SkyGreen Buildings Kft.
Hungary, Real Estate

SCOPE B+ STABLE

Corporate profile

SkyGreen Buildings Kft. (SkyGreen) was founded in 2016 as Eiffel Square Building Kft. and is owned by Green Ingatlanfejlesztő Investment Fund. SkyGreen is the universal legal successor of New Multiples Kft. (founded in 2000). The company's main activity is the letting and operation of its own or leased real estate. It currently directly owns three properties in the city of Budapest.

Key metrics

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**
Scope-adjusted EBITDA/interest cover (x)	1.7x	2.8x	3.0x	2.2x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA (x)	16.3x	10.9x	4.8x	13.4x
Scope-adjusted loan/value ratio (%)	65%	31%	13%	48%

Rating rationale

Scope Ratings has affirmed the B+/Stable issuer rating of SkyGreen Buildings Kft. Scope has also assigned an initial rating of BB to the HUF 32bn senior secured bond (ISIN: HU0000360201) and downgraded the senior unsecured debt rating to B+ from BB.

The B+ issuer rating on SkyGreen benefits from the portfolio's exposure to the second-tier investment market of Budapest, stable tenant with an almost fully let portfolio from May 2021[1] and relatively high profitability. The company's credit metrics are sound, with Scope-adjusted EBITDA interest cover above 2.2x and a Scope-adjusted loan/value ratio of around 50 after the execution of its expansion strategy in 2021.

Rating constraints include the company's limited size, which leads to greater sensitivity to unforeseen shocks and volatile cash flows, as well as the very concentrated portfolio, comprising only three properties in Budapest, with an uneven lease maturity profile.

Outlook and rating-change drivers

The Outlook for SkyGreen is Stable and incorporates: i) 18-month seller rental guarantees covering vacant areas in the Váci E asset, starting from the sixth month after the acquisition date, lifting effective occupancy to close to 100% across the portfolio; and ii) the successful placement of a HUF 32bn (around EUR 90m) secured bond in Q4 2020, with proceeds intended for additional real estate acquisitions (around EUR 95m, at a net initial yield of a minimum of 5.5%). Driven by the expected portfolio expansion, we forecast Scope-adjusted EBITDA interest cover at above 2.2x and a Scope-adjusted loan/value ratio at around 50% in the next few years.

A positive rating action is remote but may be warranted if SkyGreen can significantly improve its business risk profile. This could be achieved by the company substantially growing in size, leading to a less concentrated portfolio and strengthening its market position, while sustaining a Scope-adjusted loan/value ratio of below 50%.

Ratings & Outlook

Corporate rating	B+/Stable
Senior unsecured rating	B+
Senior secured bond (ISIN: HU0000360201)	BB

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Related Methodologies

Corporate Rating Methodology, February 2020

Rating Methodology European Real Estate Corporates January 2020

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Bloomberg: RESP SCOP

[1] 69% occupancy as at November 2020 with rental guarantees covering rental income for vacant space of Váci Green E

A negative rating action is possible if leverage increases notably, indicated by a Scope-adjusted loan/value ratio of over 60%. The Scope-adjusted loan/value ratio could increase if property values in the portfolio drop significantly due to a sudden shock to the Hungarian market or if the company continues to finance new acquisitions with external financing and a lower share of equity.

Rating drivers

Positive rating drivers	Negative rating drivers
• Exposed to second-tier investment market with healthy demand from tenants • Profitability is high (Scope-adjusted EBITDA margin of 70%-90%) but vulnerable given the concentrated portfolio • Adequate debt protection (Scope-adjusted EBITDA interest cover forecasted at above 2.2x) and moderate leverage (Scope-adjusted loan/value ratio forecasted around 50%) driven by strong and predominately equity-financed portfolio growth	• Relatively small property company with greater sensitivity to unforeseen shocks and more volatile cash flows • Small market shares in an increasingly competitive environment • Weak diversification across geographies and high tenant concentration • Cluster risk in 2023 due to uneven lease maturity profile that faces high competition in the medium term Moderate occupancy (100% in old portfolio; new asset 37% pre-let as of November 2020), but limited visibility with a short weighted average unexpired lease term (WAULT) of 3.4 years

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significant growth in size, with Scope-adjusted loan/value ratio maintained at around 50%	• Scope-adjusted loan/value ratio above 60% on a sustained basis

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**
Scope-adjusted EBITDA/interest cover (x)	1.7x	2.8x	3.0x	2.2x
Scope-adjusted debt/Scope-adjusted EBITDA (x)	16.3x	10.9x	4.8x	13.4x
Scope-adjusted loan/value ratio	65%	31%	13%	48%
Scope-adjusted EBITDA in EUR m	**2018**	**2019**	**2020E**	**2021E**
EBITDA	3.5	5.3	41.1	7.9
Operating lease payments in respective year	0.0	0.0	0.0	0.0
Other	0.0	0.0	-37.1	1.0
Scope-adjusted EBITDA	**3.5**	**5.3**	**4.0**	**8.9**
Scope-adjusted funds from operations in EUR m	**2018**	**2019**	**2020E**	**2021E**
Scope-adjusted EBITDA	3.5	5.3	4.0	8.9
less: cash interest as per cash flow statement	-2.1	-1.9	-1.3	-4.0
less: cash tax paid as per cash flow statement	0.0	0.0	0.2	-3.9
Change in provisions	0.0	0.0	0.0	0.0
Scope-adjusted funds from operations	**1.4**	**3.4**	**2.8**	**1.0**
Scope-adjusted debt in EUR m	**2018**	**2019**	**2020E**	**2021E**
Reported gross financial debt	57.9	62.7	132.6	131.2
add: finance leases	0.0	0.0	0.0	0.0
less: cash, cash equivalents	-1.1	-4.6	-113.3	-11.9
Scope-adjusted debt	**56.8**	**58.1**	**19.3**	**119.2**

Business risk profile: B

Industry risk: BB

Industry risk for SkyGreen is modest, as the company is exposed to the highly cyclical real estate industry. The company's main segments comprise the leasing and management of commercial real estate buildings. Despite disposing of its main asset in 2020, the company has reaffirmed its strategy to buy and hold premium office buildings in prime locations in Budapest.

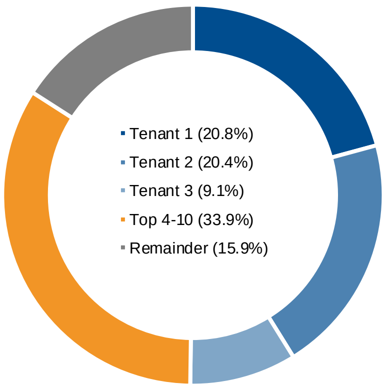
Small company with greater sensitivity to unforeseen shocks and more volatile cash flows

SkyGreen is a company of limited size, with about EUR 0.2bn in total assets and EUR 3.4m of Scope-adjusted funds from operations as at end-December 2019. The company's size dropped significantly after the disposal of its trophy asset, the Eiffel Square Building in May 2020, as well as the Millenáris Avantgarde building in October 2020. However, divestiture proceeds have been partially used to ramp-up the portfolio with the acquisition of the Váci Greens E office building in November 2020. The company intends to acquire a further office building (around EUR 95m) in 2021. Together with the prospective building, the gross leasable area in the portfolio will increase to around 75,000 sqm, up from 49,000 sqm in December 2019. Even so, we expect SkyGreen to remain small. This is a negative rating driver because it implies greater sensitivity to unforeseen shocks, larger cash flow volatility, limited economies of scale and higher key person risk. However, the latter will be addressed by the outsourcing of services to, amongst others, CBRE, Cushman & Wakefield and CE Land Management.

Small market shares in an increasingly competitive environment

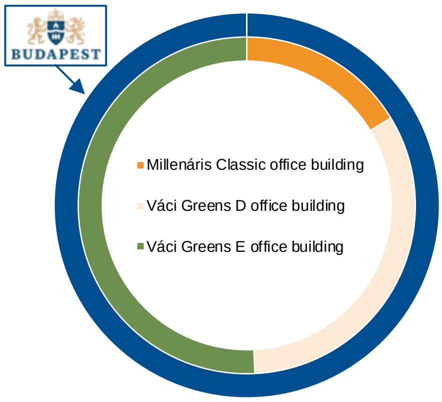
Despite its focus on Budapest, the company does not hold a significant share in the office market. This applies not only to the whole city (market share of around 1%) but also to the Váci Corridor (3% as of December 2019), the largest office submarket in Budapest with 31% of the city's class A stock. This intensifies competition from players of all sizes, the largest of which are real estate investment funds and special investors (mostly Hungarian). With the acquisition of the Váci Greens E office building, SkyGreen gained some more visibility in the Váci Corridor, where it now owns two properties (total gross leasable of 40,615 sqm). Tenant demand in the Váci Corridor was previously dominated by business process outsourcing providers and shared service centres, but is now driven by high-profile banks and IT providers .

Figure 1: Tenant diversification (share of rent)



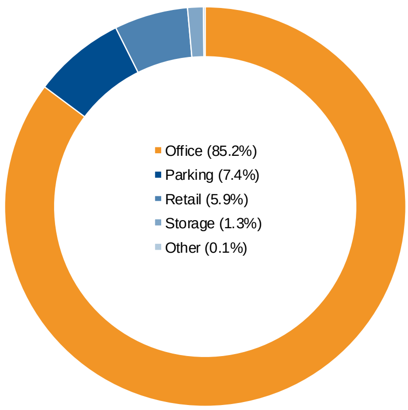
Sources: SkyGreen, Scope

Figure 2: Geographical distribution of property values



Sources: SkyGreen, Scope

Figure 3: Distribution of rental income by type of use



Sources: SkyGreen, Scope

Weak diversification across geographies and high tenant concentration

SkyGreen's limited size has also taken a toll on portfolio diversification by geography and tenant. The company intends to keep its geographical outreach within Budapest in the foreseeable future. Thus, performance will hinge on the macroeconomic environment of the Hungarian capital.

The current portfolio consists of only three buildings located in Budapest. The company aims to acquire a new property in the Váci Corridor for approx. EUR 95m, which should mainly comprise office space and generate a minimum annual yield of 5.5%.

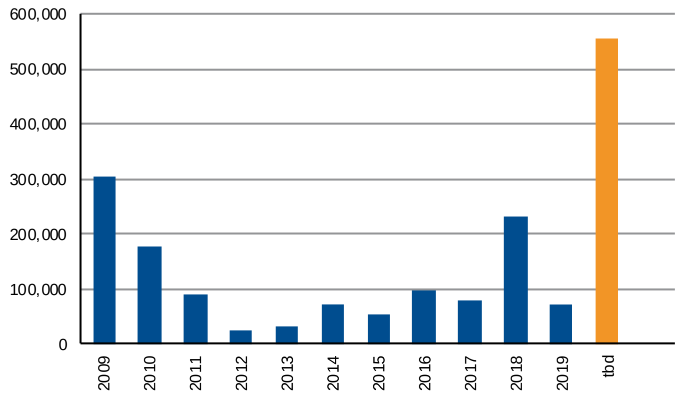
The limited number of properties in SkyGreen's portfolio combined with a focus on office space (85% of current rental income) leads to relatively high tenant concentration. 39% of rental income as of August 2020 came from the top three tenants, and 66% from the top 10. However, the likelihood of a single tenant's default impairing cash flow is somewhat mitigated by at least one-quarter of rental income being generated by investment grade tenants. In addition, all tenants provide either a bank guarantee or cash deposit equating to three months' gross rent. SkyGreen has not used these guarantees or cash deposits to date.

Cluster risk in 2023 due to uneven lease maturity profile

High tenant concentration has led to an uneven lease maturity profile, with more than 62% of leases in the current portfolio (Váci D, Váci E and Millenaris Classic) maturing between 2022 and 2024. SkyGreen's ability to extend lease contracts and/or re-let vacated space is therefore exposed to competition from stock delivered to the market by that time. The Budapest office market has been quite dynamic, with 70,545 sqm of new office space delivered in 2019, while the volume of new developments for 2020 is 230,100 sqm, with a further 325,250 sqm expected to be completed in 2021[2]. To address this competition, SkyGreen has renewed its portfolio and acquired newly developed properties that benefit from high visibility given their location in the Váci Corridor.

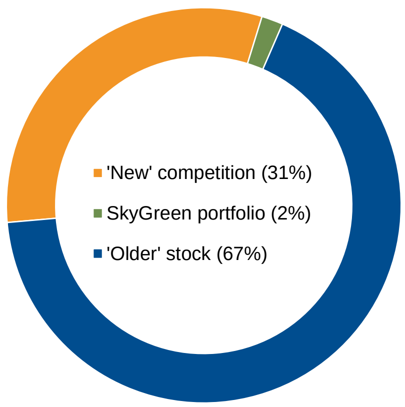
A more diversified portfolio would allow the company to spread future investments over a longer period, thus reducing the risk of weaker demand for most of the portfolio and the associated, abovementioned consequences.

Figure 4: Office completion in Budapest (sq m)



tbd – to be delivered (under construction)

Figure 5: Competitive office market in Budapest (2022)



Sources: DTZ, JLL, Savills, Scope

Exposed to second-tier investment market with healthy demand from tenants

SkyGreen's sole portfolio location is the city of Budapest, a second-tier investment market. Although the Budapest market has gained more momentum (annual investment reached EUR 1.7bn in 2019, the third-highest volume since the record EUR 2.0bn in 2007), we judge portfolio liquidity to be relatively limited. If economies cool and/or interest rates rise, investors are likely to focus on tier-one markets and safe havens like London, Paris or the seven major German cities. This could eventually lead to substantial downward pressure on property values, an increase in leverage, a reduced availability to obtain external financing, and limited recovery expectations for debt investors.

[2] BNP Paribas Real Estate. Budapest Office market 2020. https://www.realestate.bnpparibas.com/sites/default/files/2020-03/R-20-01%20FR%20%20Euro_Office_Budapest.pdf

As of September 2020, SkyGreen's properties are mostly focused around the Váci Corridor. The Millenaris property (17% of the portfolio's market value) is next to Millenaris Park (Buda North), and Váci Green D and E (83%) are within the Váci Corridor. All of the locations benefit from relatively strong demand. The vacancy rate in Budapest reached a historical low of 5.6% at the end of 2019, a consequence of the high demand for modern office space. Office take-up in 2019 totalled 361,980 sqm, a slight decline compared to 2018[3]. Market activity remains concentrated in the Váci Corridor, where 42% of transactions have been concluded. Thus, the portfolio's micro location is good, with tenants continuing to seek new space within these areas.

Moderate occupancy rate but exposed to re-letting risk in 2023 due to short WAULT in existing stock

On the one hand, the company benefits from full occupancy in two of the properties in its portfolio, Millenaris Classic and Váci Greens D. However, their WAULT is a short 2.7 years as at end-November 2020, indicating limited cash flow visibility beyond that point. We believe the company can address this risk based on its decent track record on letting activity in the last few years.

On the other hand, the newer building, Váci Greens E, only has a 37% pre-letting rate, with lease terms averaging around five years (another 34% of estimated rental value is close to being signed). This low occupancy is partially mitigated by the seller 18-month guarantee on all rent and service charges for vacant areas (indemnification period starting six months after completion). We expect the newer building to reach higher occupancy levels (above 90%) within the next 24 months because the appetite for brand new office space in Budapest is still high (35% of 2019's annual take-up).

Newly built assets will revitalise portfolio

New office buildings – currently under construction – will make the Budapest market more competitive. SkyGreen's current portfolio is mostly composed of newly built assets, and the company aims to add another new office building in 2021. This could benefit SkyGreen's portfolio as demand for modern office space is comparatively high. However, the Budapest office market is weakening, reflecting the economic changes triggered by the Covid-19 pandemic. Thus, demand is lagging the trend in previous years, with vacancy rates up to 8.1% (+2.2pp YoY) and a reduced number of transactions.

High but vulnerable profitability given concentrated portfolio

SkyGreen's profitability as measured by its Scope-adjusted EBITDA margin stood at above 75% in 2019 and is forecasted to remain at this level going forward. The forecasted development benefits from: i) the addition of a newly built property in 2021; ii) the company's lean operational setup, with services provided by external parties and services adjusted to actual needs; and iii) the low property cost structure, which passes most operating expenses on to tenants (all leases are triple-net).

However, the portfolio's diversification is limited, with only few buildings under management and high tenant concentration. Moreover, profitability is vulnerable to a cooling Hungarian economy, which is likely to increase the number of corporate defaults. The latter is exemplified by the rather short WAULT of 3.4 years (including Váci Greens E), which exposes SkyGreen's profitability to medium-term volatility.

[3] BNP Paribas Real Estate. Budapest Office market 2020.

Financial risk profile: BB+

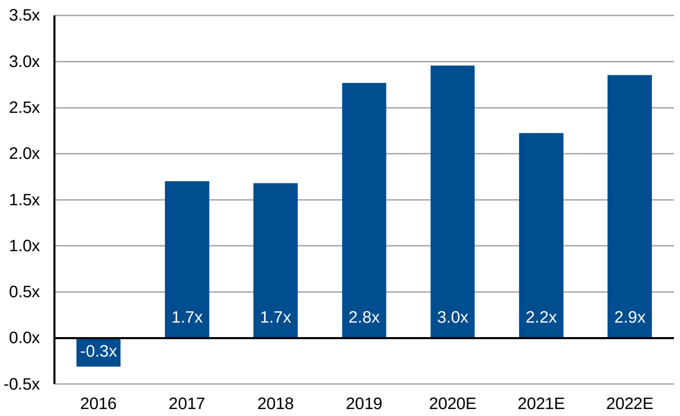
Debt protection expected to remain at adequate levels of above 2.2x

The company's debt protection, as measured by Scope-adjusted EBITDA interest cover, has stood above 1.7x in the past (2019: 2.8x). We anticipate that Scope-adjusted interest cover will remain above 2.2x going forward because: i) newer properties will contribute stable cash inflows; ii) leverage is relatively low (Scope-adjusted loan/value ratio forecasted at below 20% for YE 2020) and is forecasted to remain at moderate levels (see below) despite the debt-financed portfolio expansion planned for 2021; and iii) the weighted average cost of debt is relatively low (currently one loan with an interest rate of three-month Euribor plus a 2% margin). However, the average interest rate and interest expenses are likely to increase following the planned bond issuance in Q1 2021.

We see only minor risk from the floating-rate loan (based on three-month Euribor; provided by Raiffeisen Bank, EUR 47.4m as at August 2020), with the European Central Bank not expected to trigger a significant increase in interest rates before YE 2021.

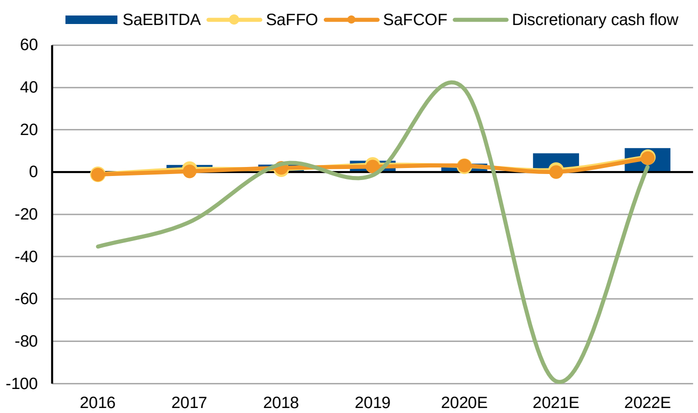
SkyGreen has so far issued all of its debt in euros. This creates a natural hedge against foreign-exchange risk because all rental contracts (and hence all rental payments) are also denominated in euros. Foreign-exchange risk could arise, however, with the prospective bond denominated in Hungarian forints, as the rental income of the property to be acquired with the bond's proceeds is likely to be denominated in another currency. Even so, we believe this risk is largely mitigated by adequate headroom in terms of interest expense cover.

Figure 6: Scope-adjusted EBITDA interest cover (x)



Sources: SkyGreen, Scope estimates

Figure 7: Cash flows (EUR m)



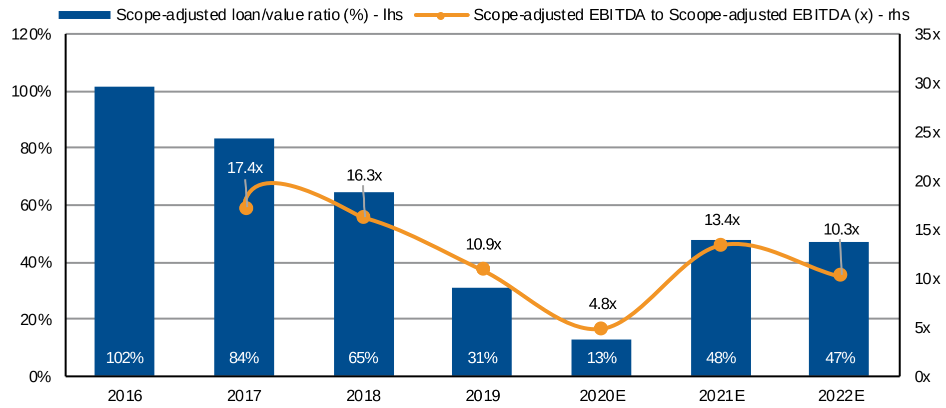
Sa = Scope-adjusted; Sources: SkyGreen, Scope estimates

Negative free operating cash flow driven by portfolio reshuffle in 2020 and 2021

The company's cash flow has benefited from portfolio growth in recent years, including the acquisition of Millenaris Classic and Avantgarde, and Váci Greens D in H2 2019. Other new properties, including Váci Greens E and a new potential asset[4], will strengthen the portfolio upon completion and once they are fully let (37% pre-let as of November 2020). However, cash flows in 2020 have weakened due to the disposal of the Eiffel Square building, which contributed around half of total rental income up to 2019. Discretionary cash flow will continue to be driven by portfolio growth and is expected to be negative until at least 2021. Investments made in 2020 have been fully financed via capital recycling, while the planned bond issuance in Q4 2020 will finance newer portfolio properties.

[4] Due diligence ongoing. Binding offer expected in Q4 2020.

Figure 8: Leverage



Sources: SkyGreen, Scope estimates

Moderate leverage, expected to increase due to debt-financed portfolio growth

SkyGreen has reduced its leverage, as measured by the Scope-adjusted loan/value ratio, to 31% as at YE 2019, from more than 100% at the company's inception in 2016. We forecast a further sharp decline in leverage in 2020 to below 20%, driven by debt redemptions following the disposal of Eiffel Square in H1 2020 and Millenaris Avantgarde in October 2020. However, our medium-term view on SkyGreen's leverage is muted, with the Scope-adjusted loan/value ratio expected at around 50% in 2021, because further portfolio growth is set to be fully financed with debt. Nonetheless, SkyGreen has some buffer against potential market value declines induced by market shocks, including weaker tenant demand.

Figure 9: Liquidity

in EUR m	2020E	2021E
Short-term debt (t-1)	0.4	1.5
Unrestricted cash (t-1)	4.6	113.3[5]
Open committed credit lines (t-1)	0.0	0.0
Free operating cash flow (t)[6]	3.1	0.1
Coverage	**18.9x**	**77.5x**

Source: Scope estimates

Adequate liquidity

We judge SkyGreen's liquidity to be adequate, as its short-term debt balance is not high. By the end of 2019, the company refinanced a EUR 40m facility with Raiffeisen Bank, due in 2021, with a new EUR 100m loan (tenor of seven years, coupon of 2%). After the disposal of the Eiffel Square building, the company redeemed EUR 51m and a further EUR 4m after the disposal of Millenaris Avantgarde.

Supplementary rating drivers

Corporate governance

SkyGreen was founded in 2016 as Eiffel Square Building Kft. and is owned by an investment fund. The investors in the fund are private, in line with the current legal framework in Hungary. However, for each public offering of securities (both equity and non-equity), the issuer must disclose the ultimate beneficiaries and legal documents. We understand that the issuer informed investors interested in the prospective HUF 32bn (around EUR 90m) bond issuance under the MNB Bond Funding for Growth Scheme about its ultimate beneficiary owners.

[5] Includes EUR 90m in bond proceeds
[6] We exclude discretionary expansion capex from our liquidity calculation because such investments are only made if external financing is available.

After selling the Eiffel Square Office building, SkyGreen lent EUR 45.4m to its ultimate owner, Green Ingatlanfejlesztő Investment Fund, at an interest rate of 5%. The owners repaid the full outstanding balance in November 2020 to finance the purchase of the Váci Greens E office building. The fund's management has confirmed verbally that no further loans will be provided in the future.

Long and short-term debt instrument ratings

The company's financial debt includes a bank loan (EUR 43m as of October 2020) secured by the existing portfolio (Millenaris Classic and Váci Greens D). SkyGreen intends to issue a HUF 32bn (around EUR 90m) senior secured corporate bond under the Hungarian National Bank's Bond Funding for Growth Scheme. The planned bond has a 3% fixed coupon (to be paid on an annual basis), 3% yearly amortisation starting in the second year after issuance, and a tenor of 10 years. SkyGreen can only use the proceeds from the bond issuance to acquire such office building that meets the following criteria:

a) It has a certificate of BREEAM Very Good, BREEAM Excellent, BREEAM Outstanding, LEED Gold or LEED Platinum

b) It is classified as being at least a CLASS A building

c) It is located in Budapest, with the exception of properties which: i) meet the Criteria of Countryside Location[7] or ii) are approved by the Security Agent

d) It is free of any liens, charges, or encumbrances or the existing burdens of the property are discharged within the framework of the transaction

The company will provide a first-ranking pledge on the newly acquired assets (Váci Greens E and the asset to be acquired in 2021 using the bond proceeds).

Senior unsecured debt: BB

Our recovery analysis assumes a potential default in 2022 and is based on SkyGreen's liquidation value, considering its planned investments in the next few years. As per our methodology and reasonable discounts on the company's asset base, an 'excellent' recovery is expected for senior secured debt. However, we only apply a two-notch uplift on the company's issuer rating of B+ due to uncertainty around liquidation values (given the relatively low pre-letting ratio of the Váci Greens E and the weakening Budapest office market) as well as execution risk around the further portfolio expansion. Therefore, we have assigned a BB rating to the senior secured bond (ISIN HU0000360201).

Senior unsecured debt: B+

We expect an 'excellent' recovery for SkyGreen's senior unsecured debt. However, the recovery expectations for senior unsecured debt are subject to the final size and conditions of any higher-ranked debt, the collateral provided to secured debt holders, and the company's ability to execute its acquisition strategy. As a result, we have not added two potential notches of uplift to the issuer rating due to risk and the possibility that senior secured debt will increase in the path to default (volatility of capital structure and share of senior unsecured debt). We have therefore downgraded the debt class rating to B+ from BB.

[7] Criteria of Countryside Location means that the aggregated market value of assets outside of Budapest cannot exceed 15% of all assets in SkyGreen's portfolio or HUF 4bn.

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