Proform Ingatlanbefektetesi Zrt. Hungary, Real Estate

B+ STABLE

Corporate profile

Proform Ingatlanbefektetési Zrt. was founded in 1989. Its main activities include the construction, development and maintenance of office buildings, hotel projects, and residential and commercial real estate. To date, it has built more than 300,000 sqm of commercial real estate, mainly in Budapest, worth around EUR 200m by market value as of year-end 2019. The company only develops properties for its own portfolio.

Key metrics

			Scope estimates	
Scope credit ratios	2018	2019	2020F	2021F
EBITDA/interest cover (x)	neg.	10.5x	9.1x	5.2x
Scope-adjusted debt (SaD)/EBITDA	1.6x	net cash	4.2x	4.1x
Loan/value ratio (look-through, %)	51%	44%	59%	58%

Rating action

Scope affirms the issuer rating of Proform Ingatlanbefektetési Zrt. at B+/Stable as well as the instrument rating on senior unsecured debt of BB-, following a review of full-year numbers for 2019 and the company's updated business plan.

Rating rationale

The affirmation reflects stable operating profits from Proform's commercial real estate portfolio as well as planned office development projects and the successful placement of a HUF 5bn senior unsecured bond within the second half of 2020.

With regard to Proform's business profile, the company is still a small player with a total portfolio market value of around EUR 270m, geographically concentrated around the Budapest office real estate market. Both the office and hospitality division, consisting of three hotels, therefore have weak market positioning and diversification. Asset quality is more credit positive as the company continued to achieve high occupancy levels of 97% for its office portfolio in 2019, along with an increased weighted average lease term of over eight years as of August 2020 (compared to around six years at the time of our initial rating last year).

Although the hospitality division suffered badly from mid-March to mid-June, occupancy has made a good recovery at the two leisure Park Inn hotels. Recovery is proving slower at the third hotel, a Park Inn in Budapest city. Rent collection rates in the office portfolio were above 95% in the first half of the year. We expect a sharp increase in revenues, but at substantially lower margins from 2020 to 2022 as a result of the planned construction activity on the two new office development projects F99 and T4. We therefore expect profitability at the level of the rated entity to fall. We affirm our business risk profile rating of B in the light of inherent development risks and Proform's clustered development pipeline.

The company's financial risk profile – rated BB – continues to benefit from moderate financial leverage, particularly following the repayment of remaining outstanding financial debt at the level of the rated entity in 2019. Leverage, measured by Scope-adjusted debt (SaD)/EBITDA, is expected to stay at 4.0x to 5.0x for the next two years, while interest coverage is expected to stay between 4.0x and 9.0x in the same period. These figures reflect discounts to the company's internal financial planning.

Ratings & Outlook

Corporate issuer rating	B+/Stable
Senior unsecured rating	BB-

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Related Methodologies

Corporate Rating Methodology, 17 January 2020

Real Estate Rating Methodology, 26 February 2020

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Bloomberg: SCOP

Going forward we expect an increase in the loan-to-value ratio (LTV) on a look-through basis, reflecting both indebtedness at special purpose vehicle (SPV) level and at the level of the rated entity Proform, to a 50%-60% range in 2020 to 2022. This is subject to a successful placement of the HUF 5bn bond as well as the development of the two new projects within the planned timeline.

Outlook and rating-change drivers

The Outlook for Proform is Stable and incorporates the assumption of an LTV, calculated on a look-through basis, in the 50%-60% range, the successful execution of growth plans and stable recurring income from the company's existing portfolio.

A positive rating action would require Proform to significantly increase recurring revenue, with its look-through LTV moving substantially below 50% on a sustained basis.

A negative rating action could be warranted if recurring operating income slumps and/or the company's look-through LTV rises above 60% on a sustained basis. This could be caused by market value declines in its existing portfolio or the underperformance of development projects.

Long-term debt instrument ratings

Proform plans to issue a new 10-year senior unsecured bond (HUF 5bn) as part of the MNB funding for growth bond scheme. The instrument will feature amortisation of 20% p.a. in 2026 to 2030. The company is expecting a coupon of around 2.75% p.a. Our base case financial forecast incorporates a successful placement of the HUF 5bn corporate bond at an assumed average cost of debt of 3.5%. The proceeds are earmarked for additional commercial real estate development projects, namely T4 and F99. Both developments are located in Budapest.

Our recovery analysis assumes a hypothetical default at year-end 2022 with a haircut of around 21% on market values as well as other liquidation costs of 10%. Our liquidation scenario also takes into account the look-through LTV on all assets. Given the expected recovery rate as well as the structural subordination of senior unsecured creditors of the rated entity below any current and future secured debt at SPV level loans at the hypothetical point of default, we rate senior unsecured debt one notch higher than the issuer rating. This leads to an affirmation of the BB- rating for senior unsecured debt.

Rating drivers

Positive rating drivers	Negative rating drivers
• Exposure to second-tier investment market with healthy demand from tenants • Strong occupancy (97% as at August 2020) and good tenant diversification with top 10 tenants accounting for only 16% of rental income • Over 20 year track record in the Budapest commercial real estate market	• Small property company with greater sensitivity to unforeseen shocks and cash flow volatility • Small market shares in an increasingly competitive environment • Weak geographical diversification • Increasing exposure to development risks with the launch of two new projects

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Expansion of rental portfolio leading to more recurring revenue and a (look-through) LTV sustained at below 50%	• An increase in LTV to over 60%

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
EBITDA/interest cover (x)	neg.	10.5x	9.1x	5.2x
Scope-adjusted debt (SaD)/EBITDA	1.6x	net cash	4.2x	4.1x
Loan/value ratio (%)	51%	44%	59%	58%
Scope-adjusted EBITDA in HUF '000	**2018**	**2019**	**2020E**	**2021E**
EBITDA	494,289.0	917,152.0	813,451.0	929,496.2
Operating lease payments in respective year	0.0	0.0	0.0	0.0
Other items	-66,055.0	-531,432.0	0.0	0.0
Scope-adjusted EBITDA	**428,234.0**	**385,720.0**	**813,451.0**	**929,496.2**
Scope-adjusted funds from operations in HUF '000[1]	**2018**	**2019**	**2020E**	**2021E**
EBITDA	428,234.0	385,720.0	813,451.0	929,496.2
less: (net) cash interest as per cash flow statement	10,648.0	-36,778.0	-89,169.8	-178,434.5
less: cash tax paid as per cash flow statement	-47,229.0	-40,392.0	-72,607.5	-74,384.9
Change in provisions	292,197.0	-442,359.0	0.0	0.0
Scope-adjusted funds from operations	**683,850.0**	**-133,809.0**	**651,673.7**	**676,676.8**
Scope-adjusted debt in HUF '000[1]	**2018**	**2019**	**2020E**	**2021E**
Reported gross financial debt	781,972.0	66,062.0	5,101,700.0	5,101,700.0
less: cash, cash equivalents	-83,818.0	-243,678.0	-1,653,200.4	-1,245,882.8
add: cash not accessible	0.0	0.0	0.0	0.0
Scope-adjusted debt	**698,154.0**	**-177,616.0**	**3,448,499.6**	**3,855,817.2**

[1] Editor's note: The currency was amended on 24 March 2022. The original publication displayed 'EUR m' as the currency in use.

Business risk profile: B

Industry risk of B, driven by development risks

Proform is a small company with about HUF 91bn/EUR 275m in total assets (mostly held indirectly via equity stakes/shareholder loans) and under EUR 3m in EBTIDA as of year-end 2019. According to management there will be significant additions to the company's development portfolio in the near future.

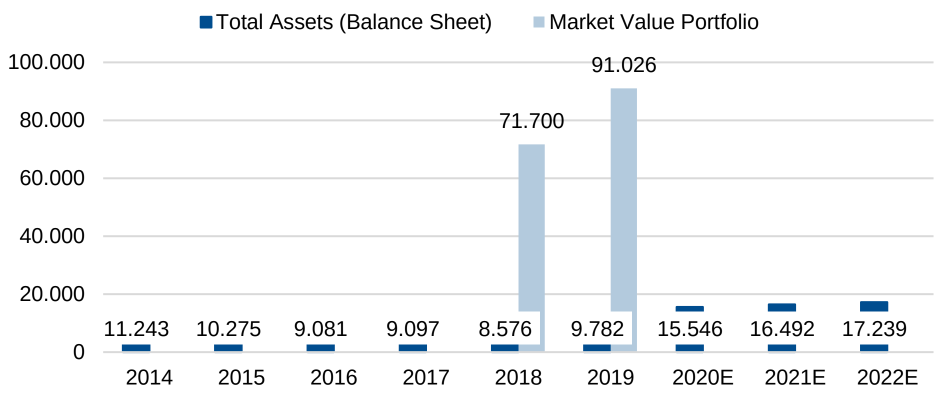
The two main projects are T-4 and F-99 (originally planned for H2 2019, now planned for H2 2020). These are two office development projects in Budapest, for which bank financing has been already secured and plots purchased.

Limited size is rating constraint

Small size is a negative rating driver because it implies a greater sensitivity to unforeseen shocks, greater cash flow volatility and higher key person risk. The limited size of the company especially affects the geographical diversification of its portfolio. The whole portfolio consists of 17 properties, 15 of which are located in Budapest. The company does not intend to move its geographical focus away from Budapest in the foreseeable future, and is therefore reliant on the macroeconomic environment of the Hungarian capital.

Nevertheless, occupancy levels at the two hotels outside of Budapest have proved more resilient during the Covid-19 pandemic in 2020, mitigating the strong cluster risk on Budapest.

Figure 1: Total Scope-adjusted assets (HUF m)



Sources: Proform, Scope

Proform's property portfolio is predominantly located in the city of Budapest, a second-tier investment market. The Budapest investment market gained some momentum in 2018 with the annual investment volume reaching EUR 1.8bn (the second-highest volume since record-breaking 2007 with EUR 2.0bn). We therefore consider the portfolio's liquidity to be average.

The assessment of average liquidity is also supported by high occupancy of over 97% as of August 2020, which hints at robust fundamental tenant demand.

Proform's properties are located within the city limits of Budapest, except for two hotel assets situated next to spa/wellness parks (Park Inn hotels Sarvar and Zalakaros). Many of the buildings are centred around Montevideo Street, where Proform acquired a large plot around 20 years ago and has developed multiple office buildings and a hotel over several years. All plots for planned developments are fully owned already, which mitigates planning uncertainty and upfront financing needs to start construction.

We project a decrease in operating margins from 2020 to 2022, because the two new development projects T4 and F99 will be managed by Proform, which collects construction fees and hands out contracts to subcontractors for construction costs. Therefore, most visible revenue at the level of the rated entity is generated by the high-volume/low-margin construction business and significantly dilutes the margin from the buy-and-hold real estate business.

As a consequence, Proform remains exposed to elevated near- and medium-term volatility of its profitability due to the impact of development and construction services on its profit and loss statement.

Financial risk profile: BB

Our rating scenario assumes the following:

- 15% lower revenue as expected by the company for the coming years
- Operating cost growth as forecast by the company
- Average cost of financial debt of 3.5% versus company assumption of around 2.7%

Debt at SPV level is all secured and at market rates. We have also assumed that an additional senior unsecured bond for HUF 5bn will be issued in Q3 2020.

Preliminary term sheet:

- Senior unsecured debt
- 10-year maturity
- Amortising from year 6 at 20% p.a.
- Coupon target 2.75%
- Covenants: minimum of EUR 1m cash upstream to issuing/rated entity

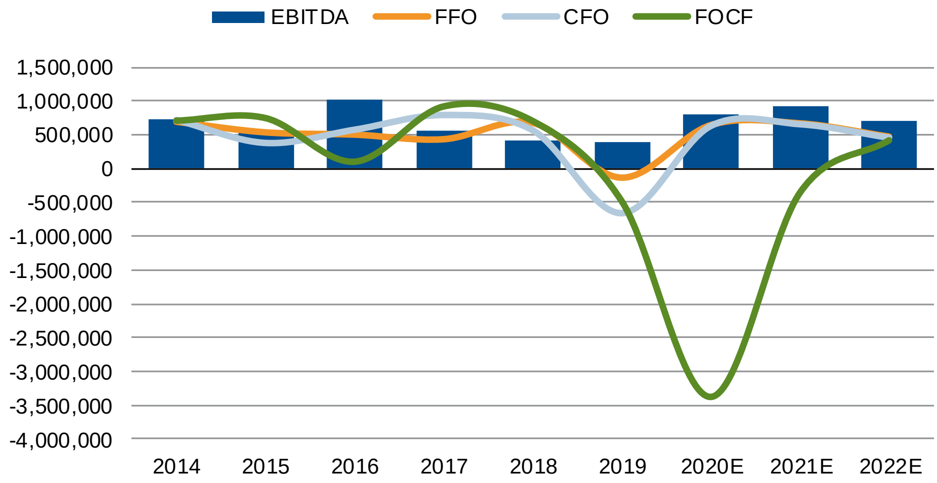
The proceeds are earmarked for additional commercial real estate development projects, namely T4 and F99. Both developments are located in Budapest.

Dividend payout has historically ranged from HUF 175m to HUF 320m, due to asset sales, and is expected to fall sharply to around HUF 50m p.a. in our base case (company guidance: no dividends planned) until 2022.

In terms of valuation and the calculation of hidden reserves, we have taken into account the actual market value of all fully owned real estate assets, held both directly and indirectly (non-consolidated) in order to calculate an estimated look-through LTV on the portfolio. This ratio is based on fair market values of properties by external appraisers and all related debt at the level of the respective operating company/SPV as well as financial debts at the level of the rated entity.

We expect the assumed senior unsecured bond proceeds of HUF 5bn to be distributed to the respective operating companies via shareholder loans/equity injections of HUF 4bn in 2020 and HUF 1bn in 2021 in order to facilitate the planned development projects.

Figure 2: Cash flow overview (HUF m)



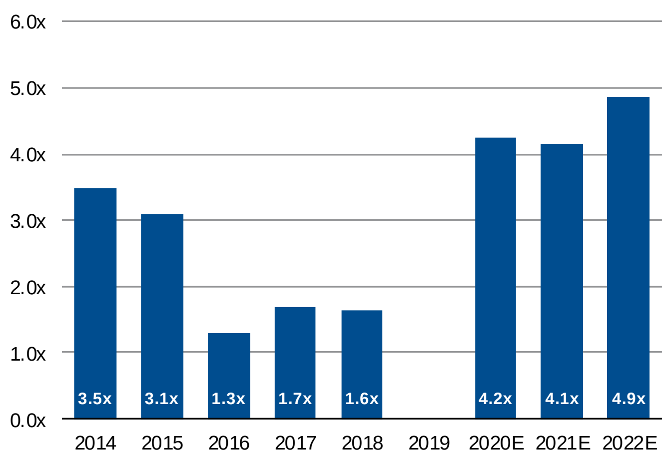
Sources: Proform, Scope

Debt protection – as measured by EBITDA interest cover – has been strong and is expected to stay within comfortable territory in the coming years. However, we have not assessed debt protection within the category suggested by our real estate methodology because the true underlying interest costs cannot be seen due to non-consolidation. Debt protection and cash flow are nevertheless commensurate with a BB category financial risk profile as all additional financing is non-recourse and there are no cross-collateralisations between subsidiaries in place, according to management.

In addition, LTV at subsidiary level is below 50% as of August 2020, with a further debt repayment schedule of +5% annually on the remaining loans, according to Proform. The company has no substantial external debt since year-end 2019. The only financial debt going forward, in our base case rating model, is the HUF 5bn senior unsecured bond to be issued in Q3 2020 according to the plans of the management.

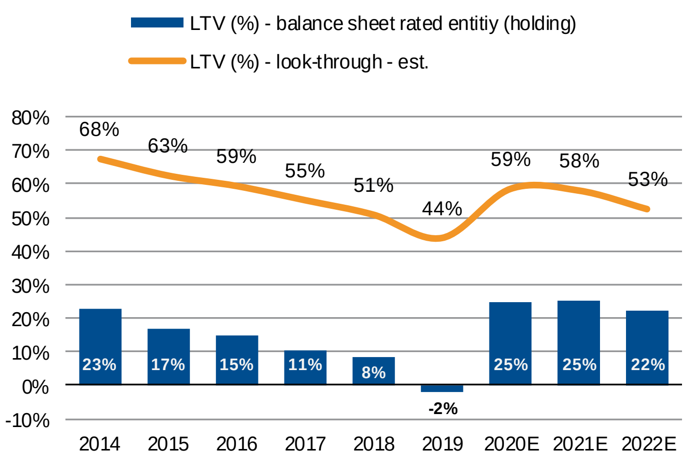
EBITDA interest expense is forecasted to stay above 3.0x at the level of the rated entity in the next few years.

Figure 3: Scope-adjusted debt (SaD)/EBITDA



Sources: Proform, Scope estimates,

Figure 4: Leverage (LTV)



Sources: Proform, Scope estimates

All debt issued by Proform – with the exception of the bond to be issued – is denominated in EUR. Related risk is mitigated by the natural hedge the company benefits from as all rent contracts (and thus all rental payments) are also denominated in EUR. The company could be exposed to exchange rate fluctuations (EUR:HUF) if the rental income from the property to be acquired using the bond issuance proceeds is not denominated in HUF. We believe any potential risk is largely mitigated by adequate headroom from interest expense cover.

Proform has no material short-term financial liabilities at this point or within the next four years until the first planned amortisation rate of the new bond in our base case financial forecast. We therefore expect liquidity to be adequate.

Liquidity: adequate

Figure 6: Liquidity

in HUF m	2019	2020F	2021F
Short-term debt (t-1)	66,815	4,362	0
Unrestricted cash (t-1)	83,818	243,678	1,653,200
Free operating cash flow (t)	-483,857	-3,380,478	-357,318
Liquidity (internal)	-599%	-71912%	no ST debt
Open committed credit lines (t)	0	0	0
Liquidity (internal and external)	**-599%**	**-71912%**	**no ST debt**

Source: Scope estimates

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