Forrás Nyrt.
Hungary, Investment Holding

SCOPE B+ NEGATIVE

Corporate profile

The legal predecessor of Forrás Nyrt. was established in 1997. Since then, the group and current management have invested in several industries including consumer goods, real estate and wholesale pharmacies (West Pharma). Forrás' assets today overwhelmingly consist of diverse real estate assets including a land bank, leisure assets and commercial real estate. Forrás is listed on the Budapest stock exchange. Arago Holding Zrt. owns 85% of the group. Forrás will use the proceeds of a HUF 20bn senior unsecured bond issued in 2020 to continue acquiring companies active in manufacturing and green-energy generation.

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
Total cost coverage (x)	1.5x	1.0x	1.2x	2.8x
Loan/value ratio (Scope-adjusted debt/portfolio market value)	-12%	-13%	below 30%	
Liquidity (internal and external)	No short-term debt	5,214.1x	269.7x	No short-term debt

Rating action

Scope Ratings has changed its issuer rating for Forrás Nyrt. to B+/Negative from B+/Stable and affirmed the B+ senior unsecured debt rating.

Rating rationale

The change in Outlook from Stable to Negative is mainly caused by the delays in the execution of the envisaged acquisition program versus the issuer's initial planning that served as the basis for the initial rating. Those delays imply that the limited visibility of future cash income of the rated entity will persist beyond 2021. If the planned acquisition will either be further delayed versus the revised time plan of the issuer or the acquired entities will fall short of the envisaged cash contribution volumes, we see an increased risk that the total cost coverage ratio will move below 1.0x and towards 0.8x, which constitutes a downward rating trigger.

The B+/Negative issuer rating on Forras Nyrt, ("Forras"), a Budapest-based industrial and real estate investment holding, is currently supported by the company's (I) still sufficient, but weaker-than-expected total cost coverage, (II) balanced financing structure that bears only moderate external financial debt compared to its current asset base and net cash position. The issuer rating is still constrained by (I) the issuer's current lack of size and scope both in the industrials and real estate segments, (II) execution risks in connection with the postponed but still planned increase of exposure to more cyclical manufacturing businesses as well as (III) a complex issuer structure incorporating a variety of different businesses, consolidation forms and financing structures.

Although there is still sufficient total cost coverage of >1.0x on a sustained basis on holding level, this ratio is highly dependent on the successful and timely execution of the targeted investments. Despite the high uncertainty on future recurring cash income from new holdings, we hint at the fact that the issuer has shown a certain degree of acquisition discipline so far and has viable acquisition options at hand to deploy its currently large cash position of HUF >20bn at the required cash flow yields.

Ratings & Outlook

Corporate rating B+/Negative

Senior unsecured rating B+

Analyst

Denis Kuhn
+49 69 6677389 83
d.kuhn@scoperatings.com

Related Methodology

Corporate Rating Methodology February 2020

Scope Ratings GmbH

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

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Outlook and rating-change drivers

The rating Outlook was changed to Negative due to delays in the portfolio ramp-up that entail risks of ongoing negative carry and total cost coverage dropping below 1x. Even so, we expect the successful but delayed execution of envisaged investments into companies from the metal parts/CNC (Computerized Numerical Control) and green energy sectors, financed by the HUF 20bn senior unsecured bond. If executed as planned within the next 18 months, the expanded portfolio should translate into a total cost coverage of more than 1.0x. In addition, the Outlook incorporates substantial cash inflows in 2021 from the redemption of more than HUF 3bn of shareholder loans between the rated entity and a parent holding company.

A negative rating action is possible if the issuer shows a further deterioration of total cost coverage to less than 0.8x on a sustained basis. This could be the result of smaller-than-expected cash contributions from the newly acquired companies in the industrials sector caused by adverse industry trends or further delays in capital deployment.

We may consider a positive rating action (i.e. a return to a Stable Outlook) in case of a higher visibility regards total cost coverage to remain sustainably above 1.0x going forward. This could follow a successful deployment of bond proceeds in line with the company's acquisition strategy.

Rating drivers

Positive rating drivers	Negative rating drivers
• Expected cost coverage ratio of around 1.0x going forward • Recurring cash flows from real estate smoothing out earnings • Hidden reserves in real estate portfolio translating into moderate leverage and access to additional liquidity • Over 20 years' experience in the sourcing, development and sale of manufacturing companies and real estate projects in different asset classes in Hungary	• Increasing exposure to cyclical manufacturing industry • Lack of scale compared to European industrial and real estate peers • High target industry concentration in industrial portfolio may translate into high cash flow volatility • Execution risks regarding acquisitions • Complex company structure with different business models, industries and holding structures • Risk of structural subordination of Forrás' senior secured creditors

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Higher visibility on future cash inflows after successful execution of expansion plans while showing total cost coverage of more than 1.0x on a sustained basis	• Deterioration of total cost coverage to less than 0.8x on a sustained basis

Financial overview

			Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Loan/value ratio (%) (single entity basis)	-12%	-13%	below 30%		
Total cost coverage	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Total cost coverage	1.5x	1.0x	1.2x	2.8x	2.6x
Scope-adjusted debt in HUF m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	1,029.8	22,865.2	22,813.2	22,813.2	22,813.2
less: cash and cash equivalents (accessible)	-3,090.4	-25,155.0	-18,750.8	-15,239.3	-13,497.6
add: other	0.0	0.0	0.0	0.0	0.0
Scope-adjusted debt	**-2,060.7**	**-2,289.8**	**4,062.4**	**7,573.9**	**9,315.6**

Business risk profile: B

Blended industry risk: BB

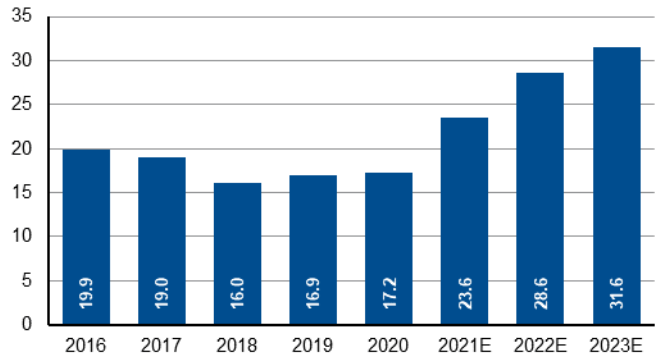
Our industry risk assessment combines the real estate sector (focused on commercial properties) with the capital goods segment. Forrás plans HUF 15bn-20bn in acquisitions in the capital goods segment within the next 18 months. Since the planned acquisitions in the metal parts manufacturing sector did not take place so far, we still deem the blended industry risk to be primarily driven by the existing real estate portfolio across several asset classes like hospitality, retail and logistics.

The company's market position is very modest, with negligible market shares in Hungarian real estate and the capital goods industry. Even with the expansion, Forrás will still have a limited size and scope in the industrial business (capital goods), implying a high vulnerability to adverse shocks and limited bargaining power with customers.

Forrás' expansion into the industrial sector will provide diversification beyond real estate. However, income will remain clustered around Budapest real estate and CNC and metal parts manufacturing. Earnings are expected to become more volatile once Forrás deployed available funds into new holdings because cash income from the industrial sector will be more cyclical than the fairly stable recurring revenues from real estate[1]. The target companies, to be acquired around one year later than in our initial base case from 2020, are predominantly suppliers to agricultural machinery makers.

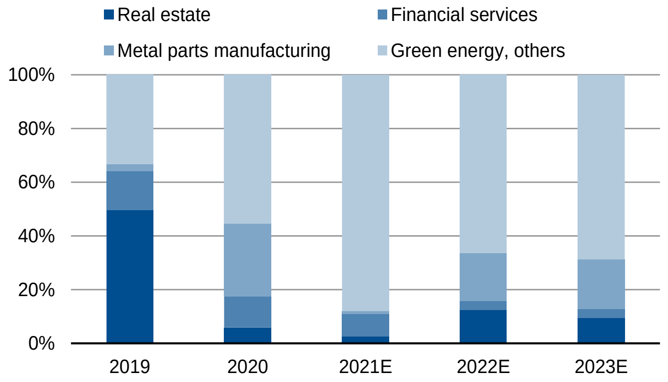
[1] Earnings have again shown high volatility in 2020, since a substantial share of recurring rental income is generated in asset classes that had a severe negative impact from the Covid-19 pandemic such as hospitality and retail.

Figure 1: Scope-adjusted total assets (HUF bn; standalone accounts)



Sources: Forrás, Scope

Figure 2: Cash income by sector and year



Sources: Forrás, Scope

Significant industry or asset concentration risk is a fundamental weakness for investment holding companies. As of H1 2021, Forrás has a high GAV concentration in Budapest real estate, even with recurring revenues from services such as the non-performing loan business and the exposure to metal parts manufacturing (Figure 2 provides a split of cash income on holding level by year, both historical and forecasted). However, we expect the high concentration on real estate to decrease substantially through the manufacturing sector acquisitions over the next two years.

Despite the ongoing recovery of those sectors, we again flag the risk of an extended volatility of earnings as the company's revenues will be increasingly cyclical going forward as a result of the expansion in comparison to the rather stable real estate-centered recurring revenues in the past. A potential mitigant of this increased earnings cyclicality might be the investment program into green energy started within 2020 and already acquired c. HUF 300m of solar energy plants and expects to ramp up investments to c. HUF 2bn over the next 12 months. The issuer has also expanded its investment focus to companies from the metal parts / CNC sector situated in Western Europe, predominantly in the German-speaking DACH-region.

Liquid, quoted investments in developed markets pose a lower credit risk than unlisted investments. Quoted investments, particularly those with a medium or large market capitalisation and high trading volumes, are easier to liquidate and, as such, may provide cash inflows if needed. Therefore, the illiquidity of Forras' assets represents a rating constraint in our view.

Financial risk profile: B+

We assess Forrás' financial risk profile at B+, mostly as a result of the persisting uncertainties regarding execution of the investment program and thus future cash earnings.

High cash outflows expected for acquisitions in 2021E and 2022E

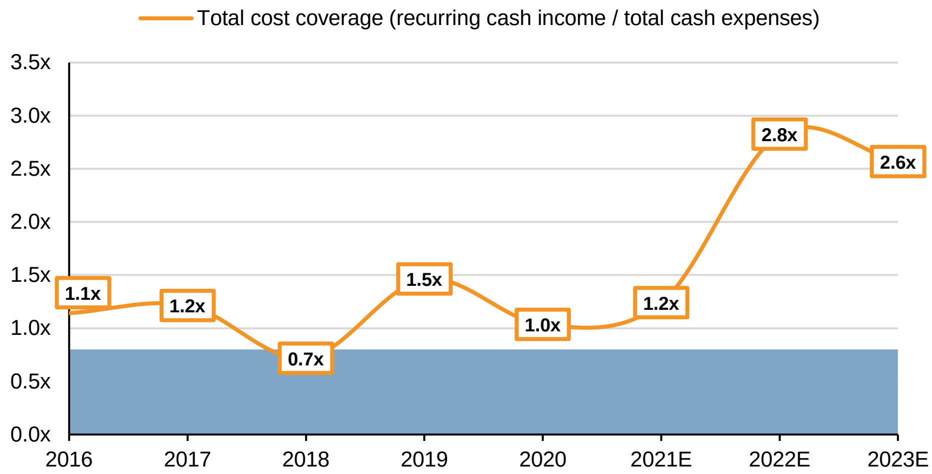
Our base case foresees sufficient total cost coverage of consistently above 1.2x at holding level, but much of the underlying cash income remains subject to the successful execution of portfolio growth via acquisitions. The issuer has broadened its investment programme to include Western European metal parts manufacturers, not just those from Hungary, as well as green energy, namely solar power parks. Debt-financed acquisitions, assumed at HUF 10bn in 2021 and HUF 7bn in 2022, will take a toll on free operating cash flow during 2021-23 (versus 2020-22 as originally planned). These acquisitions, anticipated up until YE 2022 should improve sectoral and geographical diversification. Recurring cash income is expected to exceed HUF 2bn after most targets are acquired in

2022 keeping total cost coverage above 1.2x going forward; this already incorporates reductions in expected cash dividends and shareholder loan interest income.

Moderate debt levels on standalone basis

The real estate portfolio has low external financial debt. This is shown by the look-through Scope-adjusted loan/value ratio of around 14% as of year-end 2020 and a net cash position on standalone basis. Cash can cover upcoming operating costs and financial obligations, thus mitigating liquidity concerns. Furthermore, the small volume of external financial debt on the diversified real estate portfolio should leave sufficient possibilities for secured (mortgage-) lending that mitigates liquidity concerns at this point. On the other hand, we flag the risks around financial debt on subsidiary level because it ranks senior to senior unsecured debt at holding level.

Figure 3: Total cost coverage



Sources: Forras, Scope

Decreasing visibility of future cash flows due to expansion

We expect total cost coverage to stay above 1.2x this year and above 2.0x from 2022, with bond proceeds used to acquire metal parts producers and green energy generators. Sales of the land bank and certain real estate subsidiaries may add cash income but are not incorporated into our base case due to limited visibility on both execution and any upstreaming of cash to the rated entity. The postponement of the major acquisitions in the metal parts / CNC sector have led to substantially smaller cash outflows for acquisitions in 2020 as expected in our base case, leading to a higher-than-expected cash position of c. HUF 25bn as of year-end 2020. While this implies a net cash position for the time being, we anticipate circa HUF 10bn and HUF 5bn in cash outflows for acquisitions in 2021 and 2022, respectively. We now expect a split of the HUF 20bn in total bond proceeds of around 50% investment into the metal parts / CNC sector, 25% into green energy projects and 25% to other sectors, e.g. investments in the existing real estate portfolio and potential developments.

LTV to increase along with the deployment of bond proceeds

With the successful placement of the HUF 20bn corporate bond in the second half of 2020, we expect the Scope-adjusted loan/value ratio to increase to around 30% going forward from net negative as of year-end 2020.

Liquidity is adequate with no material external financial debt due until the 10-year senior unsecured bond matures in 2030. In detail:

Liquidity: adequate

Figure 4: Liquidity

in HUF m	2020	2021E	2022E
Short-term debt (t)	956	57.0	5.0
Unrestricted cash (t)	3,090.4	25,155.0	18,750.8
Free operating cash flow (t+1)	1,894.2	-9,780.3	-3,311.5
Liquidity (internal)	**5,214.1x**	**269.7x**	**3,087.9x**
Open committed credit lines (t)	0.0	0.0	0.0
Liquidity (internal and external)	**5,214.1x**	**269.7x**	**3,087.9x**

Source: Scope estimates

Long and short-term debt ratings

Forras has issued a HUF 20bn senior unsecured corporate bond under the MNB 'Bond Funding for Growth Scheme' within 2020. The lion's share of proceeds from the bond are earmarked for the acquisition of majority and/ minority stakes in manufacturing businesses in Hungary and Western Europe within the metal parts / CNC sector as well as investments into green energy.

Senior unsecured debt affirmed at B+

We rate all current and future senior unsecured debt at the same level as the issuer rating. We anticipate average recovery for senior unsecured debt holders in a liquidation scenario. Furthermore, the rating of senior unsecured debt is limited by the fact that all current and future secured and unsecured debt on subsidiary level ranks structurally senior to senior unsecured debt of the holding.

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

23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

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

Phone +34 914 186 973

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

111 Buckingham Palace Road
London SW1W 0SR

Phone +44 020 7340 6347

info@scoperatings.com
www.scoperatings.com

Disclaimer