Research Update:

Kruk S.A. Assigned 'BB-' Rating; Outlook Stable

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Rating Action Overview

- Kruk S.A. is a listed Poland-based distressed debt purchaser (DDP), with Polish zloty (PLN) 12.1 billion (€2.5 billion) of estimated remaining collections (ERCs) at Sept. 30, 2022, and is mostly (90%) active in Eastern and Southern Europe (Poland, Romania, Italy, and Spain).
- The group enjoys deep penetration of the markets it operates in thanks to its long-lasting presence and general prudent investment approach but is not as diversified as peers in Europe and doesn't have as vast a geographical footprint as Intrum or Lowell.
- Kruk's leverage is on the more contained side at an estimated 2.4x on a cash-adjusted basis in 2022, although we expect the company's ambitious growth strategy will bring it closer to 3.0x by year-end 2024--a level that remains contained relative to peers.
- We assigned our 'BB-' long-term issuer credit rating to Kruk.
- The stable outlook reflects our expectation that Kruk will pursue growth through continuous acquisitions of debt portfolios financed by collection generated cash and additional debt, with its financial profile remaining under control including cash-adjusted leverage below 3.0x and coverage of interest by cash EBITDA above 4.0x.

Rating Action Rationale

Our rating reflects Kruk's expanding franchise and consequent increasing financial leverage. We view Kruk as an average scale European DDP, albeit steadily expanding since its inception in 1998, with still lower business and geographical diversification versus larger peers. Although leverage has been a positive differentiator so far, we understand the company's growth targets imply its financial risk will increase in the coming 24 months and already take this into account. Kruk had about PLN12.1 billion (€2.5 billion) in ERCs at Sept. 30, 2022 (12% compound annual growth rate since 2017), which makes it a midsize player in the industry, with close peers such as B2Holding, Arrow Global, and Axactor (ERCs of €1.8 billion-€2.3 billion). Kruk has expanded organically in its key markets over the past 25 years, building a robust reputation and brand name. We consider positively its focus on a few core markets, which has led to leading positions in these geographies, although we acknowledge the lack of diversification could damage business prospects in case of localized harsh downturns. We expect growth to accelerate through an ambitious debt portfolio investment strategy, without material changes in the business mix or the geographical footprint, leading to cash-adjusted debt to EBITDA of close to 3.0x by year-end 2024.

The company's strategic focus on unsecured debt collections in key countries leads to narrower business diversification than peers. Kruk concentrates primarily on unsecured consumer finance debt collection from its own investments (90% of revenue), supplemented by consumer loans (6%) and debt servicing (3%). We understand there is limited servicing potential in Poland and Romania, and that this limited third-party servicing complements collection activity to acquire loan data and build relationships with debt sellers when available. Therefore, Kruk is an outlier compared with some peers that are increasing their scale in capital-light servicing revenue to limit their financial leverage. We believe business diversification is important over the longer term, particularly by business line, because it adds an element of stability if the pricing of portfolios becomes uneconomical or the supply of debt sold restricted. To diversify within unsecured lending, Kruk acquired a digital company in 2019, Wonga, which offers consumer short- and medium-term consumer loans in Poland. We understand additional legal constraints in Poland will require a revamp of the lending product offering to pursue future business. From a geographical standpoint, Kruk operates in seven countries with four main markets. Although volatile because it depends on investment opportunities, the main share of revenue stems from the group's home market, Poland (43%), then Italy (23%), Romania (19%), and Spain (12%). Kruk is more diversified than other peers such as iQera, which genrates 85% of its revenue from France, but much less so than pan-European players such as Intrum and Lowell that operate in over 20 locations. We don't expect Kruk to materially change its footprint but assume it will consolidate its presence in non-Polish markets.

Kruk's demonstration of a long operating track record with sound investment discipline, improving operating efficiency year-on-year, and stable management, are supportive of our rating. Similar to other DDPs, Kruk's reported EBITDA margin is estimated at about 63% at year-end 2022, which is comparable with B2 Holding but above Intrum and Lowell. The focus on a large volume of small unsecured retail claims (below roughly PLN10,000 or €2,000) has the advantage of increasing predictability of collection and decreasing the risk of long legal procedures compared with larger secured claims. Therefore, collection is usually less costly and quicker, and these are simpler claims that can be automated. During the first nine months of 2022, the share of online payments as a percentage of total amicable collections was 60% in Spain, 41% in Poland, 42% in Italy, and 29% in Romania, which supports operational effectiveness. On the contrary, Kruk has a strategy of amicable collection with in-person visits, which is costly from a full-time-equivalent worker perspective, although it is probably more efficient than the traditionally impersonal collecting method of letters and calls. This allows for better recovery before moving on to more costly legal proceedings. Continuous improvements in the recovery process in recent years entail upside in collection revenue for the years to come as the company recognizes it in revaluations over time. Moreover, Kruk has a long track record of resilient collection performance and sound back-book growth as a result of gradual organic expansion into Spain and Italy. We view positively this growth approach to achieve efficient operations and scale before looking at new geographies. Furthermore, we believe the company's current market positions in core geographies are key to gaining continued access to large distressed debt portfolios, allowing Kruk to continue deploying capital above its replacement rate and underpinning future growth.

We expect Kruk's financial profile to weaken over the next two years on the back of an ambitious investment strategy, but still compare well with its more leveraged peers. The company's plans to continue deploying capital to strengthen its competitive position in core markets will only be possible by attracting new debt on its balance sheet. 2022 will be a record year for investments in the debt portfolio, estimated at PLN2.4 billion (€510 million), which would support growth in collection revenue of 5%-10% per year. We estimate debt will increase on the back of further yearly investments of about PLN1.8 billion in the next two years, deteriorating financial leverage toward 2.6x gross debt to cash-adjusted EBITDA by year-end 2024, and 4.6x on a reported-EBITDA basis at the same date. This compares with 2.3x and 3.9x respectively at year-end 2022. Although we see leverage increasing toward aggressive standards, it remains at the lower end of the DDP peer spectrum, which is usually highly leveraged. It is at a comparable level versus B2 Holding and Anacap, but lower than Intrum, Lowell, or Axactor. Cash-adjusted EBITDA interest coverage is expected to decrease to about 5x over the next two years. In addition, debt to average tangible equity (ATE) is positive and we expect it at about 1.3x over the next two years. This is a differentiator compared to DDP peers that have negative debt-to-ATE metrics due to a very high level of goodwill following years of add-ons or transformative acquisitions.

Kruk's absence of significant maturities until 2027 supports our liquidity assessment. The company's largest debt maturity is in 2027, and we don't anticipate any issues given the long time ahead to refinance if needed at that time, its strong name recognition in Poland's debt market, and its sound relationships with local banks.

Outlook

The stable outlook reflects our expectation that Kruk will display resilient earnings and cash flows over the near term despite a more challenging macroeconomic environment. We anticipate financial leverage will gradually increase but remain contained for this rating level, as the company focuses on an ambitious growth strategy.

Downside scenario

We could lower the rating over the next 12 months if we see significant delays in collections or material impairments leading profitability and liquidity to deteriorate. This would translate in the coverage of interest by EBITDA weakening below 4.0x and adjusted leverage increasing above 3.5x--both metrics on a cash basis.

Upside scenario

We could see rating upside in the medium term if the group materially scales up its operation, with strong penetration in new geographies and a wider diversification of business lines in servicing, for instance, along with a conservative financial leverage policy.

Company Description

Kruk S.A. is a DDP founded in 1998 and based in Poland. It has mainly expanded through organic growth and now operates in Poland, Romania, the Czech Republic, Slovakia, Germany, Italy, and Spain. The group is listed on the Warsaw Stock Exchange and its founder and CEO, Piotr Krupa, still holds a 9.5% stake.

Kruk derives 90% of its revenue from debt purchasing and collection, 6% from consumer lending, and the rest from credit management services and credit reference. The group's ERCs stood at

PLN12.1 billion at Sept. 30, 2022.

Our Base-Case Scenario

Assumptions

- Portfolio acquisitions of PLN2.4 billion in 2022 and PLN1.8 billion yearly in 2023 and 2024, financed with available cash and additional debt.
- ERCs expand 28% in 2022 and 3%-8% a year in 2023-2024.
- Solid collection rates in 2022-2023, in line with previous years.
- We factor in a portfolio revaluation of PLN378 million in 2022 and about the same amount in 2023 and 2024.
- Total cash revenue increases about 21% in 2022 and 6%-8% in 2023-2024.
- Total operational costs increase about 5%-7% per year.
- S&P Global Ratings-adjusted cash EBITDA reaches about PLN2 billion by 2024.
- Gross debt increases to about PLN5.3 billion in 2024, in line with portfolio purchases.

Key metrics

For year-end 2024:

- Gross debt to adjusted cash EBITDA of about 2.6x (approximately 4.6x when EBITDA is not adjusted for the add-back related to portfolio amortization).
- Funds from operations (FFO) to debt of about 30%.
- Adjusted EBITDA interest coverage of 5.2x (about 2.9x when EBITDA is not adjusted for the add-back from portfolio collections).
- Debt to tangible equity of about 1.3x.

Liquidity

We view the key liquidity use to be portfolio purchases and expect PLN1.8 billion of these over the next 12 months and PLN1.8 billion for the year starting Jan. 1, 2024. We expect Kruk to raise its net debt over the next 12 months to finance portfolio purchases and further strengthen liquidity. We take the full amount of planned deployments, not only the replacement rate, although portfolio purchases can be scaled down as needed. In our view, replacement capital expenditure (capex) is core to the business, but there is flexibility to reduce growth capex.

Principal liquidity sources include:

- Cash on the balance sheet of PLN200 million.
- Headroom under the senior revolving credit facility (RCF) and the lines of credit of approximately PLN967 million.
- Cash generation net of cash interest and taxation of about PLN1.55 billion.

- Proceeds from the new bank loans amounting to PLN0.1 million.

Principal liquidity uses include:

- Repayment of debt maturities of about PLN0.2 billion.
- Portfolio purchases and operating capex of PLN1.7 billion.
- Dividends of PLN210 million.

Covenants

Kruk is subject to maintenance covenants under its bond documentation. We expect it will remain compliant with all covenants under our base case.

Ratings Score Snapshot

Issuer Credit Rating	BB-/Stable/--
Business risk:	Fair
Country risk	Moderately High Risk
Industry risk	Moderately High Risk
Competitive position	Fair
Financial risk:	Aggressive
Cash flow/leverage	
Anchor	bb-
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bb-

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global

Corporate Issuers, Dec. 16, 2014

- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Europe's Distressed Debt Purchasers Face Mounting Risks Amid Tough Economic Conditions, Jan. 24, 2023

Ratings List

New Rating; CreditWatch/Outlook Action	
KRUK S.A.	
Issuer Credit Rating	BB-/Stable/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914