Wellis Magyarország Zrt.
Hungary, Consumer Goods

SCOPE B- NEGATIVE

Key metrics

			Scope estimates	
Scope credit ratios	2021	2022	2023 E	2024 E
Scope-adjusted EBITDA/interest cover	14.7x	0.3x	0.3x	2.4x
Scope-adjusted debt/EBITDA	3.2x	188.1x	113.6x	10.9x
Scope-adjusted funds from operations/debt	38%	-1%	-2%	5%
Scope-adjusted free operating cash flow/debt	-65%	-28%	-10%	14%

Rating rationale

The affirmation is driven by the improving liquidity following the refinancing of bank loans in June 2023 and the addition of a new working capital credit line with a preferential interest rate. Cost cuts in the previous year have also resulted in a gradual recovery of the operating profitability margin since July 2023.

The business risk profile (assessed at B) is supported by the high diversification in terms of geographies, customers and suppliers and by the brand strength that benefits from the international scope of Wellis' branded sales and the solid quality of its products. The major constraint on the business risk profile remains Wellis' limited absolute size, which is expected to shrink by 43% in 2023 because of lower demand causing a sharp decrease in sales volumes. Operating profitability is expected to remain weak in 2023 (close to 1%) followed by a gradual recovery due to strict cost controls, the optimisation of production and the positive macroeconomic developments of decreasing energy prices and logistics costs.

The financial risk profile remains assessed at B-. Leverage measured by Scope-adjusted debt/EBITDA remains high in 2023, due to weak operating profitability combined with a higher Scope-adjusted debt (including a new HUF 4bn loan). Beyond 2023, we expect leverage to improve towards 7.0x as a result of debt amortisation and improving EBITDA. Debt protection measured by Scope-adjusted EBITDA interest cover is expected to stay below 1.0x until YE 2023. We expect free operating cash flow to remain negative in 2023, mainly due to low EBITDA and the HUF 1.9bn in capex forecasted for the year. Liquidity is inadequate. Sources of liquidity, consisting of HUF 177m of available cash at YE 2022, do not cover the negative HUF 2.4bn of free operating cash flow and HUF 750m of short-term debt amortising in 2023. The company is therefore highly dependent on external funding. We note that the HUF 10bn senior unsecured bond (ISIN: HU0000360250) constitutes a major source of funding and that a negative rating action would accelerate its repayment and likely trigger a default as the bond agreement stipulates debt repayment acceleration at loss of a B- rating. This aspect is an additional weakness for the company's liquidity. Wellis is already in a two-year grace period for its rating to recover to B+ starting in October 2022, which we currently deem a remote scenario.

Outlook and rating-change drivers

The Negative Outlook reflects the uncertainty around the ability to generate revenue and improve operating profitability. Scope's base case assumes that credit metrics will remain weak in 2023, factoring in that the discretionary nature of Wellis' main products make them vulnerable to economic downturns and thus to the ongoing drop in demand. The base case also assumes a gradual recovery in the operating margin beyond 2023 because of tight cost controls and positive macroeconomic factors. Scope notes that the acceleration of bond repayment might have default implications for Wellis, with the two-year grace period for rating recovery ending in October 2024.

A downgrade could be triggered either by the further deterioration of liquidity, or interest cover staying below 1.0x. A downgrade could also be triggered by the adverse action from the financing banks, e.g. reduction of the credit lines in case of a covenant breach.

A positive rating action, along with the return to Stable Outlook, could be triggered if the EBITDA/interest cover improved sustainably above 1.0x, either as a result of interest expense or an improvement in operating profitability, while liqudity does not deteriorate below 100%. Further ratings upside is currently deemed remote.

[1] *The rating was prepared with the application of Scope's General Corporate Rating Methodology, 15 Jul 2022. The application of the General Corporate Rating Methodology, 16 Oct 2023, does not have an impact on the rating.*

Ratings & Outlook

Issuer	B-/Negative
Senior unsecured debt	B-

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Related Methodologies

General Corporate Rating Methodology; October 2023[1]

Consumer Products Rating Methodology; November 2022

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Bloomberg: RESP SCOP

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
03 March 2023	Monitoring review	B-/Negative
20 October 2023	Downgrade	B-/Negative

Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Leading market position in Hungary and strong market position in western Europe • Significantly increased production capacities with the addition of the Ózd production site • Good diversification by customers, suppliers and geographies • Implementation of cost-cutting and efficiency-improving measures • Financing secured until 2025	• Operates in the competitive global markets of discretionary products that are currently negatively affected by decreasing consumer confidence and purchasing power • Weak operating profitability at significantly below historical averages • Shrinking revenues and weaker order book caused by lower demand for jacuzzis and spas • High working capital needs and excess inventories causing insufficient liquidity

Positive rating-change drivers	Negative rating-change drivers
• Interest cover of sustainably above 1x • Adequate liquidity	• Interest cover staying below 1x as well as weaker liquidity • Adverse action implemented by financing banks in case of covenant breach

Corporate profile

Wellis is a European manufacturer of jacuzzis, spas and related wellness products. It is based in Hungary and has been operating since 2003. The company's wide range of products are mainly sold to retail customers for the purpose of relaxation and stress relief. Products are distributed in almost all European countries and Wellis entered the US market in June 2019. The Czafik brothers, who established the company, are the key executives and own 100% of the company's shares. Wellis' new production facility located in Ózd, Hungary, has been operational since May 2021.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022**	**2023 E**	**2024 E**	**2025 E**
Scope-adjusted EBITDA/interest cover	80.1x	14.7x	0.3x	0.3x	2.4x	4.0x
Scope-adjusted debt/EBITDA	1.8x	3.2x	188.1x	113.6x	10.9x	7.2x
Scope-adjusted funds from operations/debt	56%	38%	-1%	-2%	5%	10%
Scope-adjusted free operating cash flow/debt	-10%	-65%	-28%	-10%	14%	22%
Scope-adjusted EBITDA in HUF m						
Income from operations (EBIT)	2,182,717	3,758,218	-713,273	-1,003,061	392,521	800,021
Add: depreciation	-308,073	-522,430	-827,657	-1,218,861	-1,500,000	-1,500,000
Other items	0	0	0	0	0	0
Scope-adjusted EBITDA	2,490,789	4,280,647	114,383	215,800	1,892,521	2,300,020
Funds from operations in HUF m						
Scope-adjusted EBITDA	2,490,789	4,280,647	114,383	215,800	1,892,521	2,300,020
less: (net) cash interest paid	-31,112	-290,577	-392,348	-742,117	-784,840	-579,033
less: cash tax paid per cash flow statement	-23,852	-200,342	-2,411	0	0	0
add: dividends from associates	0	0	0	0	0	0
Change in provisions	150,000	1,434,367	123,342	0	0	0
Funds from operations (FFO)	2,585,826	5,224,096	-157,033	-526,317	1,107,681	1,720,987
Free operating cash flow in HUF m						
Funds from operations	2,585,826	5,224,096	-157,033	-526,317	1,107,681	1,720,987
Change in working capital	-41,250	-7,111,170	-3,084,810	36,001	2,256,730	2,434,763
Non-operating cash flow	-373,404	150,000	468,330	0	0	0
less: capital expenditure (net)	-2,651,823	-7,284,435	-3,306,632	-1,914,544	-500,000	-500,000
less: divestments	14,858	5,300	8,855	0	0	0
Free operating cash flow (FOCF)	-465,793	-9,016,209	-6,071,290	-2,404,860	2,864,411	3,655,750
Net cash interest paid in HUF m						
Net cash interest per cash flow statement	-31,112	-290,577	-392,348	-742,117	-784,840	-579,033
Change in other items	0	0	0	0	0	0
Net cash interest paid	-31,112	-290,577	-392,348	-742,117	-784,840	-579,033
Scope-adjusted debt in HUF m						
Reported gross financial debt	4,599,185.0	13,898,980.0	21,511,335.0	24,511,335.0	20,573,066.0	16,573,066.0
less: subordinated (hybrid) debt	0	0	0	0	0	0
less: cash and cash equivalents	NA	NA	NA	NA	NA	NA
Other items	0	0	0	0	0	0
Scope-adjusted debt (SaD)	4,599,185.0	13,898,980.0	21,511,335.0	24,511,335.0	20,573,066.0	16,573,066.0

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Environmental, social and governance (ESG) profile[2]

Environment		Social		Governance	
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)		Labour management		Management and supervision (supervisory boards and key person risk)	
Efficiencies (e.g. in production)		Health and safety (e.g. staff and customers)		Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)	
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)		Clients and supply chain (geographical/product diversification)		Corporate structure (complexity)	
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	

Legend
Green leaf (ESG factor: credit positive)
Red leaf (ESG factor: credit negative)
Grey leaf (ESG factor: credit neutral)

ESG factors: credit-neutral

Wellis has no explicit ESG strategy. Regarding governance, we flag that top management consists of two brothers, Zsolt and Ákos Czafik, who own 100% of the company, and that the absence of an independent supervisory board increases the risk of decisions being made to the detriment of creditors.

In 2023, we note that Wellis introduced a new energy-efficient spa. It has lower energy consumption and better insulation and was produced using sustainable, environmentally conscious technologies.

[2] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e. those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.

Business risk profile: B

Industry risk profile: BB

The company is active in the durable consumer goods industry, characterised by medium cyclicality, substitution risk and entry barriers. Wellis' main products (spas and jacuzzis) are discretionary consumer products, which are sensitive to macroeconomic drivers or changes in consumer confidence.

Stable market share on the shrinking global markets

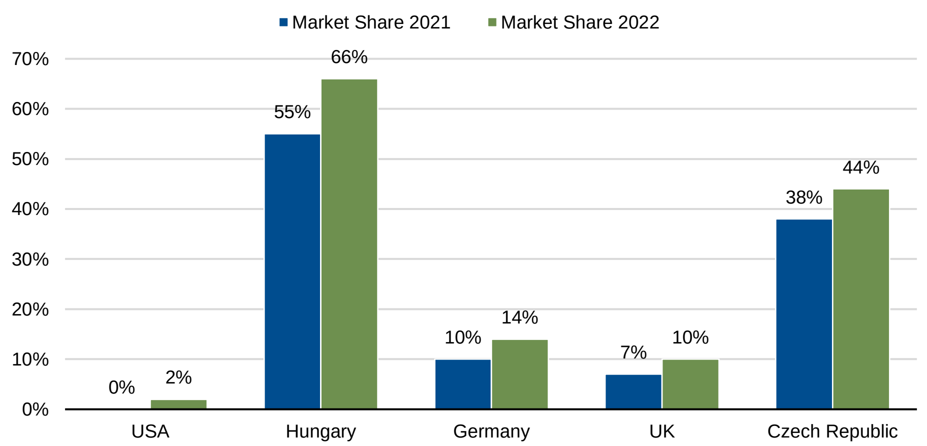
In recent years, demand in the global spa market had been fuelled by rising disposable incomes, broadening health awareness and technological advancements that have made the products more affordable. From 2022, however, rising materials, logistics and energy prices combined with high inflation and the economic downturn caused demand to fall and significantly decreased sales volumes.

On the positive side, the issuer is dominant in the Central and Eastern European market, especially in Hungary and the Czech Republic. In core European markets, the issuer holds market shares averaging around 10%-15%. In terms of the global market, notable is the issuer's gains in the US: Wellis only entered the market in 2021 and has already captured 2% of the market by 2023.

Despite an increasing hold in most relevant markets, Wellis' absolute size in terms of revenues is shrinking: currently HUF 55.5bn as of 2022 with a 43% decrease forecasted for 2023. This is due to the decline in units sold caused by weak demand for luxury products, including for spas and jacuzzis. The issuer's small absolute size compared with larger peers as well as its weak pricing power both towards suppliers and customers makes it vulnerable to macroeconomic shifts.

Wellis' main advantage to peers is the lower prices of its products. Additionally, the fact that its production facility is close to its core markets (Hungary and western Europe) makes the fulfilment of orders quicker and cheaper compared to competitors producing in east Asia.

Figure 1: Development of estimated share on key markets based on units sold



Sources: Wellis, Scope (estimates)

High geographical diversification, but limited product mix

Geographical diversification is robust and expected to further improve in the short to medium term. International customers account for 82% of revenue, mostly from the EU (67% of total revenue in 2022). The second largest and fastest growing regional market in 2022 remained the US, accounting for 26% of total revenue. Wellis also dominates its domestic market of Hungary, which accounts for around 8% of its revenue. However, the share of domestic sales in total revenues has shrunk significantly due to lower purchasing power that has pushed down demand. While the very granular sources of international revenue is clearly credit-positive, we flag the precarious situation regarding consumer confidence and purchasing power.

Wellis' product mix has a heavy concentration on spas, at about 80% of revenue. The remainder of revenue is related to sanitary products, which is highly correlated with spa sales.

Wellis' distribution network consists of own stores, both exclusive and non-exclusive retail partnerships, DIY sales and online sales. Sales channels are very diversified, with both direct and indirect sales, B2B, B2C and different kinds of retail outlets depending on the end-market.

Operating profitability remains under pressure in 2023; positive development forecasted

Historically, operating profitability ranged from 8% to 12%, supported by a strong economy and the high demand for wellness products during Covid-19 lockdowns. After the lockdowns, however, lower consumer confidence and purchasing power, in parallel with the increase in raw materials costs and operating expenses, put EBITDA margins under pressure, causing it to reach almost zero in 2022. Operating profitability in H1 2023 has been even lower, with an H1 EBITDA margin of -14%, influenced by the selling of inventory that was procured at the higher price in 2022 (Wellis accounts for inventory using the FIFO method).

To ease the pressure on operating profits, Wellis has implemented cost-cutting and efficiency-improving measures since Q3 2023, which include:

- In the Dabas facility, a halt to spa production and the termination of 63% of the workforce (to around 600 from more than 1,700 in 2022).
- Investment in solar panels on the Ózd facility, which is expected to cover 35% of the plant's electricity needs, to reduce overhead costs and the exposure to the volatile energy prices
- A 40% reduction in marketing costs by 2023
- In the case of multiple input materials suppliers, a change to cheaper Asian suppliers producing at the same quality.

At the same time, two factors in the global economy are bolstering Wellis' margin:

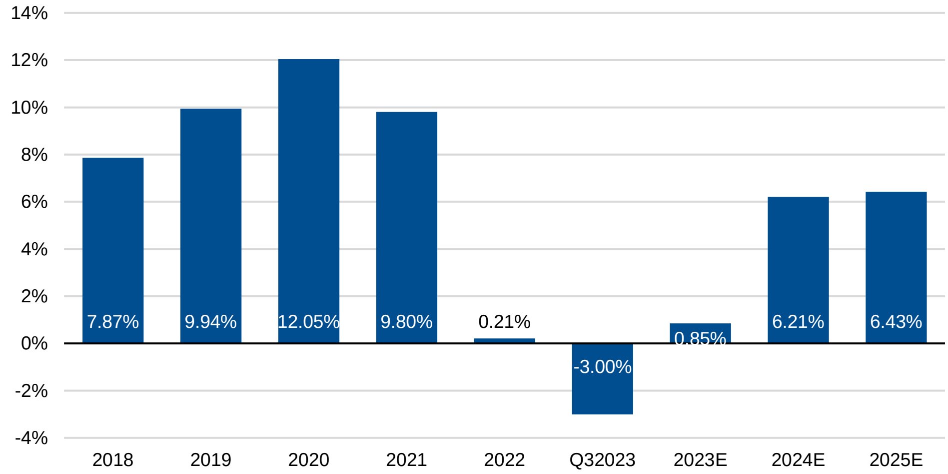
- The significant reduction of shipping/container costs, which is a major factor due to size and weight of jacuzzis
- The decreasing price for plastic and electronics from 2023 by 13% as estimated by the issuer.

The volatile demand and challenging market are making operating profitability harder to forecast. We have therefore adopted a more conservative view on profitability by applying haircuts to the management forecast.

Figure 2: Haircuts applied to profitability forecasts by management

Year	2023E			2024E			2025E		
	Wellis	Scope	Stress	Wellis	Scope	Stress	Wellis	Scope	Stress
EBITDA (HUF '000s)	400,161	215,800	-46%	5,375,461	1,892,521	-65%	6,919,505	2,300,021	-67%
EBITDA margin (%)	1.35%	0.85%	-0.50 pp	16.49%	6.21%	-10.28 pp	18%	6.43%	-11.23 pp

Figure 3: Scope-adjusted EBITDA margin



Sources: Wellis, Scope estimates

Brand strength remains limited

Wellis has limited brand strength due to its small size, young history and multi-brand strategy. Brand strength, however, is supported by the international scope of its branded sales and the solid quality of its products.

Financial risk profile: B-

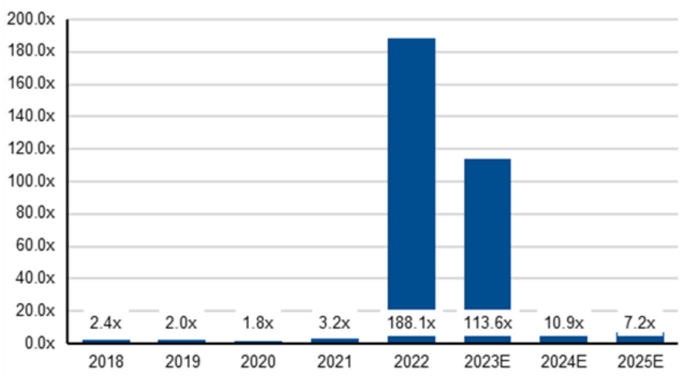
Leverage expected to remain high in the medium term

Financial leverage, as measured by Scope-adjusted debt/EBITDA, had been moderate in the past years as strong revenue growth was funded primarily by internal cash generation. However, with operating profitability deteriorating since 2022, leverage reached 188x. In 2023, we expect the same leverage level based on the forecast of almost breakeven profitability. As the margin recovers, we forecast leverage to improve below 10x until 2025, which is still high, but far from the unsustainable levels in 2022 and 2023.

Interest cover of below 1.0x in 2023

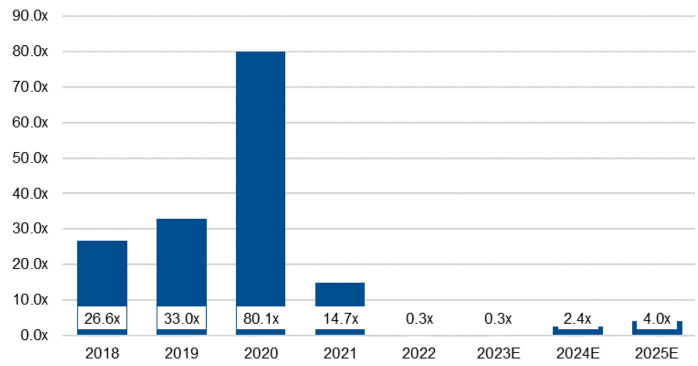
Thanks to little financial debt before 2022, the company had very comfortable cash interest coverage ratios of more than 10x. The combination of worsening profitability, increasing Scope-adjusted debt and higher interest rates are expected to move debt protection in an unfavourable direction of below 1.0x until YE 2023. We also expect interest expense to increase by 89% between 2022 and 2023 to HUF 742m. The average interest rate is expected to stay between 3%-4%, benefitting from the fixed coupon of the bond (3%) and the lower interest rate on the euro-denominated loans compared to those denominated in Hungarian forint. In 2024 and 2025, assuming no additional debt is sourced, interest cover is expected to improve above 2.0x.

Figure 2: Scope-adjusted debt/EBITDA



Sources: Wellis, Scope (estimates)

Figure 3: Scope-adjusted interest cover



Sources: Wellis, Scope (estimates)

Moderate but positive free operating cash flow in the medium term

Funds from operations and free operating cash flow will remain limited albeit positive into the medium term. The deteriorating EBITDA margin has had a significant negative effect on cash flow but capex is expected to stabilise (only for maintenance) beyond 2023, while the company continues to focus on reducing inventory and decreasing working capital.

Liquidity remains inadequate

Liquidity is inadequate. Sources of liquidity, consisting of HUF 177m of available cash at YE 2022, do not cover the negative HUF 2.4bn of free operating cash flow and HUF 750m of short-term debt amortising in 2023. The company is therefore highly dependent on external funding.

Scope notes that the HUF 10bn senior unsecured bond (ISIN: HU0000360250) constitutes a major source of funding for Wellis and that a negative rating action would accelerate its repayment and likely trigger a default as the bond agreement stipulates debt repayment acceleration at loss of a B- rating. This aspect is an additional weakness for the company's liquidity. Wellis is already in a two-year grace period for its bond rating to recover to B+ starting in October 2022.

Balance in HUF m	2023E	2024E	2025E
Unrestricted cash (t-1)	176,953	1,429,953	506,074
Amortizing short term debt (t-1)	750,000	4,000,000	4,000,000
Free operating cash flow	-2,404,860	2,864,411	3,655,750
Open committed credit lines (t-1)	0	0	0
Coverage	**-300%**	**110%**	**100%**

Long-term rating

Senior unsecured debt rating: B-

In February 2021, Wellis issued a HUF 9.9bn senior unsecured corporate bond under Hungary's Bond Funding for Growth Scheme. The bond's tenor is 10 years, with 10% of its face value amortising from 2026. The coupon is fixed at 3% and payable yearly.

We have rated the senior unsecured debt issued by Wellis at B-, the same level as the issuer rating. The recovery is 'average' for senior unsecured debt holders in a liquidation scenario.

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