7 July 2022

Corporates

Hell Energy Magyarország Kft. Hungary, Consumer Products

B+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	10.9x	18.3x	5.7x	6.2x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	2.8x	6.1x	5.8x	5.5x
Funds from operations/SaD	31%	16%	14%	15%
Free operating cash flow (FOCF)/SaD	8%	-17%	-43%	-9%

Rating rationale

Hell Energy's ratings are supported by its strong market position as the market leader in its product segment in ten countries. Revenues are somewhat concentrated in the Hungarian and central, eastern and southeastern European (CEE/SEE) markets and are limited to the non-alcoholic beverage product segment.

The company exhibits high diversification in terms of geographies (over 50 countries), customers, suppliers and new product launches (Energy Coffee) that have been well received by the market. The company benefits from a high degree of vertical integration that decreases capacity constraints and revenue volatility and helps preserve margins.

Hell Energy has a good track record of robust Scope-adjusted EBITDA margins in the range of 15%-20%. Its production site is modern and highly automated. This provides a low cost base, which enables strong operating cash flow generation.

Rapid expansion has led to high dependence on external financing and investment subsidies in recent years and a doubling of gross debt. This has resulted in negative FOCF/SaD, which is detrimental to the rating.

High debt-funded capex without fresh equity and related increase in working capital significantly increased leverage to around 6x. A similar development occurred following the first large can manufacturing line investment in 2015-17.

Outlook and rating-change drivers

The rating Outlook is Stable based on expected SaD/EBITDA staying around 6x until YE 2022, with deleveraging below 4.5x from 2024 at the earliest due to the ongoing large-scale investment programme.

A positive rating action could be warranted if the issuer showed financial leverage, measured by SaD/EBITDA, of less than 4.0x on a sustained basis.

We would consider a negative rating action if financial leverage deteriorated to above 6.0x on a sustained basis, if FOCF/SaD stayed negative beyond 2023, or if the liquidity ratio fell below 1.0x as a result of higher working capital, or a shortfall in subsidies.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
7 Jul 2022	Affirmation	B+/Stable
13 Jul 2021	Downgrade	B+/Stable
30 Oct 2020	Rating unchanged	BB/Stable
31 Oct 2019	Initial Rating	BB/Stable

Ratings & Outlook

Issuer	B+/Stable
Senior unsecured debt	B+

Lead Analyst

Barna Gáspár
+49 30 278913 25
b.gaspar@scoperatings.com

Related Methodologies

Corporate Rating Methodology; July 2021

Rating Methodology: Consumer Goods; September 2021

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

Positive rating drivers	Negative rating drivers
• High diversification in terms of geographies (over 50 countries), customers and suppliers; and new product launches (Energy Coffee) that have been well received by the market • Robust Scope-adjusted EBITDA margins of 15%-20% • Strong market position as the current market leader in its product segment in ten countries • High degree of vertical integration decreases capacity constraints and revenue volatility	• High exposure to the Hungarian and CEE/SEE market that is limited to the beverage product segment • Negative free cash flows and dependence on external financing in recent years due to rapid expansion and an increase in receivables • Risks associated with changing customer demands and punitive regulation on sugared and/or caffeinated beverages • Large debt-funded capex without fresh equity and an increase in working capital will significantly boost leverage for the next 3-4 years, as with the large can manufacturing line investment in 2015-17

Positive rating-change drivers	Negative rating-change drivers
• Leverage measured by SaD/EBITDA below 4x on a sustained basis	• Leverage measured by SaD/EBITDA above 6x on a sustained basis, triggered by cost overruns, delays in the investment timeline, a smaller subsidy or failure to increase revenues in line with installing new production lines • Negative FOCF/SaD beyond 2023 • Liquidity ratio below 1.0x, induced by increased working capital or a subsidy shortfall

Corporate profile

Established in 2004, the Hell Group (Hell Energy Magyarország Kft. and its fully owned and consolidated subsidiaries) is a Hungarian family-owned company. The Barabás family owns the Hell Group through holding companies. The Hell energy drink is currently the third largest branded energy drink at the global level.

The group is vertically integrated with its own can production and filling lines on-site in Szikszó, Hungary with all production under one roof. Hell Energy is present on over 50 foreign markets, of which it is the market leader in ten countries, mainly in CEE and CSE (Hungary, Romania, Bulgaria, Slovakia, Greece etc).

Yearly production in 2021 exceeded 1.1bn cans under the Hell, XIXO and Swiss Laboratory brands, private label and can sales.

The Hell Group is going through an intensive expansion phase and has initiated investments to increase filling and can production to 2.7bn cans effective capacity annually.

Financial overview

			Scope estimates		
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	10.9x	18.3x	5.7x	6.2x	7.2x
SaD/Scope-adjusted EBITDA	2.8x	6.1x	5.8x	5.5x	4.5x
Funds from operations/SaD	31%	16%	14%	15%	19%
FOCF/SaD	8%	-17%	-43%	-9%	2%
Scope-adjusted EBITDA in HUF '000s					
EBITDA	13,627,921	17,115,000	18,111,988	21,305,411	24,350,878
Other items					
Scope-adjusted EBITDA	13,627,921	17,115,000	18,111,988	21,305,411	24,350,878
Funds from operations in HUF '000s					
Scope-adjusted EBITDA	13,627,921	17,115,000	18,111,988	21,305,411	24,350,878
less: (net) cash interest paid	-1,246,634	-934,000	-3,195,698	-3,416,173	-3,380,383
less: cash tax paid per cash flow statement	-59,338	-56,000	-207,823	-251,402	-324,637
Change in provisions	-171,392	29,387	0	0	0
Funds from operations	12,150,557	16,154,387	14,708,467	17,637,836	20,645,857
Free operating cash flow in HUF '000s					
Funds from operations	12,150,557	16,154,387	14,708,467	17,637,836	20,645,857
Change in working capital	-2,067,232	-10,012,837	-16,434,820	-7,841,450	-8,787,717
Non-operating cash flow	323,754	5,155,290	2,967,994	255,402	602,998
less: capital expenditure (net)	-7,305,165	-28,955,016	-46,382,403	-20,287,936	-10,149,252
Free operating cash flow	3,101,913	-17,658,176	-45,140,762	-10,236,149	2,311,886
Net cash interest paid in HUF '000s					
Net cash interest per cash flow statement	-1,246,634	-934,000	-3,195,698	-3,416,173	-3,380,383
Net cash interest paid	-1,246,634	-934,000	-3,195,698	-3,416,173	-3,380,383
Scope-adjusted debt in HUF '000s					
Reported gross financial debt	51,646,196	114,438,000	114,104,302	120,423,300	118,991,695
less: cash and cash equivalents	-13,042,181	-56,781,000	-10,039,135	-4,262,118	-11,401,688
add: non-accessible cash		45,000,000			
Other items		1,000,000	1,000,000	1,000,000	1,000,000
Scope-adjusted debt	38,604,015	103,657,000	105,065,167	117,161,182	108,590,007

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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, emissions)		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)

Front-runner in dedicated ESG strategy and green bond issuance

Hell Energy has a dedicated ESG strategy. The company has state of the art production facilities with a high automation rate. Aluminium used for can production is from recycled aluminium. Hell obtained a second party opinion for its green bond. We view efforts at greener and more cost-efficient production and reporting positively.

Efficient production and recycled aluminium input for packaging

60% of soda cans not recycled in main markets

Output effective capacity of 1.9bn aluminium cans (to be increased to 2.7bn cans per year) is from recycled aluminium, however output is not widely recycled after the first usage (around 40% in Hungary and Romania vs. around 90% or above in western Europe). This creates a mixed ESG picture, although the company does not bear the full responsibility for this; regulators and retailers are also part of this process in Western Europe. The company's four main countries of operation generally have below-average regulatory expectations and no deposit system, which provides little incentive for consumers and retailers to recycle. Retailers are not involved in the process either. Deposit system will be introduced in Hungary from 2024 onwards which will incentivise consumers to recycle packaging. The product portfolio concentrates on small packaging, mostly 250 ml, and no more environmentally friendly alternatives are planned (such as drink dispensers, syrups), resulting in transportation of water.

Good product safety but products have high sugar and caffeine content

Production plants have high health and safety certifications as required in the industry. Product safety is a priority for the company; however, carbonated drinks with high sugar and high caffeine content are taxed due to governmental health considerations (so-called chips tax). Hell brand has a zero-sugar line too, and the company is diversified into soft drinks without sugar or caffeine with the XIXO brand to serve customer preferences.

Corporate structure complexity is medium. Some related entities are not consolidated (such as Üvegszikla Kft, which owns the automated warehouse).

[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: BB+

Industry risk profile: A

Hell Energy's business risk profile is primarily supported by the consumer products sector's strong industry risk profile, which benefits from low cyclicality, medium barriers to entry and an A industry rating.

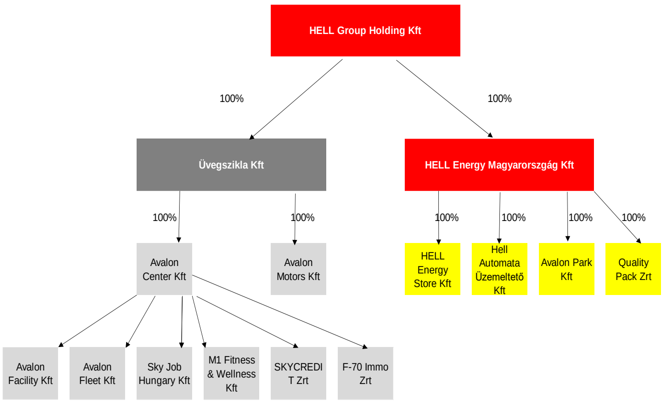
Change in group structure

The group structure above the issuer level has changed, but this has no effect on the rating. There is a new central holding company above Hell Energy Magyarország Kft. owned by the Barabás family's newly established holding companies.

Market leader in nine countries with Hell Energy Drink brand

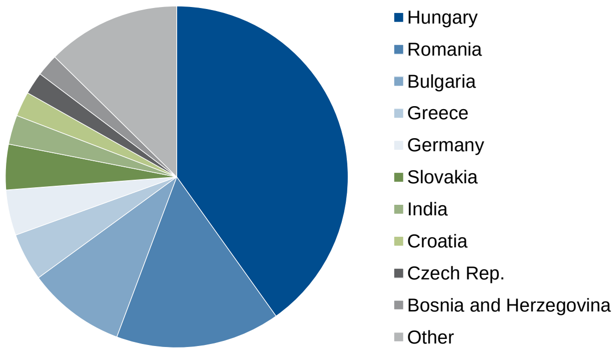
Regarding market position, the picture is mixed as the company has a leading market position in the energy drink segment of its home market of Hungary while also being the market leader in nine other countries that are mostly in central and southeastern Europe, and it has good diversification within the non-alcoholic beverages segment. The recently introduced Energy Coffee product quickly became the market leader in five countries. XIXO-branded iced tea is market leader in Hungary.

Figure 1: Organisational overview



Sources: Hell Energy

Figure 2: Geographical diversification (revenue FY 2021)



Sources: Hell Energy

Strong exposure to CEE/CSE markets, significant growth potential in several countries

Hell Energy has a market presence in over 50 countries, although most of its sales are in the CEE/CSE markets (Hungary and Romania make up more than half of revenues). This gives it room for organic growth once production capacity expands.

The ultimate number of customers (individual consumers of a drink) is extremely high due to the retail consumer products portfolio.

Strategic distribution channels often under same ownership, well-diversified supplier base

Moreover, there is no material dependency on any third-party distributor or retailer due to the group's strategy of developing and running its own global distribution via its own local operations on the ground or working with different local distributors in every market. Hence, there is no material dependency on any single partner. There is also minimal dependency on suppliers because the main raw materials used – sugar, compound (syrup) and aluminium – are all globally traded commodities with a large number of potential suppliers.

In terms of diversification, the company benefits from a relatively diversified client base, mostly thanks to its retail-focussed product portfolio, its double-track strategy of branded and white-label products, and its wide geographic reach.

Good profitability in line with global peers

Profitability on a sustainable EBITDA-margin basis is in the range of 15-20%. This is in line with sector peers, particularly given Hell Energy's above-average degree of vertical integration and its relatively new and efficient production facility. The issuer is the market leader in most of its main markets, and it prices its products significantly below Red Bull – which gives it pricing power.

Input cost inflation managed by price increases

A strong increase in input costs (sugar, aluminium, energy, transportation) and production ramp-up costs has put pressure on margins. We expect the company to use its pricing power to keep its EBITDA margin around 15%, 3pp below historical trends but in line with projections for the ramp-up phase.

Profitability is expected to shrink temporarily while production ramps up

The company's operating profitability has been below the sector average in recent years, mostly due to the rapid expansion of its business and the significant brand-building and market-development expenses that this expansion required. As the group successfully widened its geographic reach and product portfolio, it reached an EBITDA margin of more than 19% in 2018 thanks to high utilisation of production capacity, which continued in 2019 and 2020.

We nevertheless expect the issuers EBITDA margin to remain around 14%-16% for the next two to three business years given that we foresee further initial costs from the launch of new products and developing export markets. The fact that sales growth of its (higher margin) branded products cannot immediately match the planned growth in production capacity is another impediment. For the company to achieve high utilisation rates, we therefore expect a larger share of (lower margin) white-label business. In the medium term, we think EBITDA margins can benefit from significant economies of scale.

Financial risk profile: B

The company's financial risk profile remains unchanged compared to last year and is thus the weaker part of the overall issuer rating that we have assigned to Hell Energy.

Planning assumptions

Planning assumptions include:

- Strong revenue growth due to a growing product offering and expansion into export countries (India and Balkans). The growth rate for the last two years was 30%, and the projected growth rate is 15%-20% per year.
- Increasing effective output to 2.7-2.8bn filling and can production per year (increasing from 1.2bn filling and 1.9bn can production capacity of 2019) in line with the expansion plan financed by the second bond
- All receivables are insured, and all-risk insurance is in place.
- No M&A, no large new investments until ongoing expansion is completed and production ramps up.
- Insignificant off-balance sheet debt and corporate guarantees.

HUF 67bn bond issued with low coupon to finance large-scale investments

The financial risk profile is strongly affected by the investment programme that started in 2021 of around HUF 80bn plus a cost overrun of up to 10%. Of that amount, HUF 67bn is financed by a new senior unsecured bond issuance (with a fixed coupon of 3%, a 10-year maturity, linear amortisation of 10% from 2026, a 50% balloon at maturity and a corporate guarantee from Quality Pack Zrt., which is 100% owned by Hell Energy). The remainder is financed by a state subsidy of HUF 13.5bn to be received in 2023 and the company's own cash flows. HUF 6.7bn subsidy was received in 2022 for the previous investment.

The bond proceeds are earmarked for capital expenditure to greatly increase production capacity in beverage manufacturing and filling as well as aluminium can manufacturing.

Shortfall in subsidies can be mitigated by parent support

The state subsidy is not contracted at this stage, and a shortfall arising from a lower subsidy amount will be covered by equity or a subordinated intercompany loan provided by the owners. No other equity contribution is planned. Cost overruns and timing delays are mitigated using the same technology suppliers as before, and a new filling line has been quickly installed in place of the existing PET line to boost output needed to achieve high revenue-growth targets. Subsidy negotiations could extend beyond 2022 and put pressure on cash flows if the subsidy is not received by mid-2023.

Successful deleveraging followed by tripling of nominal debt

The new investment programme follows a deleveraging from the previous programme that started in 2015 for the can manufacturing facility and additional filling lines, resulting in SaD/EBITDA of above 7x in 2017. The company successfully deleveraged to SaD/EBITDA of 2.8x by YE 2020. Without netting cash earmarked for capex, SaD/EBITDA stands at 6.1x as of YE 2021.

The pandemic did not have a negative effect on the company's leverage, nor has the Ukraine war had an immediate impact on it. Current SaD/EBITDA projections are slightly more moderate at around 5.5x-6.0x for 2022-23 and a deleveraging to below 4.5x in 2024 at the earliest. SaD is expected to reach HUF 115bn as inflation and expansion increase working capital needs. Timing delays, cost overruns, a slow production ramp-up, and input price inflation (aluminium, energy) resulting in slower EBITDA growth may further increase leverage.

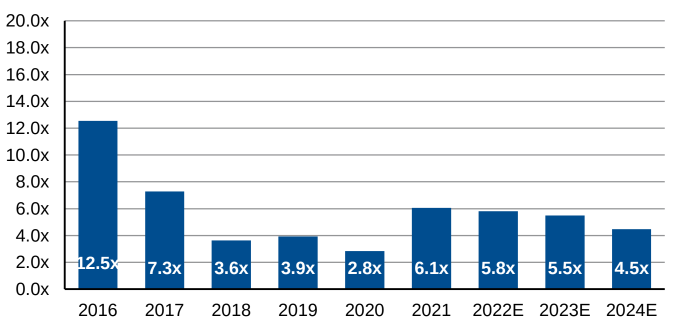
Robust interest cover, no high debt amortisation, weak FOCF

Interest coverage is rather robust at more than 5.0x on a sustained basis. This has deteriorated from double-digit levels due to interest costs rising from HUF 1.1bn p.a. to HUF 3.4bn p.a. after the new bond issuance.

The two fixed-coupon bonds adequately protect the company against soaring interest rates in Hungary.

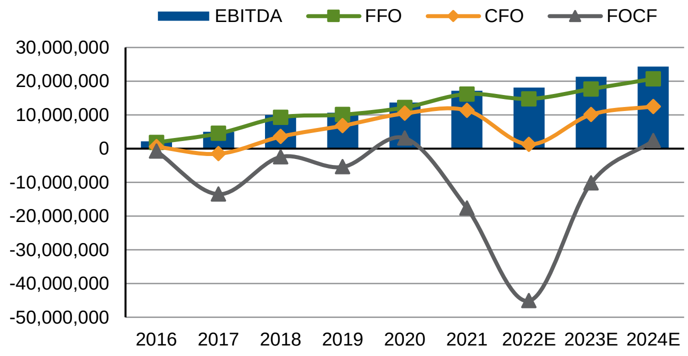
Capex coverage and free cash flow generation have both been weak in the past. This is due to the issuer's exponential growth in recent years, which is expected to continue with its massive capex programme. Although the issuer has been heavily dependent on external financing to fund its production facilities and its growing working capital needs, there should be a sustainable improvement in FOCF from 2024E onwards.

Figure 3: Scope-adjusted leverage development



Source: Scope estimates

Figure 4: Cash flow overview



Source: Scope

Weak liquidity due to inflation and expansion-related working capital increase

Liquidity has been adequate with expected coverage around 1x with temporary deviations caused predominantly by negative free operating cash flow as investment plan progresses. The assessment is supported by limited short-term debt usage so far.

The company had HUF 57bn of cash as at YE 2021, most of which is intended to finance investments.

In 2023 additional liquidity is needed as working capital grows due to inflation and strong expansion of the business and due to and possible cost overruns financed from the company's own sources. This is somewhat mitigated by possible supplier financing. Any shortfall in subsidies needs to be covered by a shareholder loan or equity to preserve a healthy liquidity.

Balance in HUF '000s	2022E	2023E	2024E
Unrestricted cash (t-1)	56,781,000	10,039,134	4,262,118
Open committed credit lines (t-1)	4,500,000	2,000,000	2,000,000
FOCF	-45,140,763	-10,236,150	2,311,886
Short-term debt (t-1)	-2,166,000	-1,500,000	-4,000,000
Coverage	**7.5x**	**1.2x**	**2.1x**

Supplementary rating drivers: no notching

The issuer has expanded aggressively in the past, but has not shown any signs of imprudent financial policy. Due to existing covenants, the company is allowed to pay reasonable dividends (payout ratio up to 20% of profit after tax).

Parent support is viewed as neutral.

The group is changing its structure above the company level to a holding structure with entities incorporated in Hungary. However, this does not affect the issuer's credit quality.

Long-term debt ratings

Senior unsecured debt rating: B+

We expect an average recovery for future senior unsecured debt for the HUF 28.5bn senior unsecured bond without a guarantee and the HUF 67bn senior unsecured bond guaranteed by Quality Pack Zrt. (a subsidiary of Hell Energy), taking into consideration a hypothetical default scenario at YE 2023 and applying reasonable discounts to existing assets and assets under construction.

Appendix: Peer comparison (as at last reporting date)

	Hell Energy Magyarország Kft.	Progress Étteremhálózat Kft.	Baromfi-Coop Kft.	Wellis Magyarország Zrt.
	B+/Stable	BB/Stable	BB-/Stable	BB-/Stable
Last reporting date	31 December 2021	31 December 2021	31 December 2020	31 December 2020
Business risk profile	BB+	BB	BB	BB
Financial risk profile	B	BB	BB-	BB -
Scope-adjusted EBITDA/interest cover	18.3x	15.2x	17.1x	80.1x
SaD/Scope-adjusted EBITDA	6.1x	2.5x	3.6x	1.5x
Funds from operations/SaD	16%	36%	26%	-12%
FOCF/SaD	-17%	0%	-19%	69%
Supplementary rating drivers	-	-	-	-

Sources: Public information, Scope

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891-0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

10 Avenue de Messine
F-75008 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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