Naturtex Kft.
Hungary, Consumer Products

B+ STABLE

Corporate profile

Naturtex' core business is the production of duvets and pillows filled with goose feathers and down, as well as products using other natural and synthetic fibres. The company operates four production plants in Hungary and exports to more than 45 countries throughout the world. The company employs around 170 people and had a total turnover of approx. HUF 10bn (EUR 28m) in FY 2019. Naturtex is headquartered in Szeged, Hungary, and is a 100% family owned company.

Key metrics

			Scope estimates	
Scope credit ratios	2018	2019	2020F	2021F
EBITDA/interest cover (x)	34.4x	76.7x	5.6x	6.4x
Scope-adjusted debt (SaD)/EBITDA	2.0x	1.1x	3.7x	3.2x
Scope-adjusted FFO/SaD	48%	89%	21%	25%
FOCF/SaD	-22.2 %	28.4 %	-6.5 %	-25.0 %

Rating rationale

Scope Ratings assigns a corporate issuer rating of B+/Stable to Hungarian-based Naturtex Kft. Senior unsecured debt is also rated B+.

The issuer rating reflects a business risk profile incorporating medium cyclicality from exposure to the durable consumer goods industry. As one of the leading bedding brands in Hungary, Naturtex has a healthy domestic market share. Nonetheless, it is a relatively small producer in the fragmented European bedding market. Inherent cyclicality risk is reduced by the generation of around 80% of revenue by exports to 46 different countries and acceptable customer diversification. This is also evident in the company's recent profitability, with EBITDA averaging around 10%. However, some cyclicality remains and there is clear seasonal volatility. Naturtex' distribution network has more than 250 resellers, 13 franchise partners and several partnerships with national hypermarket chains. Hungarian goose down/feather has a special quality and image on the global market, which helps Naturtex to price its products in a higher category than some other competitor brands.

Naturtex' financial risk profile is stronger than its business risk profile. In the recent past, the company has reported relatively conservative financial leverage, with credit ratios such as Scope-adjusted debt (SaD)/EBITDA below 2x and funds from operations (FFO)/SaD above 40%. From 2020, we see credit metrics deteriorating because of: i) the temporarily Covid-19 impact on sales and profitability; and ii) the company's plan to use some of the MNB bond proceeds to increase inventory levels to provide greater flexibility to tackle the seasonal nature of raw material purchases (feather and down). As a result, we anticipate SaD/EBITDA of 3-4x and FFO/SaD at around 25% in the medium term. Free operating cash flow (FOCF) has been somewhat volatile in the past and is expected to remain so going forward. Following the planned discretionary inventory build-up, we do not expect the company to be able to report positive FOCF in the medium term, which remains a key constraint on its financial risk profile.

Ratings & Outlook

Corporate rating	B+/Stable
Senior unsecured rating	B+

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Related Methodology

Corporate Rating Methodology, February 2020

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Historically, Naturtex’ financial risk profile has been weakened by its over-reliance on short-term debt funding, which has exposed the company to some refinancing risk. Following the proposed refinancing (expected in Q3 2020), the company will be less exposed to liquidity issues and refinancing risk. This is because one third of the proceeds from the new proposed bond (seven-year HUF 3.5bn) under the Hungarian central bank (MNB) scheme will be used to refinance a large part of bank debt. The remaining part will be used for discretionary inventory build-up, which the company can control and will happen over time. We therefore expect a larger cash balance in the short term and much lower short-term maturing debt (HUF 115m) in the medium term.

Outlook

The Stable Outlook reflects our expectation that the financial effects of the Covid-19 pandemic will be manageable for Naturtex, with a return to a more normal situation in 2021. This translates into an expectation of SaD/EBITDA at around 3-4x and FFO/SaD at around 25% in the medium term, coupled with acceptable liquidity, due to the discretionary nature of the expected inventory build-up that causes FOCF to be negative in our base case.

A positive rating action could be warranted if Naturtex experiences higher demand than expected, translating into higher profitability and cash flow, accompanied by lower negative working capital build-up. This could be exemplified by generating significant positive free operating cash flow on a sustained basis, which is being used to strengthen the balance sheet.

A negative rating action is possible if SaD/EBITDA moves above 4x and FFO/SaD remains below 15% on a sustained basis, resulting from a more aggressive debt-financed growth strategy or tougher market conditions.

Rating drivers

Positive rating drivers	Negative rating drivers
• Healthy domestic market position with acceptable profitability margins over time • Strong geographical diversification and distribution platforms • Low historical leverage and acceptable financial flexibility (i.e. limited maintenance capex needs and discretionary inventory build-up)	• Small private company operating in industry with cyclical characteristics as well as seasonal volatility • Expectation of negative FOCF, following substantial inventory build up • Temporarily negative sales and profitability effects from Covid-19 pandemic restrictions

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Reduced working capital build-up and return to a significant positive FOCF on a sustained basis, which is being used to strengthen the balance sheet.	• Weakening operational market conditions, resulting in FFO/SaD below 15% on a sustained basis • SaD/EBITDA above 4x on a sustained basis

Financial overview, figures in HUF m

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	34.4x	76.7x	5.6x	6.4x
Scope-adjusted debt (SaD)/EBITDA	2.0x	1.1x	3.7x	3.2x
Scope-adjusted funds from operations/SaD	48%	89%	21%	25%
Free operating cash flow/SaD	-22.2 %	28.4 %	-6.5 %	-25.0 %
EBITDA	**2018**	**2019**	**2020F**	**2021F**
Income from operations (EBIT)	590	1,030	625	821
add: depreciation	155	159	160	160
EBITDA	**746**	**1,189**	**785**	**981**
Scope-adjusted funds from operations	**2018**	**2019**	**2020F**	**2021F**
EBITDA	746	1,189	785	981
less: (net) cash interest as per cashflow statement	-22	-16	-141	-154
less: cash tax paid as per cashflow statement	-16	0	-18	-25
add: other	0	0	-30	-30
Scope funds from operations (FFO)	**708**	**1,173**	**597**	**772**
Scope-adjusted debt	**2018**	**2019**	**2020F**	**2021F**
Reported gross debt	1,721	1,764	4,103	3,988
Cash, cash equivalents	-236	-451	-2,002	-950
cash not accessible	0	0	0	0
Pension adjustment	0	0	0	0
Guarantees to JV (NTT Manufacturing Ltd)	0	0	800	106
Scope-adjusted debt (SaD)	**1,485**	**1,313**	**2,901**	**3,144**

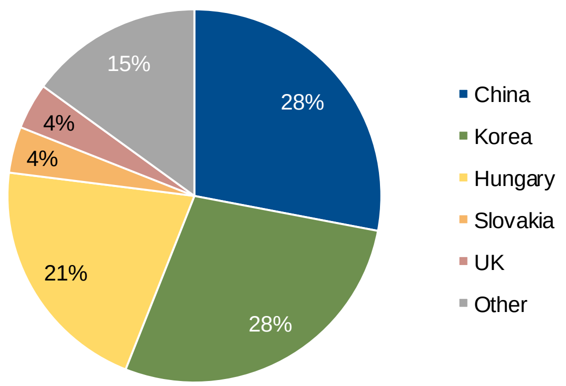
Business risk profile

Business Risk profile rated B+

We have assigned a B+ rating to Naturtex' business risk profile, which is supported by acceptable profitability margins over time and the company's relatively strong geographical diversification and distribution platform, despite its small size. Although it has a healthy domestic market share (company estimate: 35%), Naturtex is not protected from price competition in a fragmented market, as most of its revenue comes from export markets. As a player in the durable consumer product industry, the company is exposed to medium cyclicality, the goods it produces being of a more discretionary nature. This cyclicality will become more evident amid the Covid-19 situation in 2020, with the appearance of recession characteristics, leading to declining demand and sales volumes.

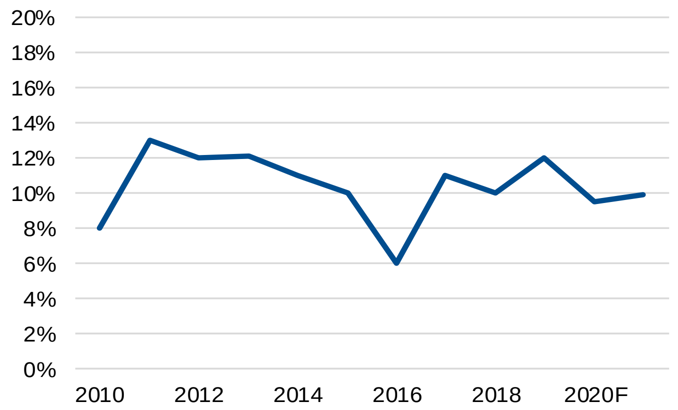
Of total sales in 2019, Naturtex ready-made products, which are manufactured using fabrics and fillings, made up approx. 45% of group sales, while the remaining part (55%) came from sales of its 'high-quality Hungarian white goose' down feathers on the international market (46 countries). While we acknowledge that the company has many different products, they make up one large product category, i.e. bedding products. More importantly, Naturtex has developed a good distribution network over time, with more than 250 resellers, 13 franchise partners and several partnerships with national hypermarket chains.

Figure 1: Sales by country



Source: Scope estimates

Figure 2: EBITDA margin development



Source: Scope estimates

10% EBITDA margin with seasonality patterns

The company has been averaging an EBITDA margin of +/-10% over time, with the FY 2019 number coming in at a high 12.3%. Following several years of production upgrades and investments, technological standards are good with a high degree of automatisation. The fact that Hungarian goose down/feathers have a special quality and image on the global market helps Naturtex to price its products in the premium category. Forex volatility (USD and EUR in particular) is mainly hedged through futures. In addition to yearly volatility in demand patterns, the company is also exposed to substantial seasonal volatility, with the majority of sales happening during Q4. As a result, the Covid-19 effects on demand will be less severe if the majority of markets return to more normal consumer behaviour during Q3.

Although we expect profitability to decline in 2020 compared to 2019, the impact is mitigated by the fact that production facilities have been operating throughout the crisis. Naturtex has also been a strategic partner of the Hungarian government, providing pandemic hospitals with duvets/pillows at a time when demand from hotels has fallen.

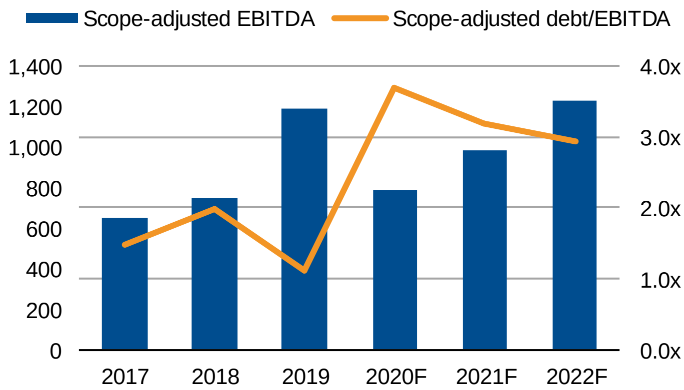
Financial risk profile

Financial risk profile rated BB-

Naturtex' financial risk profile is rated BB- and is thus slightly stronger than its business risk profile. We view positively the company's relatively conservative financial leverage in the recent past, with SaD/EBITDA below 2x and FFO/SaD above 40%. Historically, the weakest part of Naturtex' financial risk profile has been its over-reliance on short-term debt funding, which could have resulted in some refinancing risk if credit metrics had been weaker.

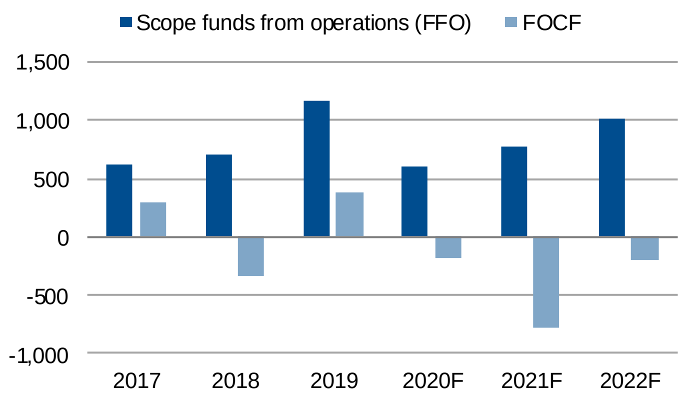
From 2020, we see credit metrics deteriorating, with SaD/EBITDA at 3-4x and FFO/SaD at around 25% in the medium term. This weakening is based on: i) the assumption of a tougher market environment in 2020 (Covid-19 effects) and; ii) the company's plan to use the MNB bond proceeds to increase inventory levels, thus providing greater flexibility to tackle the seasonal nature of its business. Although the expected leverage ratios are not particularly weak for the rating category, Naturtex' financial risk profile is mainly held back by expected negative FOCF in the short to medium term. However, the company will be less exposed to liquidity issues and refinancing risk following the MNB refinancing, as one third of the proceeds from the bond issue will be used to refinance a large part of its bank debt and for discretionary inventory build-up. Cash outflow for the latter is controlled by management. Should market conditions develop more negatively than expected, they could therefore scale back some of these outgoings and increase the cash balance instead.

Figure 3: EBITDA (HUF m) and SaD/EBITDA development



Source: Scope estimates

Figure 4: FFO and FOCF development over time (HUF m)



Source: Scope

NTT Manufacturing (joint venture company) to start operating in 2021

Naturtex has also established a joint venture company (NTT Manufacturing Ltd.) to support its growth and expansion ambitions and reduce risk. The company is 50%-50% owned by Naturtex and T-Trans Ltd., and is expected to begin operations in 2021. As Naturtex has a credit guarantee agreement with this company, we have added the maximum exposure it could have to its SaD during the agreement period up to 2023 (see page 4).

FOCF/SaD has been somewhat volatile in the past and we expect it to remain so going forward. Following the planned discretionary inventory build-up, we do not expect the company to be able to report positive FOCF. We have assumed that most of the inventory build-up will take place in 2021, represented by a working capital outflow of almost HUF 1.5bn that year. Ordinary maintenance investment needed going forward will be much less, expected to range from HUF 0.1bn to HUF 0.3bn p.a.

Supplementary rating drivers

Sound financial policy targets

We have not made any explicit rating adjustment for supplementary rating drivers. Although the company has no officially communicated financial policy, we understand that the owners and management aim to maintain a conservative dividend policy and are interested in keeping the financial condition of the company sound. This has been demonstrated in the past, with a targeted dividend pay-out ratio of 10%-30%.

While the three family member owners (Ákos Gellért, Dr. Ákos Gellért and Balázs Gellért) do not have an equal ownership share in the company, they each have a one-third voting right when it comes to strategic decision-making.

Long-term and short-term debt ratings

Senior unsecured debt rated in line with issuer rating

We expect an average recovery for future senior unsecured debt, such as the planned seven-year amortising HUF 3.5bn bond to be issued in 2020 under the MNB Bond Funding for Growth Scheme. This recovery expectation translates into the same rating as the issuer rating. Although the recovery analysis could indicate an even higher recovery, we have taken a conservative view based on our sensitivity analysis. Our recovery expectations are based on an expected liquidation value in a hypothetical default scenario in 2022, following the proposed refinancing (when most debt is senior unsecured and pari passu with negative pledge covenants) and inventory levels have been built up substantially. In this scenario we assume tough market conditions and that the outstanding bank working capital facility at that time is fully drawn.

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