Éltex Kft.
Hungary, Business Services

B+ STABLE

Corporate profile

Founded in 1989 and headquartered in Hungary, Éltex Kft plays a prominent role in waste management. The company opened its first foreign plant in 1996.

Éltex specialises in up-to-date, efficient, complex waste-handling; hazardous and non-hazardous waste recycling; the transport and disposal of confidential documents; manufacturing plastics and electronic waste recycling; environmental protection consultation; and the import, export and transit of hazardous and non-hazardous waste.

The company handles all recyclable materials on-site. If waste quantities are very high, it builds a suitable waste handling area on-site, which houses equipment and serves as a storage space.

The company is fully owned by Mr. Zoltan Vass (50%) and Mr. Péter Vermes (50%).

Key metrics

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	27x	29x	24x	7x
Scope-adjusted debt (SaD)/EBITDA	2.1x	1.0x	3.8x	3.7x
Scope-adjusted funds from operations/SaD	43%	84%	23%	22%
Free operating cash flow/SaD	-33%	34%	-68%	4%

Rating rationale

Scope Ratings assigns a B+/Stable first-time issuer rating to Hungarian waste management service company, Éltex Kft. Senior unsecured debt issued by Éltex is rated B+.

Éltex's business risk profile is supported by the increasing need for recycling, especially of industrial waste. The company is one of the top three leaders in waste management in Hungary. It benefits from medium- and long-term contracts with globally well-known groups. The contracts have a high likelihood of being renewed, which ensures stable revenues. Éltex has also committed not to use landfill (credit-positive ESG factor).

Despite a good EBITDA interest cover ratio, Éltex's business risk profile is constrained by its relatively high expected leverage and low Scope-adjusted EBITDA margin. In addition, 75% of Éltex's business is generated in its home market and all its activities are related to recycling, which leads to low diversification. Éltex also has to deal with some turbulence on the competitive waste market.

Éltex's financial risk profile is slightly stronger than its business risk profile. Our rating case incorporates the company's plans to issue a HUF 2.25bn senior unsecured corporate bond under the MNB Bond Funding for Growth Scheme. We assume that the planned bond will have a 3.5% coupon with an 8-year tenor and a 3-year grace period following by a yearly linear amortisation. Proceeds from the bond are earmarked for financing four major investment projects and refinancing some of 2020 financial debt. We expect Éltex's financial leverage ratio to increase to almost 4x in the medium term and its interest cover ratio to be above 7x. We also expect some deterioration in underlying profitability despite free cash flow fluctuating between negative and positive numbers.

Ratings & Outlook

Corporate ratings	B+/Stable
Senior unsecured rating	B+

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Related Methodology

Corporate Rating Methodology, 26 February 2020

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Outlook

Stable Outlook

The Stable Outlook for Éltex incorporates our view that key credit metrics over the next two years will deteriorate, i.e. expected Scope-adjusted debt (SaD)/EBITDA of 3.7x-3.8x compared to 1x-2x in the past. It also incorporates Éltex's position as one of the top three leaders in waste management in Hungary and our perception that the company will keep its EBITDA margin around 5-6%. Currently conducted debt-financed growth investments are not expected to impose major execution risk. Furthermore, we assume the successful issuance of a HUF 2.25bn bond under the MNB Bond Funding for Growth Scheme, with the proceeds used to finance four major investment projects and refinance a part of 2020 financial debt.

Ratings upside

A positive rating action is deemed remote in light of the company's expected size and outreach in the foreseeable future but could be warranted if the company's business risks were to be reduced while keeping the financial risk profile stable. This could be achieved by significant growth of the company's overall outreach and diversification.

Ratings downside

The rating could come under pressure if Éltex's leverage deteriorated to significantly above 4x on a consistent basis, e.g. as a result of higher capital expenditures, a higher dividend payout and/or the use of bond proceeds for purposes other than the aforementioned refinancing.

Rating drivers

Positive rating drivers	Negative rating drivers
• The increasing need for recycling, especially of industrial waste • One of the leaders in waste management in Hungary • Medium and long-term contracts with high likelihood of contract renewals • Clients are globally well-known groups • No use of landfill (credit-positive ESG factor) • Good EBITDA interest cover of more than 7x for the foreseeable future	• Competitive market • Some market turbulence • Large exposure to industrial waste collection/recycling provides market potential but tends to be more volatile than municipal waste collection • Environmental risk regarding hazardous waste (credit-negative ESG factor) • No activity diversification • Low geographical diversification • Relatively high expected leverage • Relatively low Scope-adjusted EBITDA margin

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significant growth of the company's overall outreach and diversification	• Deterioration of SaD/EBITDA to significantly above 4x on a consistent basis

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	27x	29x	24x	7x
Scope-adjusted debt (SaD)/EBITDA	2.1x	1.0x	3.8x	3.7x
Scope-adjusted funds from operations/SaD	43%	84%	23%	22%
Free operating cash flow/SaD	-33%	34%	-68%	4%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	418	678	681	693
Operating lease payments in respective year	37	42	42	42
Other	-3	56	-	-
Scope-adjusted EBITDA	452	776	723	736
Scope-adjusted funds from operations in HUF m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	418	678	681	693
less: (net) cash interest as per cash flow statement	-13	-22	-30	-106
less: cash tax paid as per cash flow statement	-18	-9	-24	-10
add: depreciation component, operating leases	33	37	37	37
add: dividends received from equity	-	-	-	-
Other	-10	-23	-15	-15
Scope-adjusted funds from operations	409	661	648	599
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020F**	**2021F**
Reported gross financial debt	906	792	3,330	3,330
less: hybrid bonds	-	-	-	-
less: cash and cash equivalents	-69	-139	-686	-705
add: cash not accessible	-	-	-	-
add: pension adjustment	-	-	-	-
add: operating lease obligations	99	113	113	113
Other	18	19	19	19
Scope-adjusted debt	953	785	2,776	2,758

Business risk profile

Éltex's **business risk profile (assessed at B+)** is supported by its market positioning in Hungary, with profitability and diversification as negative rating drivers.

Competitive market…

Most markets for environmental services are very competitive and are characterised by increasing technological challenges due to changes in regulation, as well as by the presence of experienced competitors. The competitive landscape is very diverse.

The provision of services like rubbish collection is capital intensive, with high initial investments required (a fleet of trucks, facilities, etc.) This raises barriers to entry for new competitors into the market. Municipalities and other clients cannot easily switch among providers. Both of these characteristics benefit Éltex.

…subject to EU regulation…

Waste reduction and valorisation are EU priorities. They are regulated via a directive 2018/851, which was updated in May 2018 and includes the following targets:

- By 2024: separate collection of biodegradable waste, or recycling at source (home composting for example).
- By 2025: recycling of 55% of municipal waste; 65% of packaging waste; set-up of a separate collection of textile waste and hazardous waste produced by households.
- By 2030: recycling of 60% of municipal waste and 70% of packaging waste; reduction of food losses from producers to consumers in order to contribute to the United Nations target of reducing the volume of food waste by 50% worldwide.
- By 2035: recycling of 65% of municipal waste; share of municipal waste landfilled reduced to a maximum of 10% of the total quantity.

The EU recommends the use of financial instruments such as landfill taxes or incineration taxes.

In addition to the waste directive, the EU also finances research and entrepreneurial projects related to waste reduction through its Horizon 2020 programme.

… and need to meet national goals…

Hungary has recently introduced major waste sector reforms. A state-owned company called the National Waste Management Coordination and Asset Management Company (Nemzeti Hulladékgazdálkodási Koordináló és Vagyonkezelő Zrt.) has been coordinating and overseeing the delivery of waste services at the local level since 2016. NHKV is responsible for distributing waste fees to the relevant operators, selling recyclable materials, and supervising infrastructure spending and the use of EU funds.

Industrial waste management services are provided by private-sector companies, such as Éltex.

The Hungarian government's 2019 priority actions were as follows:

- Gradually increase landfill taxes to phase-out landfilling of recyclable and recoverable waste. Use the revenues for measures that improve waste management, in line with the waste hierarchy.
- Focus on implementation of the separate collection obligation to increase recycling rates, including collection of bio-waste. Develop and implement minimum service standards and support programmes for municipalities.
- Improve the functioning of Extended Producer Responsibility Systems, in line with the general minimum requirements.

… should benefit Éltex's business

These goals (at the EU and Hungarian levels) should stimulate Éltex's business as demand for recycling grows. The relatively high initial investment required should limit the number of newcomers.

Éltex holds required permits

The company holds all of the required permits necessary for operation. There are three types of permit: i) national; ii) site specific; and iii) permits for specific activities that are regulated by the EU and Hungarian law.

Regarding the treatment of non-hazardous and hazardous waste, the following activities require permits: trading, treatment, transportation, manufacturing, recycling and recovery.

Permits are required for the operation of waste treatment plants for each location. Each Éltex owned or rented plant has a site permit, a waste handling and a recycling permit. The permits are regularly renewed by the health and safety executive team.

Éltex is the second company in Europe to obtain R2 certification, which is the highest industry-wide standard for recycling electronical equipment in a sustainable manner.

Large need for recycling in Europe

In 2016, 2.54 bn tonnes of waste were generated by European firms and households, but only 48% of that volume was recycled.

In Europe, 90% of waste is industrial waste and the remainder is municipal waste. In Hungary 80% of waste is industrial waste.

Thus, there is a high demand for recycling in Europe, which represents a great opportunity for Éltex to keep expanding its activities.

Market turbulence in waste management…

In 2016, over 70% of the world's plastic waste and 55% of paper waste was sent to China to be recycled. Since 2018, however, the Chinese waste ban has stopped 100% of solid waste imports. Consequently, recycling channels and markets for recyclable waste have practically vanished over the last few years. The ban has led to a massive oversupply in the market, driving waste prices down.

The global waste market has collapsed and recycling costs have increased tremendously leading to falling profitability but continuing loss making for most companies.

The waste paper market is also in crisis. In Hungary, for example, prices started falling in 2019. Now, paper companies not only do not pay for paper waste, but request payment for accepting the material. The slide in waste paper prices has had a highly negative effect on private waste management companies and also put the complete value chain at risk.

…has not negatively impacted Éltex

Éltex does not deal with unsorted municipal waste but rather with waste mostly from manufacturing companies in mixed/unsorted form (such as paper, foil etc.) directly on site. The company continues to send these materials to a cement factory for recycling, just as it did before the Chinese ban. According to Éltex, prices for good-quality industrial waste categories have not changed, partly thanks to EU regulation which regulates and supports the use of recycled material in new products. Prices for certain materials have even increased, e.g. clean recycled PET, post-industrial PE, and pure cardboard waste. At the same time, prices for municipal mixed waste types have not only dropped sharply but turned into costs. Nevertheless, this development has not affected Éltex's business as the company does not deal with municipal waste.

Éltex has been delivering recycling granulate to China for eight years. Following the Chinese waste import ban, Éltex created a joint venture with its Chinese partner. In 2019, it processed 4,400 tons of foil in Hungary and exported it to China as a product. The company was thus able to turn the situation to its advantage, creating added value and increasing profitability.

Somewhat exposed to environmental risk

Hazardous waste poses a greater risk to the environment and human health than non-hazardous waste and thus requires a stricter control regime. This is laid down in particular in Articles 17 to 20 of Directive 2008/98/EC. As hazardous waste recycling accounts on average for 2% of total sales, Éltex is somewhat exposed to this kind of environmental risk. Nevertheless, we note that Éltex does not use landfill as a solution (credit-positive ESG factor).

One of the leaders in Hungary in terms of revenues

According to Éltex, its main competitors in Hungary are MEH Zrt (which mainly collects metal waste and paper waste), FCC magyarorszag Kft (a multinational foreign company whose main business is landfill), and Saubermacher Mo. Kft (an Austrian company whose main business is landfill). In terms of revenues, Éltex has ranked second for at least the last three years. Éltex considers itself a regional, leading, middle-size company and aims to become the market leader. Compared to the two world leaders, however, Éltex remains fairly small.

Capex used to increase capacity and efficiency

Éltex has four major projects in progress, which aim at increasing both its capacity and efficiency. All are at the beginning phase (stages of completion are between 15% and 30%). The company has other minor investments in the pipeline, which aim at gaining new partners, better serving current partners and ensuring the long-term development of strong business relationships with partners.

Well-known clients with some concentration risk

Éltex's top five clients account for half of net revenues, while its top fifteen make up 80% of total revenues. This concentration risk is mitigated by its medium/long-term partnerships (between five and 15 years) with well-known, international groups, such as P&G, Bosch, Samsung, Henkel and Continental among others, with which it has medium-term contracts (between two and five years). The average contract length with smaller clients is 3.5 years and the total length of business partnerships averages 7.5 years. Due to these medium/long-term partnerships, we can expect contracts to be easily renewed, which supports Éltex's market position.

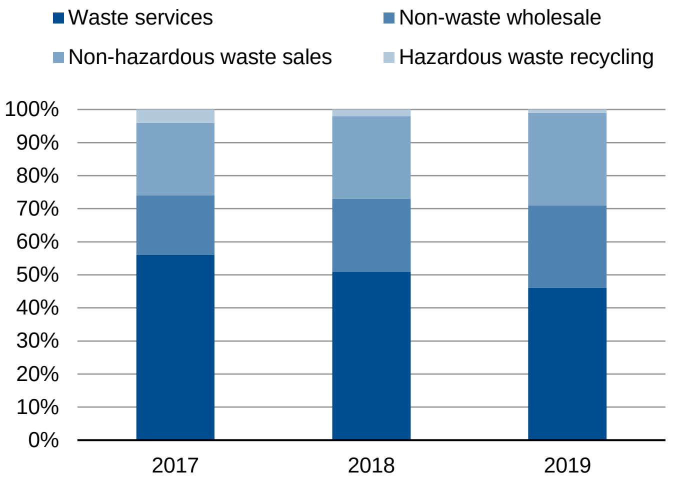
Revenues and EBITDA only related to recycling activity

We do not consider Éltex's revenues and EBITDA to be diversified in terms of sources. Indeed, all of its revenues come from recycling activity. Nevertheless, it is worth noting that the company benefits from a good diversification in terms of services provided.

Somewhat low geographical diversification

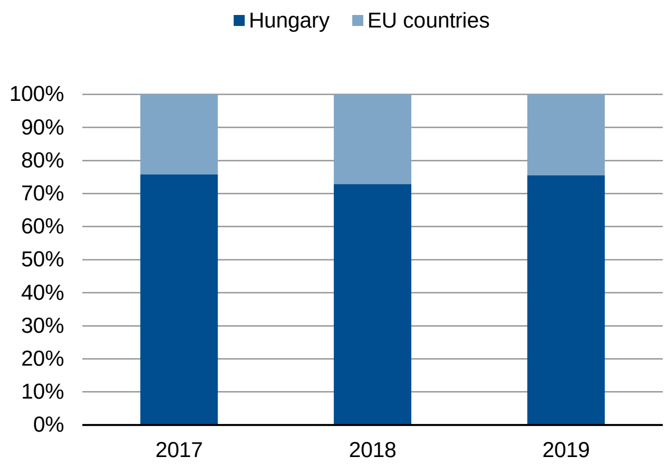
Regarding geographical diversification, 75% on average of net revenues and EBITDA is generated in Hungary. The remainder is generated within Europe. Nevertheless, Éltex has business relationships in more than 20 countries.

Figure 1: Revenue breakdown per segment (%)



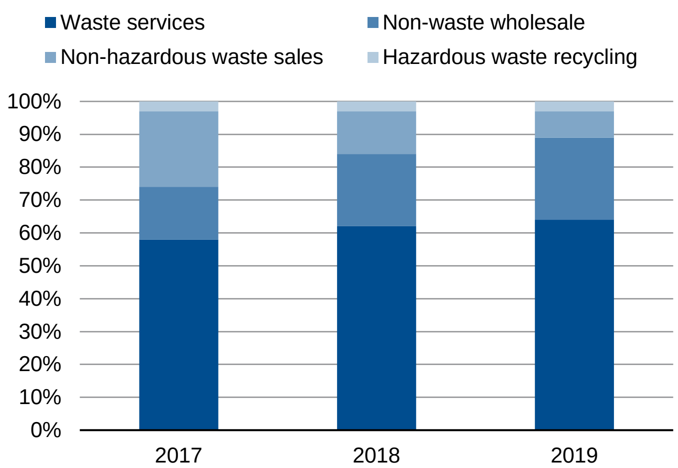
Source: Éltex, Scope

Figure 2: Geographical revenue breakdown (%)



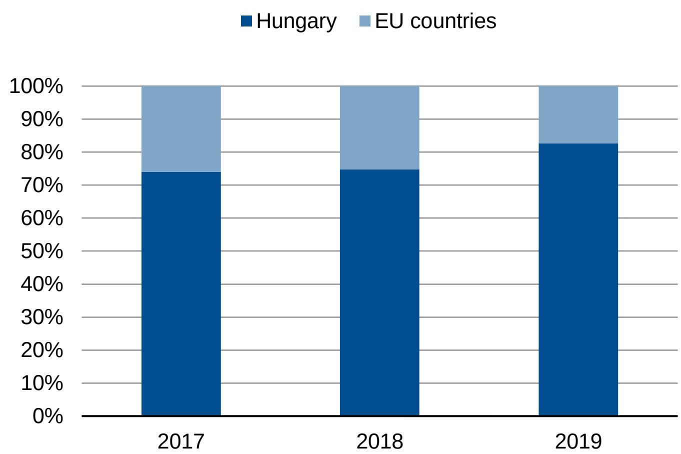
Source: Éltex, Scope

Figure 3: EBITDA breakdown per segment (%)



Source: Éltex, Scope

Figure 4: Geographical EBITDA breakdown (%)



Source: Éltex, Scope

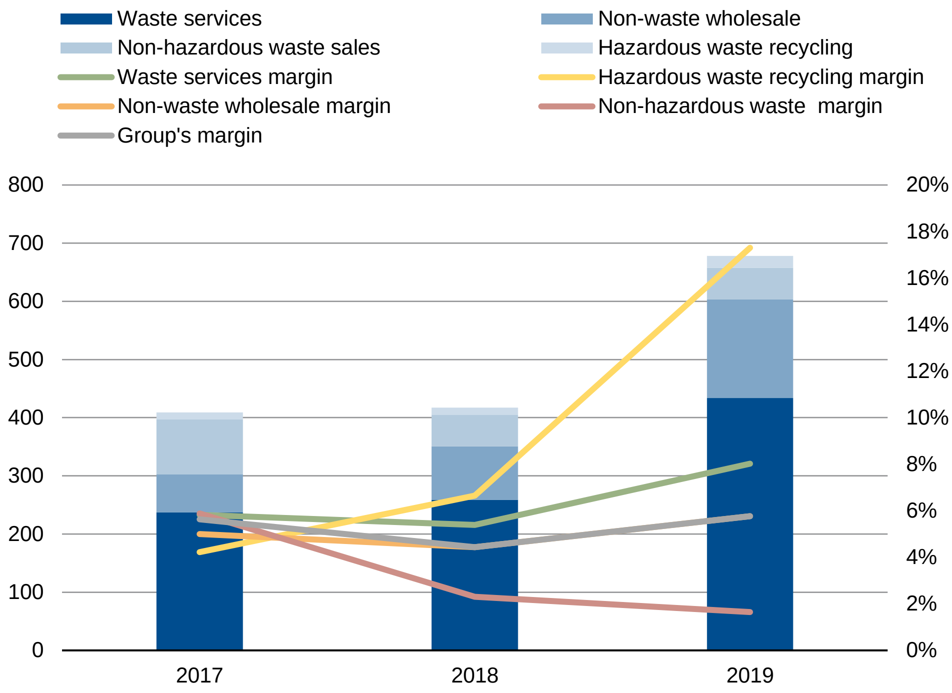
Low profitability

Éltex has a low adjusted EBITDA margin, especially compared to rated peers. Performance also fluctuated from 4.8% to 6.6% between 2017 and 2019. Éltex's margin is mainly generated via waste services, which have the second highest EBITDA margin. The second contributor to EBITDA is non-waste wholesale (products sold after the recycling of waste and the sale of detergent).

Margin profile expected to decline

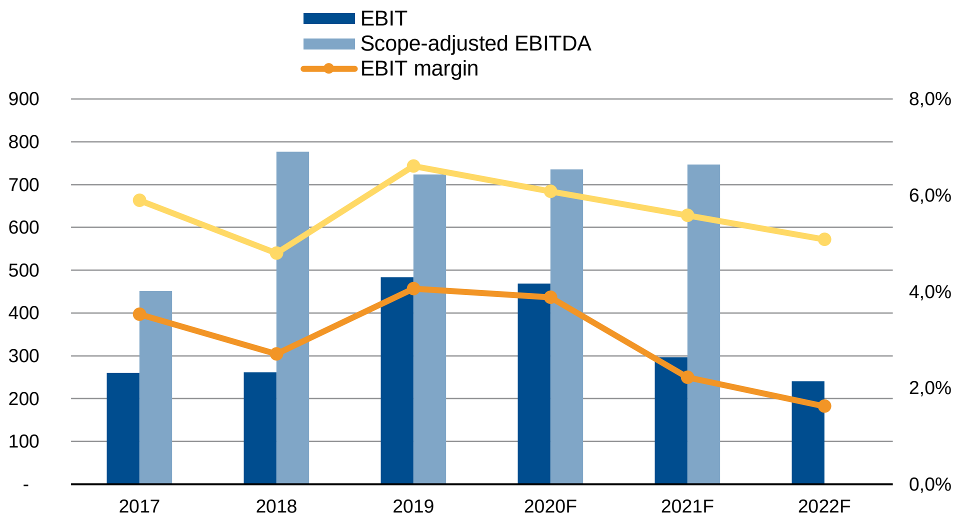
Despite its four major investment projects to increase capacity and efficiency, we expect Éltex's EBITDA margin to decrease due to a slightly higher expected cost of materials.

Figure 5: EBITDA and EBITDA margins per segment



Source: Éltex, Scope

Figure 6: EBIT and adjusted EBITDA in HUF m and their respective margins



Source: Éltex, Scope

Low Covid-19 impact

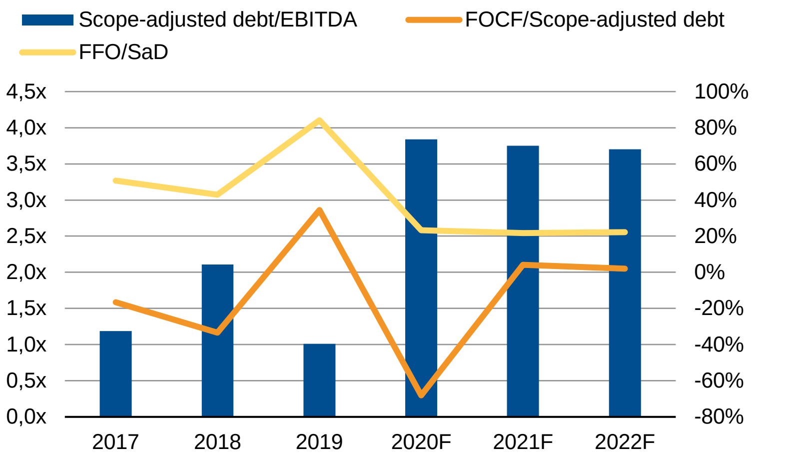
According to management, sales in the first half of 2020 went up (+2.6%) compared to same period in 2019. This is despite some lower production at its partner companies due to Covid-19. Thanks to its diverse range of clients, Éltex has been able to soften the negative impacts of the pandemic. Some of its partners in the fast moving consumer goods sector, such as P&G, Henkel, and Reckitt & Benckiser, actually increased production during the pandemic by 15%-20% in output, which generated more waste. Éltex targets a client portfolio of modern companies with innovative products which are less sensitive to market cyclicality.

Éltex also records a significant volume of revenues from service fees, which ensures fixed monthly revenues.

Financial risk profile

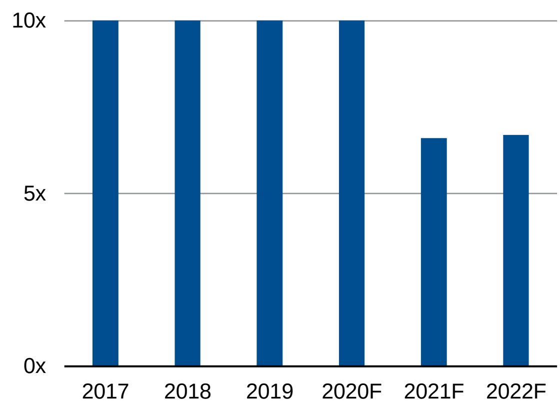
Éltex's **financial risk profile (assessed at BB-)** supports the overall issuer rating. We expect Éltex's financial leverage ratio to be under 4.0x in the medium term and its interest cover ratio to remain above 7x. We also expect some deterioration in underlying profitability and fluctuating free cash flow.

Figure 7: Scope-adjusted leverage



Source: Éltex, Scope

Figure 8: EBITDA interest coverage



Source: Éltex, Scope

Rating reflects high leverage

In previous years, Éltex recorded very good leverage, ranging from 1x to 2.1x. Nevertheless, our rating case reflects SaD/EBITDA of 3.7x-3.8x because we expect Éltex's leverage to deteriorate due to the bond issuance. As this expected leverage should be the norm for the coming years, we based our rating on this credit metric.

The funds from operations (FFO)/SaD ratio has historically been above 30%. However, expected ratios will be around 20% as a result of higher SaD following the bond issuance.

Good interest coverage

Éltex's debt protection – as measured by Scope-adjusted EBITDA/Scope-adjusted interest – was above 25x (2017: 39x, 2018: 27x ,2019: 29%). We expect Éltex to fall below this threshold in the next few years due to higher forecasted interest payments. As we expect the bond to be issued in mid-December, the full impact of the interest payment will be visible from 2021.

Weak cash flow coverage

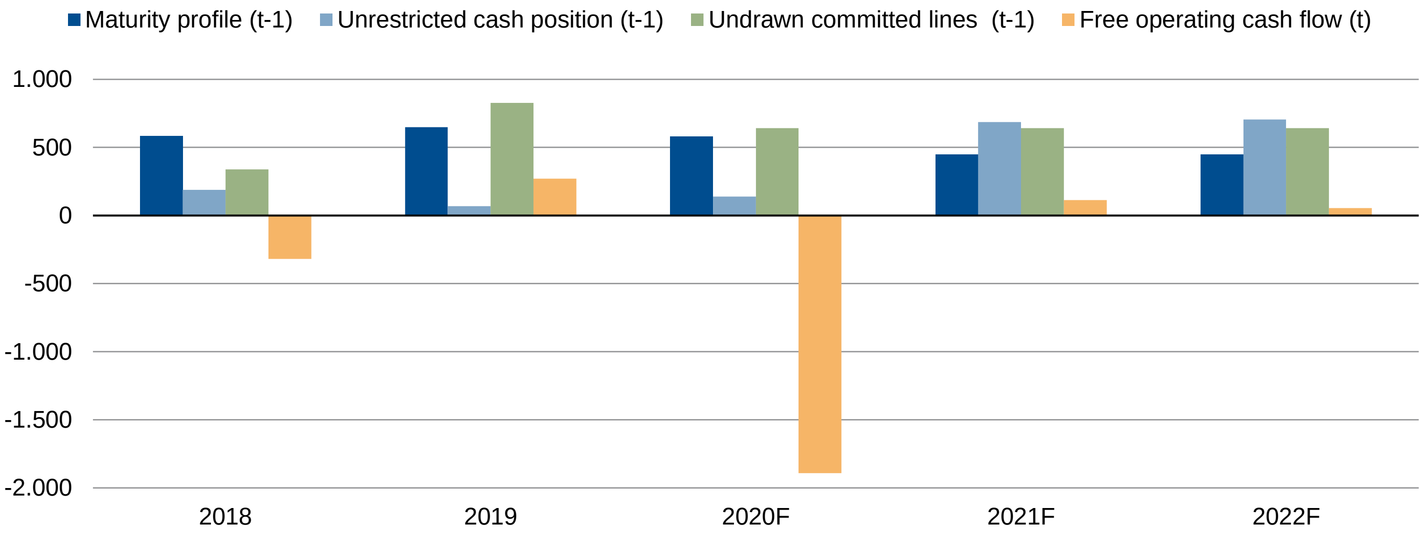
Éltex's cash flow cover – as measured by free operating cash flow (FOCF)/SaD – moves between negative and positive positions due to the fluctuation in FOCF. The variation is mainly influenced by the level of capex. Expected FOCF is primarily impacted by the higher amount of capex needed for Éltex's four major investment projects

Adequate liquidity position

Éltex's liquidity position is considered adequate, backed by committed credit lines of HUF 643m. Éltex has HUF 582m to be repaid in 2020. It also has HUF 139m of available cash and equivalents as of 31 December 2019. We expect negative FOCF in 2020, as a result of higher capex resulting from the four major investment projects but also as a result of negative working capital variation (due to our conservative view regarding the potential impact of Covid-19). Nevertheless, thanks to the bond issuance, the amount of unrestricted cash available as of 31 December 2020 will improve to HUF 686m. We expect capex needs to decrease each year and therefore expect FOCF to improve and turn positive in 2022.

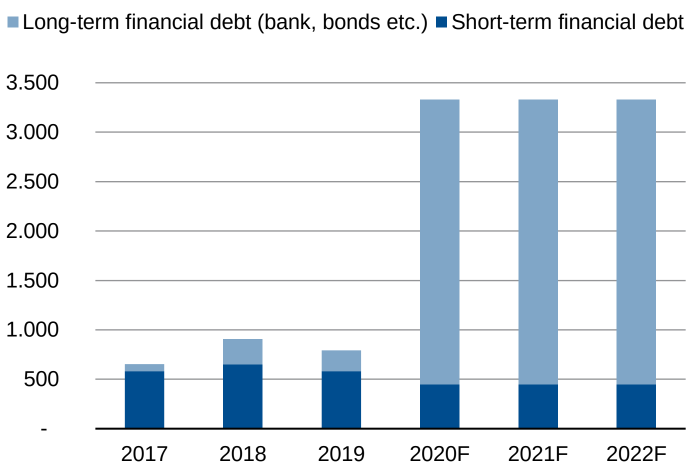
Short-term debt obligations will be fully covered by available sources in 2021 and 2022 (liquidity ratios will be higher than 300%) mainly thanks to the sustained amount of undrawn committed credit lines but also to the cash generated during the previous period.

Figure 9: Short-term debt repayment amount, available cash and FOCF (in HUF m)



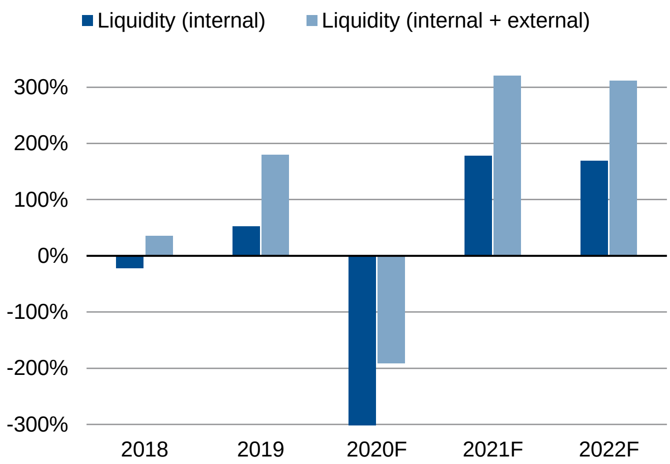
Source: Éltex, Scope

Figure 10: Financial debt (in HUF m)



Source: Éltex, Scope

Figure 11: Liquidity ratios



Source: Éltex, Scope

Conservative dividend policy

The dividend payout has been between 0% and 25% of net income in recent years. In our rating case, we expected a payout ratio of 15%. We believe this dividend policy strikes a fair balance between shareholder and creditor interests. A higher dividend distribution could alter our rating case.

No risk related to governance

Éltex is a privately owned limited liability company (Korlátolt Felelősségű Társaság [Kft.]). The highest decision-making body is the taggyűlés (members meeting). The members are the two owners: Mr. Zoltan Vass (CEO) and Mr. Peter Vermes (MD).

We found no risk related to Éltex's governance. The company's governance is also supported by an experienced and committed top management team.

Long-term debt rating

B+ rating for senior unsecured debt

We expect an average recovery for senior unsecured debt, such as the planned HUF 2.25bn MNB bond. This recovery expectation translates into a B+ rating for the senior unsecured debt category. Our recovery expectations are based on an anticipated liquidation value in a hypothetical default scenario at the end of 2022. Short-term and long-term debt (excluding the bond issue) raised from financial institutions as well as payables rank higher than senior unsecured debt. Hence, such debts would be repaid first.

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