Pannonia Bio Zrt.
Hungary, Chemicals

SCOPE 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 280 employees.

Key metrics

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EBITDA/interest cover	21x	32x	13x	11x	17x
Scope-adjusted debt (SaD)/EBITDA	1.0x	1.4x	2.9x	2.4x	1.4x
Funds from operations (FFO)/EBITDA	94%	67%	31%	37%	64%
Free operating cash flow (FOCF)/SaD	27%	33%	3%	24%	51%

Rating rationale

Scope Ratings affirms the BB+/Stable issuer rating on Pannonia Bio Zrt. as well as the BBB senior secured debt rating. Scope upgraded the senior unsecured debt rating from BB+ to BBB-.

The company plans to issue senior unsecured bonds with tenors of 10, 11 and 12 years under the Hungarian National Bank's Bond Funding for Growth Scheme in a total amount of up to HUF 44bn (around EUR 126m). The bond proceeds will be used to: i) fund the capex programme of EUR 114m in 2020-22 next to existing cash flows; ii) repay EUR 100.6m of term bank loans in 2021; iii) repay the working capital facility in 2021 (if utilised); and iv) maximise the repayment of term loans in 2022, subject to available cash after capex.

We believe the issuance of the new bonds will have only a limited impact on the company's credit metrics, because the bond proceeds will be mainly used to refinance existing bank term loans. Our updated rating case still expects a temporary increase in leverage, as measured by Scope-adjusted debt (SaD)/EBITDA, to above 2.5x in the next few years. This will be mainly driven by large dividend payments as well as significant investment levels, mainly in higher-value products. It is our understanding that, in terms of capital allocation, capex ranks ahead of dividend payments.

Ratings & Outlook

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

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Related methodologies

Corporate Rating Methodology

Rating Methodology: Chemical Corporates

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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 the leverage level – as measured by SaD/EBITDA – to not exceed 2.5x for a prolonged period.

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 in the medium term due to the enlarged investment programme, we also point out the execution risks involved before meaningful effects are seen.

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 and 2020 • Sound liquidity position	• Very high asset concentration, with a single plant as the core asset • 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	• SaD/EBITDA of towards 3x on a sustained basis

Financial overview

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EBITDA/interest cover	21x	32x	13x	11x	17x
SaD/EBITDA	1.0x	1.4x	2.9x	2.4x	1.4x
Funds from operations/SaD	94%	67%	31%	37%	64%
Free operating cash flow/SaD	27%	33%	3%	24%	51%
Scope-adjusted EBITDA in EUR m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EBITDA	46.9	112.8	71.2	69.3	87.1
Operating lease payments in respective year	-	-	-	-	-
Scope-adjusted EBITDA	46.9	112.8	71.2	69.3	87.1
Scope-adjusted funds from operations in EUR m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Scope-adjusted EBITDA	46.9	112.8	71.2	69.3	87.1
deduct: (net) cash interest paid	-2.2	-3.5	-5.7	-6.3	-5.0
deduct: cash tax paid	-0.6	-1.7	-1.7	-1.4	-2.0
add: depreciation component, operating leases	-	-	-	-	-
Scope-adjusted funds from operations	44.1	107.6	63.9	61.6	80.1
Scope-adjusted cash interest in EUR m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Net cash interest paid (Scope estimates)	2.2	3.5	5.7	6.3	5.0
Interest element of operating leases	-	-	-	-	-
Scope-adjusted cash interest	2.2	3.5	5.7	6.3	5.0
Scope-adjusted debt in EUR m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Reported gross financial debt	75.7	212.1	346.0	243.9	202.5
deduct: available cash & cash equivalents	-24.9	-45.4	-125.2	-62.7	-64.6
deduct: equity credit for hybrid debt	-3.7	-5.2	-12.7	-12.7	-12.7
add: pension adjustment	-	-	-	-	-
add: operating lease obligations	-	-	-	-	-
Scope-adjusted debt	47.1	161.5	208.2	168.5	125.3

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.

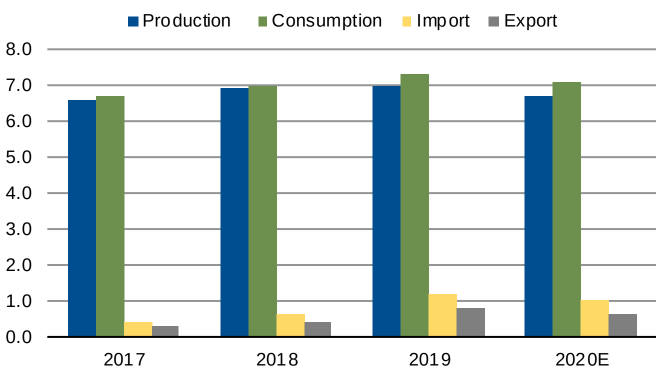
Semi-protected EU market for ethanol

Ethanol is Pannonia Bio's main output product, currently accounting for four-fifths of its revenues. Our analysis focuses 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 served to limit imports to less than 20% of total consumption over the past several years.

No uplift from industry risk profile for integrated chemical companies

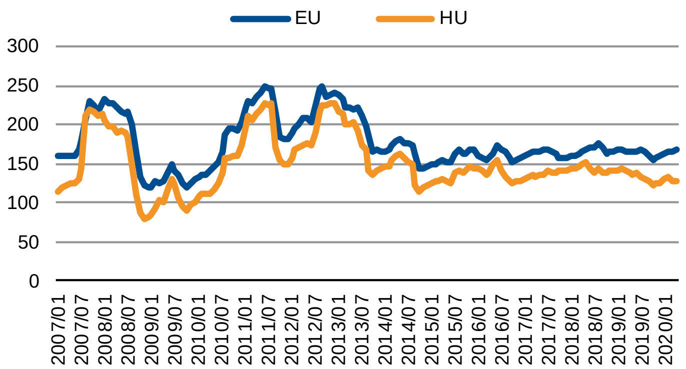
Import tariffs constitute the sole financial incentive for bioethanol producers – which clearly differentiates them from other renewable energy producers such as wind or photovoltaic parks. We have therefore treated Pannonia Bio as a commodity chemicals producer and applied our rating methodology for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

Figure 1: EU ethanol market (excl. UK, 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 its 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 works with selected industry players 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 Danube River and has a good logistical infrastructure including direct access for trucks, trains and barges.

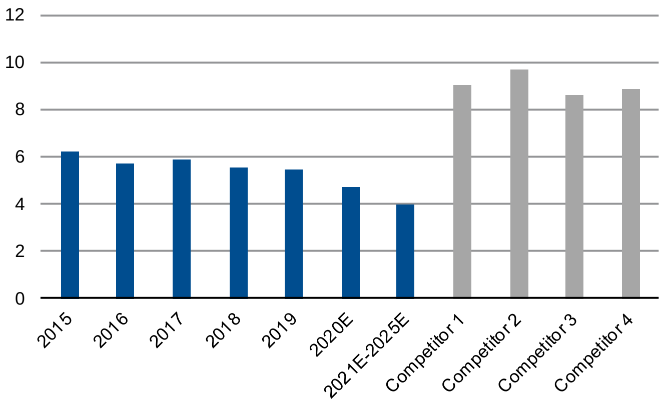
Operating costs among the lowest in the industry

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 the plant has always aimed to maximise output since operations started in 2012, even in the challenging price environments in 2014 and 2018 as well as during the lockdowns following Covid-19 outbreak in 2020, when certain producers had to (temporarily) shut down facilities. In H1 2020, lower ethanol sales for fuel have been offset by sales for the purpose of hand sanitisers and other disinfectants.

Solid profitability with EBITDA margins of 15%-25%

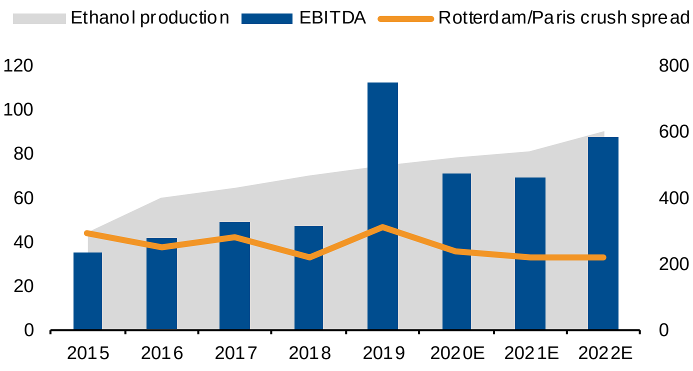
As a result, the company has solid profitability with historical and projected EBITDA margins of between 15% and 25%. This is one of the key positive rating drivers for Pannonia Bio.

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 damage, which would allow the company to preserve asset values and service debt payments for at least one year.

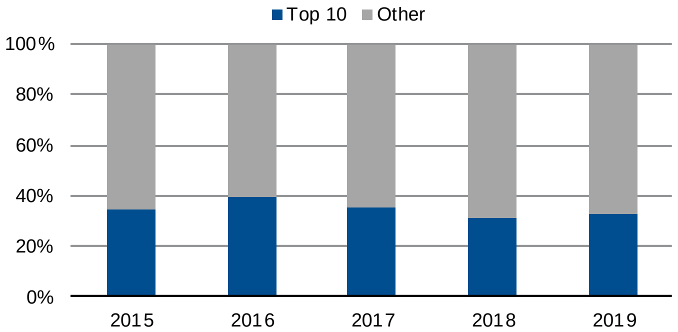
Weak product diversification and high volatility in commodity prices…

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 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 production in Europe, while Pannonia Bio was still able to generate positive margins.

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

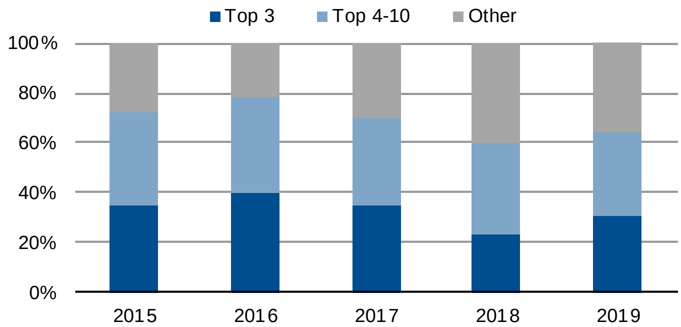
High volatility in commodity prices is partly offset by the strong correlation between DDGS and corn prices ('natural hedge'). The company has also addressed this issue by investing in the further optimisation of production processes and development of higher-value products, which should have a positive impact on margins and reduce volatility in overall performance. These investments include the biogas plant (to increase greenhouse gas savings and reduce natural gas purchases), alcohol plant (to high-grade ethanol) and barley plant (to process barley in addition to corn).

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, the associated 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. Issuance of senior unsecured bonds with tenors of 10, 11 and 12 years in a total amount of up to HUF 44bn (around EUR 126m). The bond proceeds will be used to: i) fund the capex programme of EUR 114m in 2020-22 next to existing cash flows; ii) repay EUR 100.6m of term bank loans in 2021; iii) repay the working capital facility in 2021 (if utilised); and iv) maximise the repayment of term loans in 2022, subject to available cash after capex.
2. Ethanol (Rotterdam) at around EUR 500/cbm in 2020 and EUR 480/cbm in 2021-22; corn (Paris) at EUR 170/tonne in 2020-22
3. Growth in ethanol production, from around 500m litres p.a. in 2019 to 600m litres p.a. in 2022
4. Maximisation of dividend payments in 2020 subject to financial performance and covenants/approval by bank lenders; new EUR 15m shareholder loan
5. Investments into renewable power projects of around EUR 33m in 2020 (in addition to a EUR 114m capex programme in 2020-22); disposals totalling EUR 43m in 2021
6. Ordinary dividends at a maximum covenanted level (0% of net profits in 2021 and 50% in 2022)
7. EUR 25m working capital facility remains in place, also in case of full repayment of term bank loans

Weaker financial profile going forward …

We expect Pannonia Bio's financial risk profile to weaken following substantial dividend payments in 2020 and the significant capital expenditure planned going forward. These factors are partly offset by the plant's increasing operational efficiency and scale.

…mainly due to large dividend distribution in 2020…

The company's leverage, as measured by SaD/EBITDA, is expected to increase from 1.4x in 2019 to above 2.0x in the next couple of years. This will be mainly driven by the maximisation of dividend payments in 2020. We understand that the dividend payments were planned 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 has to obtain approval from bank lenders 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 the significant levels of annual investment and ordinary dividend payments. In the medium and long term, the shareholders' main aim is to maximise the return on invested capital. They currently expect the returns from Pannonia Bio's investments to be higher than for cash received through dividend distribution.

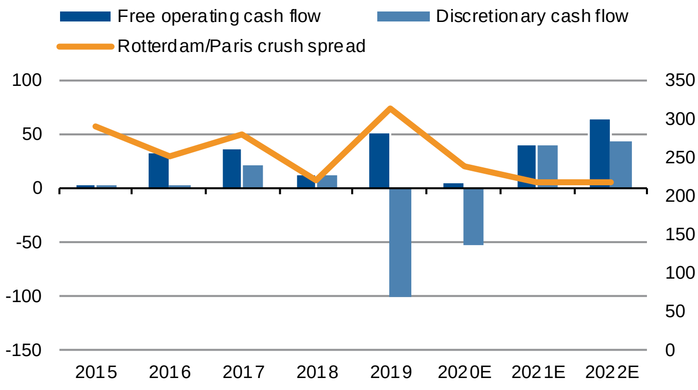
Further increase in leverage limited by covenants and increasing operational efficiency

In addition to covenants, leverage is further supported by the plant's increasing operational efficiency and scale. For 2020-22, we have conservatively assumed prices to remain low, towards the lower end of the range seen in 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

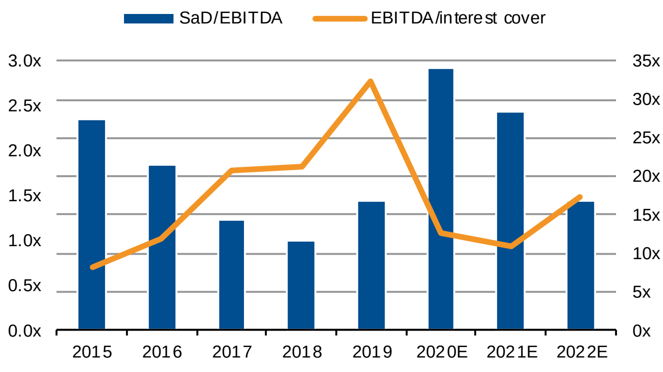
Pannonia Bio's EBITDA/interest cover was comfortably above 7x at YE 2019 and is expected to remain strong over the next couple of years.

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.

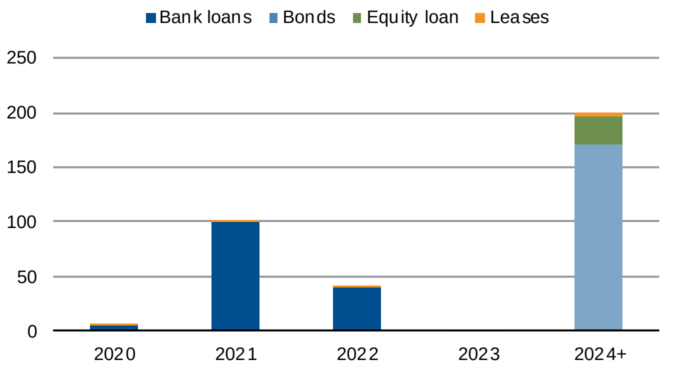
SaD includes 50% of the shareholder loan; no contingent liabilities

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

Back-end-loaded maturity profile

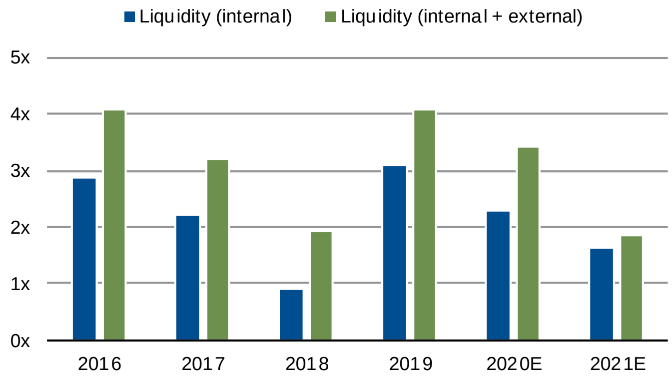
Following the issuance of new bonds and subsequent repayment of bank term loans, the company's maturity profile will become back-end loaded. The new bonds are expected to have tenors of 10, 11 and 12 years. Bank and shareholder loans are denominated in euros, while denominations of both existing and prospective bonds are 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

Adequate liquidity

The company has solid short-term liquidity cover and conservative liquidity management. For 2020-21, we expect coverage of short-term financial debt at more than 1x, including an undrawn working capital facility of EUR 25m and available cash and cash equivalents of EUR 45m as of 31 May 2020.

Supplementary rating drivers

Neutral financial policy

We assess Pannonia Bio's financial policy as transparent and neutral with respect to its issuer rating. The maximisation of its 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 the leverage level – measured by SaD/EBITDA – to not exceed 2.5x for a prolonged period.

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 in the medium term due to the enlarged investment programme, we also point out the execution risks involved before meaningful effects are seen.

Senior unsecured debt: BBB-

Above-average recovery expectations for senior unsecured debt

Assuming the issuance of new bonds and subsequent repayment of bank term loans, our recovery analysis indicates an 'above-average recovery' for senior unsecured debt, including the existing HUF 15bn bond (ISIN: HU0000359112) and prospective bonds issued under the Hungarian National Bank's Bond Funding for Growth Scheme. The recovery is based on an expected distressed enterprise value as a going concern in a hypothetical default scenario in 2022. These expectations translate into a BBB- for this debt category.

Senior secured debt: BBB

Excellent recovery expectations for senior secured debt

Our recovery analysis indicates an 'excellent recovery' for senior secured debt. These expectations translate into a BBB for this debt category.

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