



Lecta - Liquidity Intact, Senior Secured Close To Liquidation Recovery Value. Buy

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James Moylan & Rupesh Tailor, Everest Research, 4 September 2019

- Lecta held its Q2 2019 results call yesterday, highlights of which we provide below (overall positive in our view). In our [note](#) on 2/9/19, we recommended **buying Lecta € 6.5% 2023 senior secured notes at a price of 32.63 for investors who are able to invest new money in a restructuring** (closed yesterday at 34.64 following the results call), a view we reiterate following the results call premised on the following:
- **Business value.** Speciality papers (particularly self-adhesives) remains a growth business with 4.5% per annum growth potential across Lecta's mix in our view and some scope for further EBITDA margin expansion over time from 12.5% at Q2 2019 LTM towards the 15% longer term target of management (though we do not assume this). **Our DCF values Lecta at €430m which is 4.1x Q2 2019 LTM EBITDA of €105m** compared to Sappi (similarly exposed to coated wood free, CWF, and Speciality) at 4.5x and more diversified / vertically integrated competitors Stora Enso at 7.8x and UPM at 7.4x. This compares with Lecta's senior secured debt currently being valued at c. €207m with €65m RCF ahead of it
- **Liquidity.** Whilst the €65m RCF is now fully drawn subsequent to Q2 2019 and cash as of yesterday was only at similar levels to Q2 2019 (€79m) despite the RCF draw, Lecta disclosed on the call it has **€126m of trade receivables available as Permitted Liens on which it is in advanced discussions to do further non-recourse factoring / invoice discounting**. On an advance rate of 70% (in line we estimate with Lecta's historic advance rate) **this would provide an additional €88m in liquidity, reasonable compared to the implied H2 2019 guidance of c. -€5m FCF in H2 2019** (explanation as per our [note](#))
- **Liquidation recovery value.** We see a **liquidation recovery value of 24%** (see our [note](#)), not far below current trading levels (assuming: Speciality is sold; **CWF is entirely closed at a cost of €10m per 100,000 tonnes**; a remaining €94m of trade receivables sold at a 50% discount). **Conservatively this assumes no value for Lecta's substantial electricity business which had revenue of €107m in Q2 2019 LTM on what we believe will be very high EBITDA margins as a by-product of Lecta's co-generation capability**



- **Return potential.** In a restructuring as per our [note](#), we see Lecta's senior secured notes being converted into a significant majority of the post-reorganisation equity as well as investors having the opportunity to invest new money into a new 1st lien senior secured note. **Assuming a business value of €430m, and assuming other net debt of €59m (Q2 2019 pro forma for the subsequent €30m RCF draw), leaves post-reorganisation equity value of c. €370m of which a 90% share for senior secured noteholders would be worth €333m vs €207m current market valuation of the senior secured notes, upside of 60% though we can envisage this being higher**

Clearly there are risks, including:

- **CWF structural decline.** Despite H1 2019 European CWF demand running at -10% yoy (and c. -20% yoy in June alone), we see the balance between capacity reduction and demand reduction improving over the remainder of 2019 – 2020. On our estimates (see our [note](#)), **capacity closure over 2019 – 2020 amounts to c. 31% to c. 36% of 2018 European CWF demand compared to a demand decline run-rate over 2019 – 2020 of 20%. This is the first time we can recall that capacity reduction may be meaningfully higher than demand decline. Whilst this won't support volumes, it should provide some support to CWF prices**
- **Liquidity.** Whilst we found the Q2 2019 call reassuring on liquidity in respect of the remaining scope for, and advanced discussions on, non-recourse factoring of receivables, we are mindful that **Q1 2020 represents another liquidity pressure point for Lecta given its trade payables of €345m and the typical working capital outflow seen on these in Q1 together with a concentration of bond coupons in the quarter**
- **Unappreciated reliance on electricity business?** Electricity sales (a by-product of Lecta's steam co-generation) generated Q2 2019 LTM revenue of €107m on what we would imagine to be a very high EBITDA margin given the by-product nature of the business. **We believe that EBITDA on this electricity revenue effectively ends up in Lecta's CWF and Speciality segmental reporting and could be a material part of those segments' EBITDA, effectively leaving Lecta somewhat exposed to variation in wholesale electricity prices (and in subsidies)**
- **Technicals.** We believe most of Lecta's senior secured FRN 20222 is / was held by CLOs. The move from being a par credit just a few months ago to now trading in the 30s will likely have caught some CLO investors and mainstream HY investors off-guard and **the speed of the move will have afforded limited scope for investors to exit and for investors not able to commit new money in a restructuring, Lecta is likely not an investible situation for them**



Q2 Results – Highlights

See our [note](#) for more details but in short:

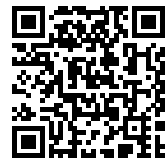
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Liquidity. Post Q2 2019, the remaining €30m available under the RCF was drawn (to fund c. €20m in bond coupons in July and c. €10m of other cash burn) so the RCF has been fully utilised and cash remains broadly at Q2 2019 levels of c. €79m. The company expects to be able to pay its next major semi-annual coupon on the fixed rate notes in January 2020

- Lecta stated it has a further €126m of trade receivables which are available for non-recourse factoring, higher than we expected. On our estimated 70% advance rate, this suggests a further €88m in liquidity from non-recourse factoring and discussions on additional factoring facilities are “well advanced”. Management also confirmed that there was nothing contractually that would force them to reduce the size or utilization of the RCF. Management confirmed there has been no change in credit insurance terms since the tightening in Q1 2019 though it has discussions with insurers this week
- **2019 guidance.** 2019 EBITDA of at least €100m, capex of €60m (excluding potential conversion of Condat Line 8 to speciality, a decision on which will be taken in the next several weeks) and working capital improvement of €25m – €30m over Q2 – Q4 combined which at the mid-point implies -€34m for FY 2019 (vs -€61m at Q1 2019). As we show in our [note](#), this guidance implies H2 2019 FCF of c. -€5m, which is manageable versus c. €79m of cash and potential factoring availability of €88m. Net debt is “not expected to rise much through year end”

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Q2 2019 Speciality EBITDA weakness yoy. The market was disappointed by the drop in Speciality EBITDA (the growth engine vs declining CWF) from €17m in Q2 2018 to €13m in Q2 2019. Management attributed this to a higher chemical cost in its thermal segment and negative pulp inventory revaluation in Q2 2019 (as pulp prices fell) vs positive revaluation in Q2 2018, though the breakdown of the yoy €4m drop was not provided. Management expects these chemical costs to come down as they are due to what it considers to be one-off supply chain disruption



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Conversion of Condat Line 8 to Speciality. A decision will be taken within the next several weeks as to whether this proceeds. Management reiterated an expected 2 – 3 year payback (capex excluding any potential energy subsidies divided by expected EBITDA)

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Days payable outstanding (DPO) higher than peers. Management see this as reflective of its long-term supplier relationships and sustainable. They see no pressure from suppliers to lower their DPO to levels in line with peers

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Long-term Speciality EBITDA margin target 15%. Management was confident that this could be attained (up from 12.5% at Q2 2019 LTM) though the horizon over which to achieve this is unclear

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Maintenance capex. Most of the €60m 2019 capex guidance (excluding Condat Line 8 conversion) relates to Speciality with maintenance capex in CWF guided at €20m



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