavy dependence on Georgia (86% of sales in 2018). However, Tegeta plans to expand its business exposure to the rest of the Caucasian region in order to drive additional growth. We view these future expansion plans positively but expect some execution risk. Product, customer and supplier diversification are already well developed, in contrast to the presently low geographical diversification. Indeed, Tegeta sells goods belonging to most of the automotive retail subindustry (new cars, car parts, specialised vehicles, etc) each with a different cyclicality and recurrence of purchases, increasing de facto the company's resilience in the event of macroeconomic turmoil. The upcoming implementation of lease financing should further enhance this advantage.

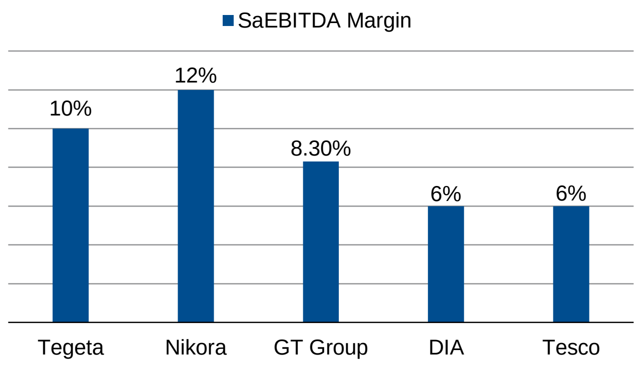
Concerning customers and suppliers, Tegeta has a diversified portfolio, with customers split into retail (40%), wholesalers (25%) and corporate/ institutional (35%). We also consider the split of the suppliers to be positive, despite the importance of Toyota which represented 26% of purchases in 2017. We expect this share to decrease swiftly with the upcoming inclusion of the Volvo license.

Figure 3: Product diversification 2018



Source: Tegeta

Figure 4: Peer group profitability 2017



Source: Annual reports, Scope

High operating profitability

Tegeta's profitability supports the rating. Tegeta benefits from a relatively high Scope-adjusted EBITDA margin, constantly above 10% since 2014. This high level of profitability in a sector context can be explained by the company's comparatively large share of profitable after-sales business (spare parts and services made up about 60% of consolidated sales in 2018), and relatively low exposure to the less profitable new car business. We expect profitability to develop positively but gradually as Tegeta remains in a period of capital expenditure expansion, involving additional costs before the new projects can fully contribute to profitability. We have thus assumed a stable operating margin for the next few years, despite our projection of sizeable revenue growth.

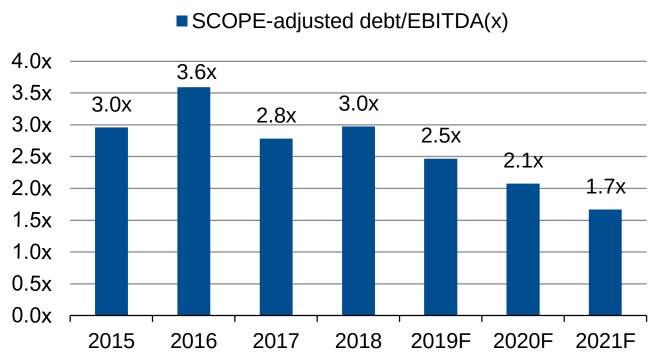
Corporate governance is developing

The company is owned by the Kokhodze family (73% of votes) and other Georgian individuals. There is no public ownership of the company so far. We understand that owners and management are currently in the process of setting up a supervisory board and enhancing transparency to outside investors. We therefore see a positive ambition to develop corporate governance, which is also demonstrated by the rating initiative. Corporate governance is neutral from a ratings perspective because Tegeta's family ownership appears to support a conservative financial policy (no outside interests of the owner, no huge dividends).

Financial risk profile

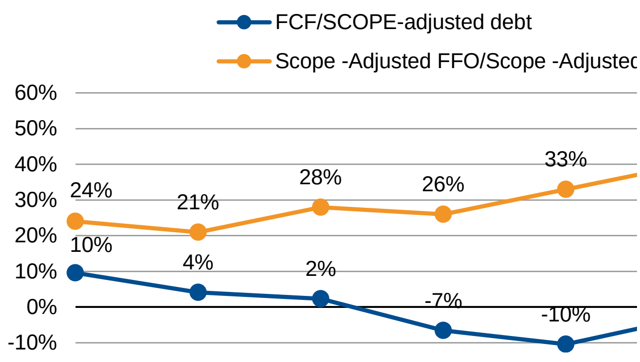
Tegeta's financial risk profile (rated BB) supports the ratings. Its comparatively high operating margins translate into good underlying cash flow conversion. Present financial credit metrics are therefore at a relatively robust level in the context of the ratings, in our view. While we expect revenue and EBITDA to increase significantly in the coming years, the company's expansion programme – which started in 2018 – will put great pressure on FOCF generation. The programme is likely to lead to a sharp rise in capital expenditure which we expect will far surpass maintenance levels of about GEL 5m. In addition, working capital is likely to expand even more greatly than sales because management aims to increase product availability (tyres). As this is very likely to take FOCF levels into negative territory in 2019 and 2020, we believe that it is important, in the context of the ratings, to expect positive FOCF after 2020 when the expansion programme ends. In 2021, EBITDA growth should no longer be consumed by the build-up in working capital and will be able to generate positive free operating cash flow. However, we understand that Tegeta has a certain amount of flexibility with regard to spending levels, both for capex and working capital, which can be stopped or reduced if need be. As the chart below shows, FOCF was in a 2%-10% range in 2015 to 2017, i.e. before the expansion phase.

Figure 5: Tegeta's leverage is expected to improve…



Source: Scope

Figure 6: … with free cash flow likely to react later



Source: Scope

We expect credit metrics to improve as early as 2019, despite Tegeta's ongoing investment programme. This is based on our assumption of strong EBITDA growth leading to comparatively less growth in financial debt in the coming years (see table on page 5). However, as explained above, we have focused on the FOCF-to-SaD ratio which we believe will become positive again after 2021. Leverage, as expressed by SaD/EBITDA, is likely to reach about 2x by 2020, from about 3x in 2018 despite the GEL 30m bond issuance.

Liquidity policy likely to improve

From a credit perspective, Tegeta has suffered from a strong exposure to short-term funding in the past. At the end of 2018, the company still had more than GEL 40m of short-term debt – mostly revolving short-term bank lines – which were only partly covered by GEL 20m of balance sheet cash and no committed multi-year credit lines. According to our methodology, liquidity needs to cover short-term maturities by 1.1x for a company's liquidity profile to be assessed as adequate. We understand that the issuance of the GEL 30m bond will be partly used to significantly reduce short-term bank lines and thus improve the group's liquidity profile.

Supplementary rating factors: a negative notch

We have applied a negative notch to account for emerging market risks in general, Tegeta's improved liquidity profile (see above), and foreign currency risks. We view Tegeta's foreign exchange exposure as material because most products are purchased in hard currencies (euros, dollars, yen) while sales are received in Georgian lari. In addition, most of Tegeta's present financial debt is denominated in foreign currencies. While Tegeta operates currency hedging policies (mainly using 6-month forwards), which are likely to smooth potential negative currency effects, its business model means we cannot realistically expect the complete avoidance of future currency risk. However, the bond placement is likely to improve Tegeta's currency risk with regard to financial debt, as we understand that it will replace a large part of the company's foreign-currency denominated debt. The negative notching under supplementary rating factors also encompasses Tegeta's ambitious growth plan and the related execution risks.

Recovery prospects for the bond at about 40%

We also examine recovery values for bond holders in a hypothetical case of default. We have calculated a recovery rate of about 40% for the GEL 30m senior unsecured bond using a liquidation approach. Our calculation is based on secured bank loans ranking ahead of the bond, the roll-over of existing bank guarantees, the first liens already held by banks on some of the assets, the possibility that some of Tegata's foreign-currency denominated debt could appreciate relative to local currency, and the risks regarding bankruptcy resolution in the emerging market of Georgia. This results in the same bond rating as the issuer rating, based on our assumed value available at default.

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