Wellis Magyarország Zrt.
Hungary, Consumer Goods

B- NEGATIVE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	80.1x	14.7x	neg.	2.2x
Scope-adjusted debt/EBITDA	1.8x	3.2x	neg.	15.5x
Scope-adjusted funds from operations/debt	56%	38%	5%	3%
Scope-adjusted free operating cash flow/debt	neg.	neg.	neg.	13%

Rating rationale

The downgrade is triggered by deteriorating operating profitability in H1 2022 following the increase in materials costs and operating expenses. Lower demand for jacuzzis and spas, which are discretionary goods, caused inventory to rise, absorbing working capital and increasing the need for external financing. Scope expects operating profitability to be negative in 2022, followed by an improvement in 2023 and 2024 as cost-cutting is implemented.

Wellis is a Hungary-based manufacturer of durable consumer products. Its business risk profile is supported by its i) strong position on its core markets (Hungary and Western Europe) and its entry onto the US market in recent years; and ii) high degree of diversification in terms of geographies, suppliers and customers. The business risk profile is rated B, still constrained by Wellis' limited size compared to competitors. Deteriorating operating profitability is also a constraint and results from the currently challenging business environment as increasing energy costs in Europe and decreasing purchasing power have lowered the demand for jacuzzis and spas.

Wellis' financial risk profile is rated B- and is supported by the interest coverage, which is expected to remain above 2.0x despite rising interest expenses and profitability remaining below historical average. Leverage as measured by Scope-adjusted debt/EBITDA is expected to rise to over 10.0x in 2023 and to remain high in the short-to-medium term, which constrains the financial risk profile. Liquidity is inadequate, as the available liquid assets (HUF 595m of available cash at YE 2021) and negative free operating cash flow cannot cover the HUF 3bn short-term debt maturing in 2022, making the company highly dependent on external funding. Scope's base case assumes that the company will be able to find appropriate funding options by the end of 2022 as Wellis has already entered discussions with its banks. One bond (ISIN: HU0000360250) constitutes a major source of funding for Wellis and a further negative rating action would accelerate its repayment and likely trigger a default as the bond agreement stipulates a debt repayment acceleration at loss of B- rating, which is an additional weakness for the company's liquidity.

Outlook and rating-change drivers

The Negative Outlook reflects the uncertainty around the ability to generate revenue and maintain operating profitability in the challenging business environment. Scope's base case assumes that credit metrics will weaken in 2022 and 2023, factoring in the discretionary nature of Wellis' main products. Scope's base case also assumes a refinancing of the existing short-term bank debt, and no legal proceedings initiated by business partners or any other third party resulting in insolvency.

Ratings & Outlook

Issuer B-/Negative

Senior unsecured debt B-

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Related Methodologies

Corporate Rating Methodology; July 2022

Rating Methodology: Consumer Goods; September 2021

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Bloomberg: RESP SCOP

A positive rating action, currently deemed remote, along with the return to a Stable Outlook, would be possible if Wellis managed to deleverage to a Scope-adjusted debt/EBITDA of below 6.0x on a sustained basis, while improving liquidity and maintaining positive free operating cash flow.

A negative rating action would be possible following a further deterioration of operating profitability or the failure to refinance existing debt, which would hinder the company's liquidity. In the event of a downgrade, the repayment acceleration clause in the bond agreement (as described above) would kick in.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
27 July 2022	Placement under review for a downgrade	BB-/None
05 January 2022	Affirmation	BB-/Stable
22 January 2021	New	BB-/Stable

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 Ozd production site • Good diversification of customer and supplier base and geographical outreach	• Operates in competitive global markets for discretionary products, negatively affected by decreasing consumer confidence and purchasing power • Rapidly deteriorating operating profitability, second round of layoffs in 2022 to reduce operating expenses • Small absolute size • Worsening order book especially on the US market, caused by skyrocketing energy prices and inflation • High working capital needs and excess inventory causing insufficient liquidity

Positive rating-change drivers	Negative rating-change drivers
• Deleveraging towards a Scope-adjusted debt/EBITDA consistently below 6.0x while showing positive free operating cash flow on a sustained basis; improving liquidity	• Further deterioration of operating profitability or failure to refinance the current short-term debt

Corporate profile

Wellis is a European manufacturer of jacuzzis, spas and related wellness products based in Hungary. It has been operating since 2003. The company's wide range of products are mainly sold to retail customers for relaxation and stress relief purposes. Products are distributed to almost all European countries and Wellis also 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	**2019**	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	33.0x	80.1x	14.7x	Neg.	2.2x	2.0x
Scope-adjusted debt/EBITDA	2.0x	1.8x	3.2x	Neg.	15.5x	16.4x
Scope-adjusted funds from operations/debt	48%	56%	38%	5%	3%	3%
Scope-adjusted free operating cash flow/debt	Neg.	Neg.	Neg.	Neg.	Neg.	3%
Scope-adjusted EBITDA in HUF m						
Income from operations (EBIT)	1,107,080	2,182,717	3,758,218	-1,742,828	-164,019	-330,141
Add: depreciation	278,900	308,073	522,430	909,149	1,556,288	1,642,727
Other items	0	0	0	0	0	0
Scope-adjusted EBITDA	1,385,980	2,490,790	4,280,648	-833,687	1,392,270	1,312,585
Funds from operations in Scope-adjusted EBITDA in HUF m						
Scope-adjusted EBITDA	1,385,980	2,490,790	4,280,648	-833,687	1,392,270	1,312,585
less: (net) cash interest paid	-42,008	-31,112	-290,577	-921,995	-646,982	-646,982
less: cash tax paid per cash flow statement	-30,474	-23,852	-200,342	0	0	0
add: dividends from associates	0	0	0	0	0	0
Change in provisions	0	150,000	1,434,367	2,790,203	0	0
Funds from operations	1,313,497	2,585,825	5,224,095	1,034,529	745,287	665,603
Free operating cash flow in Scope-adjusted EBITDA in HUF m						
Funds from operations	1,313,497	2,585,825	5,224,095	1,034,529	745,287	665,603
Change in working capital	-970,554	-41,250	-7,111,170	-4,350,923	3,535,683	1,524,248
Non-operating cash flow	0	-373,404	150,000	0	0	0
less: capital expenditure (net)	-812,960	-2,651,823	-7,284,435	-4,905,235	-1,556,288	-1,642,726
less: Divestments	120,500	14,858	5,300	0	**0**	**0**
Free operating cash flow	-349,516	-465,793	-9,016,209	-8,221,629	2,724,682	547,125
Net cash interest paid in Scope-adjusted EBITDA in HUF m						
Net cash interest per cash flow statement	-42,008	-31,112	-290,577	-921,995	-646,982	-646,982
Change in other items	0	0	0	0	0	0
Net cash interest paid	-42,008	-31,112	-290,577	-921,995	-646,982	-646,982
Scope-adjusted debt in Scope-adjusted EBITDA in HUF m						
Reported gross financial debt	2,734,617	4,599,185	13,898,980	21,566,083	21,566,053	21,566,053
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	2,734,617	4,599,185	13,898,980	21,566,083	21,566,053	21,566,053

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Environmental, social and governance (ESG) profile[1]

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)	Grey leaf
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)	Grey leaf
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)	Grey leaf
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	Grey leaf

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 the company's governance, we flag the fact that top management consists of the two brothers Zsolt and Ákos Czafik, who are 100% shareholders. The absence of an independent supervisory board increases the risk of overreaching to the detriment of creditors.

[1] 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

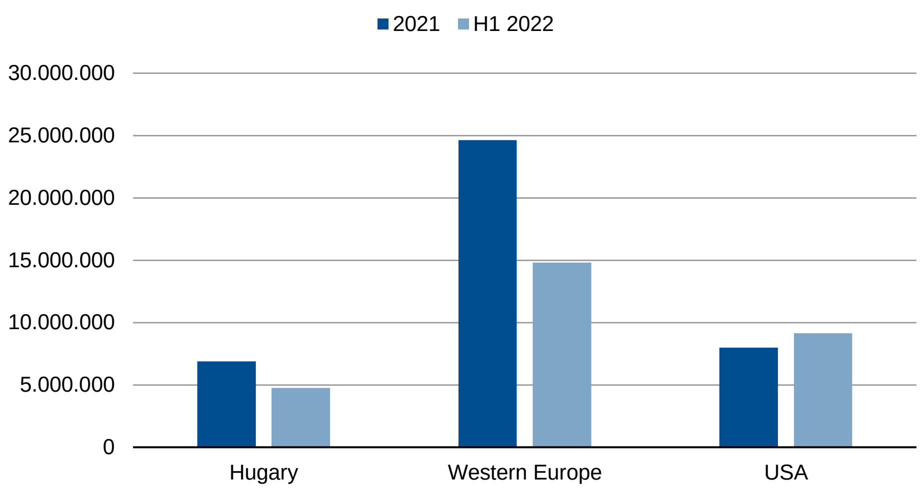
Industry risk profile: BB

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.

Still limited relative size despite increasing revenue

Despite the rapid revenue increase in recent years, the most limiting factors with regards to market position are the issuer's limited size (annual revenue of EUR 100m) compared to larger peers as well as weak pricing power, both towards suppliers and customers. Wellis' main comparative advantage is the relatively low prices of its products, as most of its OpEx is denominated in HUF, which has been subject to rapid depreciation in the past year. Additionally, the fact that the production facility is close to the core markets (Hungary and Western Europe) makes the fulfillment of orders quicker and cheaper compared to competitors with production based in East Asia.

Figure 1: Sales per region as of H1 2022



Sources: Wellis, Scope

High geographical diversification, but limited product mix

Geographical diversification is robust and expected to further improve in the short-to-medium term, with international customers currently accounting for 80% of revenue. In 2021, Wellis generated most if its revenue in the EU (+62% compared to FYE 2020, accounting for 63 % of 2021 revenue). The second largest and fastest growing in 2021 (+152% compared to FYE 2020) was the US. While the very granular international revenue diversification is clearly credit-positive, we flag the fact that there are substantial uncertainties regarding consumer confidence and purchasing power.

Wellis' product mix is heavily concentrated on spas, which generate about 80% of revenue. The remainder of revenue, related to sanitary products, is significantly correlated with spa sales as well.

Wellis' distribution network consists of own stores, exclusive and non-exclusive retail partnerships, DIY sales and online sales. It has a very diversified portfolio of sales channels with both direct and indirect sales, B2B, B2C and different kinds of retails outlets, depending on the situation in the relevant end-market.

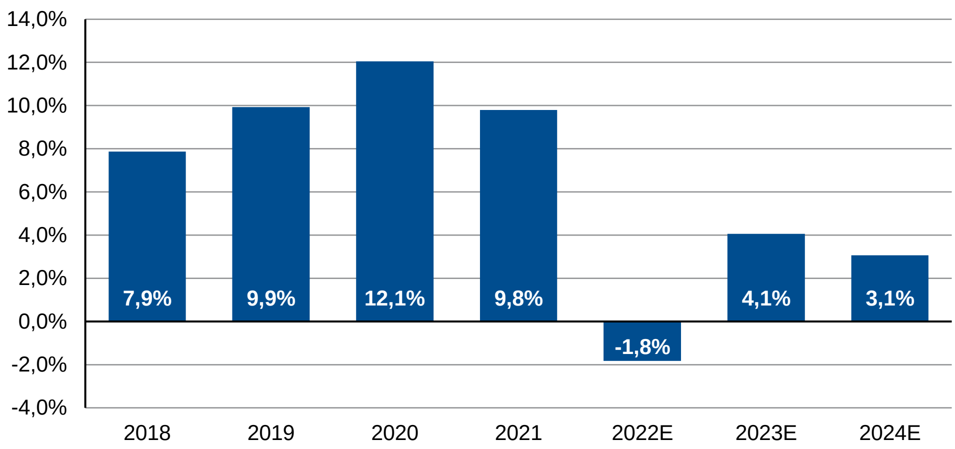
Operating profitability under pressure

Historically, operating profitability was in the range of 8-12%, fuelled by favourable economic conditions and excess demand generated by the Covid-19 pandemic lockdowns. EBITDA margins came under pressure post lockdown, as consumer confidence and purchasing power were negatively affected, parallelly to the increase in raw material costs and operating expenses. We expect 2022 FYE EBITDA to be negative at -1.8% and profitability to be more stressed than management's forecast.

From Q3 2022, Wellis implemented strict cost cutting measures in order to mitigate the increased pressure on margins. Wellis laid off 600 workers due to decreasing production in both the Dabas and Ozd facilties, while furter efforts were concentrated on reducing fixed costs such as logistics or security costs.

In the medium term, we expect the EBITDA margin to gradually improve as a result of the rationalisation, lower headcount and shrinking of raw material costs in 2023 as manufacturing will slow down and products are sold from the stocks. We expect EBITDA to turn positive in 2023 and 2024, but to stay significantly below historical levels until global demand recovers, which seems remote.

Figure 2: Scope-adjusted EBITDA margin



Sources: Wellis, Scope estimates

Limited brand strength

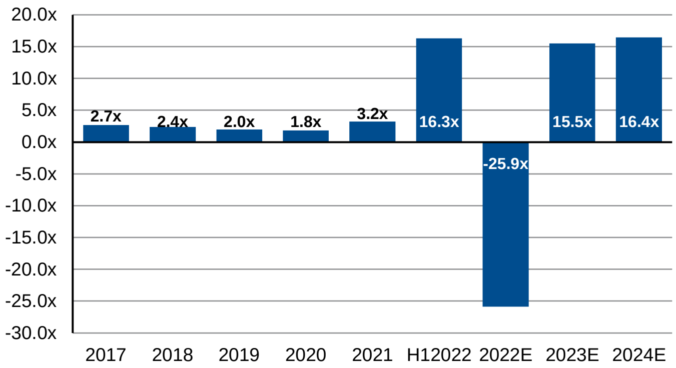
Wellis has limited brand strength as a result of its small relative size, young history and multi-brand strategy. Brand strength, however, is supported by the international scope of branded sales activities and the solid quality of the company's products.

Financial risk profile: B-

Swift deterioration in leverage

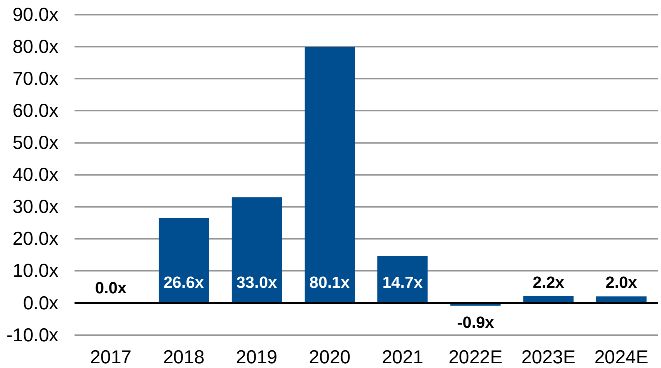
Wellis has seen its leverage deteriorate due to worsening operating profitability and increased indebtedness. Wellis sourced a new short-term working capital financing loan of EUR 10m maturing in 2023, increasing Scope-adjusted debt to HUF 21.5bn. In 2022, with operating profitability expected to turn negative and as the need for additional working capital arose, leverage is also expected to go negative. With profitability expected to remain moderate in the medium term and no amortisation of Scope-adjusted debt, Scope-adjusted debt/EBITDA is expected to remain above 10.0x in the medium term.

Figure 3: Scope-adjusted debt/EBITDA



Sources: Wellis, Scope estimates

Figure 4: Scope-adjusted interest cover



Sources: Wellis, Scope estimates

Interest cover expected to stabilise at around 2.0x

Thanks to historically low financial debt, the company has shown very comfortable cash interest coverage ratios of more than 20x in recent years. Following the HUF 9.9 bn bond issuance, this ratio decreased towards 14.0x and is likely to further deteriorate in the medium term due to the decline in profitability and increasing interest costs of the new working capital loans. Following the negative EBITDA expected for 2022, interest cover will land at around 2.0x in the medium term, assuming existing loans are renewed with unchanged interest rates.

Moderate but positive free operating cash flow in the medium term

On the one hand, the deteriorating EBITDA margin has a significant negative effect on cash flow. On the other, the fact that capex is expected to stabilise at a lower level (all the ongoing investments were finished till end-Q2 2022) and the company focuses on reducing inventory and decreasing working capital needs enables it to keep both funds from operations and free operating cash flow at a limited, positive level.

Inadequate liquidity

Liquidity is inadequate, as available liquid assets (HUF 595m of available cash at YE 2021) and negative free operating cash flow cannot cover the HUF 3bn short-term debt maturing in 2022, making the company highly dependent on external funding. Our base case assumes that the company will be able to find appropriate funding options by end 2022 as Wellis has already entered discussions with its banks.

Balance in HUF m	2021	2022E	2023E
Unrestricted cash (t-1)	843,589	586,798	182,089
Open committed credit lines (t-1)	0	0	0
Free operating cash flow	-9,016,209	-8,221,629	2,724,683
Short-term debt (t-1)	1,510,276	3,024,820	10,618,663
Coverage	**-5.4x**	**-2.5x**	**0.3x**

Long-term ratings

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 .

Scope highlights the fact that the senior unsecured bond issued by Wellis (ISIN: HU0000360250) includes a rating clause triggering repayment if the rating is not restored to at least B+ within two years.

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