Research Update:

Pro.Gest SpA Downgraded To 'B' On Likely Covenant Breach, Liquidity Risks, And Higher Leverage; Remains On Watch Neg

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Rating Action Overview

- The operating performance of Italian packaging group Pro.Gest SpA was weaker than we expected in the first half of 2019, leading to a material deterioration in its liquidity position and credit metrics.
- The company is in negotiations with lenders to waive a covenant breach that it anticipates in December 2019. In addition, Pro.Gest might face the payment of a material anti-trust fine in May 2020.
- We are lowering our long-term issuer credit rating on Pro.Gest to 'B' from 'BB-'. We are also lowering our issue rating on Pro.Gest's fixed-rate senior unsecured notes to 'B' from 'BB-'. At the same time, we are keeping the ratings on CreditWatch with negative implications.
- Our CreditWatch negative placement reflects a one-in-two likelihood that we could lower the issuer credit rating further. We expect to update the CreditWatch status in the coming months, as we receive further clarifications from the company on the progress of its covenant waiver negotiations with lenders and on its liquidity position.

Rating Action Rationale

The downgrade follows our discussions with Pro.Gest following the release of the company's half-year 2019 results, which showed larger working capital outflows and weaker EBITDA generation than we expected, resulting in weaker credit metrics.

Looming covenant breach in December 2019

We now expect Pro.Gest to generate negative free operating cash flow (FOCF) of €95 million in 2019 and post leverage of 6.0x in December 2019. We also expect liquidity to remain under pressure as the company has no access to undrawn committed credit lines, and experienced a material erosion of available cash in the first six months of 2019. In addition, Pro.Gest anticipates that it will breach the covenants under its bilateral loan and mini-bond agreements in December 2019. The covenant breach would only crystallize in March or April 2020, when the covenant certificates are due. Some of the agreements include a grace period. We understand that Pro.Gest intends to request a covenant waiver from lenders. We believe that the business is viable and anticipate that lenders will be supportive of the company's request.

Possible liquidity deterioration in 2020

Pro.Gest successfully stemmed its working capital outflows in the third quarter of 2019, notably via a reduction in waste-paper purchases. However, if there is no material improvement in market conditions, we expect FOCF generation to remain minimal or negative in 2020. The company could generate cash from inventory sales or from the disposal of nonstrategic assets (€50 million). However, we still see risks to liquidity, notably if the €47.5 million anti-trust fine ends up being due in its entirety in May 2020. We understand that the company is seeking approval to pay this fine in instalments over 30 months.

CreditWatch

The negative CreditWatch placement reflects a one-in-two likelihood that we could lower the issuer credit rating on Pro.Gest further. We expect to update the CreditWatch status in the coming months, as we receive further clarifications from the company on:

- The progress of its negotiations with lenders to waive the covenant breach it anticipates in December 2019;
- Its liquidity position, notably on the timing and final amount of the anti-trust fine, which we estimate at €47.5 million; and
- Its asset disposal plans.

Downside scenario

We could lower the rating if Pro.Gest's lenders do not waive the anticipated breach of the leverage covenants under its bilateral loan and mini-bond agreements in December 2019. We could also lower the rating if Pro.Gest's liquidity deteriorated further; for instance, if the entire €47.5 million fine is due in May 2020, or if working capital needs continue to increase.

Upside scenario

We could remove the rating from CreditWatch and consider raising it if Pro.Gest's lenders waive the anticipated breach of the leverage covenants under its bilateral loan and mini-bond agreements in December 2019. We could also remove the rating from CreditWatch and consider raising it if we see a material improvement in the company's liquidity position.

Company Description

Pro.Gest is an Italian vertically integrated producer of containerboards (31% of 2017 revenues), corrugated cardboard (37%), and packaging solutions (32%). The company was founded by Bruno

Zago in 1973 and is now run by his son, Francesco Zago. Pro.Gest is headquartered in Treviso, Italy, and has around 1,036 employees. All of its 23 plants are in Italy. In 2018, revenues amounted to €469 million and S&P Global Ratings-adjusted EBITDA to €95 million.

Our Base-Case Scenario

- Our estimate of minimal GDP growth in Italy of 0.1% in 2019 and 0.4% in 2020.
- A 10% decline in revenues in 2019, in line with the trend in the first six months of 2019. We expect a more modest decline in revenues for 2020.
- Adjusted EBITDA margin of 17% for 2019, down from 18.1% in 2018. The margin deterioration reflects the decline in sales prices and the negative impact of the unexpected shutdown of the Mantova plant since May 2019. We do not assume any improvement in EBITDA margins in 2020, but note that the reopening of the plant in Mantova would improve EBITDA by around €20 million.
- Around €100 million of working capital outflows in 2019, due to a combination of large inventory build-ups of both raw materials and finished goods, and the settling of trade and capital expenditure (capex) payables in the first half of 2019. For 2020, we assume that working capital will remain flat, but believe that there is upside potential if Pro.Gest decides to sell some of its accumulated inventory. We assume that the company will start selling its inventory from 2021, leading to a working capital inflow of around €40 million.
- Annual capex of €40 million in 2019 and €30 million in 2020.

Liquidity

We have revised our assessment of Pro.Gest's liquidity downward to less than adequate from adequate. This reflects risks on the outcome of the company's negotiations with lenders to avoid the imminent covenant breach, as well as uncertainties on the amount and timing of the €47.5 million anti-trust fine. Although we do not reflect it in our liquidity assessment, we understand that the company could raise around €50 million in 2020 from the disposal of nonstrategic real estate assets.

Principal liquidity sources in the 12 months from June 30, 2019, are:

- €78.1 million in cash on the balance sheet; and
- €30 million-€40 million in funds from operations.

Principal liquidity uses in the 12 months from June 30, 2019, are:

- Around €60 million in debt repayments;
- Our estimate of working capital outflows of around €10 million; and
- Up to €30 million in capex.

Covenants

Some of Pro.Gest's bilateral debt agreements include leverage covenants set between 4.0x and 5.0x for December 2019. We expect the company to breach these covenants by year-end 2019.

Environmental, Social, And Governance

Environmental, social, and governance factors are key for containerboard producers as they consume large quantities of energy and water. Residents local to the production plants are often concerned about air and noise pollution, as well as traffic.

We believe that Pro.Gest is in a less favorable position in terms of environmental and governance factors than other companies in the sector, as it faces a higher degree of political and legal uncertainties in the Italian jurisdiction.

When we initially assigned a rating to Pro.Gest in December 2017, we expected the company's containerboard mill in Mantova to start operating at a capacity of 200,000 tonnes per year from July 2018. Local authorities have so far not granted the mill an environmental impact assessment, and in May 2019, ordered the suspension of its operations. Although management is hopeful that the mill will reopen in the next 12 months, we cannot rule out further regulatory delays. As Pro.Gest planned to use most of the mill's output internally, we expect the suspension of its activities to negatively affect EBITDA by €20 million in 2019. The mill's €16 million inventory build-up in the first half of 2019 was one of the factors that led to the large working capital outflow in the first six months of 2019.

Our assessment of Pro.Gest's governance and liquidity also reflects the €47.5 million fine imposed by Italian anti-trust authorities in 2019 for the company's alleged participation in an industry-wide price-fixing cartel. Although the company is appealing the amount of the fine and seeking to pay it in instalments over 30 months, we understand that payments relating to this fine will kick in from May 2020.

Issue Ratings - Recovery Analysis

Key analytical factors

- We lowered the issue rating on the €250 million 3.25% fixed-rate unsecured notes due 2024 to 'B' from 'BB-' and kept it on CreditWatch negative, mirroring the CreditWatch negative placement of the issuer credit rating. The recovery rating of '4' on the notes is unchanged and continues to reflect our expectation of average (30%-50%; rounded estimate: 40%) recovery of principal in the event of payment default.
- Due to restrictions under the Cartiere Villa Lagarina (CVL) bilateral facility agreements, the unsecured notes are not guaranteed by CVL, which accounts for 34% of Pro.Gest's EBITDA. In addition to this, dividend payments by CVL are prohibited before September 2019 and are very restricted thereafter. Some of Pro.Gest's bilateral debt agreements include leverage covenants set between 4.0x and 5.0x for December 2019. We expect the company to breach these covenants by year-end 2019.
- Our hypothetical default scenario assumes that Pro.Gest continues to burn cash due to further working capital outflows resulting from inventory build-ups and the unwinding of payables; the payment of the €47.5 million anti-trust fine; weak market conditions; and the ongoing stoppage of production at the Mantova plant. As a result of this, we assume that the company would not be able to meet its scheduled debt repayments.
- We value Pro.Gest on a going-concern basis, given its leading niche positions, patented products, and strong and longstanding customer relationships.

Simulated default assumptions

- Year of default: 2022
- Emergence EBITDA after recovery adjustments: €266 million
- Implied enterprise value multiple: 5.5x
- Jurisdiction: Italy

Simplified waterfall

- Emergence EBITDA: €48 million
- Distressed EBITDA multiple: 5.5x
- Gross recovery value: €266 million
- Net recovery value after administrative expenses (5%): €252 million
- Estimated priority claims (mainly bilateral facilities and mini-bonds): €138 million*
- Remaining recovery value: €114 million
- Senior unsecured debt claims: €265 million*
- Recovery range: 30%-50% (rounded estimate: 40%)
- Recovery rating: 4

*All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer credit rating: B/Watch Neg

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: highly leveraged

- Cash flow/leverage: Highly leveraged

Modifiers:

- Diversification: Neutral
- Capital structure: Neutral
- Liquidity: Less than adequate
- Financial policy: Neutral
- Management and governance: Fair

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded

	To	From
Pro.Gest SpA		
Issuer Credit Rating	B/Watch Neg/--	BB-/Watch Neg/--
Pro.Gest SpA		
Senior Unsecured	B/Watch Neg	BB-/Watch Neg
Rating Affirmed		
Recovery Rating	4(40%)	

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.