2 September 2019 Corporates

Pannonia Bio Zrt.
Hungary, Chemicals

BB+ STABLE

Corporate profile

Pannonia Bio Zrt. owns and operates an ethanol and animal feed production facility in Dunaföldvár, Hungary. The plant has a capacity to process over 1.1m tonnes of corn annually, producing around 500m litres of ethanol, which is primarily blended into gasoline. The plant also produces around 325,000 tonnes of dried distillers grains with solubles (DDGS) and 12,000 tonnes of corn oil annually. The company has more than 200 employees.

Key metrics

			Scope estimates		
Scope credit ratios	2017	2018	2019E	2020E	2021E
EBITDA/interest cover	23x	21x	22x	15x	18x
Scope-adjusted debt (SaD)/EBITDA	1.2x	1.0x	2.1x	2.5x	1.9x
Funds from operations (FFO)/EBITDA	78%	94%	44%	36%	48%
Free operating cash flow (FOCF)/SaD	63%	27%	3%	18%	26%

Rating rationale

Scope Ratings affirms the BB+ issuer rating of Pannonia Bio Zrt, an ethanol and animal feed producer based in Hungary. The rating Outlook is Stable. Scope also affirms the BBB instrument rating for senior secured debt and the BB+ instrument rating for senior unsecured debt.

The issuer rating mainly reflects the company's plant, whose large scale, high efficiency and favourable location lead to competitive operating costs and solid profitability overall. Challenges include a strong exposure to very volatile commodities, very weak asset and product diversification, and no current exposure to low-cyclicality speciality products. From a financial perspective, we expect an increase in the company's leverage from the historic low in 2018, driven by dividend payments as well as significant investment levels, mainly in higher-value products and renewable electricity generation. We understand that, in terms of capital allocation, capital expenditure ranks ahead of dividend payments. This is reflected in our base case for the ratings, which assumes leverage to stay in a corridor of around 2.0x-2.5x for 2019 to 2021.

Outlook

The Stable Outlook reflects our expectation of the company's resilient operating performance and limited pressure on credit metrics from projected investment and dividend payments. We therefore forecast a leverage level – measured by Scope-adjusted debt (SaD)/EBITDA – of about 2.0x-2.5x for the next few years.

A negative rating action could be triggered by a deterioration in credit metrics, e.g. if SaD/EBITDA increased towards 3x for a prolonged period.

A positive rating action appears unlikely under the current business setup but could be triggered by significant improvements in the company's diversification and/or outreach. While we foresee improved diversification due to the enlarged investment programme,

Ratings & Outlook

Corporate ratings	BB+/Stable
Senior secured rating	BBB
Senior unsecured rating	BB+

Analysts

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Related methodologies

Corporate Rating Methodology

Rating Methodology: Chemical Corporates

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we also point out the execution risks before the programme will affect diversification meaningfully in the medium term.

Rating drivers

Positive rating drivers	Negative rating drivers
• Ethanol plant among the largest and most efficient in Europe, as measured by production capacity and EBITDA margins, respectively ○ Large plant size allowing significant economies of scale and market relevance ○ Solid profitability with historical and projected EBITDA margins of between 15% and 25% • Proximity to low-price corn-producing areas and good logistical infrastructure • Operating costs among the lowest in the industry • Strong financial risk profile relative to business risk profile, even after large dividend payments in 2019 • Sound liquidity position	• Very high asset concentration, with a single plant as the core asset, though partly offset by investments in renewable electricity generation • Weak product diversification, with commodities as output and ethanol representing four-fifths of revenues • Strong exposure to very volatile commodities (corn and ethanol), though partly offset by correlation in DDGS/corn prices • No exposure to speciality products with low cyclicality, but the company is investing in the development of such products

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Unlikely under the current business setup but could be triggered by significant improvements in the company’s diversification and/or outreach, with investment being subject to time lags and execution risk	• If SaD/EBITDA moves towards 3x on a sustainable basis

Financial overview

			Scope estimates		
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA/interest cover	23x	21x	22x	15x	18x
SaD/EBITDA	1.2x	1.0x	2.1x	2.5x	1.9x
FFO/SaD	78%	94%	44%	36%	48%
FOCF/SaD	63%	27%	3%	18%	26%
Scope-adjusted EBITDA in EUR m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA	48.9	46.9	86.8	65.6	72.3
Operating lease payments in respective year	-	-	-	-	-
Scope-adjusted EBITDA	48.9	46.9	86.8	65.6	72.3
Scope-adjusted FFO in EUR m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Scope-adjusted EBITDA	48.9	46.9	86.8	65.6	72.3
deduct: (net) cash interest paid	-2.2	-2.2	-3.9	-4.5	-4.1
deduct: cash tax paid	-0.4	-0.6	-3.1	-1.9	-2.1
add: depreciation component, operating leases	-	-	-	-	-
Scope-adjusted FFO	46.3	44.1	79.8	59.2	66.1
Scope-adjusted cash interest in EUR m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Net cash interest paid (Scope estimates)	2.2	2.2	3.9	4.5	4.1
Interest element of operating leases	-	-	-	-	-
Scope-adjusted cash interest	2.2	2.2	3.9	4.5	4.1
Scope-adjusted debt in EUR m	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Reported gross financial debt	72.0	75.7	204.9	183.6	162.4
deduct: available cash & cash equivalents	-8.6	-24.9	-18.9	-14.0	-20.0
deduct: equity credit for hybrid debt	-3.6	-3.7	-3.8	-3.8	-3.8
add: pension adjustment	-	-	-	-	-
add: operating lease obligations	-	-	-	-	-
Scope-adjusted debt	59.7	47.1	182.3	165.9	138.6

Business risk profile

The business risk profile reflects our assessment of the industry in which the company operates and its competitive position within that industry.

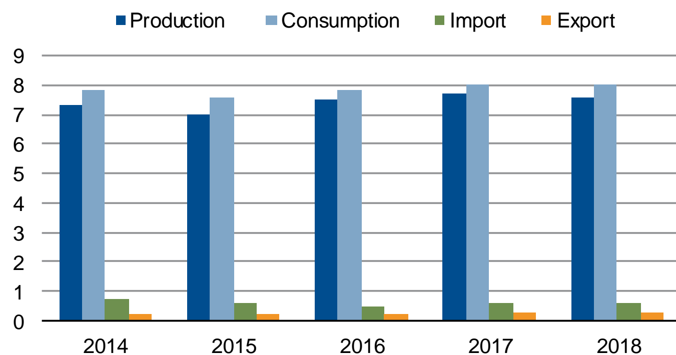
Semi-protected EU market for ethanol

Ethanol is Pannonia Bio's main output product and currently accounts for four-fifths of the company's revenues. Our analysis focused on the European rather than the global ethanol market. This is because the EU ethanol market is protected by import tariffs and significant shipping costs, which has resulted in limited imports of less than 10% of total consumption over the past several years.

No uplift from industry risk profile for integrated chemical companies

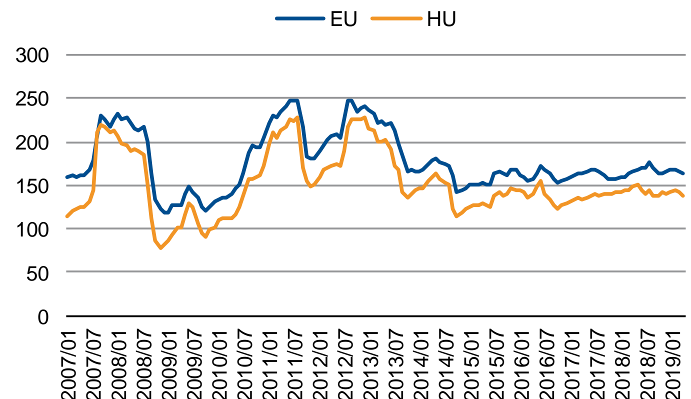
Import tariffs are the sole financial incentive for producers of bioethanol – a factor which clearly differentiates them from other renewable energy producers such as wind or photovoltaic parks. We have therefore treated Pannonia Bio as a commodity chemicals producer and applied our rating methodology for chemical corporates. Based on the company's plans to expand into speciality products, we classify it as integrated chemical producer. However, we will not incorporate any uplift from the industry risk profile for integrated chemical companies of BBB until the share of speciality products reaches a critical size.

Figure 1: EU ethanol market (million cbm)



Source: F.O. Licht, Scope

Figure 2: Feed corn price (EUR/t)



Source: Eurostat, Scope

Large plant size enables significant economies of scale and market relevance

Pannonia Bio's competitive position benefits from the plant's large size, which enables significant economies of scale and market relevance. With a current ethanol production capacity of around 500m litres per year, the plant is one of the largest in the EU and accounts for 6%-7% of the region's production. In addition, the company cooperates with selected industry players in order to optimise the production and distribution of its products.

Proximity to low-price corn-producing areas and good logistical infrastructure

The plant further benefits from its proximity to low-price corn-producing areas in Hungary, Slovakia, Croatia, Serbia and Romania. It is located on the bank of the River Danube and has a good logistical infrastructure including direct access for trucks, trains and barges.

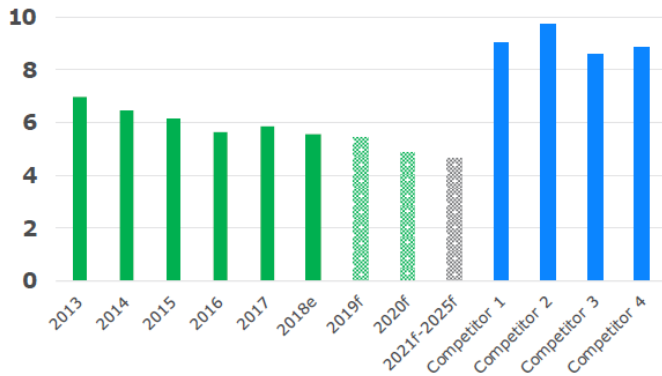
Operating costs among the lowest in the industry

The abovementioned factors together with continuous investment in efficiency initiatives make operating costs for the plant among the lowest in the industry. Pannonia Bio's management has stated that, since the start of operations in 2012, the plant has always aimed to maximise output, even in the challenging price environment in 2014 or in 2018 when certain producers had to (temporarily) shut down facilities.

Solid profitability with EBITDA margins of 15%-25%

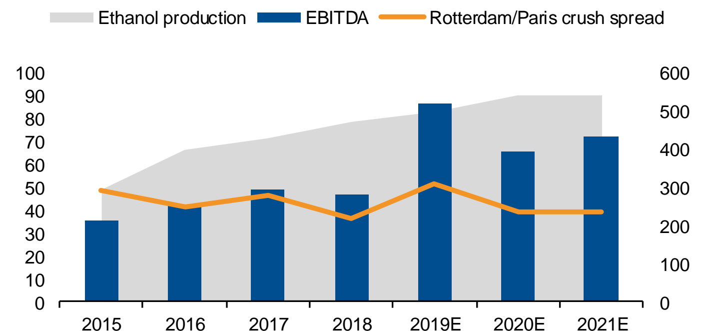
As a result, the company has solid profitability with historical and projected EBITDA margins of between 15% and 25%. This is one of the key positive rating drivers for Pannonia Bio.

Figure 3: Gas consumption (MJ/litre)



Source: Pannonia Bio

Figure 4: EBITDA (lhs, EUR m) as a function of market prices (rhs, EUR/t), plant efficiencies and production volumes (rhs, m litres yearly)



Source: Pannonia Bio, Scope

Very high asset concentration

Pannonia Bio's business risk profile is restricted by very high asset concentration with a single plant as the company's core asset. This risk is mainly addressed by extensive insurance coverage against severe damages, which would allow the company to preserve its asset values and service its debt payments for at least one year. Planned investments in renewable electricity generation are expected to result in only a moderate reduction in asset concentration.

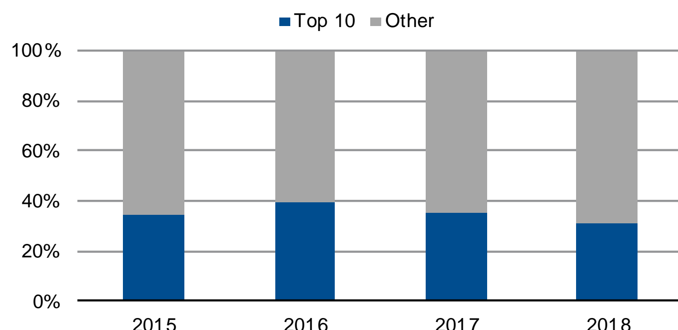
Weak product diversification and high volatility in commodity prices…

Performance volatility may also arise from weak product diversification. All of Pannonia Bio's main products are commodities, with a dominant share of ethanol. Furthermore, commodity prices, such as for corn or ethanol, are highly volatile. Pannonia Bio is a pure price taker. In the event of extremely low or negative spreads between input and output prices, also known as a crush spread, the company may be forced to temporarily cease operations. However, we deem any prolonged production interruption resulting from low crush spreads to be unlikely, mainly because of the company's low-cost position. In this type of challenging price environment, most other market players with less favourable cost structures would cease their operations first, thus reducing the overall supply of ethanol with positive implications for prices. This occurred as recently as 2018, when two plants had to halt their production in Europe, while Pannonia Bio was still able to generate positive margins.

…are partly offset by strong correlation between DDGS and corn prices

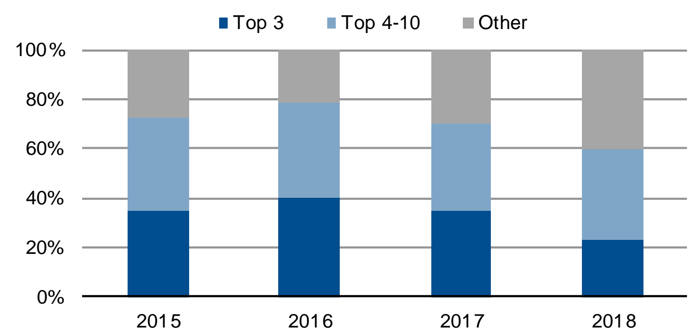
High volatility in commodity prices is partly offset by the strong correlation between DDGS and corn prices ('natural hedge'). The company has also addressed this issue by investing in the development of higher-value speciality products, which should have a positive impact on margins and reduce volatility in overall performance.

Figure 5: Supplier concentration



Source: Pannonia Bio, Scope

Figure 6: Customer concentration



Source: Pannonia Bio, Scope

High customer concentration mainly mitigated by solid credit quality of counterparties

The company has relatively low supplier concentration with the top 10 accounting for 30%-40% of total purchases over the past few years. In contrast, customer concentration is high, with the top 10 representing 60%-80% of total revenues. However, credit risk is mainly mitigated by the solid credit quality of counterparties. Ethanol and animal feed are sold across Europe, mainly to Germany, Italy, Romania and Poland.

Financial risk profile

Key planning assumptions

Our financial projections are mainly based on the following assumptions:

1. Ethanol (Rotterdam) at around EUR 570/cbm for 2019 and EUR 500/cbm in 2020-21, corn (Paris) at EUR 170/t in 2019-21
2. Production growth from 500m litres of ethanol p.a. in 2019 to 540m litres p.a. in 2020
3. Maximisation of dividend payments in 2019 subject to financial performance and covenants/approval by bank lenders
4. Investment of up to EUR 50m in 2019 in small solar power plants with a total capacity of 45 MWp under feed-in-tariff scheme (in addition to annual capex of around EUR 30m), mainly financed through the issuance of the HUF 15bn bond (around EUR 46m)
5. Capex and dividends at a maximum level provided by covenants: capex of around EUR 30m p.a., ordinary dividends at 20% of net profit starting in 2020

Weaker financial profile going forward …

We expect Pannonia Bio's financial risk profile to weaken following substantial dividend payments in 2019 and significant capital expenditure going forward. These factors are partly offset by favourable market conditions YTD 2019 and the plant's increasing operational efficiency.

…mainly due to large dividend distribution in 2019…

The company's leverage, as measured by SaD/EBITDA, is expected to increase from its historic low of 1.0x in 2018 to around 2.0x-2.5x in the next couple of years. This is mainly driven by the maximisation of dividend payments in 2019 with EUR 81m already paid in April. We understand that the company's plans regarding 2019 dividend payments were made independently of the bond placement. Moreover, dividends are subject to financial performance and to covenants set by the bank loan agreement from April 2019. The latter not only limits dividend distribution, capex, and overall indebtedness, but also sets a minimum level of liquidity. We also understand that the company requires an approval from bank lenders in case it wants to (temporarily) exceed predefined thresholds. Additionally, according to management, all shareholders are ready to fund the business as and when needed.

…and high capex and ordinary dividend payments

Leverage is further affected by assumed annual investments and ordinary dividend payments. In the medium and long term, shareholders' main aim is to maximise the return on invested capital. They currently expect higher returns from investments made by Pannonia Bio compared to cash received through dividend distribution. For this reason, we assume higher capex amounts (at around EUR 30m per year) compared to ordinary dividend payments at 20% of the previous year's net profit.

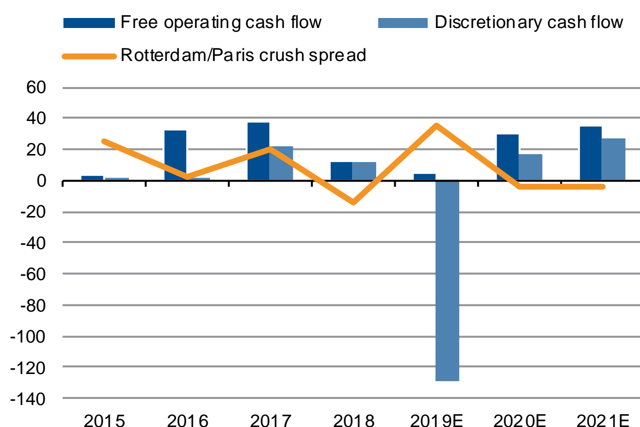
Further increase in leverage limited by covenants and increasing operational efficiency

In addition to covenants, leverage is further supported by the plant's increasing operational efficiency. For 2020-21 we assumed conservative prices, which are in the low range for the past four years. We expect the company to perform more strongly under these conditions than in a better price environment, e.g. in 2017.

Very strong interest cover

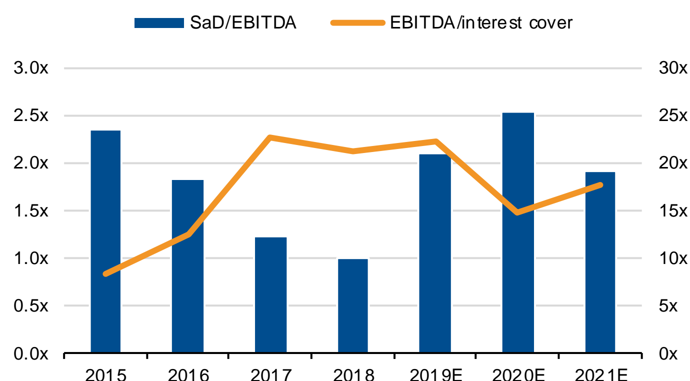
Pannonia Bio's EBITDA/interest cover was comfortably above 7x at YE 2018 and is expected to remain strong over the next couple of years.

Figure 7: Cash flow generation (lhs, EUR m) vs crush spread (rhs, EUR/t)



Source: Pannonia Bio, Scope

Figure 8: Leverage (lhs) and interest cover (rhs)



Source: Pannonia Bio, Scope

Solid internal financing capacity

The company's operating cash flow is sufficient to cover maintenance and development capex at the projected level, indicating a solid internal financing capacity. External financing may, however, be required for substantial development projects (e.g. large-scale renewable electricity generation).

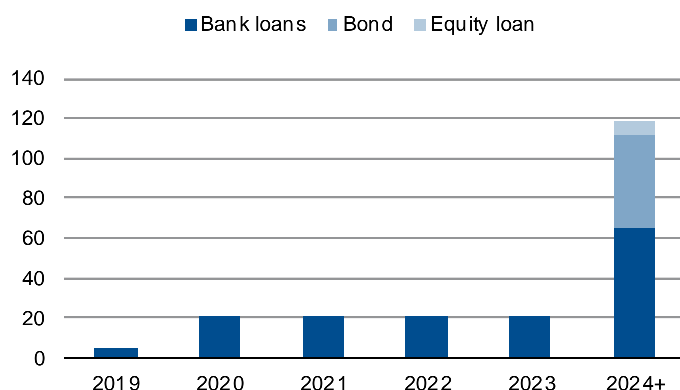
SaD includes 50% of the shareholder loan; no contingent liabilities

In line with our conservative approach, our SaD calculation included restricted cash of EUR 1m as well as 50% of the shareholder loan, based on its contractual subordination and the ability to defer coupon payments.

Balanced maturity profile

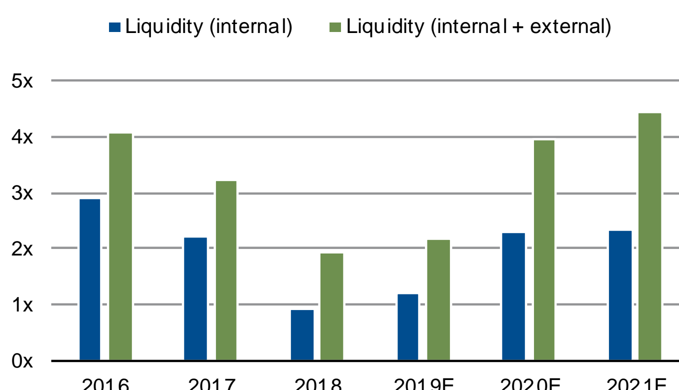
Bank loans are amortised quarterly over 7.5 years, ensuring a balanced maturity profile over the next few years. The new bond is expected to have a maturity of 10 years. Bank and shareholder loans are denominated in euros. The prospective bond is expected to be denominated in Hungarian forint.

Figure 9: Expected maturity profile of long-term financial liabilities (EUR m)



Source: Pannonia Bio, Scope

Figure 10: Liquidity



Source: Pannonia Bio, Scope

Sound liquidity

The company has a solid short-term liquidity cover and conservative liquidity management. For 2019-20, we expect coverage of short-term financial debt at more than 1x, including undrawn committed credit lines of EUR 25m and EUR 35m, respectively, and available cash and cash equivalents of EUR 68m as of 30 June 2019.

Supplementary rating drivers

Prudent financial policy

We assess Pannonia Bio's financial policy as transparent and neutral with respect to its issuer rating. The maximisation of return on invested capital through capex and dividend payments goes hand in hand with the sustainability of the company's business model. Substantial cash outflows are further prevented by covenants set by the bank loan agreement.

No impact from shareholder structure

Our assessment of the group structure indicates no impact (either negative or positive) from potential parent support.

Outlook

Stable Outlook

The Stable Outlook reflects our expectation of the company's resilient operating performance and limited pressure on credit metrics from projected investment and dividend payments. We therefore forecast a leverage level – measured by SaD/EBITDA – of about 2.0x-2.5x for the next few years.

A negative rating action could be triggered by a deterioration in credit metrics, e.g. if SaD/EBITDA increased towards 3x for a prolonged period.

A positive rating action appears unlikely under the current business setup but could be triggered by significant improvements in the company's diversification and/or outreach. While we foresee improved diversification due to the enlarged investment programme, we also point out the execution risks before the programme will affect diversification meaningfully in the medium term.

Senior unsecured debt: BB+

Average recovery expectations for senior unsecured debt

Our recovery analysis indicates an 'average recovery' for senior unsecured debt such as the prospective bond (HUF 15bn, 2019/2029). This expectation translates into a BB+ rating for this debt category. The recovery is based on an expected distressed enterprise value as a going concern in a hypothetical default scenario, of around EUR 170m in 2021, and the application of a 10% haircut on that value for administrative claims.

Senior secured debt: BBB

Excellent recovery expectations for senior secured debt

Our recovery analysis indicates an 'excellent recovery' for senior secured debt such as the collateralised bank loans. This expectation translates into a rating of BBB for this debt category.

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