# Inotal Zrt.
# Hungary, Metals and mining

B+ STABLE

## Corporate profile

Inotal Zrt. is an aluminium products manufacturer located near Székesfehérvár in Várpalota, Hungary. The company's prime activities are the production of different types of aluminium products, centred on five product groups: strips, drawn wires, wire rods, slugs and continuous rotary extrusion products. Strips are primarily used by the building and electrical industries; drawn wires by building, electrical, engineering and food industries; wire rods by the steel and armaments industry; slugs by the fast-moving consumer goods industry; and continuous rotary extrusion products by the electrical industry. The company's customer base is broadly diversified with a wide international exposure.

## Key metrics

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2018** | **2019E[1]** | **2020F** | **2021F** |
| EBITDA/interest cover (x) | 10.8x | 8.4x | 10.6x | 6.2x |
| Scope-adjusted debt (SaD)/EBITDA | 3.6x | 4.8x | 3.7x | 3.7x |
| Scope-adjusted funds from operations/SaD | 28.3% | 23.3% | 27.5% | 26.1% |
| Free operating cash flow/SaD | -31.0% | 18.0% | 1.8% | 0.2% |

## Rating rationale

**Scope assigns a first-time rating of B+/Stable to Inotal Zrt. Senior unsecured debt issued by the company has been rated at B+.**

The rating is supported by the financial risk profile of BB-, which reflects the consolidation of debt with extension of tenor. The rated entity plans to issue a HUF 6bn senior unsecured corporate bond under the Bond Funding for Growth Scheme of the Hungarian National Bank (MNB). We anticipate the coupon for this instrument to be approximately 4% and the bond to amortise with a tenor until 2027, with amortisation in 2023 (20%), 2025 (20%) and 2027 (60%). Scope expects SaD/EBITDA to fall to between 3x and 4x during the rating period, reflecting improved EBITDA, after having increased in 2019 to 4.8x due to lower EBITDA as trading margins weakened. Scope-adjusted funds from operations/SaD also shows improvements in 2020, reflecting the recovery of EBITDA. FOCF/SaD is volatile, reflecting rises in capex to maintain competitiveness and changes to EBITDA as price developments affecting EBITDA roll out and then recover.

The rating is constrained by the business risk profile of B-. Scope places the industry risk profile is that of the mining and metals industry (BB). The rating is constrained by Inotal's concentration on commodity products, relatively low margins and its position as a small player in international markets. Good geographical and customer diversification supports the rating, but the concentration on one product group (semi-finished aluminium products) with over 95% of revenues outweigh these factors.

Scope places greater weight to the financial risk profile, reflecting the greater importance of financial risk to non-investment grade companies.

[1] Based on unaudited reporting for 2019 and including dividend after merger with Salker Ltd.

### Ratings & Outlook

| | |
|---|---|
| Corporate ratings | B+/Stable |
| Senior unsecured rating | B+ |


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### Related Methodology

Corporate Rating Methodology, 20 February 2020


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## Outlook

**Rating drivers**

The Outlook is Stable and incorporates our view of stable revenues in a challenging environment. Furthermore, the Stable Outlook reflects Scope's expectation that INOTAL's indebtedness (SaD/EBITDA) will be around 3x-4x in the medium term.

**Rating-change drivers**

A negative rating action could occur if market price volatility leads to weakened margins, resulting in a SaD/EBITDA ratio of 4x on a sustained basis.

A positive rating action could be warranted if profitability were to be higher than our base-case scenario, leading to SaD/EBITDA ratio of 2x on a sustained basis.

| Positive rating drivers | Negative rating drivers |
| --- | --- |
| • Decrease in leverage following planned issuance with debt consolidation and longer tenor<br>• Conservative financial policy<br>• Bond issuance for refinancing purposes only | • Lack of product diversification<br>• Narrow EBITDA margins<br>• Exchange rate vulnerabilities<br>• Small niche player with limited economies of scale<br>• Lack of vertical integration |

| Positive rating-change drivers | Negative rating-change drivers |
| --- | --- |
| • SaD/EBITDA sustained at 2x or lower | • SaD/EBITDA sustained at 4x or higher |

## Financial overview

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2018** | **2019E[2]** | **2020F** | **2021F** |
| EBITDA/interest cover (x) | 10.8x | 8.4x | 10.6x | 6.2x |
| Scope-adjusted debt (SaD)/EBITDA | 3.6x | 4.8x | 3.7x | 3.7x |
| Scope-adjusted funds from operations/SaD | 28.3% | 23.3% | 27.5% | 26.1% |
| Free operating cash flow/SaD | -31.0% | 18.0% | 1.8% | 0.2% |
| **Scope-adjusted EBITDA in EUR Tsd.** | **2018** | **2019E** | **2020F** | **2021F** |
| EBITDA | 4,895.8 | 3,390.6 | 4,356.4 | 4,350.1 |
| Operating lease payments in respective year | 0 | 0 | 0 | 0 |
| Other | 0 | 0 | 0 | 0 |
| Scope-adjusted EBITDA | 4,895.8 | 3,390.6 | 4,356.4 | 4,350.1 |
| **Scope-adjusted funds from operations in EUR Tsd** | **2018** | **2019E** | **2020F** | **2021F** |
| EBITDA | 4,895.8 | 3,390.6 | 4,356.4 | 4,350.1 |
| less: (net) cash interest as per cash flow statement | -453.2 | -401.5 | -411.8 | -705.9 |
| less: cash tax paid as per cash flow statement | -42.9 | 0 | -98.9 | -92.5 |
| add: dividends received | 0 | 1,000 | 0 | 0 |
| Other changes | 632.8 | -156.4 | 585.8 | 646.1 |
| Scope-adjusted funds from operations | 5,032.5 | 3,832.7 | 4,431.5 | 4,197.8 |
| **Scope-adjusted debt in EUR Tsd** | **2018** | **2019E** | **2020F** | **2021F** |
| Reported gross financial debt | 20,648.0 | 17,001.7 | 17,756.0 | 17,719.7 |
| less: hybrid bonds | 0 | 0 | 0 | 0 |
| less: cash and cash equivalents | -2,895.6 | -584.6 | -1,659.5 | -1,663.0 |
| add: cash not accessible | 0 | 0 | 0 | 0 |
| add: pension adjustment | 0 | 0 | 0 | 0 |
| add: operating lease obligations | 0 | 0 | 0 | 0 |
| Other changes | 0 | 0 | 0 | 0 |
| Scope-adjusted debt | 17.752.4 | 16,417.1 | 16,096.5 | 16,056.7 |

[2] Based on unaudited reporting for 2019 and including dividend after merger with Salker Ltd.

## Business risk profile: B-

**Industry risk profile: BB**

Inotal operates in the metals and mining industry (rated BB by Scope), which is generally highly cyclical with volatile revenues and profitability. The industry is also very capital-intensive, with high entry barriers for high value-added products and downstream companies, and low entry barriers for upstream companies and commodity producers. We note that Inotal is a secondary producer with significant trading activity (2019: 18% of sales).

**Competitive position: B-**

Inotal's competitive position is rated at B-. Ingot and semi-finished aluminium products are an exchange commodity, i.e. they are standardised, interchangeable, and easy to transport and divide, can be delivered in batches, and consumers usually have no preference for a particular manufacturer. Forty percent of Inotal's production (unalloyed aluminium rod) are commodities; sixty percent are alloyed materials with less of a commodity character.

**Aluminium prices determined by speculative futures trading**

In Europe, aluminium prices are largely determined by futures speculation on the London Metal Exchange, with additional changes from price premiums (or discounts) reflecting local supply and demand as well as a mark-up based on the metal being traded. This results in some disconnect between purely market-driven prices and actual prices, as well as strong price volatility.

**Recent price developments**

More recently, supply and demand have been driving aluminium prices, with the Covid-19 pandemic leading to limited scrap availability and a large supply overhang. This has placed heavy pressure on margins and may result in major price cuts. However, due to the large warehouses and holdings of the London Metal Exchange, prices will continue to be largely influenced by futures trading – barring a complete cessation of trading. Overall, prices are expected to fall in the medium term due to the supply overhang. This will work in Inotal's favour by reducing the cost of inventory purchases and alleviating pricing pressures.

**Small player**

Inotal is a small player in its regional markets. Inotal has no own mining capacity and lacks integration with major industry groups (such as automobiles or aerospace, whose customers demand higher value-added in the supply chain for semi-finished aluminium products). The product portfolio also shows relatively low value-added in production.

**Comparative advantage**

Companies with own mining capacity and/or significant access to independent smelter foundries benefit from strategic price protection and the ability to hedge production capacity (placing the burden of curtailments on independent foundries). That stated, Inotal has a comparative advantage in that it is better at managing input prices than competitors with significant own capacity (as they must produce for futures markets if the stock price of aluminium is lower than that for own-produced, which is the current situation). A further advantage over competitors is Inotal's geographical proximity to its customers, with the caveat, however, that adding capacity would become counterproductive beyond a certain point.

**Robust geographic and customer diversification; weak product diversification**

Geographic and customer diversification is robust. However, product diversification is weak, with almost all revenues linked to semi-finished aluminium products. This high vulnerability to a single product group limits overall diversity.

**Low margins**

Probability and efficiency are low. Inotal increased its trading activities markedly between 2015 and 2018, resulting in a deterioration of margins as its trading activities have generally lower returns than its manufacturing activities. Inotal's returns are also lower than the industry average, with recurring EBITDA margins of between 3.2% and 5.2% for the rating period.

**Business risk profile: B-**

Assessing the BB industry risk profile and the B- competitive position places the industry risk profile at B-, as we place a higher weight on Inotal's competitive position.

## Financial risk profile: BB-

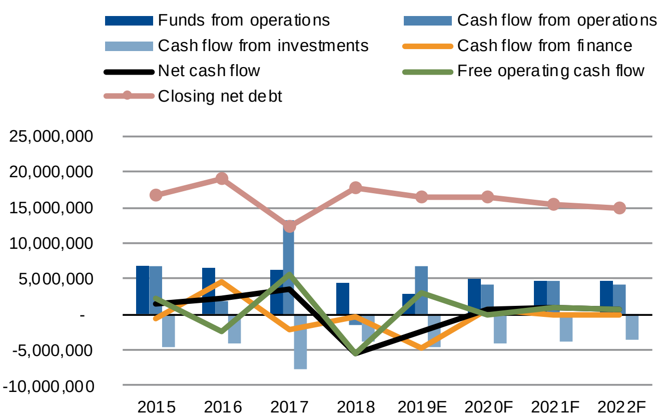
**Assumptions**

Our main assumption for the financial risk profile is that the key metrics for the rating will show improvement in 2020 and later. Scope's rating metrics deteriorated in 2019 as the result of worsening trade margins and a drop-off in trading activity following a one-off four-year (2015-2018) programme of trade in alumina and alumina hydrate from an external supplier. We expect the rating metrics to improve in 2020 and 2021, reflecting increased price stability and recovering customer demand.

**Positive growth despite market downturn**

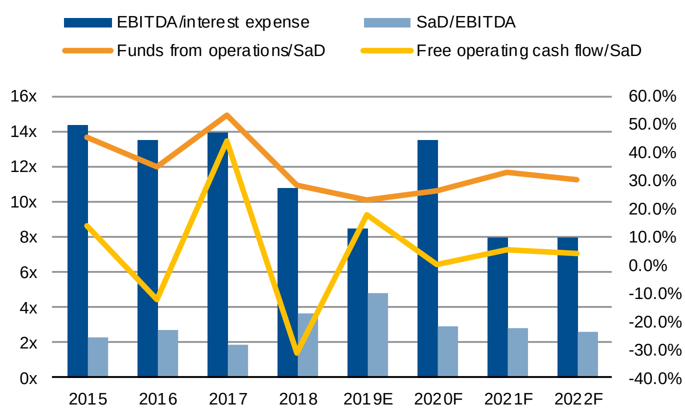
We anticipate Inotal's revenue growth in the current challenging environment to be zero in 2020, reflecting negative effects of the covid-19 pandemic, despite an initial strong showing in Q1 2020. While Inotal has profited from increased demand from customers still in production during the Covid-19 lockdowns, Scope expects overall demand to decline in H2 2020 as secondary effects of the lock-down in Europe appear. Inotal should benefit from a resurgence of demand for European suppliers. Inotal reports its customer portfolio to be stable. We expect moderate growth in 2021 and 2022 (2%), reflecting capacity constraints.

**Figure 1: Cash flow (in HUF '000s)**




Source: Inotal, Scope estimates

**Figure 2: Scope credit metrics**




Source: Inotal, Scope estimates

**Leverage**

Leverage protection, measured as SaD/EBITDA, reflects a modest EBITDA position. In the past, SaD/EBITDA varied between 3.5x and 3.9x during 2012-14, and became more volatile during the alumina and alumina hydrates trading period between 2015 and 2018, ranging from 1.9x in 2017 (lower EBITDA due to price effects) to 4.8x in 2019 (lower EBITDA due to top-line effects). We anticipate this metric to be between 3x and 4x during the rating period as EBITDA improves and debt is consolidated.

**Debt protection**

Debt protection, measured as the funds from operations/SaD ratio, is in the 15%-30% category. The decline in 2019 reflects a drop in funds from operations as trading dropped, but also personnel costs falling more slowly than revenues, leading to a drop in EBITDA. We anticipate this metric to improve moderately during the rating period as operating expenses stabilize and growth picks up.

**Free cash flow generation**

Scope anticipates that free cash flow generation, measured as free operating cash flow/SaD, will be positive in 2020 and 2021. Capex increases, but at a slower rate than funds from operations, which we see improving due to stronger EBITDA as margins increase, helped by lower aluminium prices and stronger demand. We expect this to be below 5% during the rating period.

**Interest cover**

The interest cover ratio, measured by SaD to interest expense, is robust, averaging 6.6x in 2012-14 and 12.2x in 2015-19. We expect interest cover to increase to be above 7x after the expected MNB bond issuance and retirement of existing debt, in line with plans to consolidate and extend the tenor of existing debt.

**Liquidity**

Liquidity is adequate, reflecting primarily the retirement of all short-term debt as part of the debt consolidation.

**Supplementary rating drivers**

Supplementary rating drivers have no effect on the rating.

**Financial policy**

We view the financial policy to be appropriate and prudent, reflected in past dividend policy for limited disbursements in 2015 and 2017.

**Peer group**

We reviewed Inotal relative to its peer group and found no issues that would warrant a change to the rating.

**Parent support**

We view parent support as credit-neutral.

**Corporate governance**

Scope has no issues with Inotal's corporate governance.

## Senior unsecured debt

We assign a first-time B+ senior unsecured debt rating. The planned financial restructuring would reduce complexity and banking exposure. Collateral agreements from existing loans have also been freed, meaning existing assets are now unencumbered.

In our recovery assessment, we recognise that, despite a strong unencumbered asset position, the limited repurposing of plant and equipment for other uses limits recovery to 'average' (30-50%) for outstanding senior unsecured debt in a hypothetical default scenario based in 2022. We have assumed about 10% of trade payables to micro- and small-sized companies to be senior secured obligations in line with Hungarian insolvency law, thus ranking ahead of the planned MNB bond in a default scenario. For these reasons, there is no uplift to the rating for senior unsecured debt as a category.

## Outlook

The Outlook is Stable and incorporates our view of stable revenues in a challenging environment. Furthermore, the Stable Outlook reflects Scope's expectation that INOTAL's indebtedness (SaD/EBITDA) will be around 3x-4x in the medium term.

A negative rating action could occur if market price volatility leads to weakened margins, resulting in a SaD/EBITDA ratio of 4x on a sustained basis.

A positive rating action could be warranted if profitability were to be higher than our base-case scenario, leading to SaD/EBITDA ratio of 2x on a sustained basis.

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