Enviro: Sets the structure for growth

Scandinavian Enviro Systems **Research Update** 2023-04-12 07:00 **Updated** 2023-04-12 07:10

Redeye updates its estimates following the ground-breaking news of the establishment of a Joint Venture (JV) with Antin and Michelin, creating a framework for the roll-out of recycling plants capable of handling up to 1m tons of end-of-life tyres pa by 2030. The JV increases our confidence in the investment case of Enviro, and several aspects are now significantly de-risked in our view.


Mattias Ehrenborg

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The JV announcement came as a positive surprise to us

We argue that the establishment of the JV with Antin and Michelin verifies Enviro’s investment case and provides an attractive framework for reaching up to 1m tons in ELT capacity by 2030, as we argue Enviro’s coming equity investments should be greatly reduced relative to what we expected before. Furthermore, the JV aligns all stakeholders' interests and incentivizes them to succeed.

Financial risk should be greatly reduced, but we do expect a directed share issue of SEK300m

We find it very positive that Antin will designate its own management team in the JV and that Enviro will be reimbursed for all its previous work and future works regarding the Uddevalla plant and other plants included in the JV. This further reduces the financial risk in Enviro. However, we believe a directed share issue of up to SEK300m will take place in the coming quarters to finance the first plant (Uddevalla) and to receive 30% ownership in the JV.

Increased estimates and valuation

We have reviewed our estimates following the JV announcement, primarily with regards to prices per ton, the roll-out of plant capacity, and awaiting capital requirements, where we expect a directed share issue of up to SEK300m to take place in the coming quarters. Our assumptions for this expected share issue include the issuance of 150m shares, at the price of SEK2.0 per share (19% dilution). All in all, this results in an increased fair value range of SEK2.1 (1.1) – SEK11.0 (9.6) per share, with a base case of SEK6.1 (4.1) per share.

Key financials

SEKm	2020	2021	2022	2023E	2024E
Revenues	2	9	8	59	53
Revenue Growth	59.6%	353.0%	(10.7%)	675.4%	(11.3%)
EBITDA	(37)	(43)	(70)	(24)	(34)
EBIT	(50)	(57)	(84)	(38)	(48)
EBIT Margin	(2628.9%)	(663.2%)	(1093.8%)	(64.6%)	(90.6%)
Net Income	(50)	(57)	(84)	(40)	(49)
EV/Revenue	704.9	123.5	176.0	18.4	24.3
EV/EBIT	(26.8)	(18.6)	(16.1)	(28.6)	(26.8)

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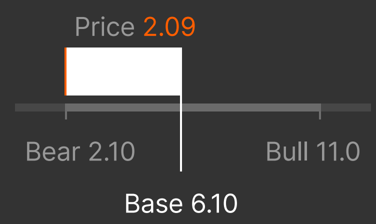
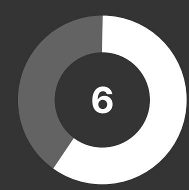
REDEYE QUALITY RATING

FAIR VALUE RANGE



TIMELINESS



KEY STATS

Market Cap	1.3 BSEK
Entprs. Value (EV)	1.0 BSEK
Net Debt (2023e)	-276.8 MSEK
30 Day Avg Vol	2742 K
Shares Outstanding	656.6 M
Price / Earnings	N/A
PEG	N/A
Dividend Yield	N/A

Data from 2023-04-12 07:10

IMPORTANT INFORMATION

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Follow-up to our research note published the morning after the JV announcement

The fact that a leading private equity firm within infrastructure investments (Antin) has conducted market research of the ELT market identified its problems and opportunities for more than one year, to conclude that tyre pyrolysis offers a fantastic market opportunity – followed by more than one-year-long JV negotiation to conclude in a JV with Enviro and Michelin, is a validation of Enviro's value proposition. Furthermore, the JV aligns all stakeholder's interests and incentivizes them all to succeed.

We believe Antin has evaluated all of Enviro's competitors only to conclude that Enviro is the best company to partner with in terms of technology, products, strategic partnerships etc. This, once again, verifies Enviro and its business case, as well as the opportunity to categorize Enviro's plants as infrastructure investments (allowing a high portion of debt financing) as opposed to traditional industrial investments.

This allows for very high leverage, requiring relatively small equity investments, thus making the plant roll-out until 2030 very asset-light from an equity investment perspective.

For example, this means Enviro does not have to invest SEK400m in equity in a new plant, as 80% gearing would only require SEK80m in total equity, of which Enviro (through its 30% ownership) would invest SEK24m – which is roughly 3x the amount of Enviro's recurring royalties per plant.

We also find it very positive that Enviro will be reimbursed for all its previous work, and future works, regarding the Uddevalla plant and other plants included in the JV. This further reduces the financial risk in Enviro.

Also, Antin has designated its own management team in the JV and has a long track record of scaling industrial initiatives such as this – which provides further comfort in the roll-out, even if we consider the first plant to be critical in terms of proving the commercial viability and modular concept of Enviro's plants.

We believe Enviro will be compensated for historical costs related to Uddevalla once a final investment decision has been made, which we expect to take place during Q2-Q3 2023 – as construction needs to start by then in order to meet the deadline of commissioning by the end of 2024 (we expect 18 months construction time). This should be further supported by Michelin's dependency on the JV's near-term success as it is to launch its recycled tyres containing Enviro's rCB in 2025.

We expect Enviro to have a capacity of 960k tons by 2030 – equivalent to 27% of total ELTs arising in 2020. By 2040, we expect 1560k tons, which is equivalent to 45% of Europe's total ELT arisings in 2020, or equivalent to 27% of the market in Europe and 16% in the US.

Should Enviro sign a similar strategic partnership in the US, we should also expect to increase our assumptions further, even if we already include 1.5m tons capacity in 2040. Even if Enviro should deliver on our estimates, that global potential remains massive.

We make estimate changes following the JV announcement, primarily related to prices per ton, the roll-out of plant capacity, and awaiting capital requirements, where we expect a directed share issue of up to SEK300m to take place in the coming quarters. Our assumptions for this expected share issue include the issuance of 150m shares, at the price of SEK2.0 per share (19% dilution). All in all, this results in an **increased fair value range of SEK2.1 (1.1) – SEK11.0 (9.6) per share, with a base case of SEK6.1 (4.1) per share.**

Capital requirements

We expect the JV to be able to fund its operations with a very high degree of debt. This is something that characterizes Infrastructure investments, and we are certain Antin would not have been interested in creating a JV and taking the operational lead in it if it was not as certain it could reach a high degree of leverage.

The beauty of high leverage, coupled with solid and recurring cash flows, is that it requires a relatively low degree of equity as opposed to if the venture was to be solely funded with equity. We argue this makes an immense difference for Enviro going forward, as we have previously highlighted the otherwise massive equity investments ahead.

However, for the first plant (Uddevalla), we do not expect 80% leverage. We rather think it will be financed by equity solely to fully prove its commercial viability. We also believe the first plant could be more expensive to construct than coming plants – given that it is the first time Enviro and the JV will construct a commercial plant of this dignity.

Enviro has previously stated SEK400m in CAPEX per plant. If we take a conservative approach and expect SEK500m for the first plant, combined with 100% equity financing, it would require a SEK150m investment from Enviro for its 30% owner share. We also believe this SEK150 m will make Enviro a 30% shareholder in the JV – which is the option Enviro has 24 months from now to utilize.

Enviro is to receive royalties from each plant, which is linked to the profitability of each plant (we expect 7% of EBITDA). We have previously expected 5% of sales, corresponding to 7% of EBITDA, which we still consider a fair level given that the JV depends on Enviro's technology. Having royalties linked to EBITDA also protects the JV from downside risk for the JV if it should not be as profitable as previously expected, given a certain level of sales.

Given Enviro's favourable long-term outlook, coupled with near-term capital requirements (to fund the first plant), and the lack of institutions in the list of shareholders, we argue the company should try to raise new equity through a directed share issue.

We note the company has a mandate of 20% dilution, equivalent to 25% of total market capitalization – and we believe a directed share issue could be a very cost- and time-efficient approach to raising the desired amount of capital.

We argue the interest in Enviro should be high following the press release regarding the JV with Antin and Michelin – as the path toward 2030 has crystalized, with offtake agreements and capital commitments from one of the biggest private equity firms in Europe with >30bn in AUM, and one of the largest tyre manufacturers in the world, whose interests and incentives are all aligned.

Given the valuation of listed companies with similar characteristics as Enviro (primarily unique recycling technologies), who have not come as far with regards to technology, business model, and financing - but still have a valuation higher than Enviro - should provide a good opportunity for new institutional investors to enter the share.

We have previously expected SEK240m to be raised in equity/debt to fund the previous business plan ahead of the roll-out. We still think this is realistic: however, Enviro will receive fees for its work put down for the JV, which means its underlying OPEX will be lower going forward. We still think Enviro should utilize as much as possible of the mandate, however, if it has the possibility, to remove any doubts of future equity raises and capital requirements to become cash flow positive. This is also likely something that would give support for the Enviro share. Furthermore, should Enviro need additional capital beyond the scope of the first plant, we believe various types of green debt could be an attractive alternative.

Estimate changes

We make several estimate changes following the announcement of the JV as we believe the road towards 1m tons capacity by 2030 has crystalized. The following section describes the key parameters behind our estimate changes.

Increased price per ton
We use the lower range of Enviro's previously communicated price range in our base case and its upper range for our bull case. For our bear case, we use 75% of our base case for oil and 50% of the carbon black. All in all, this results in a bear/bull price range of SEK 4888 – SEK 9443 per ton, with a base case of SEK 7771 per ton. These numbers are the same as Enviro has previously communicated in various presentations, but we decided not to fully incorporate them in our estimates before we saw more evidence. We now believe the price levels of the offtake agreements in the JV are largely in line with what Enviro has communicated before – otherwise; we think it would have to be restated.

An increased pace of plant roll-out
Regarding plant roll-out, we expect Enviro to reach a capacity of 960k tons by 2030, which aligns with the JVs target of capacity of up to 1m tons by 2030. We had previously expected a capacity of 1m tons by 2036. The new figure corresponds to 27% of ELT arisings in 2020, which we find fair given the JV's growth agenda until 2030 and its first-mover advantage. By 2040, we expect a capacity of 1560k tons, which is equivalent to 27% in Europe and 16% in the US. This capacity is still only scratching the global surface, as it is equivalent to 6% of the total global annual supply of ELT.

Cost compensation
Enviro will be compensated for historical costs related to Uddevalla once a final investment decision has been made, which we expect to take place during Q2-Q3 2023 – as construction needs to start by then if it is supposed to be commissioned by the end of 2024 (we expect 18 months construction time). Enviro will also be compensated for future work that will benefit the JV. This means Enviro can address more capital on R&D and future potential partnerships. We believe the historical costs might amount to SEK50m, which is a majority of the total OPEX during the last two years. Going forward, we expect around 50% of OPEX to be compensated for, which means Enviro will invoice the JV and thus recognize revenues of the corresponding amount in the P&L.

Capital structure in future plants
We expect plants in the coming years to have 80% leverage, which means 20% equity needs to be injected. For Enviro, with a 30% owner share, each plant should require an equity injection of SEK24m, given a total plant CAPEX of SEK400m. Given Enviro's expected royalties and cash flows from the ownership in the JV, the roll-out should be financed. Especially if Enviro can raise additional debt in its holding company.Furthermore, we do not rule out that EU grants can come into play, but we do not include it in our estimates.

All in all, we believe the outlook is more favourable today relative to our old estimates, where we had anticipated Enviro to hold a 20% owner share in its initial plants and a 50% equity ratio. The new assumptions mean Enviro will invest less equity than before but have a larger ownership share than before.

Capital requirements
As previously stated, we had expected Enviro to raise SEK240m ahead of its plant roll-out. We had previously modelled Enviro would raise this sum in debt, but we now expect SEK300m to be raised in equity – or roughly 23% of current market cap. As a result, this increases the share base by 23% (19% dilution), negatively affecting our fair value per share range.

Profitability
The plants' high profitability, with EBITDA margins of 65%, is mainly driven by the very cheap raw material end-of-life tyres offer. This is because it is an environmental problem hard to deal with, but that pyrolysis offer a circular approach. Long term, we think competition for ELTs will increase, which will likely increase the price per ton of ELT, given the very high profitability levels in the sector.

As a result, we lower the current gross margin of 77% to 72% in 2030 and 54% in 2040, down to 31% in 2070 (terminal). The EBITDA margin per plant also goes from today's expected 65% to

60% in 2030 and 41% in 2040 to 18% in 2070. The margin drop could be offset by price increases higher than inflation of TPO and rCB – but we do not expect it in our current estimates.

Valuation

Following our estimate changes, primarily related to prices per ton, the roll-out of plant capacity, and awaiting capital requirements, where we expect a directed share issue of up to SEK300m to take place in the coming quarters. Our assumptions for this share issue include the issuance of 150m shares, at the price of SEK 2.0 per share. All in all, this results in an increased fair value range of SEK2.1 (1.1) – SEK11.0 (9.6) per share, with a base case of SEK6.1 (4.1) per share.

Going forward, we consider the next big events for the share to be:

- a potential directed share issue to institutional investors,
- a final investment decision for Uddevalla,
- additional offtake agreements for TPO,
- and potential new partnerships outside of the JV (potentially North America)

We consider the two latter events to be somewhat more long-term oriented in its character relative to the first two events.

We at Redeye will host a recycling event on 19 April where Enviro will present, and a consecutive Q&A session will be held, where we will allow investors to ask questions via a web form found on the site (questions can be posted already today).

Scandinavian Enviro Systems: Base case

Assumptions	**2024-30**	**2031-40**	**2041-70**	**DCF-value**	
Plants deployed	32	20	42	WACC	12%
Accumulated capacity, kton	960	1560	2826	Net present value FCF '23-'30e	629
% of European ELT market, 2020	27%	45%	81%	Net present value FCF '31-'40e	2 857
% of Global ELT market, 2020	4%	6%	11%	Net present value FCF '41-'70e	1 369
				Net present value terminal value '70e	69
Conversion value, SEK per ton	7771				
Average plant equity stake, %	30%			EV	4 925
Royalty, % of EBITDA	7%			Net debt	-24
Gross margin per plant, end of period	72%	54%	31%		
EBITDA per plant, end of period	60%	41%	18%		
Recurring royalty, SEKm, end of period	244	329	472		
				DCF-value	**4 949**
Terminal				Number of shares, m	807
Enviro's Terminal growth FCF	2%			**Estimated Fair value per share**	**6.1**
Enviro's Terminal EBITDA margin	22%			Current share price	2.1
Exit EV/EBITDA multiple	7.4x				
				Potential/Risk	**194%**

Source: Redeye Research

Investment thesis

Case

Offering a highly attractive solution for unsolved ELT recovery issue

Over the years, many attempts have been made to recover the valuable materials inside a tyre once it has reached its end of life. Attempts have failed due to material complexity, making it very difficult to produce high-quality materials for commercial use. Enviro has proved it possible, using its patented technology that allows for full ELT material recovery (rCB, TPO, steel) that can be sold, and re-introduced to a wide range of applications. As a pioneer in the industry, with many years of trial and error and a good track record in terms of material validation from production tests, we argue Enviro enjoys a first-mover advantage and should be several years ahead of competitors.

Evidence

Michelin and Antin have validated Enviro and its technology

Since 2020, Enviro has managed to attract Michelin to become the largest shareholder in Enviro, who also has unveiled 2 sustainable commercial tyres with rCB inside for launch in 2025. Enviro has also received ISCC certification for its rCB and TPO, making it possible to sell it commercially - and successful production tests from a top 10 global oil company have taken place. These events have led to a JV establishment with Antin and Michelin, which we argue provides an attractive framework for reaching up to 1m tons in ELT capacity by 2030. This also categorises the plants as infrastructure (allowing for a high degree of debt, thus reducing equity requirements, which we have considered a concern for Enviro). We, therefore, argue that Enviro has managed to fulfil its growth plan upon this point. The demand for Enviro's products has been further spurred since the war in Ukraine and structural high oil prices –increasing incentives for companies to use Enviro's recycled products.

Challenge

Capital intensive business

Enviro plans to co-own the production facilities it builds through the JV with Antin and Michelin, where we expect it to hold a 30% equity stake. CAPEX for one plant is expected to be around SEK400m, which is a sizeable figure for a company of Enviro's current size. Even a 30% share in the venture (SEK120m) is a significant amount that needs to be financed, which may require future capital injections into Enviro if the JV does not manage to reach a high degree of debt in each plant. However, we believe that plant financing will be possible if Enviro signs off-take agreements for its raw materials, and we do not believe Antin would have been interested in establishing a JV if it was not certain it could use high leverage.

Challenge

rCB fails to take off

Following the successful TPO production test from one of the worlds leading oil companies, we believe there should be no issues offsetting produced TPO volumes, given its sustainable characteristics and the high global demand for crude oil. Instead, one of our greatest concerns is that rCB-demand fails to take off, which would harm the calculation of Enviro's plants and/or the pace of the rollout phase. However, after Michelin's unveiling of two sustainable tires (incl.-rCB) approved for road use that will be launched within 2-3 years, we feel more comfortable than ever that rCB will play an important role in the future.

Valuation

Significant upside potential but dependent on growth plan execution

We have derived a fair value range for Enviro of SEK2.1 – SEK10.6, with a base case of SEK6.1 per share. Our scenarios are primarily driven by the extent to which recovered materials can replace current materials in the future and Enviro's estimated market share. In our base case, Enviro will install a plant capacity equivalent to 960k tons by 2030, equivalent to 27% of total ELT arisings in 2020. The wide range illustrates our long-term horizon in our estimates and the risks involved, as Enviro is still to construct its first plant and is yet to sell significant volumes of its raw materials. As milestones are met and risks removed, we expect to tighten this wide range, reduce the risk premium, and make updated base case assumptions using the realised sales figures from the sales of TPO and rCB.

Quality Rating

People: 4

Enviro has since 2001 developed its pyrolysis process, which evidently produces high-quality materials – which has been confirmed by Michelin and global oil companies. This gives us great belief in the people, as the founder is still active in the company (R&D manager) and CEO and CFO holds 5 years in their current positions, showcasing they can develop a technology to produce high-quality products. Furthermore, Enviro has attracted and successfully negotiated with Michelin, and is set to co-produce and co-own a production facility – a result of a demanding process that requires competences not often found in a relatively small organization as Enviro. However, given Enviro's governance structure, a wide range of competencies can be found and utilized in the board of directors, in addition to management. Enviro is still in the inception of its commercialization phase, which makes it difficult to assess the track record of Enviro's management, however, it looks solid to this date. To raise the score to a five, we would like to see a successful rollout of the commercialisation phase.

Business: 4

We believe Enviro is in an excellent position to benefit from several sustainability- and ESG trends in several markets. Enviro has a strong value proposition for customers and partners, offering raw materials with attractive sustainable characteristics with attractive margins and short payback times – whilst solving the environmental issue caused by ELTs. However, to this date, the business model is relatively unproven as Enviro is just entering its commercialisation phase, therefore scoring low in our rating system. However, future demand is expected to be very high, and we consider Enviro to possess several moats such as high product quality due to its patented pyrolysis process, and its partnership with Michelin, which we believe puts Enviro in the pole position.

Financials: 0

Enviro is now on the verge of fully commercializing its patented ELT pyrolysis technology. However, historical sales figures have been very low, and earnings deep in the reds – 2021 recorded a loss of SEK-57m. Without significant sales and so far, only negative earnings and cash flows, Enviro scores low in Financials category. We expect the company to rapidly grow sales over time from its current levels as plants are consecutively installed, while we also view additional funding necessary before break-even.

Financials

Income statement

SEKm	2020	2021	2022	2023E	2024E
Revenues	2	9	8	59	53
Cost of Revenue	0.4	2	1	52	44
Operating Expenses	(38)	(51)	(76)	(82)	(84)
EBITDA	(37)	(43)	(70)	(24)	(34)
Depreciation	(13)	(13)	(14)	(14)	(14)
Amortizations	-	-	-	-	-
EBIT	(50)	(57)	(84)	(38)	(48)
Shares in Associates	-	-	-	-	-
Interest Expenses	0.4	0.3	0.21	2	2
Net Financial Items	(0)	(0)	0.2	(1)	(1)
EBT	(50)	(57)	(84)	(40)	(49)
Income Tax Expenses	-	-	-	-	-
Net Income	(50)	(57)	(84)	(40)	(49)

Balance sheet

Assets

Non-current assets

SEKm	2020	2021	2022	2023E	2024E
Property, Plant and Equipment (Net)	71	71	79	71	183
Goodwill	-	-	-	-	-
Intangible Assets	41	42	53	52	51
Right-of-Use Assets	-	-	-	-	-
Other Non-Current Assets	0.15	0.15	-	-	-
Total Non-Current Assets	112	113	132	123	234

Current assets

SEKm	2020	2021	2022	2023E	2024E
Inventories	2	2	2	3	3
Accounts Receivable	0.15	0.37	1	1	1
Other Current Assets	3	4	6	26	26
Cash Equivalents	40	123	30	323	138
Total Current Assets	45	130	39	353	168
Total Assets	157	243	171	475	402

Equity and Liabilities

Equity

SEKm	2020	2021	2022	2023E	2024E
Non Controlling Interest	-	-	-	-	-
Shareholder's Equity	142	227	144	404	355

Non-current liabilities

SEKm	2020	2021	2022	2023E	2024E
Long Term Debt	1	-	5	45	45
Long Term Lease Liabilities	-	-	-	-	-
Other Non-Current Lease Liabilities	-	-	-	-	-
Total Non-Current Liabilities	1	-	5	45	45

Current liabilities

SEKm	2020	2021	2022	2023E	2024E
Short Term Debt	3	1	1	1	1
Short Term Lease Liabilities	N/A	N/A	N/A	N/A	N/A
Accounts Payable	11	15	21	25	1
Other Current Liabilities	-	-	-	-	-
Total Current Liabilities	14	16	22	26	2
Total Liabilities and Equity	157	243	171	475	402

Cash flow

SEKm	2020	2021	2022	2023E	2024E
Operating Cash Flow	(38)	(41)	(66)	(42)	(60)
Investing Cash Flow	(11)	(14)	(33)	(5)	(125)
Financing Cash Flow	29	139	5	340	-

Rating definitions

Company Quality

Company Quality is based on a set of quality checks across three categories; PEOPLE, BUSINESS, FINANCE. These are the building blocks that enable a company to deliver sustained operational outperformance and attractive longterm earnings growth.

Each category is grouped into multiple sub-categories assessed by five checks. These are based on widely accepted and tested investment criteria and used by demonstrably successful investors and investment firms. Each sub-category may also include a complementary check that provides additional information to assist with investment decision-making.

If a check is successful, it is assigned a score of one point; the total successful checks are added to give a score for each sub-category. The overall score for a category is the average of all sub-category scores, based on a scale that ranges from 0 to 5 rounded up to the nearest whole number. The overall score for each category is then used to generate the size of the bar in the Company Quality graphic.

People

At the end of the day, people drive profits. Not numbers. Understanding the motivations of people behind a business is a significant part of understanding the long-term drive of the company. It all comes down to doing business with people you trust, or at least avoiding dealing with people of questionable character.
The People rating is based on quantitative scores in seven categories:

- Passion, Execution, Capital Allocation, Communication, Compensation, Ownership, and Board.

Business

If you don't understand the competitive environment and don't have a clear sense of how the business will engage customers, create value and consistently deliver that value at a profit, you won't succeed as an investor. Knowing the business model inside out will provide you some level of certainty and reduce the risk when you buy a stock.
The Business rating is based on quantitative scores grouped into five sub-categories:

- Business Scalability, Market Structure, Value Proposition, Economic Moat, and Operational Risks.

Financials

Investing is part art, part science. Financial ratios make up most of the science. Ratios are used to evaluate the financial soundness of a business. Also, these ratios are key factors that will impact a company's financial performance and valuation. However, you only need a few to determine whether a company is financially strong or weak.
The Financial rating is based on quantitative scores that are grouped into five separate categories:

- Earnings Power, Profit Margin, Growth Rate, Financial Health, and Earnings Quality.

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