Cordia International Zrt Hungary, Real Estate

BB STABLE

Corporate profile

Cordia International Zrt. (Cordia) is a privately owned Hungarian residential real estate developer predominantly active in the business-to-customer (B2C) for-sale market. The company focuses on major cities in Hungary, Poland and Romania and develops properties located in and around the city centre with good transportation access. Its developments are aimed mainly at middle/upper-middle-class customers and, to a smaller degree, investors. Cordia as a brand has existed since 2005 and was spun out of Futureal as an independent company in 2016.

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	19.5x	9.8x	7.1x	3.3x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	2.6x	5.7x
Scope-adjusted FFO/SaD	net cash	net cash	32%	12%
Free operating cash flow (FOCF)/SaD	net cash	net cash	(-) FOCF	(-) FOCF

Rating rationale

Scope assigns a first-time issuer rating of BB to Cordia International Zrt. and a BB instrument rating on all senior unsecured debt currently issued by the company. The Outlook is stable.

The BB issuer rating on Cordia benefits from the company's well-diversified project pipeline; good asset quality spread over three different economies and five first- or second-tier cities; and a well-established position in its home market of Budapest. We also expect the company's leverage ratios to remain moderate despite a debt-funded growth plan, and EBITDA interest coverage to remain above 3x.

Rating constraints include the company's small scale and core focus on pure-play residential real estate development, which results in a high sensitivity to unforeseen shocks and volatile cash flows as well as limited recurring rental and other income. Its historical strong foothold in Budapest also hampers its diversification ambitions.

Outlook

The Outlook for Cordia is Stable and incorporates i) the company successfully executing its growth plan without diluting underwriting standards; and ii) the successful placement of a HUF 40bn (EUR 125m) bond in the second half of 2019.

A positive rating action would require a significant improvement in the business risk profile through a further diversification of development projects, and a much higher share of recurring cash flows independent of continued asset sales.

A negative rating action would be possible in the event of a significant slump in sales volumes; a serious deterioration in real estate conditions in Cordia's core markets that negatively affect overall business prospects; or a decline in EBITDA interest coverage to below 2.2x.

Ratings & Outlook

Corporate ratings	BB/Stable
Senior unsecured rating	BB

Analyst

Thomas Faeh
+47 9305 3140
t.faeh@scoperatings.com

Related Methodologies

Corporate Rating Methodology

Rating Methodology European Real Estate Corporates

Scope Ratings GmbH

Haakon VII´s gate 6
N-0161 Oslo

Phone +47 21 623142

Headquarters

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Rating drivers

Positive rating drivers	Negative rating drivers
• Low expected leverage with a 33% loan-to-value (LTV) despite a significant debt-funded growth programme • Strong debt protection (EBITDA interest coverage) with a trough of 3.3x on our estimates, giving confidence on the company's ability to service debt • Well-diversified project pipeline and good asset quality across three different economies and five cities classified as either 'A' or 'B' locations by Scope • Well-established market position in residential real estate in Budapest	• Small property developer (compared to Western peers), resulting in high sensitivity to unforeseen shocks and volatile cash flows, and limited recurring income (rental/other) • Negative free operating cash flow driven by continuous portfolio expansion and funded through debt markets • Historically strong home bias in Budapest with the need to establish a foothold or market share in its other locations

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significant improvement in business risk profile through further diversification of development projects and a much higher share of recurring cash flows independent of continued asset sales	• Significant slump in sales volumes, a serious deterioration in real estate conditions in Cordia's core markets that negatively affect overall business prospects, or a decline in EBITDA interest coverage to below 2.2x

Financial overview

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	19.5x	9.8x	7.1x	3.3x
Scope-adjusted debt (SaD)/EBITDA	net cash	net cash	2.6x	5.7x
Scope-adjusted funds from operations/SaD	net cash	net cash	32%	12%
Loan/value ratio (%)	-7%	-2%	17%	32%
Scope-adjusted EBITDA in HUF bn	**2017**	**2018**	**2019F**	**2020F**
EBITDA	2,014	4,182	9,655	10,747
Operating lease payments in respective year	0	0	0	0
Other items	0	0	0	0
Scope-adjusted EBITDA	2,014	4,182	9,655	10,747
Scope-adjusted funds from operations (FFO) in HUF bn	**2017**	**2018**	**2019F**	**2020F**
EBITDA	2,014	4,182	9,655	10,747
less: (net) cash interest as per cash flow statement	-104	-429	-1,355	-3,286
less: cash tax paid as per cash flow statement	-55	-428	-389	-255
add: depreciation component, operating leases	0	0	0	0
Scope-adjusted funds from operations	1,856	3,428	7,911	7,206
Scope-adjusted debt in HUF bn	**2017**	**2018**	**2019F**	**2020F**
Reported gross financial debt	6,482	10,069	78,495	91,173
less: hybrid bonds	0	0	0	0
less: cash, cash equivalents and cash advances[1]	-18,175	-23,400	-63,705	-42,832
add: cash not accessible[2]	8,204	11,110	10,038	12,897
add: pension adjustment	0	0	0	0
add: operating lease obligations	0	0	0	0
Other items	0	0	0	0
Scope-adjusted debt	-3,489	-2,220	24,828	61,238

[1] In addition to cash and cash equivalents as per IFRS, this number includes customers' advance payments classified as restricted cash under current and non-current financial assets.

[2] Customer advances classified as restricted cash and not accessible for general corporate purposes

Business risk profile: BB-

Industry risk: B

As a real estate developer, Cordia is exposed to the highly cyclical real estate industry with low barriers to entry and low substitution risk. We view real estate development as the most risky sub-segment in real estate and define a B industry risk for companies active within it.

European real estate companies face an evenly balanced set of risks in 2019, resulting in a stable credit outlook. This outlook factors in less dramatic increases in property prices as a result of: i) slowly rising interest rates; ii) some easing of the supply-demand imbalance for most asset classes as development activity picks up; iii) slowing economic growth; iv) political uncertainty – notably, surrounding Brexit and budget difficulties in Italy; and v) international trade relations.

For more information, refer to our corporate outlook for real estate (click here).

Small real estate company in a European context…

Cordia is a small property company in a European context, but a large developer within its home market of Budapest. This is based on its total asset value of HUF 120bn (EUR 373m), including hidden reserves of HUF 26bn at year-end 2018, and funds of operations of HUF 3.4bn (EUR 10.6m), Cordia's small size constitutes a negative rating driver, as it implies a greater sensitivity to unforeseen shocks and greater cash flow volatility. We forecast the company to grow significantly over the next 2-3 years, reaching a total asset value of HUF 220bn (EUR 670m) and funds from operations of HUF 15.4bn (EUR 48m) in 2021.

…but leading in its home market

Within Budapest, Cordia is a leading residential real estate developer, annually accounting for about 10% of new-builds. The company focuses on the mid-market segment, which represents some 60-70% of the residential market, and captures more than 20% in its target markets. The market in Poland is more fragmented than Hungary's and we assess Cordia's combined market share for Warsaw, Krakow and the tri-city area at around 1%. The company plans to scale its organisation in these markets to 1,500-2,000 flats annually, capturing 3%-5% of the mid-market segment and becoming a top-10 residential developer. The Bucharest market is relatively new for Cordia, with only one project completed so far, but the company aims to capture more than 5% of that market and become a top-five residential developer.

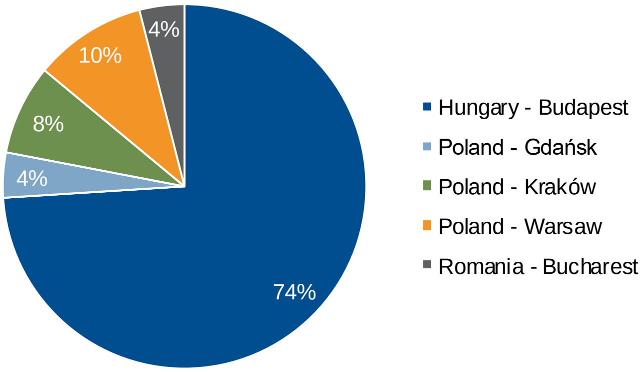
Pure play developer a limiting factor

Cordia's main focus on residential real estate development, with only a small property management business targeted at own investors, is a limiting factor for the rating as results in a very low level of recurring revenues. The company's business diversification would benefit from more exposures to different types of asset classes and real estate sub-segments.

Geographically diversified with a home bias

The company's geographical diversification is spread over five cities in three countries: Hungary (Budapest), Poland (Krakow, Warsaw, and the tri-city metropolitan area comprising Gdańsk, Gdynia and Sopot), and Romania (Bucharest). Despite a historically strong home bias and currently modest geographical diversification (74% of the project pipeline is still in Budapest), the company's ambition to expand into other regions is a credit-positive as this would mitigate potential adverse developments in local markets and, given significant land acquisitions, allow for project portfolio rebalancing if needed.

Figure 1: Geographical diversification of pipeline



Source: Cordia, Scope estimates

Figure 2: Project pipeline plus landbank by expected cost (inner) and exit proceeds (outer circle)

Source: Cordia, Scope estimates

Well-diversified project pipeline

Cordia's project pipeline is well diversified, with top-three projects accounting for less than 15% of both costs and revenues. As of end-2018, the construction pipeline consisted of 3,800 units split into 23 independently operated and funded projects, in addition to a landbank that exceeds the current pipeline. A pre-sale rate of over 80% of 2019 and 2020 deliveries and developer-friendly contracts with end-customers also minimise speculative risks and liquidity shortfalls arising from high working capital allocation.

A credit strength is the company's highly diversified customer base with mostly single-unit buyers. Top-three buyers are well below 2.5%; the top 10, well below 10%.

Exposed to prime locations within second-tier cities

Cordia's development portfolio is situated in what we define as 'A' (tri-city area; Bucharest) and 'B' cities (Budapest, Warsaw, Krakow), based on population growth over a decade of above 7.5% and 2.5%, respectively, and healthy macroeconomic fundamentals. The company focuses on prime locations within these five cities (which have good transportation links), supporting property fungibility and lowering potential haircuts in a distressed sales scenario.

Volatile EBITDA margin

Given the short history as an independent company (outside of Futureal), Cordia's reported EBITDA is rather volatile: 43% in 2016, 29% in 2017, and 21% in 2018. We expect EBITDA to remain volatile on a year-over-year basis, in line with other real estate developers, but foresee less volatility on a project level due to Cordia's stringent underwriting policy of more than 25% gross margin, which projects have so far not breached.

Long-term owners with strong market competence

Cordia is owned by the Futó family, which has strong market competence and experience through its longstanding involvement in large-scale, mixed urban renewal and redevelopment projects, office and retail developments, and commercial property investments. The owners have shown a long-term commitment to Cordia through financial and personal support and entrusting a management team with the company's operations for over a decade, with minimal fluctuation.

Financial risk profile: BB+

Cordia's short financial history as a standalone company (since 2016) shows remarkable Scope-adjusted metrics, driven by a mostly equity-financed balance sheet and limited use of secured construction loans.

Rating case based on higher leverage

Our rating case assumes more debt-funded growth going forward, based on the issuance of a senior unsecured bond at HUF 40bn (EUR 125m) in the second half of 2019, continued drawdowns on construction loans, and the redemption of non-controlling shares in the co-invested equity fund.

We have built Cordia's tangible construction pipeline into our rating case with eight projects (two of which were completed in 2018) to be handed over in 2019 and seven in 2020, resulting in expected revenue of HUF 35bn and HUF 56bn respectively and forecasted EBITDA of HUF 9.6bn and HUF 10.7bn respectively. Funds from operations stood at HUF 3.4bn for 2018 and is forecasted to increase to HUF 7.9bn in 2019 and HUF 7.2bn in 2020. However, the company's significant growth ambitions also translate into large changes in working capital, including substantial investments into land banks and into the commencement of new projects. These efforts will increase Cordia's inventory by HUF 39bn in 2019 and HUF 34bn in 2020, resulting in strongly negative free operating cash flow of HUF -30bn in 2019 and 2020.

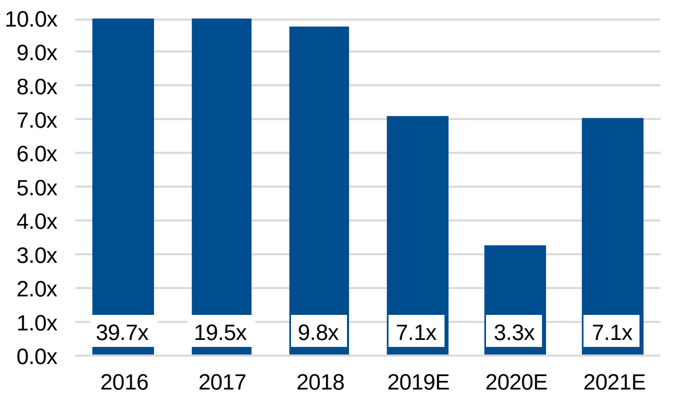
Strong debt protection, mitigated by business model

The company's debt protection – as measured by EBITDA interest cover – stood at a comfortable 9.8x in 2018 and was even higher in the years before. Given the anticipated increase in debt, we foresee a reduction in that ratio to 3.3x in 2020 before it recovers due to an assumed increase in EBITDA. The latter effect is based on operating profit stemming fully from ongoing non-recurring property sales, an uncertainty hampering the ratio's strength.

Manageable forex risk

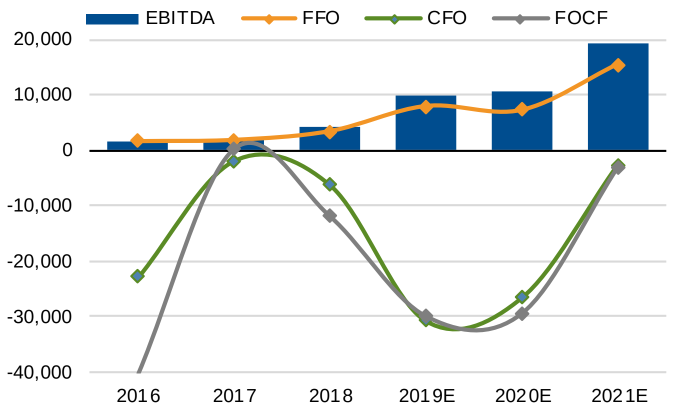
All interest-bearing debt has so far been issued on the SPV level in the form of construction loans in local currency, which acts as a natural hedge because revenue is also in local currency. Foreign-exchange risk could arise with the prospective bond issuance denominated in Hungarian forint, as proceeds are also likely to be used in Poland and Bucharest. We do not foresee this to be a major risk, given the headroom in Cordia's interest coverage.

Figure 3: Debt protection (EBITDA interest coverage)



Source: Scope estimates

Figure 4: Cash flows



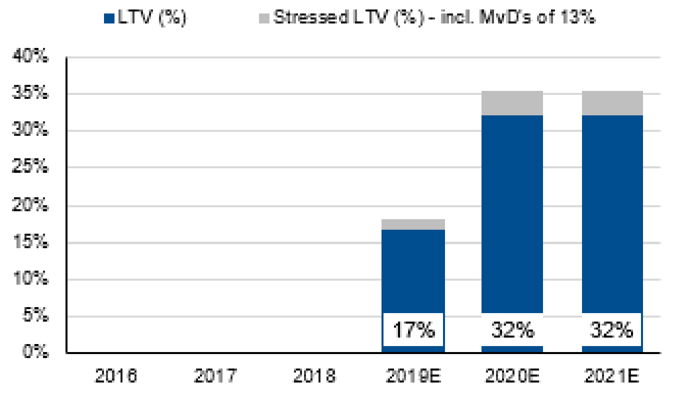
Source: Cordia, Scope

Negative free operating cash flow a result of growth

We foresee a continuation in the company's positive cash flows, as measured by funds from operations. The strong growth in Cordia's development pipeline since it began as an independent company has led to free operating cash flow being highly negative and volatile. We expect free operating cash flow to remain negative based on i) further strong growth anticipated for upcoming years; and ii) the nature of Cordia's core business of real estate development. Accordingly, inflows and outflows of cash are not necessarily matched during a project's lifetime.

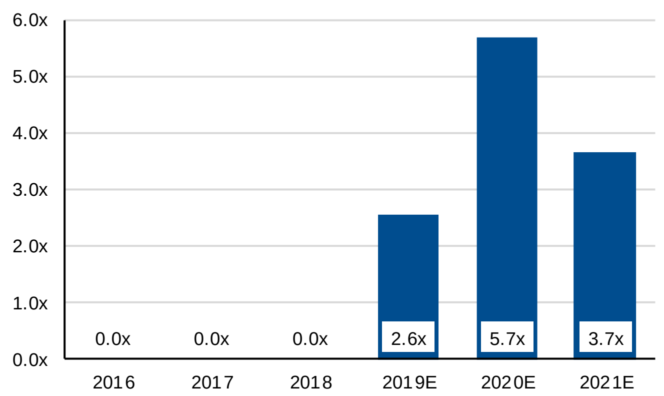
Cordia's leverage as measured by loan/value (LTV) at year-end 2018 has been zero, respectively negative, given that the cash balance has exceeded the negligible amount of Scope-adjusted debt. Our rating base case anticipates a debt-funded project pipeline, which will lead to an increase in LTV to 17% in 2019 and a moderate leveling-out at 32% during 2020/21.

Figure 5: Leverage measured by LTV



Source: Scope estimates

Figure 6: SaD/EBITDA



Source: Scope estimates

Leverage to increase sharply

The company's leverage as measured by SaD/EBITDA has historically been zero as well. Similar to the LTV development, we forecast a steep increase to 5.7x in 2020 before reducing at a moderate pace due to the strong EBITDA forecasts in 2021.

Financial risk profile restrained by nature of core business

While both leverage measures, especially debt protection, typically imply a higher financial risk profile sub-score, Cordia's is hindered at BB+ for the time being. This is due to i) the nature of its business and the uncertainty and timing of future sales, which affect EBITDA; ii) the strong debt-funded growth, resulting in very negative free operating cash flow; and iii) very low levels of recurring income. These factors limit the analytical value of Scope's ratios.

Liquidity

We consider Cordia's liquidity to be adequate, in detail:

Position	YE 2018		2019E	
Unrestricted cash	HUF	12.3bn	HUF	53.7bn
Open committed credit lines	HUF	26.9bn	HUF	26.9bn
Free operating cash flow (t+1)	HUF	-30.0bn	HUF	-29.6bn
Short-term debt	HUF	5.2bn	HUF	19.2bn
Coverage		**1.8x**		**2.7x**

We judge the company's liquidity to be adequate, with unrestricted cash exceeding short-term debt. Free operating cash flows is a drag on coverage. However, open committed credit lines in the form of construction loans cover liquidity comfortably, when taking into account both internal and external sources.

Senior unsecured debt

Senior unsecured debt: BB

Our recovery analysis shows a very high sensitivity to attainable prices in a distressed sales scenario. For this reason, and given that secured debt at property SPV level consisting of fully drawn construction loans at the hypothetical point of default will have to be repaid first, we have limited the notching-up between senior unsecured debt and the issuer rating. This translates into a BB rating for senior unsecured debt.

Recovery is based on a hypothetical default occurring in year-end 2020, at which we assume outstanding secured financing (including fully drawn construction loans) of HUF 78bn, and senior unsecured debt of HUF 40bn.

Outlook

The Outlook for Cordia is Stable and incorporates i) the company successfully executing its growth plan without diluting underwriting standards; and ii) the successful placement of a HUF 40bn (EUR 125m) bond in the second half of 2019.

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Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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