Forrás Nyrt.
Hungary, Investment Holding

SCOPE B+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Total cost coverage	0.5x	0.8x	2.2x	1.9x
Scope-adjusted loan/value ratio	49%	52%	59%	58%
Liquidity	>100%	>100%	>100%	>100%

Rating rationale

The issuer rating on Forrás Nyrt., a Budapest-based industrial and real estate investment holding company, is supported by: i) the portfolio's sustainability, reflecting relatively low concentration on a single subsidiary in terms of cash interest and dividend income; ii) improved diversification of holdings across sectors and industries as a result of the acquisition of Kiss és Társa Kft. (capital goods sector) and Váll-Ker Kft. (manufacturer of durable consumer products) on top of the existing commercial real estate and renewables portfolio; and iii) rapidly improving total cost coverage, benefitting from higher dividend inflows from the newly acquired entities, higher interest income from the solar portfolio and yields from financial assets.

The issuer rating is mainly constrained by the Scope-adjusted loan/value (LTV) ratio. The corporate guarantee behind the loans taken out by Aquila New Energy and Miklósfai has increased Scope-adjusted debt, moving the LTV ratio to near 60%. The liquidity of holdings is another constraining factor. As of YE 2022, Forrás holds the vast majority (around 90%) of its gross asset value in private/unlisted companies and real estate assets.

The combination of no material financial debt maturities prior to 2030 at the holding company level and high levels of unrestricted cash on a sustained basis in our base case scenario results in adequate liquidity within the rated entity. We nevertheless flag the substantial maturity wall, with close to 100% of external financial debt due in 2030.

Outlook and rating-change drivers

The Outlook is Stable and encompasses the assumption that Forrás' credit metrics will develop in line with our base case forecast, resulting in total cost coverage of around 2.0x and an LTV ratio of below 60% in 2023. Our forecast does not include any acquisitions or divestments beyond 2023 due to limited visibility on the company's medium-term investment portfolio management strategy.

A positive rating is unlikely at this stage but could be justified in case of better visibility of the medium-term strategy/investment philosophy and a rigorously established financial policy at the core investment level, while the LTV would decrease to below 50%.

A negative rating action could occur if total cost coverage deteriorated to below 1.0x on a sustained basis. This could be the result of smaller-than-expected cash contributions from the newly acquired companies in the manufacturing sector, caused by adverse industry trends or further delays in capital deployment. A negative rating action could also occur if the LTV ratio rose above 70%, caused either by asset divestments or an increase in Scope-adjusted debt.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
22 Jun 2023	Upgrade	B+/Stable
27 Jun 2022	Downgrade	B/Stable
29 Jun 2021	Outlook change	B+/Negative

Ratings & Outlook

Issuer	B+/Stable
Senior unsecured debt	B+

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Related Methodology and Related Research

General Corporate Rating Methodology; July 2022

Investment Holding Companies Rating Methodology; May 2023

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Multiple successfully executed acquisitions in 2022 and 2023, resulting in higher recurring cash income • Record of over 20 years in the sourcing, development and sale of manufacturing companies and real estate projects in different asset classes in Hungary • Hidden reserves in real estate and solar portfolio, partially mitigating the high LTV ratio and providing potential access to additional liquidity if needed	• High LTV ratio due to Forrás acting as guarantor of subsidiary debt • Very small player with lack of scale compared to other European industrial and/or real estate players • Complex corporate structure, including a variety of business models, industries and holding structures • Risk of structural subordination of the rated holding entity's senior secured creditors

Positive rating-change drivers	Negative rating-change drivers
• Higher visibility regarding recurring cash income • LTV ratio below 50%	• Total cost coverage below 1.0x on a sustained basis • LTV ratio above 70%

Corporate profile

Forrás Nyrt. is a Hungarian investment holding company with current shareholdings in the commercial real estate, renewable energy and manufacturing sectors. Established in 1998, it has a long track record of investments in a wide range of industries from the past 20 years, including consumer goods, real estate and wholesale pharmacies. The shares of Forrás Nyrt are listed on the Budapest Stock Exchange (BÉT), with Arago Investment Holding as the majority owner (88%).

Financial overview

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Total cost coverage	0.5x	0.8x	2.2x	1.9x
Scope-adjusted LTV ratio	49%	52%	59%	57%
Liquidity	>100%	>100%	>100%	>100%
Total cash income in HUF m				
Recurring cash interest and dividends received	404.2	842.4	2,712.7	2,340.4
Rental income and fees	12.3	7.7	8.3	8.9
Recurring income	**416.5**	**850.1**	**2,721.0**	**2,349,3**
Total expenses in Total cash income in HUF m				
Operating expenses	-185.1	-239.8	-282.9	-294.2
Taxes paid	-6.4	-19.5	-125.3	-91.0
Interest paid	-689.0	-760.1	-791.2	-789.6
Cash dividend paid	-30.0	-30.0	-30.0	-30.0
Total expenses	**-910.5**	**-1,050.1**	**-1,229.5**	**-1,204.8**
Scope-adjusted debt in HUF m				
Reported gross financial debt	22,797.6	31,677.8	22,726.6	22,291.5
Less: cash and cash equivalents	-3,531.9	-4,006.9	-4,197.4	-3,134.9
Other items (guarantee)	0	898.0	9,207.0	8,664.9
Scope-adjusted debt	**19,265.8**	**28,568.9**	**27,736.2**	**27,821.5**
Scope-adjusted gross asset value in HUF m				
Non-solar long-term investments (as per balance sheet)	25,691.8	28,149.3	28,970.2	28,970.2
Solar portfolio (market value, based on valuation)	NA	7,240.0	7,240.0	7,240.0
Short-term investments	13,514.7	19,800.6	10,905.3	12,253.0
Scope-adjusted gross asset value	**39,206.5**	**55,189.9**	**47,115.5**	**48,463.2**

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Environmental, social and governance (ESG) profile[1]

Environment	Social	Governance
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)	Labour management	Management and supervision (supervisory boards and key person risk)
Efficiencies (e.g. in production)	Health and safety (e.g. staff and customers)	Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)	Clients and supply chain (geographical/product diversification)	Corporate structure (complexity)
Physical risks (e.g. business/asset vulnerability, diversification)	Regulatory and reputational risks	Stakeholder management (shareholder payouts and respect for creditor interests)

Legend
Green leaf (ESG factor: credit-positive)
Red leaf (ESG factor: credit-negative)
Grey leaf (ESG factor: credit-neutral)

Management, supervision and complex group structure

The strong influence of main shareholder Arago (88% of voting rights) could be disadvantageous for external creditors like bondholders (and minority equity shareholders) in case of a dispute or liquidation. There is also key person risk as Tamás Leisztinger, Arago's main shareholder, makes all major operational decisions and sets the investment strategy at the holding company level, although a board of directors provides assistance. The company also operates with a complex corporate structure incorporating different businesses, consolidation forms and financing structures (ESG factor: credit-negative).

[1] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e. those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.

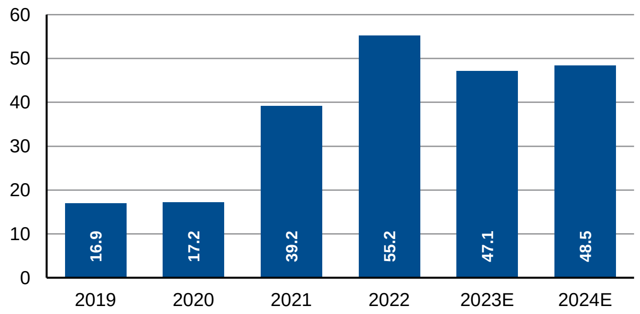
Business risk profile: B+

Weighted average portfolio risk remains driven by the real estate and solar sector

Despite acquisitions in the capital goods sector (Kiss és Társa Kft.) and the durable consumer products sector (Váll-Ker Kft.) in 2022, Forrás' weighted average portfolio risk remains primarily driven by its real estate portfolio and its assets in the renewables sector. Given that the assets in the financial sector are expected to be divested in 2023, they are not considered in our assessment of portfolio risk.

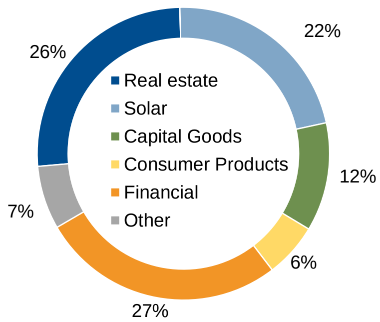
The weighted average industry risk based on gross asset value shows the mixed industry risk of commercial real estate (assessed at BB) and unregulated renewables (also BB), which are defined by high-to-medium cyclicality, medium barriers to entry and high-to-medium substitution risk.

Figure 1: Scope-adjusted gross asset value in HUF bn



Sources: Forrás, Scope estimates

Figure 2: Distribution of gross asset value across sectors, YE 2022



Sources: Forrás, Scope

Portfolio sustainability benefits from low recurring cash income concentration

Forrás has relatively low concentration in terms of cash interest and dividend income as of year-end 2022 and based on management's business plan for 2023-25. The largest cash-effective contributions to interest income from 2021 onwards have been from Studio V (interest on the shareholder loan provided to buy Magnetbank bonds) and Aquila New Energy. The latter has contributed the lion's share of recurring cash income upstreamed to the holding recently. In addition to interest income from the solar holding, the SPVs themselves are paying less, but steady, interest on their shareholder loans.

There are six income-generating core holdings (with gross asset value above 5%), showing a well-diversified investment portfolio. There is also a high proportion of income-generating assets in the portfolio (close to 90%). Together they make cash flow more resilient to sector shocks and portfolio performance less dependent on individual companies. The top core holding with the highest income concentration is Aquila New Energy, which generated around 25% of recurring cash income in 2022.

Weak geographical diversification

Geographical diversification has remained limited - 95% of revenues come from the Hungarian market, exposing the investment portfolio to economic downturns and changes in the macroeconomic environment. However, Forrás indicated the potential expansion of the company's investment focus to the metal parts and computer numerical control machining (CNC) segments in western Europe, predominantly in the German-speaking countries. This will benefit geographical diversification once the acquisitions are completed.

As of YE 2022, Forrás holds the vast majority (around 90%) of its gross asset value in private/unlisted companies and real estate assets. We deem this credit-negative in terms of liquidity. In our view, a situation requiring urgent liquidation is rather remote. However, if a liquidation did become necessary, it would be caused by a severe downturn in the financial performance of the newly acquired industrial assets. In a hypothetical situation like this, we deem demand for such small (likely loss-making) industrial assets to be weak.

On the other hand, the diversified and largely unencumbered real estate portfolio (including a land bank in Budapest and hotel, retail, residential and agricultural assets) should provide some liquidity if needed, either via sales or secured lending. Additionally, the liquidity of the solar portfolio is seen as above average, benefitting from the high demand on the market for similar assets, which would enable the issuer to sell it quickly and without significant discount to the market price.

While smaller portion of Forrás's share portfolio has been sold, the issuer still holds a portfolio of Hungarian blue-chip shares (OTP and AKKO) with a total face value of HUF 5.2bn (as of YE 2022). Management states that they own this portfolio as an alternative to cash. However, due to highly volatile share prices, this portfolio's market value is subject to rapid, significant changes.

Lack of long-term investment strategy limits visibility

The Investment Holding Companies Rating Methodology takes into account the company's investment philosophy as an additional factor when assessing its business risk profile. Despite the company's strong track record of insourcing, developing and selling manufacturing companies and real estate projects in different asset classes in Hungary, we still consider its investment philosophy to be rather opportunistic, with acquisition and divestment targets changing rapidly. This results in limited visibility on medium-term cash flows at the investment holding company level.

Financial risk profile: B+

Total cost coverage expected to significantly increase beyond 2022

With the delayed acquisitions and the solar portfolio being in the construction phase in 2021-22, total cost coverage has fallen below 1.0x during the past two years. This meant recurring cash income was not able to cover cash expenses. As the acquisition of the dividend-paying entities has already taken place and solar plant construction been completed, we forecast lower volatility in recurring cash flow starting from 2023.

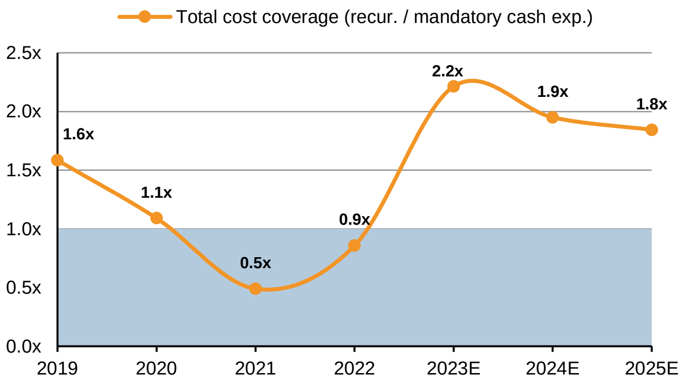
Total cost coverage (Figure 3) only takes into account the issuing entity's recurring cash income after our discounts. As per the base case forecast, a significant improvement in total cost coverage is expected for 2023. This is mainly due to cash contributions from the newly acquired Kiss és Társa Kft. and cash dividends to be paid by the divested Kreditor Zrt. after the 2022 business year.

The cash interest received can be separated into two categories:

- Interest from shareholder loans, which consists mainly of the income from the solar portfolio (the SPVs and the portfolio's main holding entity pay yearly interest but no dividends)
- Cash income from the financial asset portfolio

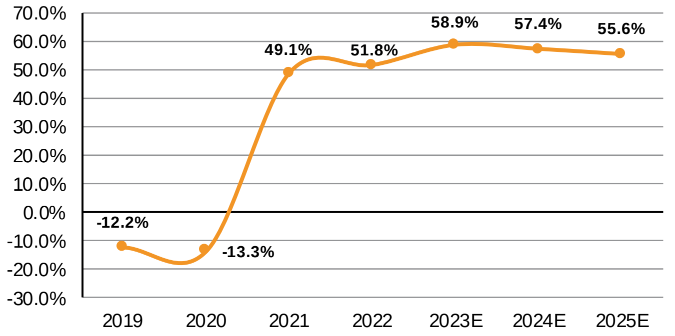
We highlight the fact that approximately HUF 1.1bn of cash interest received is forecasted for 2023. This fully covers cash interest payable and serves as a solid foundation for total cost coverage, even if dividend income changes significantly compared to management's forecast (as witnessed in previous years).

Figure 3: Total cost coverage



Sources: Forrás, Scope estimates

Figure 4: Scope-adjusted LTV ratio



Sources: Forrás, Scope estimates

Guarantees on subsidiaries' debt have significantly increased the LTV ratio

The LTV ratio is the weak point in the financial risk profile. The corporate guarantee behind the loans taken out by Aquila New Energy and Miklósfai increased Scope-adjusted debt (HUF 9.2bn in 2023) on top of the HUF 21.7bn central bank bond. We note that most assets in the LTV calculation are kept at book value and are thus significantly undervalued. No valuation is available for the real estate portfolio and the 23MW PV plant. The 28 0.5MW PV plants have a market value of HUF 7.2bn based on a valuation dated Q3 2022 (compared to a book value of HUF 690m).

We highlight that there is currently limited visibility on the market value of the real estate and solar portfolio. The availability of valuations might influence the Scope-adjusted gross asset value significantly.

Adequate liquidity

Liquidity is adequate, benefiting from HUF 4.0bn in cash available as of YE 2022. This covers the HUF 1.8bn of negative free operating cash flow forecasted for 2023. The company has negligible short-term external debt as of YE 2022.

Balance in HUF m	2023E	2024E
Unrestricted cash (t-1)	4,006.3	9,395.3
Open committed credit lines (t-1)	0.0	0.0
Free operating cash flow	-1,785.8	-5,422.2
Short-term debt (t-1)	61.2	59.6
Coverage	**>100%**	**>100%**

Long-term debt rating

Senior unsecured debt rating: B+

Forrás issued a HUF 21.7bn senior unsecured bond under Hungary's Bond Funding for Growth Scheme in October 2020. The bond's tenor is 10 years, with 10% of its face value to amortise from 2027. The coupon is fixed (3.2%) and payable yearly. Most of the bond proceeds were used to acquire assets in the renewable energy, manufacturing and real estate sectors, while the remaining proceeds have been invested in shares of companies listed on the Hungarian stock exchange.

Our recovery analysis is based on a hypothetical default scenario at year-end 2024. Corporate guarantees on the subsidiaries' loans are placed above senior unsecured debt in the waterfall of debt, as senior unsecured debt at the holding company level is structurally subordinated to debt at the subsidiary level. Thus we rate senior unsecured debt at the same level as the issuer rating (B+).

We note that the senior unsecured bond Forrás issued under the Hungarian central bank's bond scheme has an accelerated repayment clause. The clause requires Forrás to repay the nominal amount (HUF 21.7bn) within 30 days if the bond rating falls below B-, which could have default implications.

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