SCOPE Scope Ratings

Rating Action Release 03 Nov 2022

Scope affirms BB rating of Futureal Development Holding Kft., changing Outlook to Negative

The affirmation follows the company's refocusing on a develop-to-hold strategy and its successful execution thus far, providing more stable rental cash flows, while the Outlook reflects the low interest cover in the current market environment

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

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Rating action

Scope Ratings GmbH (Scope) has today affirmed the BB issuer rating on issuing entity Futureal Development Holding Kft. and revised the Outlook to Negative. Scope has also affirmed the BB issuer rating on the holding company and guarantor of the outstanding senior unsecured bonds, Futureal Holding B.V., and changed its Outlook to Negative. Scope has also affirmed the BB rating on senior unsecured debt issued by Futureal Development Holding Kft..

Rating rationale

The rating affirmation follows the company's operational and financial development, which Scope expects to continue being broadly in line with the rating case. Futureal has executed on its pipeline in the last 12 months, with the completion and opening of Etele Plaza Mall, the partial completion and rent-out of Budapest One, and the completion and full occupation of the first two HelloParks logistics buildings. Scope expects a prudent execution of the develop-to-hold pipeline, balancing growth and the company's credit profile in the current uncertain economic environment.

The business risk profile (assessed at BB) reflects Futureal's market position and strengthened geographic diversification with an increased share of properties in Poland (16%) and more balanced asset class spread of 30% office, 40% retail and 30% industrial as measured by GLA as of Q2 2022. These segments possess different demand patterns, which reduces volatility in cash flows. The pipeline of develop-to-hold projects is skewed towards industrial/logistics parks, responding to strong occupant demand for new space (especially urban last-mile facilities) and good rental growth prospects. This is largely supported by: (i) a favourable balance of supply and demand; (ii) the growth of e-commerce; (iii) occupants' willingness to optimise supply chains; and (iv) Hungary's ambition to become a major European hub/platform for electric vehicle batteries/parts. The business risk profile is further supported by Futureal's asset quality, as evidenced by a young portfolio (>5 years) in and around Budapest with a high level of BREEAM certifications (Credit neutral ESG factor). The company's profitability as measured by EBITDA margins (overall 35%-40%, rental activity margin of 60%) also plays major role, benefiting from an increasing share of performing rental properties compared to its previous strategy of develop-to-sell.

A predominant exposure to the weakening Hungarian economy and high cluster risk around Budapest holds back the business risk profile. Further constraints lie in tenant concentration and development risk, with potential cost overruns from the cost of labour (materials price pressure has recently eased) putting pressure on future yields.

The financial risk profile (assessed at BB-) is characterised by the company's change in strategy from develop-to-sell to a develop-to-hold, financed to a large degree with debt, resulting in an expected increase in leverage. The Scope adjusted loan/value (LTV) ratio increased in line with expectations to 43% in 2021 and is expected to increase to levels in the low 50s in 2023-24 based on further growth. The ratio was expected to rise more strongly in last year's business case, but

Futureal has communicated that it will slow down its pace of growth, abandoning and/or delaying certain projects in light of the current, more challenging economic environment. Scope-adjusted debt/EBITDA is expected to decline from its Covid-era peak in 2021 towards 20x in 2023E and lower thereafter. This is very high for a developer, and it limits the rating. However, given the change in strategy towards rental activities, the company is expected to grow to a level witnessed in other buy-and-hold commercial real estate players. Interest cover weakened significantly from pre-2020 levels, with Scope-adjusted EBITDA/interest down to 1.2x at end-June 2022, largely driven by the dynamic and mostly debt-financed portfolio growth and a slower ramp-up of rental activities induced by extended development periods (large-scale projects). Futureal's current interest cover suggests limited headroom against the risk of cash flow volatility, but Scope considers this to be mitigated by prudent liquidity management and risk policy. The risks arising from development are somewhat mitigated by a non-speculative approach to new projects, a 90% hedging/fixed rate ratio with favourable conditions on development debt and long maturities on bonds (2031 and 2036), and the gradual ramp-up of rental income with euro-denominated rents. Nevertheless, those are not shielded from the current economic environment which could lead to impaired rents and higher vacancies. The company could also suffer from widening yields with corresponding corrections in asset values as the required returns in a rising interest rate environment are not fully mitigated by rising rents, in addition to potentially widening spreads to secure financing.

Scope considers Futureal's liquidity to be adequate, with cash sources (unrestricted cash of EUR 290.3m as of end-December 2021) fully covering short-term debt of EUR 14.7m due in the 12 months to end-December 2022 paired with forecasted negative FOCF of negative EUR 187m. In light of the company's good relationships with established banks and its sound track record in the capital markets, Scope considers liquidity/refinancing risk to be manageable. Hence, Scope expects liquidity to remain adequate in the short term, largely owing to the lack of major upcoming debt maturities.

Outlook and rating-change drivers

The Outlook is Negative and reflects Scope's concerns about Futureal's EBITDA interest cover around 1x in the current deteriorating market environment, leaving little headroom in case of slower than expected rental of projects, loss of tenants given the challenging business environment, or delays and cost overruns in its ongoing developments. Scope's base case assumes the company will be able to grow its recurring revenue base by successfully completing develop-to-hold projects on time and on budget while keeping its LTV ratio under control. Scope assumes that the LTV ratio will climb above 50% from its current level of 42% but will remain between 50%-55% and that Scope-adjusted EBITDA interest cover will remain between 1.0x and 1.5x, not taking potential asset sales into account.

A positive rating action back to Stable would require the company to demonstrate a stable interest coverage above 1x, in the upper end of Scope's base case. A positive rating action with an upgrade is remote at this point. It would require the company to reduce leverage, as measured by its LTV ratio, to below 50% on a sustained basis while achieving Scope-adjusted interest coverage from recurring rental income of around 2.0x. In addition, Scope would expect significant diversification in terms of geographies and tenant base to mitigate potential cash flow volatility.

A negative rating action could occur if Futureal's LTV ratio approached 60% or if Scope-adjusted interest coverage dropped below 1.0x. This could be triggered by a slump in market prices/rents or delayed up-letting of new properties.

Long-term and short-term debt ratings

As at H1 2022, Futureal has two senior unsecured bonds outstanding issued under the Hungarian National Bank's Bond Funding for Growth Programme: a HUF 63.05bn bond with a fixed coupon of 4% maturing in 2031 and a HUF 57.95bn bond with a fixed coupon of 3.5% maturing in 2036. Scope's recovery analysis is based on a hypothetical default scenario at year-end 2024E, showing an average recovery for the senior unsecured bonds. Scope's analysis shows high sensitivity to attainable prices in a distressed sales scenario and high sensitivity to the volume of senior secured bank debt at the time of a hypothetical default. Senior unsecured debt at the issuer level, affirmed at BB, benefits from a relatively high unencumbered asset ratio of around 160%, providing a large pool of collateral to debt holders.

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