

Research Update:

# Pro.Gest SpA Downgraded To 'B-' On Weakening Liquidity; Ratings Remain On CreditWatch Negative

February 28, 2020

## Rating Action Overview

- Italian packaging group Pro.Gest SpA's liquidity position continues to deteriorate and it is likely to weaken further during 2020.
- We anticipate that liquidity deterioration will be the result of weak cash flow generation, and high capital expenditure and debt repayments.
- The company's liquidity position will depend on whether, in 2020, the plant in Mantova reopens, working capital improves, the company receives payables from an associated company, and the site in Monza is sold.
- We are therefore lowering our ratings on Pro.Gest and its fixed-rate senior unsecured notes to 'B-' from 'B'. The ratings remain on CreditWatch with negative implications.
- Our CreditWatch negative reflects a one-in-two likelihood of a further downgrade. We expect to resolve the CreditWatch status in the coming months as we receive updated information from the company on its liquidity position, including on the collection of receivables from associated companies and the disposal of noncore assets.

### PRIMARY CREDIT ANALYST

**Lina Sanchez**  
Milan  
+ 39 0272111203  
lina.sanchez  
@spglobal.com

### SECONDARY CONTACT

**Desiree I Menjivar**  
London  
+ 44 20 7176 7822  
desiree.menjivar  
@spglobal.com

## Rating Action Rationale

**We expect Pro-Gest's liquidity will remain weak in 2020.** The company had €30 million cash on its balance sheet as of February 2020, and no availabilities under committed credit lines. Currently, the company has about €26 million of payments due in 2020 relating to an antitrust fine. We understand that the company hopes to raise a guarantee for the entire amount of the fine; obtaining the guarantee would allow Pro.Gest to postpone future payments (the first payment toward the fine was made in February 2020) until at least July 2020. Furthermore, the company revised its capital expenditure (capex) expectations for 2020 to €35 million-€40 million from €15 million previously, and we therefore expect the company will generate negative free operating cash flow (FOCF) in 2020. We believe liquidity is further undermined by material debt repayments under bilateral loan agreements. We understand that the company is looking into several options to improve its liquidity position, including new financing (for €45 million), noncore asset sales (€50

million), and the collection of receivables due from associated companies (€40 million in 2020; €18 million in 2022).

**We expect covenants will be breached again at year-end 2020.** The company has finalized the waiver for the anticipated breach of certain year-end 2019 financial covenants. We expect Pro.Gest will breach these covenants again in December 2020, but understand that the company is looking into options to avoid this.

**Potential reopening of Mantova plant is now expected in second-quarter 2020, but we cannot rule out further delays to this process.** Local authorities are still reviewing the environmental impact assessment submitted by Pro.Gest. Pro.Gest continues to believe that they are likely to receive authorization to reopen the plant at Mantova, given that they abandoned their initial plan to set up a new waste incinerator there. However, any delay would lead us to revise our EBITDA expectations for 2020. We currently anticipate a €5 million EBITDA contribution from Mantova for 2020.

## CreditWatch

Our CreditWatch negative reflects a one-in-two likelihood that we could lower the issuer credit rating further. We expect to resolve the CreditWatch status in the coming months as we receive updated information from the company on its liquidity position, including on the collection of receivables from associated companies and the disposal of noncore assets.

We could lower the rating if Pro.Gest's liquidity tightens further. This could happen if Pro.Gest does not collect the €40 million in receivables from an associated company in 2020, or if it fails to sell its site in Monza (€50 million) this year. Liquidity could also weaken if containerboard prices continue to decline materially or if the company experiences further unexpected working capital or capex outflows.

We could remove the ratings from CreditWatch and consider an upgrade if we see material improvement in the company's liquidity position. This could result from improved cash generation following the re-opening of Mantova, improved market conditions, and better working capital management.

## Company Description

Pro.Gest is an Italian vertically integrated producer of containerboards (26% of 2018 revenue), corrugated cardboard (38%), and packaging solutions (36%). 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 about 1,036 employees. All of its 23 plants are in Italy. In 2018, revenue amounted to €469 million and S&P Global Ratings-adjusted EBITDA was €95 million.

## Our Base-Case Scenario

- Our estimate of minimal GDP growth in Italy of 0.4% in 2020 and 0.6% in 2021.
- 8% decline in revenue in 2019, reflecting the low sale-price environment during the year. For 2020, we expect revenue will remain broadly stable.
- We expect an S&P Global Ratings-adjusted EBITDA margin of 15% for 2019 due to lower sales prices, the shutdown of the plant in Mantova, and maintenance repairs at the Villa Lagarina

plant. In 2020, we expect EBITDA margins will improve due to the reopening of the Mantova plant. If the plant reopens in June 2020, we estimate that it will generate about €17 million in EBITDA (€5 million EBITDA generation and €12 million from white certificates granted to the plant).

- About €95 million of working capital outflows in 2019 due large inventory buildups of both raw materials and finished goods, and the settling of trade and capex payables in first-half 2019. For 2020, we assume a minimal working-capital-related inflow, but we believe that there is upside potential if the company starts selling its accumulated inventory.
- Capex of €35 million-€40 million in 2020 (about €15 million of this relates to payables for capex incurred in 2019).
- Negative free operating cash flow (FOCF) generation during 2020 of about €16 million and about €10 million of positive FOCF in 2021.
- No dividends or acquisitions.

## Liquidity

We continue to assess Pro.Gest's liquidity as less than adequate because we expect liquidity sources will cover uses by only 1x in the next 12 months. Our assessment reflects the company's weak cash generation, no availabilities under committed credit facilities, and a low cash balance, as well as higher-than-expected payments toward the antitrust fine during 2020 and higher-than-expected capex. Our assessment relies on the receipt of payables (€40 million) from an associated company, the reopening of its plant in Mantova, and no further working capital outflows.

We view Pro.Gest's liquidity as weaker than that of similarly rated peers, which is reflected by a one-notch negative adjustment in our rating on the company.

We believe that liquidity could deteriorate if the Mantova plant remains closed, containerboard prices continue to decline, or the company experiences further unexpected large working capital outflows.

We understand that the company is seeking to improve its liquidity via various initiatives. Given that these initiatives remain uncertain, we have not reflected them in our liquidity assessment. These initiatives include proceeds from the potential sale of their site in Monza (for €50 million in fourth-quarter 2020), and potential cash inflows (€45 million) from the sale and lease back of inventories and from new financing arrangements.

Principal liquidity sources during 2020 are:

- €30 million in cash on the balance sheet at February 2020,
- €20 million funds from operations;
- €40 million due from associated companies; and
- Minimal working-capital-related inflows.

Principal liquidity uses in the same period are:

- About €57 million in debt repayments; and,
- Capex of €35 million-€40 million.

## Covenants

Some of Pro.Gest's bilateral debt agreements include leverage covenants set between 4.0x and 5.0x for December 2019.

The company just received a waiver for the expected breaches of its December 2019 covenants (the relevant covenant compliance certificates were only due in March and April 2020).

We also understand that the company is looking into options to avoid another covenant breach at year-end 2020.

## Environmental, Social, And Governance

Environmental, social, and governance factors are key for containerboard producers because 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 because 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. However, 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 2020, with a capacity of about 400,000 tonnes per year, we cannot rule out further regulatory delays. The mill's €16 million inventory build-up in first-half 2019 was one of the factors that led to the large working capital outflow during 2019.

Our assessment of Pro.Gest's governance and liquidity also reflects the €47.5 million fine imposed by Italian antitrust authorities in 2019 for the company's alleged participation in an industry-wide price-fixing cartel. The first of 20 monthly installments relating to this fine was paid in February 2020. We understand that further payments under the fine could be postponed until July 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 'B' and kept it on CreditWatch negative, mirroring the CreditWatch negative placement of the issuer credit rating. The recovery rating remains '4', reflecting our expectation of average recovery (30%-50%; rounded estimate: 40%) 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. The company just received the waiver for the expected breaches of these covenants tested at Dec. 31, 2019 (the relevant covenant compliance certificates were

only due in March and April 2020). We expect Pro.Gest will breach these covenants again in December 2020.

- Our hypothetical default scenario assumes continued cash burn, worsening liquidity, sustained weak market conditions, and an ongoing stoppage of production at the Mantova plant. Because 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: €48.5 million
- Implied enterprise value multiple: 5.5x
- Jurisdiction: Italy

### **Simplified waterfall**

- Gross enterprise value at default: €267 million
- Net recovery value after administrative expenses (5%): €254 million
- Estimated priority claims (mainly bilateral facilities and mini-bonds): €138 million\*
- Remaining recovery value: €116 million
- Senior unsecured debt claims: €266 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

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

## 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
<b>Pro.Gest SpA</b>		
Issuer Credit Rating	B-/Watch Neg/--	B-/Watch Neg/--
<b>Pro.Gest SpA</b>		
Senior Unsecured	B-/Watch Neg	B-/Watch Neg
Recovery Rating	4(40%)	

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