Scope Ratings

Credit Rating Announcement 08 December 2023

Scope downgrades Futureal's issuer rating to BB- from BB and maintains Negative Outlook.

The rating action reflects increased leverage and a low interest coverage ratio, which put pressure on the financial risk profile. Current credit metrics leave limited headroom given high inflation and a high interest rate environment.

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

Rating action

Scope Ratings GmbH (Scope) has today downgraded the issuer rating of Futureal Development Holding Kft. (Futureal) to BB- from BB and maintained the Negative Outlook. The issuer rating of Futureal Holding B.V., the holding company and guarantor of outstanding senior unsecured bonds, has also been downgraded to BB- from BB with Negative Outlook. Scope has downgraded the senior unsecured debt rating to BB- from BB as well.

Rating rationale

The downgrade reflects credit metrics that are considered insufficient amid an unsupportive business environment for commercial real estate companies, leaving little room to manoeuvre given Futureal's current indebtedness. This captures the risk that leverage (Scope-adjusted loan-to-value) is likely to move towards 60%, with current portfolio yields coming under further pressure in Scope's view. Interest coverage could face additional pressure in the next 12 to 18 months given that financing is currently more expensive than the issuer's sustainable level of around 4%, as indicated by a Scope adjusted debt/EBITDA of 25x (last 12 months to end-June 2023). This is mitigated to some extent by the issuer's active interest rate hedging policy.

The business risk profile (assessed at BB) reflects Futureal's solid market position and improved geographical footprint with higher exposure in Poland and broader diversification across asset classes, with 37% office, 34% retail and 29% industrial as measured by gross leasable area (GLA) as of Q2 2023. The development pipeline is largely biased towards logistics properties (90% of the pipeline), which benefit from robust underlying fundamentals. The business risk profile is further supported by Futureal's asset quality, evidenced by a portfolio of modern, energy-efficient properties with high BREEAM certification levels (ESG factor: neutral). The risk of cash flow deterioration linked to tenants' defaults or delayed payments has diminished as the top three tenants now account for 11% (down 7 pp from end-June 2022) of annual rents and the top 10 account for around 23% (down 12 pp). Profitability as measured by the Scope-adjusted EBITDA margin (30% 40% overall and 50%-60% for rental activities alone) is gradually normalising with project completions and moving towards buy-and-hold commercial real estate company levels, with less pronounced swings.

The company's business risk profile continues to be constrained by a predominant exposure to Budapest (cluster risk) and development risks that bring high earnings volatility.

The financial risk profile (revised to B+ from BB-) is characterised by the company's develop-to-hold business model. This is largely financed with debt, which has led to increased leverage. Against this backdrop, recurring rental cash flows are gradually ramping up, but so is the interest burden. Debt protection as measured by the Scope-adjusted EBITDA interest cover ratio stood at 1.4x as of end-June 2023 (2022: 2.1x). This suggests very limited headroom against cash flow volatility, amplified by the risk that development projects might not be finished on time or take longer to be leased. Scope expects interest cover to remain above 1.0x, supported by the build-up of rental income, good protection from rising interest rates (over 85% of debt is hedged or fixed-rate as of end-September 2023) and interest income from excess liquidity. However, cash flow volatility could lead to additional pressure on interest cover beyond Scope's expectations.

Leverage as measured by the Scope-adjusted loan-to-value ratio reached 54% as at end-June 2023 (2022: 46%) due to increased indebtedness from a EUR 125m bond issue (private placement in early 2023). Current leverage narrows the issuer's access to external financing and shrinks the buffer against market value declines. The increase in leverage remains in line with Scope's previous expectations, but it materialised more forcefully and sooner than anticipated. Scope expects leverage to increase even further due to current portfolio yields coming under additional pressure. As communicated, Futureal has slowed down its growth, abandoning and pausing certain projects within the office segment, while it has prioritised industrial/logistics projects in response to market dynamics and to meet occupiers' demand. Furthermore, the company has some leeway in its development spending, with full discretion to postpone or even cancel uncommitted projects to preserve capital.

Liquidity is adequate, with cash sources (unrestricted cash of EUR 242.4m as of end-December 2022) fully covering short-term debt of EUR 37.1m due in the 12 months to end-December 2023 and forecasted FOCF of negative EUR 56m. With regard to ongoing projects, the company has secured financings for development/operational phases (EUR 105m undrawn as of end-September 2023), limiting external debt needs in the short term. The first bond maturity is not due before 2028, and Futureal currently has a three-year cash reserve for bond redemption.

Outlook and rating-change drivers

The Outlook is Negative and reflects the high risk that Futureal's Scope-adjusted EBITDA interest cover ratio will drop below 1.5x. This level is considered insufficient in an environment of sharply higher financing costs, and it leaves little room to manoeuvre considering the issuer's current debt level and development plans. Thus, the development of interest cover is linked to external factors outside the company's control. These include a slower buildup of rental income caused by weaker-than-expected tenant demand and/or delays and cost overruns in ongoing developments. The Outlook also captures that the issuer will not face any liquidity issues in the short-term as the available cash as of end-June 2023 covers utilisations for the next 12 months.

A positive rating action (i.e. Outlook back to Stable) would require the company to demonstrate a stable Scope adjusted EBITDA interest cover ratio above 1.5x. Further upside is remote for the time being but could be warranted if the Scope-adjusted loan-to-value ratio remained below 50% while the Scope adjusted EBITDA interest cover ratio reached 2.0x. In addition, the company would need to improve its geographical diversification to mitigate the risk of cash flow deterioration.

A downgrade could occur if Futureal's Scope adjusted EBITDA interest cover ratio dropped to or below 1.5x. This could be triggered by prolonged development phases of individual projects or slower up-letting of newly developed properties. The rating could also be downgraded if the issuer's liquidity became inadequate.

Long-term debt rating

Scope has downgraded Futureal Development Holding Kft.'s senior unsecured debt rating to BB- from BB. Scope expects an 'average' recovery for outstanding senior unsecured debt in a hypothetical default scenario in 2024 based on the company's liquidation value. Given an unencumbered asset ratio of above 110%, senior unsecured debt holders could also benefit from a pool of assets not pledged as collateral.

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 Outlooks, (General Corporate Rating Methodology, 16 October 2023; European Real Estate Rating Methodology, 25 January 2023), are available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

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-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. 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-governance/definitions-and-scales. 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://scoperatings.com/governance-and-policies/rating-governance/methodologies.

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 Outlooks and the principal grounds on which the Credit Ratings and/or Outlooks are based. Following that review, the Credit Ratings and Outlooks were not amended before being issued.

Regulatory disclosures

These Credit Ratings and Outlooks are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and Outlooks are UK-endorsed.

Lead analyst: Fayçal Abdellouche, Specialist

Person responsible for approval of the Credit Ratings: Philipp Wass, Managing Director

The Credit Ratings/Outlooks were first released by Scope Ratings on 16 February 2021. The Credit Ratings/Outlooks were last updated on 4 November 2022.

Potential conflicts

See www.scoperatings.com under Governance & Policies/Regulatory for a list of potential conflicts of interest disclosures related to the issuance of Credit Ratings.

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Contact

Analyst Fayçal Abdellouche f.abdellouche@scoperatings.com
Team leader Sebastian Zank s.zank@scoperatings.com

Scope Ratings GmbH • Lennéstraße 5 • D-10785 Berlin • Phone: +49 30 27891-0 • Fax: +49 30 27891-0
www.scoperatings.com