Inotal Zrt.
Hungary, Metals and Mining

STABLE
B+

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022 E**	**2023 E**
Scope-adjusted EBITDA/interest cover	12.8x	8.3x	9.9x	7.9x
Scope-adjusted debt/EBITDA	3.2x	3.6x	3.1x	4.0x
Scope-adjusted funds from operations/debt	28.6%	24.1%	30.2%	22.1%
Scope-adjusted free operating cash flow/debt	12.9%	55.8%	-3.3%	-4.9%

Rating rationale

Inotal's business risk profile (assessed at B) continues to be supported by strong geographical, customer and end-market diversification; direct customer relationships; access to scrap through associate Martin Metals and its slag recycling operation; and the effective management of metals price risk through customer and supplier contracts and hedging. The business risk profile is constrained by Inotal's small size in a global context and limited profitability, which is under pressure from rising energy costs.

The financial risk profile (assessed at BB-) reflects strong interest coverage, with EBITDA/interest cover expected to remain around 8x until 2024. Scope expects leverage as measured by Scope-adjusted debt/EBITDA to deteriorate to 4x in 2023, in line with the expected drop in profitabiltiy. Scope expects Scope-adjusted free operating cash flow/debt to remain negative in the coming years, mainly based on the assumption that the high maintenance capex will follow depreciation. Liquidity is adequate, with no debt maturity other than the future amortization of the bond. The bond amortization, along with the negative Free-operating cash flow, is expected to be fully covered by the available liquid assets.

Scope acknowledges the ongoing ownership change at Inotal. Scope's base case assumes neither the management's financial policy to become more aggressive nor any additional debt to be transferred to Inotal as a result of the ownership change. Thus, Scope considers this change credit-neutral.

Outlook and rating-change drivers

The Stable Outlook reflects the assumption that Inotal can maintain its current financial risk profile in the medium term. Our base case assumes profitability below historical averages due to challenging market conditions including softening end-market demand and high energy prices. However, We expect EBITDA/interest cover to remain at around 8x and leverage as measured by Scope-adjusted debt/EBITDA to remain at around 4x.

A positive rating action could be warranted if profitability, measured by Scope-adjusted EBITDA would move sustainably above 5%, while Scope-adjusted Debt/EBITDA moves below 3x.A negative rating action could occur if leverage significantly exceeded 4x on a sustained basis. This could result from further deterioration of profitability, or drawing of additional third party debt. Additionally, inability to bring FOCF to positive levels on the medium term might warrant a negative rating action. Scope notes that Inotal's senior unsecured bond issued under the Hungarian Central Bank's Bond Scheme has an accelerated repayment clause. The clause requires Inotal to repay the nominal amount (HUF 6bn) within 30 days after the bond rating falls below a B-, which could have a default implication.

Ratings & Outlook

Issuer	B+/Stable
Senior unsecured debt	B+

Analyst

Istvan Braun
+49 302 7891 378
i.braun@scoperatings.com

Related Methodology

Corporate Rating Methodology; July 2022

Metals and Mining Rating Methodology; November 2022

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

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
07 December 2022	Affirmation	B+/Stable
08 April 2022	Monitoring review	B+/Stable
06 May 2021	Affirmation	B+/Stable

Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Comparatively strong financial risk profile despite challenging market conditions • Good diversification by customer and end-market; direct customer relationships • No short-term debt	• Small niche player with limited economies of scale • Relatively low value-added products • Low profitability, further under pressure by rapidly increasing input prices • Negative FOCF in the medium term, caused by high maintenance capex

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted EBITDA sustainably above 5% • Scope-adjusted Debt/EBITDA below 3x	• Scope-adjusted debt/EBITDA sustained significantly above 4x • Inability to generate positive Free-operating cash flow in the medium term

Corporate profile

Inotal Zrt. is a private Hungarian aluminium processor, slag recycler and trader. The company's key products are wire rod, slugs, strips, and drawn wire. Wire rod is primarily sold to the electrical industry, slugs to the cosmetics and food industries, strips to the building and transformer industries, and drawn wire to the lightning conductor, electrical and food industries. Over 70% of production is exported to nearby countries. The company employs 322 people and operates three sites in Hungary.

Mr. László Kálmán, current majority owner of Inotal Zrt., acquired the company in 2006. The current minority shareholder (24%) is going to acquire the remaining 76% stake from Mr. Kálmán. The parties have already agreed on the terms and conditions of the sale and the ownership change is expected to happen by January 2023.

Financial overview

				Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021**	**2022 E**	**2023 E**	**2024 E**
Scope-adjusted EBITDA/interest cover	10.6x	12.8x	8.3x	9.9x	7.9x	8.0x
Scope-adjusted debt/EBITDA	3.8x	3.2x	3.6x	3.1x	4.0x	3.9x
Scope-adjusted funds from operations/debt	23.0%	28.6%	24.1%	30.2%	22.1%	22.3%
Scope-adjusted free operating cash flow/debt	8.3%	12.9%	55.8%	-3.3%	-4.9%	-5.6%
Scope-adjusted EBITDA in EUR '000s						
EBITDA	3,445	5,250	4,543	5,191	3,361	3,195
Special items	0	0	0	0	0	0
Scope-adjusted EBITDA	3,445	5,250	4,543	5,191	3,361	3,195
Funds from operations in EUR '000s						
Scope-adjusted EBITDA	3,445	5,250	4,543	5,191	3,361	3,195
less: (net) cash interest paid	-418	-412	-549	-522	-457	-400
less: cash tax paid per cash flow statement	0	0	0	-136	0	0
add: dividends from associates	1000	0	0	400	0	0
Change in provisions	-124	-111	-60	0	0	0
Funds from operations	3,904	4,728	3,934	4,933	3,153	2,794
Free operating cash flow in EUR '000s						
Funds from operations	3,904	4,728	3,934	4,933	3,153	2,794
Change in working capital	3,611	816	10,981	-3,356	-296	-8
Non-operating cash flow	0	0	-545	0	0	0
less: capital expenditure (net)	-6,105	-3,411	-5,263	-2,112	-3,558	-3,486
Free operating cash flow	1,410	2,133	9,107	-536	-701	-700
Net cash interest paid in EUR '000s						
Net cash interest per cash flow statement	-426	-431	-549	-522	-457	-400
Interest received	9	19	0	0	0	0
Net cash interest paid	-417	-412	-549	-522	-457	-400
Scope-adjusted debt in EUR '000s						
Reported gross financial debt	17,001	16,551	16,325	16,325	14,293	12,514
less: cash and cash equivalents	NA	NA	NA	NA	NA	NA
add: non-accessible cash	NA	NA	NA	NA	NA	NA
Other items	0	0	0	0	0	0
Scope-adjusted debt	17,001	16,551	16,325	16,325	14,293	12,514

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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)	
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)

Credit neutral ESG factors

About 20% of Inotal's production is based on recycled aluminium, mostly sourced from the related company Martin Metals Kft Recycled aluminium exhibits minimal debris and quality loss and requires about 5% of the energy needed to produce primary aluminum.

[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

We classify Inotal as a metals and mining company, an industry we rate BB based on high cyclicality, medium substitution risk, and medium barriers to entry. Given the highly commoditised nature of the industry, all market players are price-takers as metal prices depend on global demand.

Since the beginning of 2021, aluminium prices have increased significantly, mainly due to the post-Covid-19 pandemic economic recovery, fuelled further by soaring energy prices in Europe. Prices peaked around USD 4000/tonne around March 2022, as financial sanctions on Russia fuelled worries about supplies from major Russian producers. Prices then started to gradually decline from Q2 2022, mainly driven by recession fears and lower demand.

Business risk profile: B

Inotal's business risk profile (assessed at B) is constrained by its small size by global standards, its concentration on commodity products and its relatively low margins. The rating is supported by good geographical, customer and end-market diversification; direct customer relationships; access to scrap through associate Martin Metals and its slag recycling operation; and effective management of metals price risk through customer and supplier contracts and hedging.

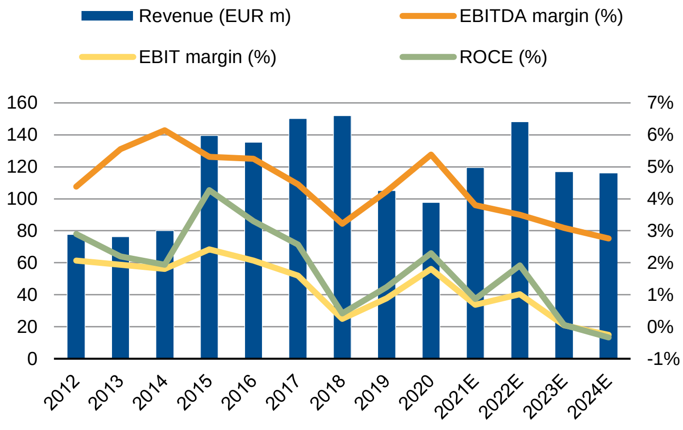
Limited company size in a European context

Inotal is the third largest aluminium processor in Hungary after Arconic and Norsk Hydro. With a yearly production of 35,000 to 40,000 tonnes, Inotal is a small player by international standards. Regional peers generally produce in excess of 100,000 tonnes yearly and global leaders in excess of 1m tonnes. The constant changes in the cost of aluminium, alum earth and energy prices have significantly restructured the market. In Europe, major aluminium producers and manufacturers of aluminium-based semi-finished goods have reduced or interrupted their output to minimise losses.

High degree of end-market, customer and geographical diversification

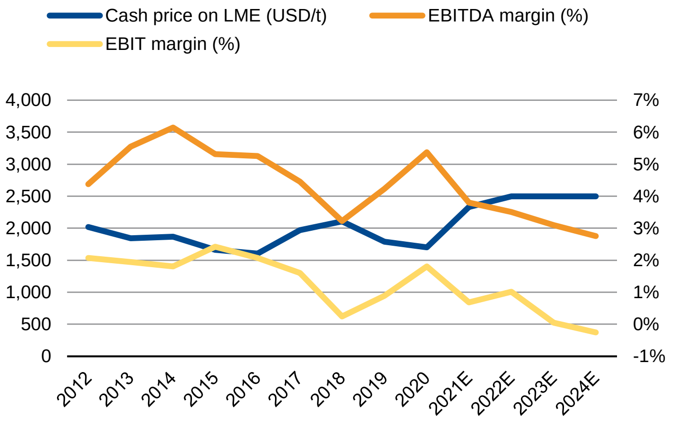
Production is focused on wire rod, slugs, strips and drawn wire. End-markets are diverse and include the electrical, building materials, cosmetics, and food industries. The company operates three furnaces (10, 15 and 25 tonnes), with production focusing on markets within a 1,500km radius of Hungary. Sales are almost exclusively direct sales to end-customers. Products are relatively low value added, although the company is increasingly focusing on alloys (around 60% of production), which generate higher margins and can be produced with a relatively high ratio of scrap (38%). External scrap is sourced through Inotal's own slag recycling operation and associated aluminium recycler Martin Metals.

Figure 1: Scope-adjusted revenue, margins and ROCE



ROCE: return on capital employed
Source: Inotal, Scope

Figure 2: Scope-adjusted margins and aluminium price



LME: London Metal Exchange
Source: Inotal, Scope

Operating profitability under pressure from rising energy costs

Aluminium processing is a margin business, where the price risk is broadly eliminated through contracts with suppliers and buyers as well as through metal price hedging. Inotal's EBITDA margin has ranged between 3% and 6% over the past decade (Figures 1 and 2), in line with small-to-medium sized peers focused on lower value-added products.

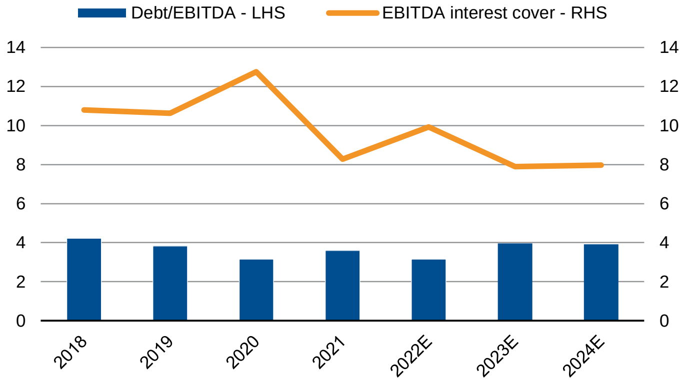
Profitability is expected to deteriorate in 2023. While the price for most of Inotal's electricity and gas consumption has been fixed for 2022, in 2023 Inotal has locked-in prices for gas only and will have to purchase electricity at spot price. Moreover, demand is expected to soften as the previously price-taking customer base becomes more price sensitive, driven by fears of a global recession. Inotal stated that it is planning to mitigate the upcoming challenges through i) a EUR 6m investment into a solar park (6.5 MW capacity), which is expected to reduce electricity consumption by about 25%; and ii) dynamic order management, focusing on the less energy intensive, higher value-added products. In the current base case, however, profitability is expected to stay below historical averages in the medium term.

Financial risk profile: BB-

Financial risk profile: BB-

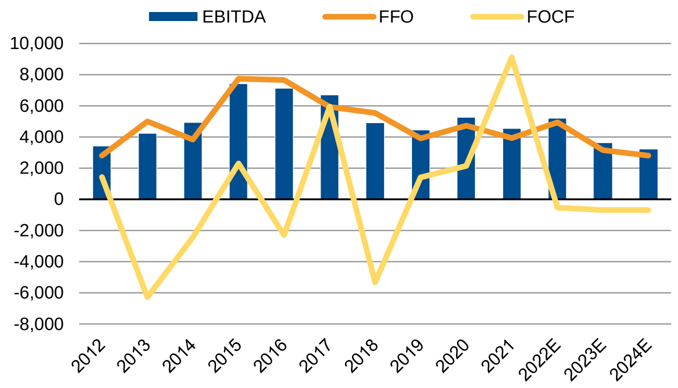
Inotal's financial risk profile (assessed at BB-) reflects moderate leverage and a long-term debt maturity profile. Gross margin is expected to remain close to the historical average, with a slow deterioration after 2022 (affected by the hike in energy costs). We expect the cost of goods sold to represent 90% of revenue and assume 10% of annual wage inflation in 2022 and 2023 and 4% in 2024. Other operating expenses are expected to remain flat. With high energy prices remaining high in the medium term and wage pressure not expected to ease until at least the end of 2023, the EBITDA margin is likely to remain below the historical average, close to 3%.

Figure 3: Scope-adjusted interest cover and leverage



Sources: Inotal, Scope (estimates)

Figure 4: Cash-flow analysis



FFO: Funds from operations
Sources: Inotal, Scope (estimates)

Strong interest coverage despite lower profitability

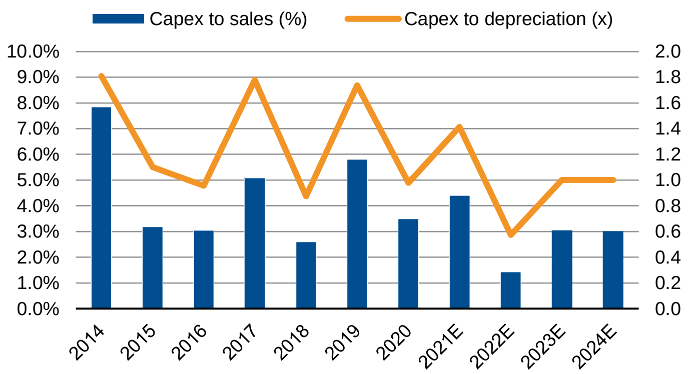
Despite the anticipated deterioration of profitability, we expect Scope-adjusted debt/EBITDA at around 4.0x in the medium term. This is due to the composition of Scope-adjusted debt, which only consists of the HUF 6bn (EUR 16.4m) bond that will start to amortise in 2023 with 12.5% of face value YoY. As we expect no additional third party debt to be drawn in the medium term, leverage should remain in the BB category.

Interest cover remains robust, slightly above 8.0x in the medium term. This is mainly due to the relatively favourable cost of debt (coupon rate of the bond: 3.2%, fixed for the whole tenor of seven years). In line with the bond amortisation, interest costs are expected to gradually decrease.

Negative FOCF in the medium term

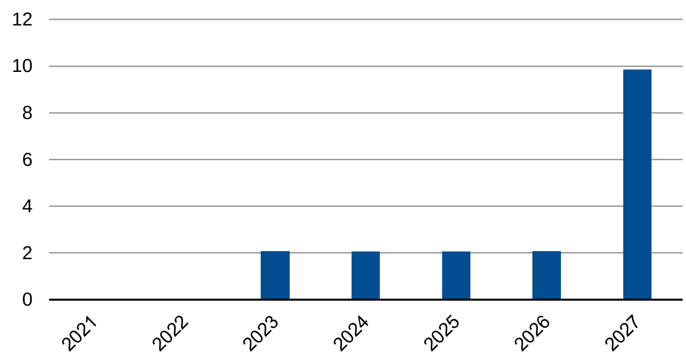
Cash flow will likely remain more volatile than earnings, driven primarily by fluctuations in working capital. FOCF and discounted cash flow are expected to remain negative in the medium term, mainly as a result of lower funds from operations and higher maintenance capex needs. We expect a temporary spike in FOCF in 2021 as the result of a cash inflow from working capital items, namely significantly higher trade payables. We expect capex to remain at or just above deprecation going forward, with investments focused on efficiency improvements and higher value-added products such as alloy goods, rather than capacity enhancement. Dividends are not permitted under the terms of the HUF 6bn bond.

Figure 5: Capex to sales and depreciation



Source: Inotal, Scope

Figure 6: Debt maturity profile, EUR mn, 2022



Source: Inotal, Scope

Adequate liquidity

Liquidity is adequate in the absence of any debt maturities in 2022. The first instalment (12.5%) under the HUF 6bn bond is in 2023 (Figure 6). The company has a short-term EUR 7m receivable factoring facility, currently unutilised.

Balance in EUR '000s	2021	2022E	2023E
Unrestricted cash (t-1)	756	8,159	7,623
Open committed credit lines (t-1)	0	0	0
Free operating cash flow	9,107	-536	-701
Short-term debt (t-1)	0	0	2,033
Coverage	**No ST Debt**	**No ST Debt**	**341%**

Supplementary rating drivers: credit neutral

Parent support deemed credit neutral

Scope has reviewed the confidential information about the currently ongoing ownership change and deem parent support credit neutral.

Long-term debt ratings

Senior unsecured debt rating: B+

In September 2020, Inotal issued a HUF 6bn senior unsecured bond (ISIN: HU0000359948) through the Hungarian Central Bank's Bond Funding for Growth Scheme. The bond proceeds have been used to refinance the existing third-party debt. The bond's tenor is seven years, with a fixed coupon of 3.2%. Bond repayment is in five tranches: 12.5% of the face value payable yearly between 2023 and 2025, and 50% at maturity in 2027.

We have rated the senior unsecured debt issued by Inotal at B+, the same level as the issuer rating. Recovery is 'average' for senior unsecured debt holders in a liquidation scenario.

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
FR-75008 Paris

Phone +33 6 6289 3512

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

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