Futureal Development Holding Kft.
Hungary, Real Estate

STABLE
BB

Corporate profile

Founded in 2003, Futureal Development Holding Kft. has become one of the leading real estate developers in CEE over the past 17 years. It has developed 500,000 sqm of class A office and prominent retail projects in Hungary, Romania, Poland. Until the corporate spin-off of Cordia International Zrt.in 2016, it also had some 4800 residential units. In terms of property value, Futureal has realised projects worth EUR 5bn in CEE property markets.

Key metrics

			Scope estimates	
Scope credit ratios	2018	2019	2020E	2021E
Scope-adjusted EBITDA/interest cover (x)	19.1x	-2.0x	7.5x	1.2x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	net cash	-21.9x	27.9x	24.3x
Scope-adjusted loan/value (LTV) (%)	-1%	18%	29%	48%

Rating action

Scope assigns an issuer rating of BB/Stable to the issuing entity Futureal Development Holding Kft. and an issuer rating of BB/Stable to the holding company and guarantor of the contemplated senior unsecured bond Futureal Holding B.V.. Furthermore, Scope assigns a long-term debt rating on senior unsecured debt of BB.

Rating rationale

We rate Futureal's business risk at BB. This includes a blended industry risk of B+ to reflect the company's core activity of real estate development as well as the dynamic growth of its commercial investment property portfolio, which generates recurring revenues.

Competitive positioning (rated BB+) is supported by Futureal's strong market position as Hungary's largest commercial real estate developer with a long track record, high visibility and an excellent industry network. The absolute size of Futureal's commercial portfolio is, however, still limited at this point. The company has properties/projects in Hungary, the UK and Poland. Nevertheless, diversification is a rating constraint since the lion's share of anticipated rental revenue will be concentrated around Budapest. Despite a substantial increase in the company's project pipeline, also in the logistics segment, a strong dependency on the Budapest retail and office markets remains for now.

Futureal's financial risk profile, assessed at BB-, benefits from an anticipated increase in recurring and more granular revenue. It is constrained by the remaining execution risks posed by the company's transition to a commercial real estate owner. In the short term (2021 and 2022), we expect a temporary slump in interest cover to 1.2x-1.7x, based on much higher financial debt, our weighted average debt assumption and the gradual ramp-up of rental revenues. In the medium term (2023 and beyond) we expect interest cover to move towards 2.0x. A delay in construction or the start of project operations may result in prolonged interest payments at potentially higher rates. We expect lower revenues due to the negative impact of the Covid-19 pandemic. Our financial forecast also includes stressed costs.

Ratings & Outlook

Corporate rating	BB/Stable
Senior unsecured rating	BB

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Related Methodologies

Corporate Rating Methodology, European Real Estate Rating Methodology

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Outlook and rating-change drivers

The Outlook is Stable and reflects Scope's view that Futureal will be able to grow its recurring revenue base by successfully completing its develop-to-hold projects on time and on budget. As a consequence, Scope assumes an increasing Scope-adjusted loan/value ratio of 50%-60% and Scope-adjusted EBITDA interest cover of above 1.0x from recurring revenues only, not taking potential asset sales into account.

A positive action would require the company to reduce leverage, as measured by its Scope-adjusted loan/value ratio, to below 50% on a sustained basis while achieving Scope-adjusted interest coverage from recurring rental income at least in line with Scope's financial base case.

A negative rating action is possible if either Futureal's Scope-adjusted loan/value ratio increases to more than 60% on a sustained basis or Scope-adjusted interest coverage from recurring revenues lags Scope's base case expectations. This could be triggered by a slump in market prices/rents or weak rent collection rates as the result of a prolonged crisis in the retail sector.

Rating drivers

Positive rating drivers	Negative rating drivers
• Robust track record of 17 years in developing over 150 real estate projects in Hungary with a combined market value of EUR 5bn • Market leader for commercial real estate development in Hungary with high visibility and good tenant quality • Balanced long-term financing structure allows for 100% develop-to-hold project pipeline, mitigating some development risks and increasing recurring revenue over time • Above-average operating profitability via economies of scale, good access to external financing and preferred partnerships in construction	• Inherent development risks despite high pre-letting ratio, plus focus on asset classes like office and retail, which are riskier than residential • Limited recurring rental cash flows as majority of previous projects have been sold • Complex, multinational legal structure with limited historical consolidated financial data • Strong geographical cluster risk on Budapest, Hungary

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significant business risk improvement via much higher recurring cash flows while keeping Scope-adjusted LTV below 50% on a sustained basis	• Scope-adjusted LTV above 60% on a sustained basis • Weaker-than-expected build-up of recurring rental revenue

Financial overview

		Scope estimates		
Scope credit ratios	**2019**	**2020E**	**2021E**	**2022E**
EBITDA/interest cover (x)	-2.0x	7.5x	1.2x	1.7x
Scope-adjusted debt/EBITDA	-21.9x	27.9x	24.3x	19.0x
LTV (%)	18%	29%	48%	56%
Scope-adjusted EBITDA in EUR '000	**2019**	**2020E**	**2021E**	**2022E**
EBITDA	-4,415	5,679	16,266	33,821
Operating lease payments in respective year	0	0	0	0
Other	0	0	0	0
Scope-adjusted EBITDA	**-4,415**	**5,679**	**16,266**	**33,821**
Scope-adjusted debt in EUR '000	**2019**	**2020E**	**2021E**	**2022E**
Reported gross financial debt	146,252	224,569	552,569	729,569
deduct: cash, cash equivalents	-67,735	-83,906	-175,307	-105,815
add: restricted cash	18,016	18,016	18,016	18,016
Scope-adjusted debt	**96,533**	**158,679**	**395,278**	**641,770**

Business risk profile (BB)

Blended industry risk of B+

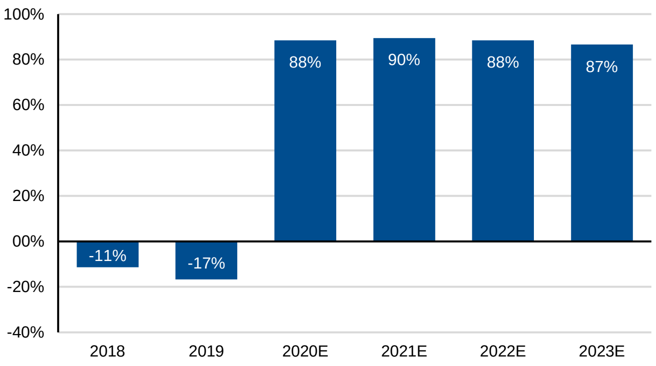
We assess industry risk as B for developers and BB for commercial real estate corporates. We assign a blended industry risk of B+, reflecting the development risks which the majority of Futureal's current project/property portfolio is still subject to. The company already has recurring rental income from finished commercial investment properties (around EUR 6m p.a. in 2019 and 2020E) that it does not intend to sell. We have therefore applied a one-notch uplift for the relative share of finished properties in the current portfolio.

The three finished properties which produce recurring rental income are: BudapestOne (building A), Spectrum in Glasgow, UK and Corvin/Vaci street retail, also located in Budapest.

Largest player in a rather fragmented market

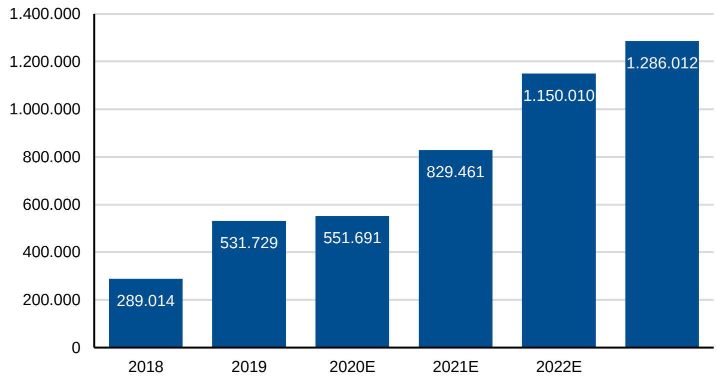
Futureal's market position is credit positive, with Scope-adjusted assets of around EUR 550m as of year-end 2020 (2019: EUR 532m) and a gross leasable area of 477,000 sqm (including under development) or 47,000 of finished properties. The company has a moderate market share. It is the largest commercial real estate developer in Hungary, implying a relatively strong position in a fragmented market.

Figure 1: Scope-adjusted EBITDA margin



Source: Scope estimates

Figure 2: Scope-adjusted assets (EUR '000)



Source: Scope estimates

Geographical cluster risk on Budapest

Geographical diversification is a constraint on overall diversification. Futureal has only two projects/properties outside of the greater Budapest area (e.g. the Antares office in Warsaw and Spectrum office building in Glasgow), representing less than 10% of gross asset value going forward. We therefore see substantial cluster risk regarding the Budapest commercial property market.

Strong tenant quality in prime office developments

Tenant diversification and quality is credit positive because Futureal has consistently managed to attract a diversified range of large international corporations as tenants for its properties. We expect tenant diversification to further improve once more projects are kicked off and marketed.

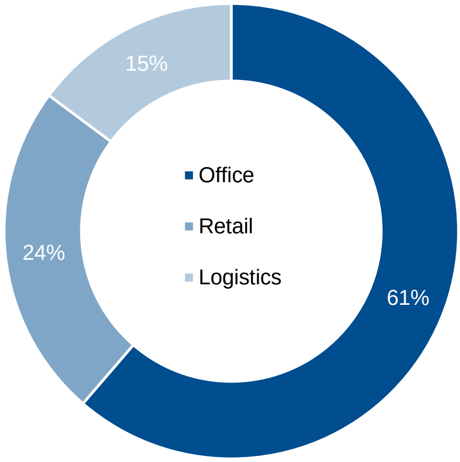
High pre-lease ratios mitigate development risk

Futureal has averaged robust pre-lease rates of around 40% in the past before starting construction. We believe this mitigates development risks.

The development pipeline contains projects in three asset classes. While the company has its track record in offices and retail, the retail share is shrinking with Etele Plaza as the only remaining retail asset under development (Corvin/Vaci is already finished and income producing). In terms of gross leasable area, the largest share of new projects will be in office development (Marina City's office component) as well as logistics with Futureal's newly created 'hello! Park' brand. In order to speed up its market entry in logistics, Futureal has won over part of the management team of market leader CTP

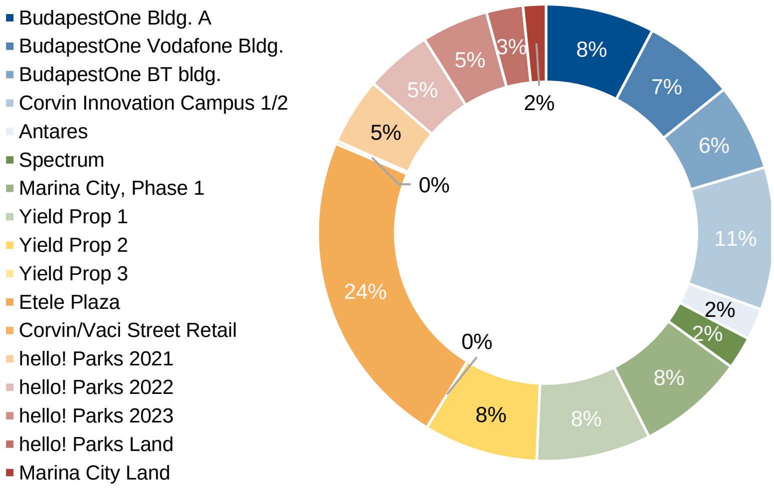
Invest. This includes the former country manager for Hungary, Mr. Rudolf Nemes, who now serves as managing director of 'hello! Park' and head of logistics at Futureal Group.

Figure 3: Asset class diversification



Source: Scope estimates

Figure 4: Project pipeline concentration (per cost in EUR m)



Source: Scope estimates

Diversified between commercial real estate asset classes

Market entry in logistics development with own brand

Preferred partners in construction

In Hungary, Futureal has long-standing preferred partnerships with leading general contractors for commercial projects. In all other markets, the group uses general contractors but does not have a preferred partner. Futureal uses sophisticated internal planning tools including project management software as well as electronic bidding software for external contractors. We expect the company to have consistently good access to a variety of external contractors thanks to its size, visibility, track record and moderately levered financing structure compared to local peers.

Futureal's development portfolio is predominantly located in Budapest, which is considered a B location with population growth of around 3% over the last 10 years (20010-20). The company's asset quality is credit positive thanks to a clear focus on upscale (mostly inner city) locations with excellent public infrastructure in Budapest, such as the South Buda city centre (e.g. the Etele Plaza and Budapest One Business Park offices). This translates into high quality micro locations.

Good inner-city locations in Budapest

The average economic age of Futureal's assets is below five years. In the past, pre-letting rates have averaged 90% upon completion of the properties. We expect pre-letting rates to stay at a sufficient level. Etele Plaza, for example, is around 85% pre-let as of January 2021 and is expected to open in Q3 2021. The pre-letting rates for the largest projects currently underway (next stages of Budapest One and Etele Plaza) range from 70% to 85% as of January 2021.

Above-average margins driven by increasing scale

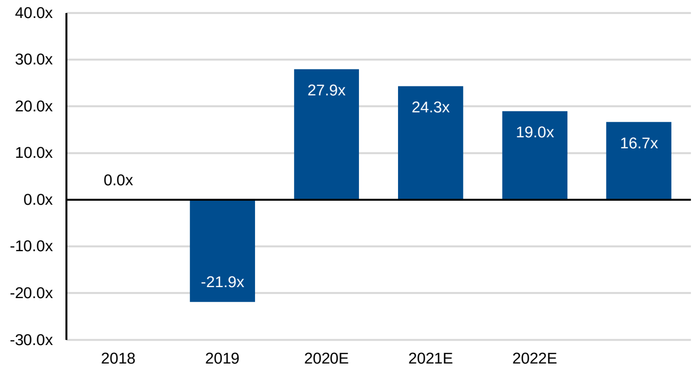
We expect profitability, measured by the Scope-adjusted EBITDA margin, to exceed 80% going forward as an increasingly large rental portfolio is built up, allowing for some economies of scale. We look at net rental revenues after management costs in our financial model and have therefore limited comparability with peers.

All in all, we assess profitability as above average, overweighting the new structure and business model, which is likely to generate a Scope-adjusted EBITDA margin commensurate with a commercial portfolio company rather than a typical build-to-sell developer.

Financial risk profile: BB-

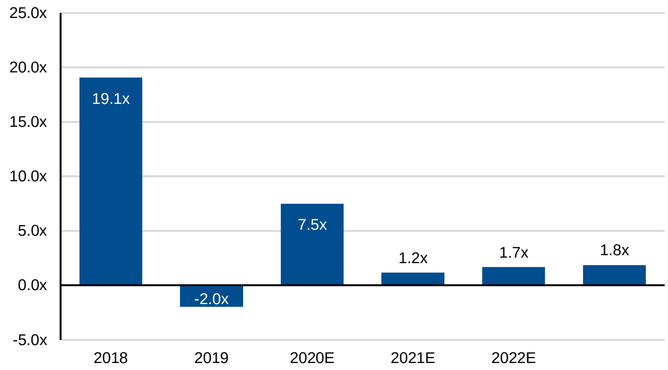
Our financial model represents the full consolidated numbers of the group holding company Futureal Holding B.V., also assumed to be the guarantor of the contemplated senior unsecured bond in our base case scenario.

Figure 5: SaD/Scope-adjusted EBITDA



Source: Scope estimates

Figure 6: Scope-adjusted EBITDA interest cover



Source: Scope estimates

In the short term (2021 and 2022), we expect a temporary slump in interest cover to 1.2x-1.7x based on much higher financial debt, our weighted average debt assumption and the gradual ramp-up of rental revenues. In the medium term (2023 and beyond) we expect interest cover of more than 2.0x.

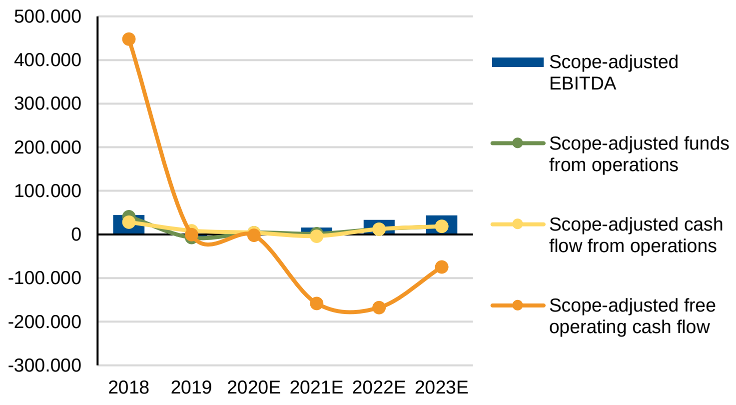
We expect leverage in terms of Scope-adjusted debt/EBITDA to jump to 20x-30x temporarily in 2020 to 2022. This is based on very little EBITDA generation (no sales planned, most properties still under construction) together with a substantial increase in secured and unsecured debt in our base case models to finance the large growth programme.

Portfolio expansion driving LTV in 2021-2022

According to our calculations, the LTV will increase towards 50%-55% based on Scope-adjusted debt/Scope-adjusted assets. This is the result of a gradual drawdown of senior secured development loans as well as the spending of previously issued senior unsecured debt as capex on investment properties. The increase in financial debt and the gradual spending, reducing the cash balance, will cause Scope-adjusted debt to rise.

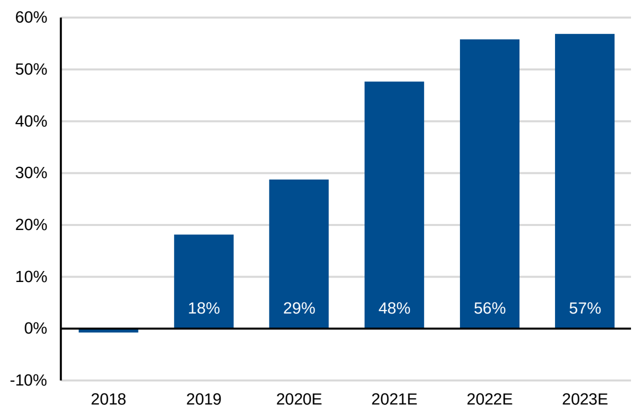
Management has confirmed that it does not intend to cross the 60% LTV threshold. It aims at a long-term LTV of around 50%-60%, which we deem realistic. Moreover, some projects are bundled under the FINEXT Capital subsidiary. This is a Hungarian REIT, which is not allowed to have an LTV above 65% under Hungarian legislation, further supporting management’s long-term LTV target.

Figure 5: Cash flows (EUR '000)



Source: Scope estimates

Figure 6: Scope-adjusted LTV



Source: Scope estimates

High expansion capex leads to negative FOCF until ramp-up of recurring rental revenue

The company's cash generation has been volatile in the past, due to its develop-to-sell business model, with negative free operating cash flow driven by the expansion of the business. We expect free operating cash flow to remain negative for several business years as a result of the current expansion.

A considerable part of capex is of a discretionary nature, since projects can be postponed, renegotiated or cancelled in the event of a severe market downturn. We would assume some sunk costs in such a case but no further substantial cash outflows once a project had been stopped.

Position	2020E		2021E	
Unrestricted cash (t-1)	EUR ´000	49,719	EUR ´000	65,890
Open committed credit lines (t-1)	EUR ´000	0	EUR ´000	0
Free operating cash flow (t)	EUR ´000	-1,828	EUR ´000	-157,599
Discretionary cash flow (t)	EUR ´000	40,171	EUR ´000	-75,297
Short-term debt (t-1)	EUR ´000	22,860	EUR ´000	15,000
Coverage		**3.9x**		**-0.6x**

Liquidity is adequate

We expect Futureal's liquidity to temporarily drop below 1.0x for 2021, due to substantial capex volumes and the resulting negative discretionary cash flow. It should then return to significantly higher ratios of 4.0x to 5.5x for the next two years, taking into account the discretionary nature of the majority of capex. We believe the company will be able to refinance its financial debt in the next 12-24 months.

Long-term and short-term debt instrument ratings

Senior unsecured debt rating of BB

Futureal contemplates to issue a new 10-year senior unsecured bond (HUF equivalent of EUR 150m) with a fixed coupon under the MNB's Bond Funding for Growth Scheme. The contemplated bond will be amortizing annually by 10% from end of year seven and will feature a bullet repayment of 70% at maturity. Scope's base case assumptions incorporated a successful placement of the above-mentioned bond in Q1 2021.

The proceeds are earmarked for the financing of investments into real estate development and investment projects, acquisitions (acquisition of real estate directly or indirectly through the acquisition of legal entities, acquisition of companies, including management companies, and of immaterial goods, etc.), working capital as well as refinancing of outstanding loans (including senior loans, shareholder loans, etc.). Bond proceeds shall be used in line with the Issuer's Green Financing Framework being in accordance with the Green Bond Principles issued by the International Capital Markets Association.

Scope's recovery analysis is based on a hypothetical default scenario at year-end 2022. It shows a high sensitivity to attainable prices in a distressed sales scenario as well as very high sensitivity to the volume of senior secured bank debt at the time of hypothetical default. Given the structural subordination of senior unsecured creditors of the rated entity below current and future secured debt at property SPV level in the agency's default scenario. This translates into a BB rating for senior unsecured debt.

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