8 November 2022 Corporates

Éltex Kft.
Hungary, Business Services

BB- STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	21x	21x	8x	9x
Scope-adjusted debt/EBITDA	4.2x	1.4x	1.9x	1.7x
Scope-adjusted funds from operations/debt	29%	76%	51%	60%
Scope-adjusted free operating cash flow/debt	-4%	44%	-10%	23%

Rating rationale

The ratings are supported by Éltex's low leverage and its very strong debt protection. Its position among the top three in waste management in Hungary also supports the ratings.

The main rating constraints relate to the low diversification by geographies and activities and the relatively low profitability.

Outlook and rating-change drivers

The Stable Outlook incorporates our view that i) key credit metrics over the next three years will improve with Scope-adjusted debt/EBITDA at 1.0x-2.0x and debt protection remaining above 7x; and ii) Éltex will remain top three in waste management in Hungary.

A positive rating action could occur if Scope-adjusted debt/EBITDA were sustained below 1.0x, e.g. due to significantly stronger operating results and/or lower capex than expected. A positive rating action could also be warranted if the company's business risks were to be reduced while the financial risk profile remained stable. This could be achieved through significant growth in overall outreach and diversification.

The rating could come under pressure if leverage deteriorated to close to 3x on a consistent basis, e.g. as a result of higher capital expenditures, material debt-financed M&A activities and/or lower-than-expected operating results.

Rating history

Date	Rating action	Issuer rating & Outlook
8 Nov 2022	Upgrade	BB-/Stable
10 Nov 2021	Outlook change	B+/Positive
20 Oct 2020	New	B+/Stable

Ratings & Outlook

Issuer	BB-/Stable
Senior unsecured debt	BB-

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Related Methodology

Corporate Rating Methodology; July 2022

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Low leverage, also expected for the foreseeable future • Strong EBITDA interest cover of more than 7x for the foreseeable future • Increasing need for recycling, especially of industrial waste • Relatively high entry barriers • A leading waste management company in Hungary with a business model focusing on circular economies and resource efficiencies (credit-positive ESG factor) • Medium and long-term contracts with high likelihood of renewal • Globally well-known groups as clients • No use of landfill (credit-positive ESG factor)	• No activity diversification • Low geographical diversification • Relatively low Scope-adjusted EBITDA margin • Some market turbulence, even if it has not negatively impacted Éltex • Large exposure to industrial waste collection/recycling, which provides market potential but tends to be more volatile than municipal waste collection • Environmental risk regarding hazardous waste (credit-negative ESG factor)

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted debt/EBITDA sustained below 1.0x • Reduced business risks via significant growth of overall outreach and diversification	• Scope-adjusted debt/EBITDA close to 3.0x on a consistent basis

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 and complex waste-handling, hazardous and non-hazardous waste recycling, the transport and disposal of confidential documents, plastic manufacturing 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 an on-site waste handling area to house equipment and serve as storage.

The company is owned by Zoltan Vass (15% direct ownership), Péter Vermes (15% indirect ownership via PU&I 2019 Vagyonkezelo Kft, a wealth management company owned solely by Mr Vermes), Figura Ferenc (14% indirect ownership via Global Refuse Holding Zrt.) and Equilor PE fund (56% indirect ownership via Global Refuse Holding Zrt.).

Financial overview

			Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	21x	21x	8x	9x	10x
Scope-adjusted debt/EBITDA	4.2x	1.4x	1.9x	1.7x	1.3x
Scope-adjusted funds from operations/debt	29%	76%	51%	60%	76%
Scope-adjusted free operating cash flow/debt	-4%	44%	-10%	23%	31%
Liquidity (internal and external)	>100%	>200%	>200%	>200%	>200%
Scope-adjusted EBITDA in HUF m					
EBITDA	872	2,360	1,733	2,052	2,244
Operating lease payments in respective year	54	71	71	71	71
Disposal gains (losses) on fixed assets	5	25	0	0	0
Scope-adjusted EBITDA	**931**	**2,456**	**1,805**	**2,124**	**2,316**
Scope-adjusted funds from operations in HUF m					
EBITDA	872	2,360	1,733	2,052	2,244
less: (net) cash interest paid	-37	-108	-219	-219	-219
less: cash tax paid as per cash flow statement	-20	-37	-38	-45	-49
add: depreciation component of operating leases	47	63	63	63	63
Other changes	265	379	250	250	250
Funds from operations (FFO)	**1,128**	**2,658**	**1,789**	**2,101**	**2,289**
Free operating cash flow in HUF m					
Funds from operations	1,128	2,658	1,789	2,101	2,289
Change in working capital	-977	278	-748	-322	-272
Non-operating cash flow	0	0	0	0	0
less: capital expenditure (net)	-324	-1,407	-1,400	-960	-1,080
add: disposal gains (losses) on fixed assets	5	25	0	0	0
Free operating cash flow (FOCF)	**-168**	**1,555**	**-360**	**819**	**936**
Net cash interest paid in HUF m					
Net cash interest per cash flow statement	37	108	219	219	219
add: interest component, operating leases	6	8	9	9	9
Net cash interest paid	**44**	**116**	**228**	**228**	**228**
Scope-adjusted debt in HUF m					
Reported gross financial debt	3,789	3,279	3,279	3,279	2,789
less: cash and cash equivalents	-	-	-	-	-
add: cash not accessible	-	-	-	-	-
add: operating lease obligations	142	178	178	178	178
add: asset retirement obligations	9	62	62	62	62
Scope-adjusted debt (SaD)	**3,939**	**3,518**	**3,518**	**3,518**	**3,028**

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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)	Green leaf	Clients and supply chain (geographical/product diversification)		Corporate structure (complexity)	Grey leaf
Physical risks (e.g. business/asset vulnerability, diversification)	Red leaf	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 strategy

Éltex's work in waste management has direct ESG impacts. Indeed, the company aims to return waste to the circular economy and create resource efficiencies through the addition of value-adding treatment processes. It acquires waste from the cleanest sources, which are production lines. Handling all recyclable materials on-site is beneficial both environmentally and economically. Éltex also has a zero-landfill policy (credit-positive ESG factor).

Nevertheless, as hazardous waste recycling accounts for less than 10% of total sales on average, Éltex is somewhat exposed to this kind of environmental risk (credit-negative ESG factor).

[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+

Éltex's business risk profile (assessed at B+) is supported by its market position in Hungary but constrained by its profitability and diversification.

Competitive market…

Most markets for environmental services are very competitive due to increasing technological challenges as regulation changes as well as through 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 (e.g. a fleet of trucks, facilities). This raises barriers to entry for new competitors. 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 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 (e.g. home composting).
- By 2025: recycling of 55% of municipal waste and 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 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; municipal waste landfill reduced to 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 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. or NHKV) has been coordinating and overseeing the delivery of waste services at the local level since 2016. NHKV distributes waste fees to the relevant operators, sells recyclable materials, and supervises infrastructure spending and the use of EU funds.

Industrial waste management is performed by private-sector companies such as Éltex.

The Hungarian government's 2019 priorities were as follows:

- Gradually increase landfill taxes to phase out landfilling of recyclable and recoverable waste and use the revenues for measures that improve waste management, in line with the waste hierarchy
- Focus on implementing a separate collection obligation to increase recycling rates, including the 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

Besides this, Éltex confirmed that the government will support the circular economy for at least the next five years. The government will also put a greater emphasis on recycling waste for industrial production.

… should benefit Éltex's business

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

Éltex holds required permits

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

Permits are also required for the trading, treatment, transport, manufacturing, recycling and recovery of both non-hazardous and hazardous waste. They are also required for the operation of waste treatment plants for each location.

Each plant owned or rented by Éltex has a site permit, a waste-handling permit and a recycling permit. Éltex's health and safety executive team ensures permits are regularly renewed.

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

Those permits give Éltex a competitive advantage.

Large need for recycling in Europe

In 2020, European firms and households generated 2.2bn tonnes of waste, of which only half was recycled. In Europe, 90% of waste is industrial waste and the remainder is municipal waste. In Hungary 70% of waste is industrial. Thus, demand for recycling in Europe is high, 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 until 2019. The global waste market has collapsed and recycling costs have rocketed, leading to falling profitability and continued loss-making for most companies.

…has not negatively impacted Éltex

Éltex deals not with unsorted municipal waste but mostly with mixed/unsorted waste (such as paper and foil) from manufacturing companies 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 PET and pure cardboard waste. At the same time, prices for municipal mixed-waste types have not only dropped but turned into costs. Nevertheless, this development has not affected Éltex's business as it 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. 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 for less than 10% of total sales on average, Éltex is somewhat exposed to this kind of environmental risk (credit-negative ESG factor). Nevertheless, we note that Éltex does not use landfill as a solution (credit-positive ESG factor). Éltex indicates that it has insurance covering any environmental risk that may arise from operations.

One of the leaders in Hungary in terms of revenues

According to Éltex, its main competitors in Hungary are Alcufer Kft (which focuses on metal waste), 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 among the top three for at least the last four years. Éltex considers itself a regional, leading, medium-size company and is the market leader in terms of volume of treated waste. Compared to the world leader, however, Éltex remains fairly small.

Capex used to increase capacity and efficiency

Éltex has several major projects aimed at increasing both capacity and efficiency. The company has other minor investments in the pipeline, which aim at gaining new partners as well as better serving and ensuring strong long-term relationships with current partners.

Well-known clients with some concentration risk

Éltex's top five clients account for two-thirds of net revenues. This concentration risk is mitigated by its medium/long-term partnerships (between five and 15 years) with well-known international groups. These include P&G, Bosch, Samsung, Henkel and Continental, 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.

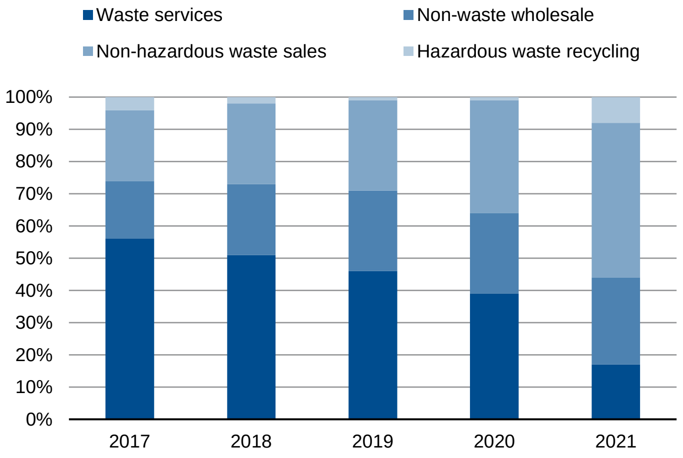
Revenues and EBITDA only related to recycling and secondary raw material

We do not consider Éltex's revenues and EBITDA to be diversified in terms of sources. Indeed, all of its revenues come from recycling and secondary raw material (including in non-waste wholesale). Nevertheless, it is worth noting the good diversification of the services it provides.

Somewhat low geographical diversification

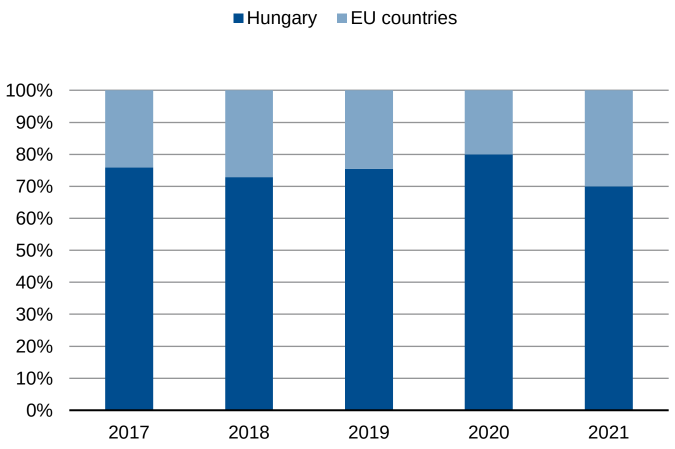
Regarding geographical diversification, more than 70% of net revenues and EBITDA on average is generated in Hungary. The remainder is generated within Europe. Nevertheless, Éltex has business relationships in more than 20 countries.

Figure 1: Revenue breakdown per segment (%)



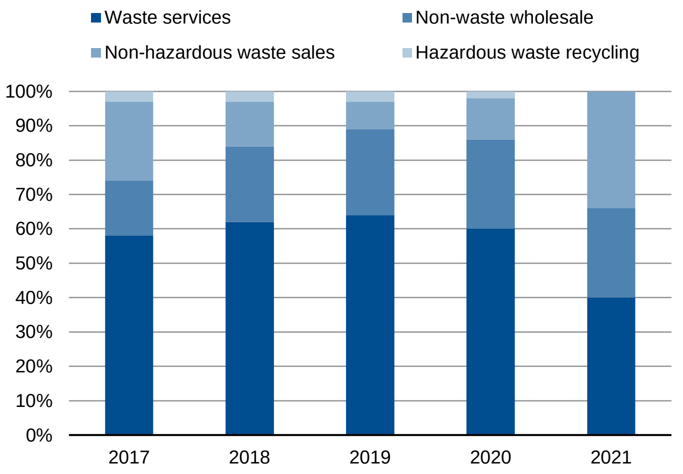
Source: Éltex, Scope

Figure 2: Geographical revenue breakdown (%)



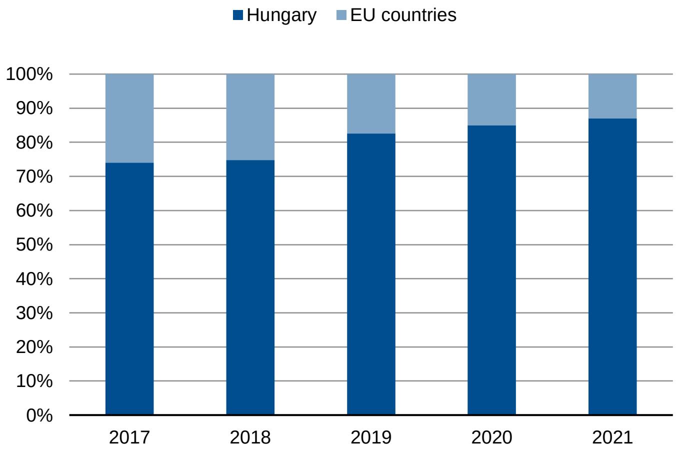
Source: Éltex, Scope

Figure 3: EBITDA breakdown per segment (%)



Source: Éltex, Scope

Figure 4: Geographical EBITDA breakdown (%)



Source: Éltex, Scope

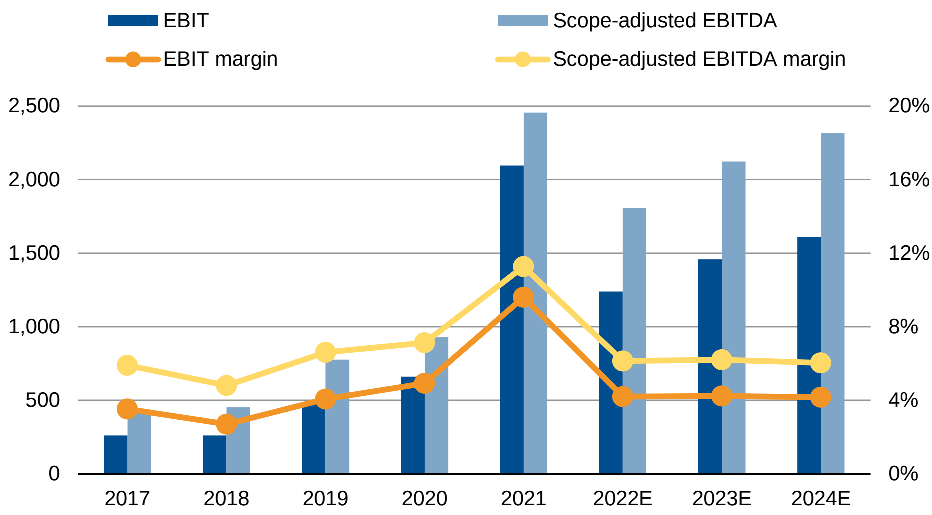
Low profitability

Éltex has a low Scope-adjusted EBITDA margin, especially compared to rated peers. Performance also fluctuated from 4.5% to 11.5% between 2017 and 2021. Waste services is the biggest contributor to EBITDA followed by non-waste wholesale (products sold after the recycling of waste and the sale of detergent).

Margin profile expected to erode

We expect Eltex's EBITDA margin to decrease to 6.0%-6.5%, due to the higher expected cost of materials and despite major investment projects to increase capacity and improve efficiency.

Figure 5: EBIT and adjusted EBITDA in HUF m and their respective margins

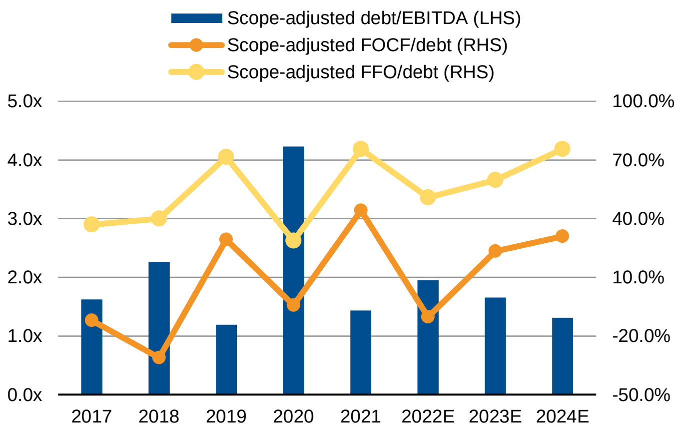


Source: Éltex, Scope estimates

Financial risk profile: BBB-

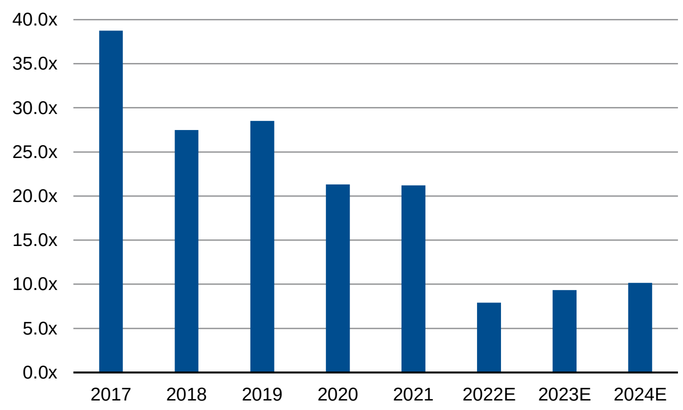
Éltex's financial risk profile (assessed at BBB-) is expected to improve and supports the overall issuer rating. We expect Éltex's financial leverage ratio (Scope-adjusted debt/EBITDA) to remain between 1.0x-2.0x over the next few years thanks to a significant increase in operating results as well as the repartitioning over 2020-22 of capex initially planned for 2020. We expect its interest cover ratio to remain above 7x.

Figure 6: Scope-adjusted leverage and cash flow cover



Source: Éltex, Scope estimates

Figure 7: EBITDA interest coverage



Source: Éltex, Scope estimates

Rating reflects improvement in leverage

In previous years, Éltex recorded very good Scope-adjusted debt/EBITDA ratios, ranging from 1x to 2.5x. Scope-adjusted debt/EBITDA deteriorated in 2020 following the issue in late December of the bond under the Hungarian National Bank programme before reverting to 1.4x in 2021. We did not subtract cash and equivalents from financial debt as these are not deemed to be permanent. We expect leverage to range between 1.0x and 2.0x for the coming years, thanks to the repartitioning of capex, the new contracts signed and the higher demand for recycled material that will translate into higher income.

The Scope-adjusted funds from operations/debt ratio has historically been above 25%. We expect it to remain above that threshold in the coming years.

Strong interest coverage

Éltex's debt protection – as measured by Scope-adjusted EBITDA/interest – has been above 20x. We expect it to fall below this threshold in the next few years, due to the surge in the short-term interest rate in Hungary resulting in lower forecasted interest payments, but to remain higher than 7x.

Weak cash flow coverage

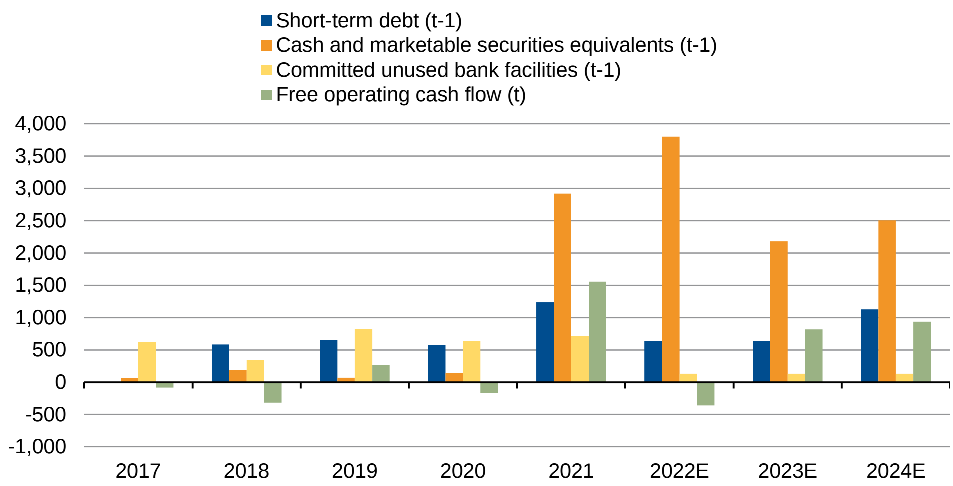
Cash flow cover – as measured by Scope-adjusted free operating cash flow (FOCF)/debt – moves between negative and positive due to the fluctuation in FOCF. The variation is mainly influenced by capex.

Adequate liquidity position

Liquidity is adequate, backed by committed credit lines of HUF 130m and a large cash buffer of HUF 3.8bn (as of 31 December 2021), mostly from the bond issue in December 2020. Éltex has to repay HUF 0.6bn in 2022. We expect Éltex to repay HUF 0.6bn in 2023 and HUF 1.1bn in 2024. We expect negative FOCF in 2022, as a result of higher capex resulting from its major investment projects along with negative working capital variations.

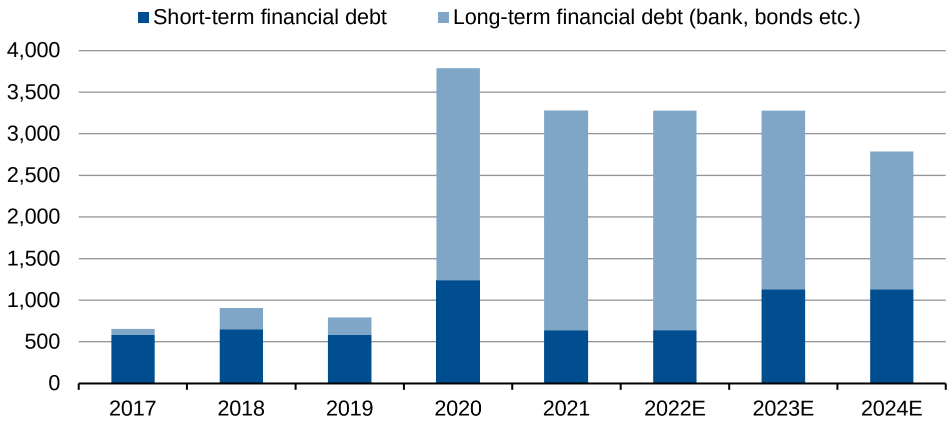
Short-term debt obligations will likely be fully covered by available sources in 2022, 2023 and 2024 (liquidity ratios will be higher than 200%), mainly thanks to the cash generated during the previous periods.

Figure 8: Short-term debt repayment amount, available cash and FOCF (in HUF m)



Source: Éltex, Scope estimates

Figure 9: Financial debt (in HUF m)



Source: Éltex, Scope estimates

Balance in HUF m	2022E	2023E	2024E
Unrestricted cash (t-1)	3,802	2,180	2,505
Open committed credit lines (t-1)	130	130	130
Free operating cash flow (t)	-360	819	936
Short-term debt (t-1)	639	639	1,129
Coverage	**>200%**	**>200%**	**>200%**

Supplementary rating drivers: +/- 0 notch

Conservative dividend policy

The dividend payout has been between 0% and 25% of net income in recent years, except in 2022 when there was an exceptional dividend payment of HUF 1.2bn. This higher payment followed the change in the shareholders and was justified by the higher-than-expected operating results. In our rating case, we expect a payout ratio of 35%, the maximum allowed in the bond prospectus. We believe this dividend policy strikes a fair balance between shareholder and creditor interests.

Limited concerns 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 Zoltan Vass (CEO), Péter Vermes (managing director) and Ferenc Figura (managing director).

We have limited concerns related to Éltex's governance. The company's governance also benefits from an experienced and committed top management.

Long-term rating

BB- rating for senior unsecured debt

We expect an 'above-average' recovery for senior unsecured debt, such as the HUF 2.45bn bond issued under the Hungarian National Bank programme. Despite the above-average recovery rate, we have refrained from granting a rating uplift to senior unsecured debt. This is because the recovery assessment is highly sensitive to the applied advance rates, especially on tangible assets. As such, Éltex needs to execute on its investments before we would consider a rating uplift. Thus, this recovery expectation translates into a BB- rating for the senior unsecured debt category, in line with the issuer rating. Our recovery expectations are based on an anticipated liquidation value in a hypothetical default scenario at the end of 2024. Short-term and long-term debt (excluding the bond issue) raised from financial institutions, undrawn committed medium- and long-term facilities as well as payables rank higher than senior unsecured debt in terms of repayment.

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