Scope Scope Ratings

01 Sep 2021 - Scope Ratings GmbH

Scope affirms BB/Stable issuer rating of Futureal Development Holding Kft.

The ratings are primarily driven by the company's robust market position but remain constrained by increasing leverage and inherent development risks.

The latest information on the rating, including rating reports and related methodologies, is available on this LINK.

Rating action

Scope Ratings GmbH (Scope) has affirmed the issuer rating of BB/Stable for issuing entity Futureal Development Holding Kft. as well as the issuer rating of BB/Stable for the holding company and guarantor of outstanding senior unsecured bonds, Futureal Holding B.V. Scope has also affirmed its long-term debt class rating on senior unsecured debt of BB for both entities.

Rating rationale

Scope's assessment of the issuer's business risk remains at BB. This consists of a blended industry risk of B+ that reflects the issuer's core activity of real estate development and a growing portfolio of commercial investment properties that generates recurring revenues. Credit-positive factors for the issuer's competitive positioning are its strong market position and track record as Hungary's largest commercial real estate developer and the high visibility resulting from that status. The absolute size of its commercial portfolio is limited at this time, given that the vast majority of previous development projects have been sold. However, the issuer aims to create a roughly EUR 1.0-1.5bn commercial portfolio via its own develop-to-hold projects and selective acquisitions within the next two to three years. While the company has properties/projects in several regions of Hungary and some properties in the UK, Scope still sees diversification as a rating constraint. This is because the lion's share of anticipated rental revenue will come from commercial real estate (mostly office space) and a geographically concentrated area around Budapest, Hungary. Thus, the issuer's performance hinges on the macroeconomic environment of Budapest. The planned add-on acquisitions of existing cash generating properties are expected to take place predominantly in Hungary and Central and Eastern Europe and should therefore only have a limited impact on business diversification.

Profitability is expected to increase to a Scope-adjusted EBITDA margin of 45%-60% over the next two to three years (2020: -1%) as higher recurring rental revenues are expected to lift profitability when more projects are finished. However, the transition from a typical developer operating margin to a higher-margin commercial property owner is still subject to execution risks in the develop-to-hold project portfolio.

The financial risk profile remains unchanged at BB-. This is because the most relevant financial metrics for the rating case, particularly the Scope-adjusted loan/value ratio (LTV), are still expected to develop within Scope's previous financial base case. Scope expects the issuer to increase its LTV to a range of 50%-60% (YE 2020: 25%) with a trend towards 60% for at least the next two years due to its dynamic, mostly debt-funded expansion programme. However, the agency does not believe the issuer will clear the 60% threshold. Scope expects free operating cash flow to remain negative for several business years to come as a result of current expansion. For 2020, Scope-adjusted EBITDA interest coverage was below par and is expected to stay below 1.0x for the current year caused by the gradual ramp-up of rental income from current developments. Scope expects EBITDA interest coverage to return to above par at 1.2x for 2022 and 1.6x for 2023 after additional project completions such as Etele Plaza (retail) in 2021 and further stages of BudapestOne (office) in 2022.

With regard to anticipated free operating cash flows, Scope nevertheless hints at the fact that a considerable part of capex is of a discretionary nature, since projects may be postponed, renegotiated or cancelled in case of a severe market downturn. Scope expects the issuer to maintain a high level of pre-lets (no speculative developments) as well as turnkey contracts with construction companies/contractors to limit the risk of severe cost overruns.

Futureal's liquidity situation is expected to temporarily drop into negative territory in 2021 due to its substantial capex volumes (EUR 167m for 2021 and EUR 177m for 2022) and resulting negative free operating cash flow. Yet it is expected to return to double-digit ratios for 2022-23 given high expected cash levels. Scope did not incorporate any open committed credit lines as the issuer does not have any committed lines with a maturity of over one year. Scope believes the company will be able to refinance its financial debt in the next 12-24. This follows Scope's view, that at least completed projects (subject to an LTV of below 60% and sufficient cash rental income) should allow for secured refinancing with banks.

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 develop-to-hold projects on time and on budget. Consequently, Scope assumes higher LTV that stays between 50%-60% and Scope-adjusted EBITDA interest cover to return to more than 1.0x from recurring revenues after 2021E, not taking potential asset sales into account.

A positive action is remote at this point. It would require the company to reduce leverage, as measured by LTV, to below 50% on a sustained basis while achieving Scope-adjusted interest coverage from recurring rental income of around 2.0x.

A negative rating action is possible if Futureal's LTV approached 60% or if Scope-adjusted interest coverage stayed below par beyond FY 2021E. This could be triggered by a slump in market prices/rents or delayed up-letting of new properties.

Long-term debt ratings

Futureal is contemplating an issue or tap issue of senior unsecured bonds within the Hungarian National Bank's Funding for Growth in the maximum amount of HUF 44bn (including 10% over-allotment) and have a tenure of up to 15 years with a fixed coupon, paid annually. 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.). Scope incorporated a successful placement of the above-mentioned bonds in the assumptions of its financial base case.

Scope's recovery analysis results in above average expected recovery and is based on a hypothetical default scenario at YE 2023E. It shows high sensitivity to attainable prices in a distressed sales scenario and very high sensitivity to the volume of senior secured bank debt at the time of hypothetical default. This is particularly true given the structural subordination of the rated entity's senior unsecured creditors and current and future secured debt at the property SPV level. For these reasons, Scope assesses senior unsecured debt at the same level as the issuer rating. This translates to a BB rating for senior unsecured debt.

Stress testing & cash flow analysis
No stress testing was performed. Scope Ratings performed its standard cash flow forecasting for the company.

Methodology
The methodologies used for these Credit Ratings and/or Outlooks, (Corporate Rating Methodology, 6 July 2021; Rating Methodology: European Real Estate Corporates, 15 January 2021), are available on https://www.scoperatings.com/#!methodology/list.
Scope Ratings GmbH and Scope Ratings UK Limited apply the same methodologies/models and key rating assumptions for their credit rating services, while Scope Hamburg GmbH's methodologies/models and key rating assumptions are different from those of Scope Ratings GmbH and Scope Ratings UK Limited.
Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/#!governance-and-policies/rating-scale. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/#governance-and-policies/rating-scale. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://www.scoperatings.com/#!methodology/list.
The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information
The Rated Entity and/or its Related Third Parties participated in the Credit Rating process.
The following substantially material sources of information were used to prepare the Credit Ratings: public domain, the Rated Entity and Scope Ratings' internal sources.
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Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and/or Outlooks and the principal grounds on which the Credit Ratings and/or Outlooks are based. Following that review, the Credit Ratings were not amended before being issued.

Regulatory disclosures
These Credit Ratings and/or Outlooks are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and/or Outlooks are UK-endorsed.
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The Credit Ratings/Outlooks were first released by Scope Ratings on 16 February 2021.

Potential conflicts
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Scope Ratings provided the following Other Services to the Rated Entity and/or its Related Third Parties within the two years preceding this Credit Rating action: Rating Assessment Service.

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