Wellis Magyarország Zrt.
Hungary, Consumer Goods

SCOPE

STABLE

BB-

Corporate profile

Wellis is a European manufacturer of spas, pools and related wellness products based in Hungary, and 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. Management is currently focusing on expanding production capacities and the international distribution network.

Key metrics

		Scope estimates		
Scope credit ratios	2019	2020E	2021E	2022E
EBITDA/interest cover (x)	33.0x	16.0x	9.5x	11.6x
Scope-adjusted debt (SaD)/EBITDA	2.0x	1.7x	3.4x	2.6x
Scope-adjusted FFO/SaD	48%	54%	26%	34%
Free operating cash flow (FOCF)/SaD	-13%	-55%	-64%	16%

Rating action

Scope Ratings assigns a first-time corporate issuer rating of BB-/Stable on Hungary-based Wellis Magyarország Zrt. Senior unsecured debt is rated at BB-.

Rating rationale

Wellis' business risk profile is rated BB, consisting of a BB industry risk profile for durable consumer goods and a competitive position that is mainly supported by good diversification in terms of geographies, customers and suppliers. More than 75% of revenues are already generated internationally, outside Wellis' home market of Hungary, including a fast-growing share of revenues from exports to the USA. Both the single largest supplier and largest individual customer accounted for less than 7% of total revenue/costs in 2020, demonstrating a high degree of diversification.

The major constraints on Wellis' business risk profile include its limited absolute size (annual revenues of below EUR 50m), also compared to peers, and its single-digit historical operating profitability, which is below the sector average. We expect operating profitability to improve to a Scope-adjusted EBITDA margin of around 12% in our financial base case, incorporating substantial stresses to the company's business plan.

Wellis is heavily dependent on its core product, spas, which represents 80% of revenues. The company has only moderate brand strength, due to its multi-brand and multi-channel sales strategy as well as its limited size. On the other hand, these strategies serve Wellis well enough to address the different segments of the market efficiently.

Wellis' financial risk profile is rated BB-, mostly supported by robust interest coverage of more than 7.0x on a sustained basis and moderate financial leverage, which we expect to range between 2.0x and 3.5x Scope-adjusted debt (SaD)/Scope-adjusted EBITDA for the next two business years.

Ratings & Outlook

Corporate issuer rating	BB-/Stable
Senior unsecured debt	BB-

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Related Methodology

Corporate Rating Methodology
26 February 2020

Consumer Product Methodology
30 September 2020

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We highlight the execution risks arising from the planned bond placement as well as from the substantial increase in production capacity and envisaged further dynamic growth in the United States. These uncertainties could translate into elevated cash flow volatility, which we have incorporated into our assessment of financial risk for the time being.

Based on our assumption of a full placement of the new HUF 9bn senior unsecured bond in Q1 2020, Wellis will not have significant short-term financial debt going forward as most secured bank debts will be refinanced with the bond proceeds. In addition to its unrestricted cash position and expected positive operating cash flow from 2022 on, the company has an approx. HUF 1bn committed bank line at its disposal. We therefore deem the issuer's liquidity adequate, assuming the planned bond transaction is successful.

Outlook and rating-change drivers

The Stable Outlook reflects our expectation that Wellis will be able to successfully place the new HUF 9bn MNB bond while being able to increase sales and ramp up production at the new production facility in line with our financial base case. This should lead to financial leverage returning to less than 3.0x Scope-adjusted EBITDA after 2021.

A positive rating action may be warranted if SaD/EBITDA decreases towards 2.5x while showing positive free operating cash flows on a sustained basis.

A negative rating action may be warranted by financial leverage of more than 4.0x on a sustained basis. This could be triggered by weaker-than-expected sales growth and/or operational delays in the planned ramp-up of production capacity.

Rating drivers

Positive rating drivers	Negative rating drivers
• Leading market position in Hungary and growing market shares in Western Europe and the US • Positive sector fundamentals • Good diversification of customer and supplier base as well as geographical outreach	• Operates in competitive global markets • Execution/operational risks with regard to market entries, tariffs and new production site • Small absolute size • Current, partially debt-financed investment phase leading to volatile free operating cash flows in the near future

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Deleveraging towards SaD/EBITDA of 2.5x with positive free operating cash flows on a sustained basis	• Increase in financial leverage to more than 4.0x on a sustained basis

Financial overview

		Scope estimates		
Scope credit ratios	**2019**	**2020E**	**2021E**	**2022E**
EBITDA/interest cover (x)	33.0x	16.0x	9.5x	11.6x
SaD/EBITDA	2.0x	1.7x	3.4x	2.6x
Scope-adjusted FFO/SaD	48%	54%	26%	34%
FOCF/SaD	-13%	-55%	-64%	16%
Scope-adjusted EBITDA in HUF '000	**2019**	**2020E**	**2021E**	**2022E**
Income from operations (EBIT)	1,107,080	1,740,689	2,654,558	2,553,881
Add: depreciation	278,900	288,864	482,107	893,925
other	0	0	0	0
Scope-adjusted EBITDA	**1,385,980**	**2,029,553**	**3,136,665**	**3,447,806**
Scope-adjusted funds from operations in HUF '000	**2019**	**2020E**	**2021E**	**2022E**
Scope-adjusted EBITDA	1,385,980	2,029,553	3,136,665	3,447,806
Less: (net) cash interest per cash flow statement	-42,008.3	-127,039	-331,039	-298,039
Less: cash tax paid per cash flow statement	-30,474.0	-55,790	-69,706	-67,675
Less: other items	0	0	0	0
Scope-adjusted funds from operations	**1,313,498**	**1,846,725**	**2,735,921**	**3,082,093**
Scope-adjusted debt in HUF '000	**2019**	**2020E**	**2021E**	**2022E**
Reported gross financial debt	2,734,617	4,234,617	11,034,617	9,934,617
Less: cash, cash equivalents	-18,606	-814,321	-467,512	-965,374
Add: other items	0	0	0	0
Scope-adjusted debt	**2,716,011**	**3,420,295**	**10,567,104**	**8,969,242**
Liquidity ratios	**2019**	**2020E**	**2021E**	**2022E**
Liquidity (internal + external)	-0.1x	-0.7x	-1.4x	1.0x
Liquidity (internal)	0.4x	-0.3x	-1.2x	1.5x

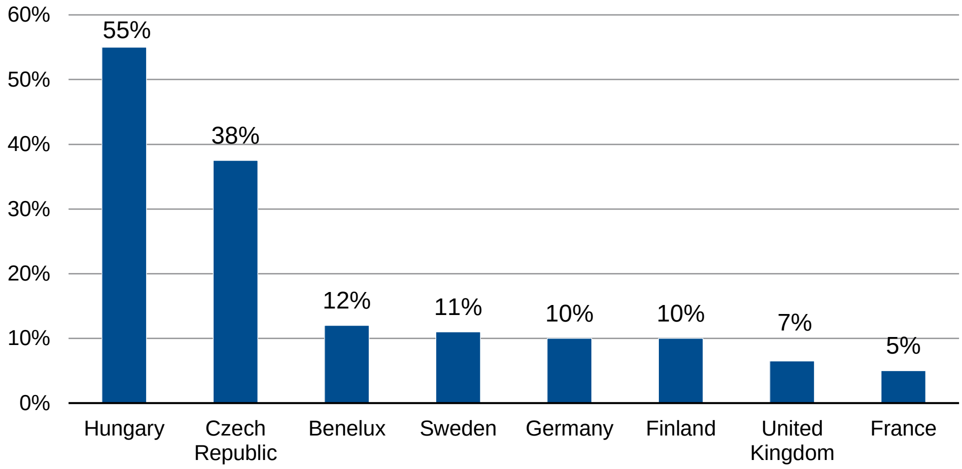
Business risk profile

We have assigned a BB industry risk profile rating. This reflects the industry risk of the durable consumer goods industry, determined by entry barriers, cyclicality and substitution risk.

BB industry risk as manufacturer of durable consumer goods

The picture regarding Wellis' market position is mixed. On the credit-positive side, the company holds a dominant market position in Hungary and a strong market position in the Czech Republic. Internationally, Wellis has average market shares of around 10%-15% in its 10 most relevant markets. The most important limiting factors with regard to market position are the company's small absolute size (annual revenues of EUR 40-50m) compared to peers as well as its relatively weak pricing power with respect to both suppliers and customers.

Figure 1: Market shares – top eight countries (2020)



Source: Company

Robust international diversification of revenue

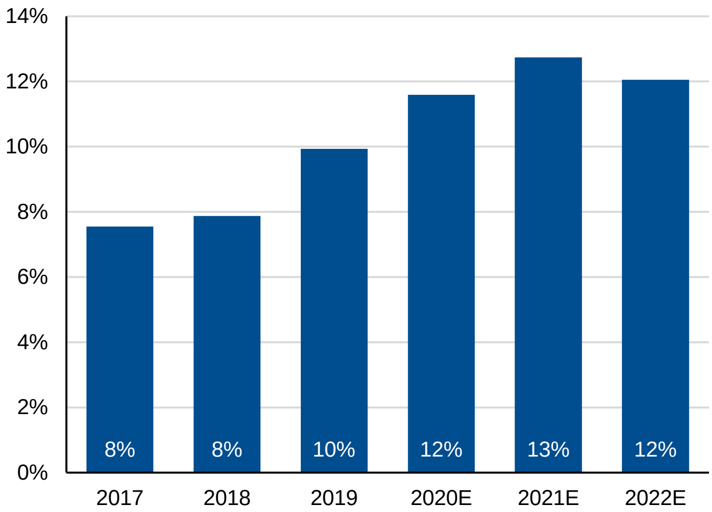
Concerning diversification, Wellis benefits from a relatively diversified client base, mostly thanks to its retail-focussed product portfolio, multi-track/multi-brand product strategy and wide geographical outreach. With international customers accounting for 77% of revenues, geographical diversification is robust. We expect it to improve further in the short to medium term, thanks to fast-growing sales in the United States. Wellis has a medium exposure to its home market of Hungary, which accounts for around 23% of sales. However, the fact that it is the clear leader in this market is a risk mitigant in our view.

Very granular international revenue diversification is clearly credit positive. At the same time, substantial uncertainties regarding trade tensions/tariffs between a large number of countries/regions including the EU/UK, the USA/China, and the EU/USA could impact the attractiveness of certain end-markets.

Diversified customer base

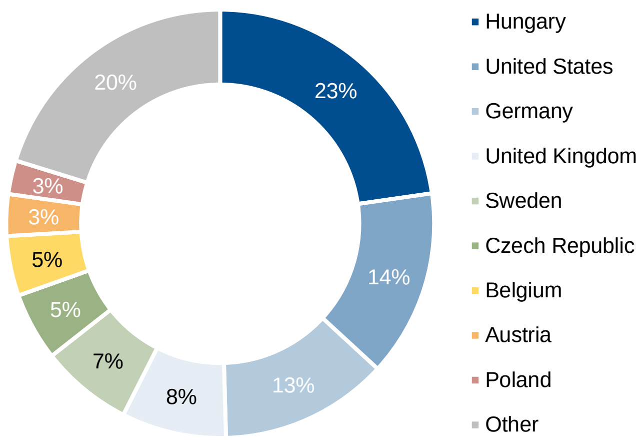
Wellis' ultimate number of end-customers is very high, due to a large share of B2C/residential use. Moreover, there is no material dependency on single suppliers thanks to a broad mix of Asian, European and other global suppliers. The single largest supplier accounted for less than 6% of supplier costs as of 9M 2020. In addition, we believe there is very limited dependency on certain suppliers because all parts needed are on offer from many producers in fairly competitive markets. The main parts needed include plastics, pumps, electrical parts, and electronic parts. We also highlight the good international availability of these products and the already-high geographical diversification of Wellis' current supplier mix.

Figure 2: Scope-adjusted EBITDA margin



Source: Scope

Figure 3: Geographical diversification (revenue 9M 2020)



Source: Company

Wellis' product mix is heavily concentrated on one product, spas, which generate around 80% of revenues. We believe that the remainder of revenues is significantly correlated with spa sales as well. In terms of quality and price alternatives, the company offers a wide range of products and brands catering to different price categories.

Highly diversified distribution mix

The company's distribution network consists of its own stores, exclusive and non-exclusive retailing partnerships, DIY sales as well as (recently established) online sales. It has a very diversified portfolio of sales channels with both direct and indirect sales, B2B and B2C, and different kinds of retail outlets used, depending on the situation in the respective end-market.

Low product diversification

Operating profitability has been below the sector average in recent years, with single-digit Scope-adjusted EBITDA margins, which was also due to significant business expansion in this period. We expect Scope-adjusted EBITDA margins of 12%-13% in our financial base case going forward. The forecasted operating profitability in our financial base case is about one-fourth lower than the 15%-17% EBITDA margin forecasted by Wellis. This is due to several adjustments we have made, resulting in lower revenue and higher cost assumptions. These adjustments were made, despite the company's high revenue growth, due to: i) weaker historical margins; and ii) operational and execution risks associated with the current rapid expansion.

Below-average operating profitability in the past – improvement expected

Wellis has limited brand strength as a result of its small size, young history and multi-brand strategy. Brand strength is, however, supported by the international scope of branded sales activities as well as the solid quality of the company's products. All in all, brand strength is neutral for Wellis' business risk profile.

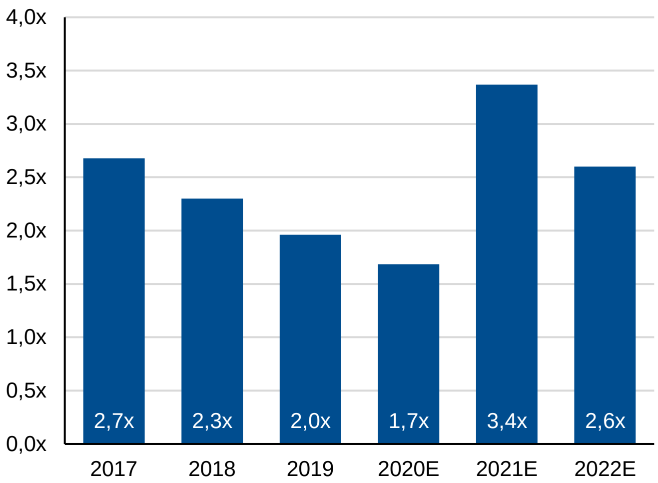
Financial risk profile

Wellis' financial risk profile, rated BB-, is the weaker part of the overall issuer rating.

Financial leverage expected to spike temporarily in 2021

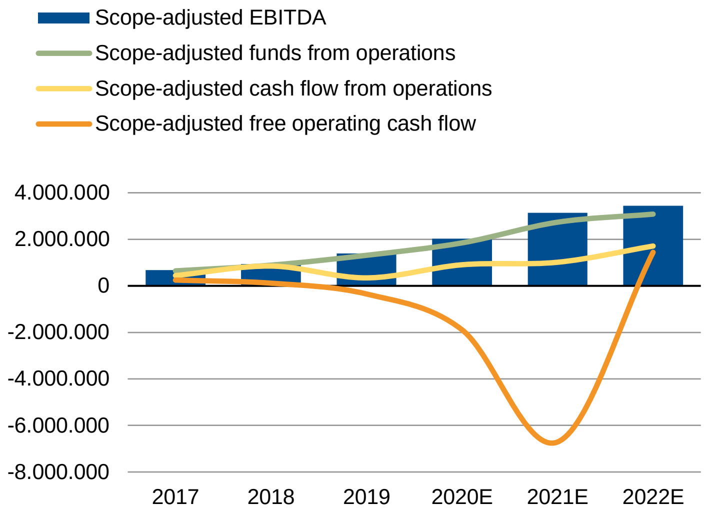
Financial leverage has been moderate in recent years, despite strong revenue growth funded primarily via internal cash generation. For 2021, we expect a temporary spike in leverage to more than 3.0x, driven by the partially debt-funded investment programme, with a gradual reduction of financial leverage towards 2.5x in the following years.

Figure 4: Scope-adjusted leverage



Source: Scope estimates

Figure 5: Cash flow overview



Source: Scope estimates

Thanks to little financial debt in the past, Wellis has had very comfortable cash interest coverage ratios of more than 20x in recent years. We expect this ratio to decline towards 10x due to the planned HUF 9bn in new financial debt after the bond placement, which will be partially used for refinancing.

Double-digit cash interest coverage expected to be sustained

Negative free operating cash flows due to investment programme

We expect Wellis' strong EBITDA growth to continue. At the same time, free operating cash flows have become increasingly volatile, driven mostly by the large capex programme for the building of a new production facility in Ozd, Hungary with a total volume of around HUF 8.5bn. Once this investment is completed, we expect a return to fairly stable positive free operating cash flows starting in 2022. Until these substantial investments have taken place and bear fruit as expected, however, Wellis' financial risk profile will remain commensurate with the lower BB category.

Adequate liquidity, also thanks to HUF 1bn credit line

Based on our assumption of a full placement of the new HUF 9bn senior unsecured bond in Q1 2020, Wellis will not have significant short-term financial debt going forward as nearly all 'old' secured bank debts will be refinanced with the bond proceeds. In addition to its unrestricted cash position and expected positive operating cash flow from 2022 on, the company has an approx. HUF 1bn committed bank line at its disposal. We therefore deem the issuer's liquidity adequate, assuming the planned bond transaction is successful.

Supplementary rating drivers

We have not made any explicit rating adjustment due to supplementary rating drivers.

Senior unsecured rating

Wellis plans to issue a HUF 9bn senior unsecured bond under the MNB Bond Funding for Growth Scheme with a 10-year tenor, 10% annual amortisation in 2026-2030 and a remaining 50% bullet repayment in 2031. We assumed a fixed coupon, payable annually, in our financial forecast. The bond proceeds are earmarked for the refinancing of current financial secured bank debt totalling HUF 3.1bn, capex of HUF 4.4bn for the new production facility in Ózd and HUF 1.5bn to finance working capital expansion.

Average expected recovery leads to BB- senior unsecured rating

Based on our recovery analysis, which assumes the successful placement of the new HUF 9bn bond and a hypothetical default scenario in 2022, we expect an 'average recovery' for future senior unsecured debtholders. This translates into a BB- instrument rating for senior unsecured debt.

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