# Budapesti Ingatlan Nyrt.
# Hungary, Real Estate

SCOPE B+ STABLE

## Corporate profile

Budapesti Ingatlan Hasznosítási[1] és Fejlesztési Nyrt. (BIF), founded in 1994, lets, develops and manages properties (buy-and hold), and develops residential projects for sale. As of 31 December 2018, BIF is classified as a Regulated Real Estate Investment Company (REIT/SZIT in Hungary).

## Key metrics

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2017** | **2018** | **2019E** | **2020E** |
| EBITDA/interest cover | na | 8.7x | 8.7x | 3.3x |
| Scope-adjusted debt (SaD)/EBITDA | 3.3x | 0.0x | 2.1x | 12.9x |
| Scope-adjusted FFO/SaD | 29% | 2540% | 41% | 5% |
| Loan/value ratio | 22% | 0% | 8% | 30% |

## Rating rationale

**Scope assigns a first-time issuer rating of B+ to Budapesti Ingatlan Nyrt., Outlook Stable.**

The B+ issuer rating on BIF benefits from the portfolio's exposure to the second-tier investment market of Budapest, and stable tenant demand indicated by a relatively high occupancy rate of 93% as at October 2019. Furthermore, the rating is supported by the company's relatively strong credit metrics including: i) high debt protection combined with a low leverage; and ii) strong liquidity. We expect its credit metrics to remain adequate.

Rating constraints include the company's small size and market shares, which leads to greater sensitivity to unforeseen shocks and volatile cash flow. In addition, we view BIF's exposure to the development business as negative because it exposes the company to the industry's inherent cyclicality. Weak geographical and limited tenant diversification paired with exposure to small-to-medium size Hungarian companies, as well as a very short weighted average unexpired lease term (WAULT) mean visibility on the company's future cash flows is limited.

## Outlook

The Outlook for BIF is Stable and incorporates the successful placement of a HUF 20bn bond in Q1 2020 with 10 years' maturity and a coupon of 1.8% under the Hungarian national bank's Bond Funding for Growth Scheme. Bond proceeds will be used to co-finance investments of around HUF 45bn in the next three years, mainly to develop existing properties. Although we forecast an increase in the company's indebtedness, we anticipate EBITDA interest cover at levels above 1.7x and a loan/value (LTV) ratio increasing to around 40%.

A positive rating action would require a significant improvement in BIF's business risk profile. This could be achieved by the company growing in size and strengthening its market position, increased geographical and tenant diversification of the portfolio, and more cash flow visibility through longer WAULTs while sustaining an LTV below 50%. A negative rating action would be possible if leverage increased notably, indicated by an LTV ratio of over 60%, or a fall in the unencumbered asset ratio to below 1.7x.

[1] The name was amended on 18 November 2019 after the initial publication.

### Ratings & Outlook

| | |
|---|---|
| Corporate ratings | B+/Stable |
| Senior unsecured rating | BB- |


### Analyst

Rigel Patricia Scheller
+49 30 27891 319
r.scheller@scoperatings.com


### Related Methodologies

Corporate Rating Methodology

Rating Methodology European Real Estate Corporates


### Scope Ratings GmbH

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

Tel. +49 69 66 77 389 0

### 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 |
| --- | --- |
| • Portfolio across primary and secondary locations in the second-tier investment market of Budapest, a market with strong tenant demand<br>• Relatively high occupancy rate of 93% as at October 2019<br>• Stable profitability, with EBITDA margin of around 50% forecasted to remain at that level going forward<br>• Strong credit metrics, with EBITDA interest cover forecasted to remain above 1.7x (2018: 8.7x) and LTV ratio forecasted to stay below 50% (YE 2018: 22%)<br>• Strong liquidity supported by available undrawn credit lines of HUF 12.4bn as at October 2019 | • Small property company compared to western European peers with high sensitivity to unforeseen shocks and volatile cash flows<br>• Small market shares in an increasingly competitive environment<br>• Exposure to development activities leads to volatile cash flow pattern, partially mitigated by stable recurring rental income<br>• Limited tenant diversification and exposure to small-to-medium size Hungarian companies, partially mitigated by credit quality of main tenant (Hungarian Ministry of Agriculture)<br>• Weak diversification across geographies with portfolio solely focused on Budapest<br>• Cluster risk in 2022 resulting from short WAULT (2.7 years as at October 2019), slightly mitigated by well-developed network, long-term relationships with tenants and prime location of core assets<br>• Key person risk due to heavy dependence on management /owner Ungár family<br>• Forecasted negative free operating cash flow due to portfolio expansion in 2020 and 2022 |

## Rating-change drivers

| Positive rating-change drivers | Negative rating-change drivers |
| --- | --- |
| • Significant growth in size, while keeping LTV below 50% | • Increase in LTV above 60%<br>• Fall in unencumbered asset ratio to below 1.7x |

## Financial overview

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2017** | **2018** | **2019E** | **2020E** |
| EBITDA/interest cover | na | 8.7x | 8.7x | 3.3x |
| Scope-adjusted debt (SaD)/EBITDA | 3.3x | 0.0x | 2.1x | 12.9x |
| Scope-adjusted funds from operations/SaD | 29% | 2540% | 41% | 5% |
| Loan/value ratio | 22% | 0% | 8% | 30% |
| **Scope-adjusted EBITDA in HUF m** | **2017** | **2018** | **2019E** | **2020E** |
| EBITDA | 2,269.6 | 2,096.1 | 1,929.4 | 1,687.6 |
| Operating lease payments in respective year | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 |
| Scope-adjusted EBITDA | 2,269.6 | 2,096.1 | 1,929.4 | 1,687.6 |
| **Scope-adjusted funds from operations in HUF m** | **2017** | **2018** | **2019E** | **2020E** |
| Scope-adjusted EBITDA | 2,269.6 | 2,096.1 | 1,929.4 | 1,687.6 |
| less: (net) cash interest as per cash flow statement | 0.4 | -240.4 | -221.2 | -506.4 |
| less: cash tax paid as per cash flow statement | -97.6 | -16.6 | -19.1 | -5.5 |
| add: provisions, impairments | 2.0 | 2.8 | 2.5 | 0.0 |
| Scope funds from operations | 2,174.4 | 1,842.1 | 1,691.7 | 1,175.7 |
| **Scope-adjusted debt in HUF m** | **2017** | **2018** | **2019E** | **2020E** |
| Reported gross financial debt | 9,377.7 | 9,923.1 | 15,953.6 | 40,784.0 |
| less: cash and cash equivalents | -1,790.3 | -9,850.8 | -11,806.6 | -19,066.9 |
| add: cash not accessible | 0.0 | 0.0 | 0.0 | 0.0 |
| add: operating lease obligations | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 |
| Scope-adjusted debt | 7,587.4 | 72.3 | 4,147.0 | 21,717.2 |

## Business risk profile: B

**Industry risk: BB-**

BIF's main business segments comprise the leasing and management of commercial real estate buildings, as well as the development of residential projects. This exposes the company to the highly cyclical real estate industry, especially its development activities, which tend to increase cash flow volatility. Industry risk for BIF is therefore modest.

**Credit outlook stable for 2019: tighter monetary policy, slowing growth, political risks**

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.

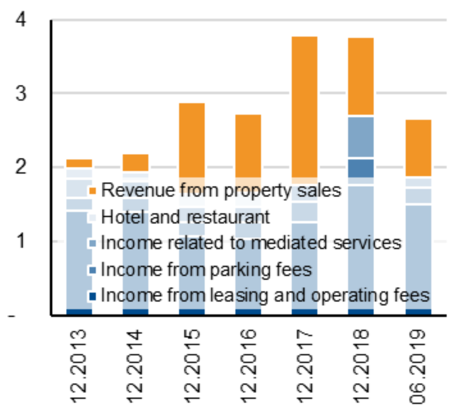
**Small property company exposed to sudden shocks and the real estate cycle**

BIF's limited size, with about HUF 53.4bn (EUR 0.2bn) of total assets and HUF 1.8bn (EUR 5.7m) in funds from operations, is a negative rating driver. The company is targeting some growth, with HUF 45.3bn of investments in the next three years focused on brownfield development (including a significant increase in the gross leasable area of two of its office properties and the continuation of its residential development project). However, despite these investments, we expect BIF to remain relatively small. This is a negative rating driver because it implies greater sensitivity to unforeseen shocks, greater cash flow volatility, limited economies of scale and higher key person risk.

**Small market shares in an increasingly competitive environment**

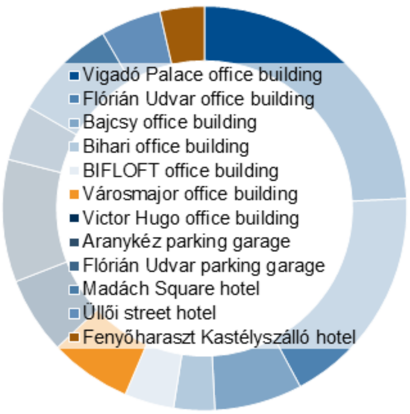
Despite the company's focus on Budapest it has no significant share in the city's real estate market (market share of approx. 1% for the office segment). Development activity in Budapest (around 540,000 sqm of new office space under construction) will expose the company's property portfolio to intense market competition. To address this challenge, BIF plans to re-develop and upgrade two of its existing properties, following a major revamp of the portfolio's largest property, the Vigadó Palace, in 2018. The latter is the company's trophy asset because it benefits from high visibility given its good location in the city's central business district.

**Figure 1: Distribution of revenues by type of use**



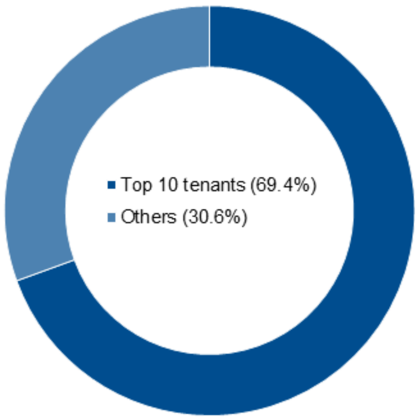

Source: BIF, Scope

**Figure 2: Distribution of NLA[2] by property**




Source: BIF, Scope

**Figure 3: Tenant diversification by rental income**




Source: BIF, Scope

**Development activities lead to volatile cash flow, partially mitigated by stable recurring rental income**

The company's core portfolio is diversified across different property types (offices, hotels, parking, and residential development), with the office and development segment generating most of its rental revenues. (Figure 1). Whilst BIF's development activities have significantly contributed to revenues in the past, they also lead to greater cash flow

[2] Net lease area

volatility. Associated risk is partially mitigated by recurring rental income, which has been relatively stable in recent years.

**Weak diversification across geographies with a portfolio solely focused on Budapest**

BIF focuses on investing in the Budapest real estate market, with 100% of its portfolio distributed across the city's districts. The company does not intend to increase its geographical outreach beyond Budapest. This is because it defines itself as a market specialist and recognises the risk inherent in expansion without good market knowledge or networks in other geographies. While this strategy seems prudent given the limited size of the company, it also fully exposes BIF to the macroeconomic environment of one market.

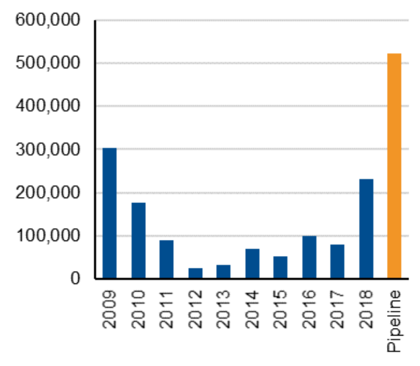
**Limited tenant diversification and exposure to small-to-medium size companies, mitigated by credit quality of main tenant**

The company is exposed to high tenant concentration with a considerable net rental income contribution from its main tenant, the Hungarian Ministry for Agriculture. The top 10 tenants represent 69% of total rental income as of October 2019 (Figure 3). However, associated risk is partially mitigated by the main tenant's credit quality. Mostly local, small-sized companies represent the remainder of BIF's tenants. The general economic upturn has supported an increase in demand from these companies, which generate revenues and sign leases in local currency. However, worsening macroeconomic conditions and unforeseen shocks are expected to directly translate into softer demand and defaults from these tenants. The presence of bank guarantees or cash deposits for at least 98% of the leases partially mitigates the risk of a single tenant default which might impair rental cash flow. Such guarantees amount to an equivalent of three months' rent. In addition, there have been no significant impairments in recent years, as evidenced by overdue receivables of 0.9% of the total rent as of October 2019 (average of 0.5% in 2016-2019).

**Relatively high occupancy rate but exposed to re-letting risk in 2022 due to short WAULT**

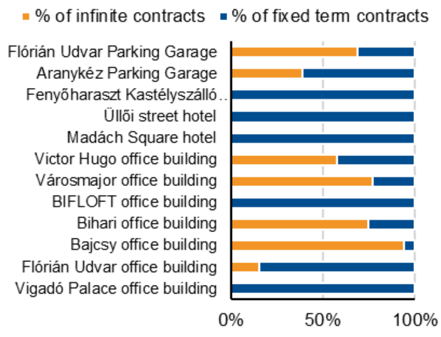
The high occupancy rate of the company's core property portfolio in the last few years (93% as of October 2019) has helped to keep net rental income relatively stable (Figure 1). But the short WAULT of 2.7 years as at October 2019 provides only limited visibility on future cash flows and exposes the properties to re-letting risk (Figure 6). Cluster risk arises from the relatively short lease on Vigadó Palace, with a lease end in September 2021. The short WAULT is partly explained by BIF's business plan, which requires short-term or infinite leases (23% of net rental income as at October 2019) to provide the flexibility to terminate leases and start the development of properties, e.g. Bajcsy and Városmajor in 2020.

**Figure 4: Office completion in Budapest (sq m)**



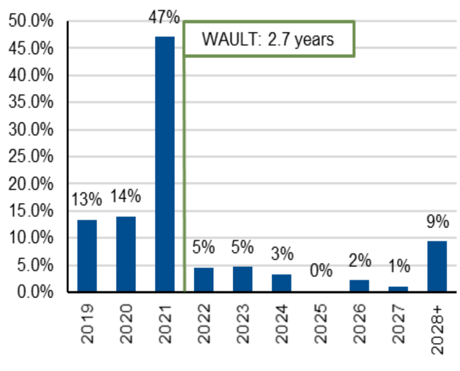

Source: BIF, Scope

**Figure 5: Type of contract by property**




Source: BIF, Scope

**Figure 6: Lease maturity profile as of October 2019**




Source: BIF, Scope

Buildings with a short WAULT tend to have a high turnover of tenants, higher costs associated with re-letting and require more asset management. However, BIF has demonstrated its ability to keep the buildings almost fully let. It has also established long-term relationships with tenants, which have remained in the properties for extended periods, albeit on a yearly rolling basis in some cases.

**Portfolio in Budapest, a market with strong tenant demand**

BIF's property portfolio is well diversified across Budapest, a second-tier investment market. Although international funds' interest in the Hungarian real estate market is improving, with the volume of transactions reaching a record EUR 1.8bn in 2018, portfolio liquidity is still relatively low. If the economy cools 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, the reduced availability of external financing, and limited recovery expectations for debt investors.

The portfolio consists of seven "A" and "B" grade office buildings, three hotels, two parking garages, a church and a residential project development (plot of 39 hectares). The properties are close to transport hubs and are situated in prime and secondary locations in Budapest. Approximately 40% of the net leasable area in the portfolio is located within Budapest's central business district, and buildings like Vigadó Palace, Madách Square or Aranykéz benefit from a strong visibility given their prime locations. Other properties in the portfolio are in upcoming districts and are easily accessible by public and private transport, e.g. the Bajcsy office building, which is very close to Nyugati Railway station (the western railway station and the second largest in the city), or Flórián Udvar, at the most important traffic junction point of North Buda.

**Relatively old but well-maintained property portfolio**

The assets in the portfolio are relatively old with a weighted average economic age of over 15 years. As new office buildings – currently under construction – will make the market more competitive, BIF is always looking for opportunities to upgrade its stock of properties. Between 2020 and 2022, for example, two properties, Bajcsy and Városmajor, will be fully re-developed, requiring larger amounts of investments.

**Stable profitability but exposed to development activities in the portfolio**

BIF's profitability, as measured by its EBITDA margin, stood at levels above 50% in 2017 and 2018. This reflects the company's business profile, which includes development activities (pure developers usually have lower EBITDA margins than buy-and-hold companies, some of which have margins above 80%). We expect the EBITDA margin to remain at levels above 40% with limited upside potential because of: i) the company's concentrated tenant base; ii) the short WAULT; and iii) BIF's increasing exposure to development activities.

**Long-term owners with strong market competence**

BIF is one of the first regulated real estate investment companies in Hungary, listed on the Budapest Stock Exchange in February 1998 with a free float of 25.1% (as at October 2019). The company has a Board of Directors (five members, three of them independent) and an audit committee that supervises the company's operations.

The company is owned by the Ungár family, which has strong market competence and experience through its longstanding involvement in real estate projects, including the modernisation or repositioning of office buildings and development projects. The owner's long-term commitment is reflected in prudent financial management and the equity-financed growth observed in recent years, together with a 100% involvement in BIF's operating activities. Whilst we recognise this commitment as positive, we also see key person risk due to the heavy dependence on the management /owner Ungár family.

## Financial risk profile: BB+

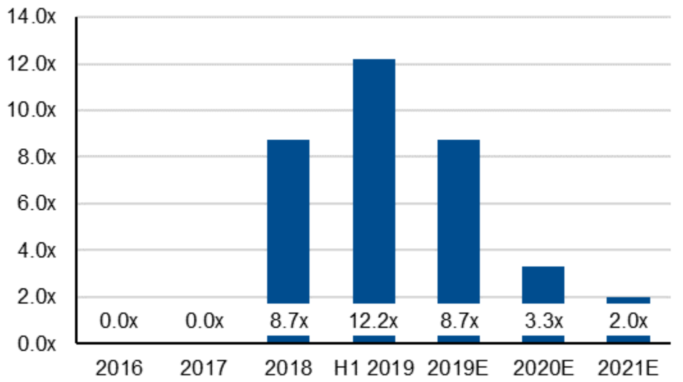
Our rating scenario assumes the following:

- No extension or re-letting of expired lease contracts/vacated lease area, and six-month notice period for open-ended leases
- 3.2% inflation rate for operational expenditure and rental growth
- Interest to increase by 50 bp for floating-rate and newly issued debt from 2019 onwards, based on a weighted average cost of debt of 1.8% as at H1 2019
- HUF 20bn bond issuance in Q1 2020 (1.8% coupon; 10 years) to co-finance development of existing portfolio properties
- Expansion capex of HUF 1.7bn in 2019, HUF 16bn in 2020 and HUF 17bn in 2021
- Dividend payments according to the REIT/SZIT regulation in Hungary, and in line with previous years

**Strong credit metrics including very low leverage**

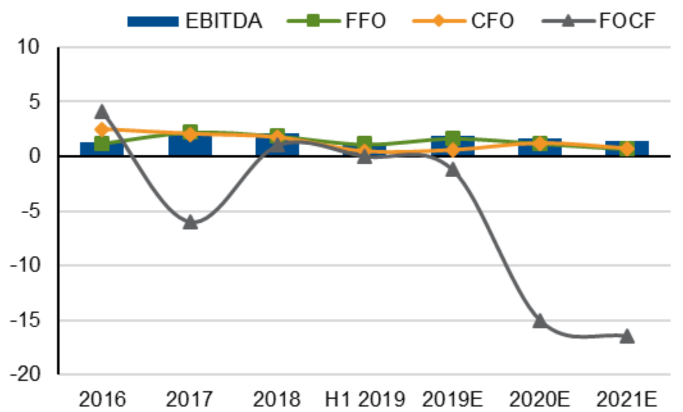
BIF's debt protection, as measured by EBITDA interest cover, stood at above 8x in 2018 and benefitted from a net cash position in previous years. We anticipate declining debt protection in the years to come, as a result of the higher leverage component in the company's balance sheet. However, we forecast that EBITDA interest cover will remain above 1.7x.

**Figure 7: Scope-adjusted EBITDA interest cover (x)**




Source: Scope estimates

**Figure 8: Cash flows (HUF m)**

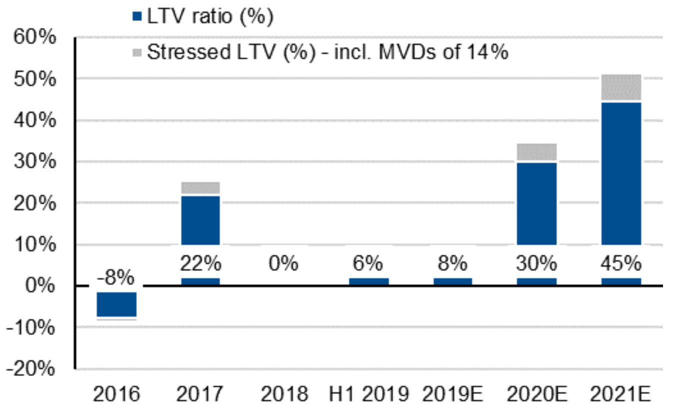



Source: Scope estimates

**Negative free operating cash flow driven by portfolio expansion in 2019 and 2020**

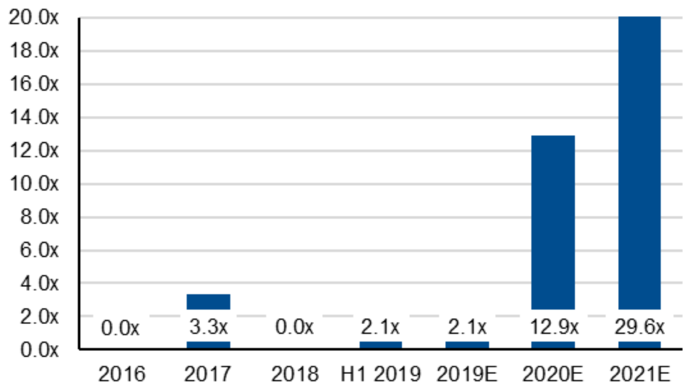
We forecast relatively stable and positive funds from operations (FFO) and cash flow from operations (CFO) in the next few years, due to BIF's solid recurring rental income, subject to some lease terminations in the short run. Free operating cash flow (FOCF) has been more volatile and we expect it to turn negative from 2019 on, driven by the portfolio expansion planned for the 2020-2021 period, which is expected to bear fruit from 2022 on.

**Figure 9: Loan/value ratio (%)**




Source: Scope estimates

**Figure 10: SaD/EBITDA (x)**




Source: Scope estimates

**Low leverage reflecting predominately equity-financed portfolio growth**

The company benefits from relatively low indebtedness. Long-term debt stood at HUF 9.9bn at YE 2018 and net debt at HUF 0.1bn. BIF's financial debt is solely denominated in HUF at an average interest rate of 1.8% and with only a small share exposed to a floating interest rate. Foreign exchange risk is non-existent as of now because 95% of revenues are generated in HUF.

In accordance with the Hungarian REIT regulation, the maximum LTV ratio is set at 65%. BIF aims to keep its LTV below 50% according to the company's management. We forecast that LTV will increase to around 40% in the coming years, considering the HUF 20.0bn bond and approx. HUF 20bn in additional loans necessary to finance the company's business plan. We judge BIF to benefit from sufficient financial headroom to execute its planned portfolio expansion.

We consider liquidity to be adequate. In detail:

| Position | YE 2018 | | H1 2019 | |
|---|---|---|---|---|
| Unrestricted cash | HUF | 9.8bn | HUF | 6.9bn |
| Open committed credit lines | HUF | 20.0bn | HUF | 12.4bn |
| Free operating cash flow (t+1) [3] | HUF | 0.6bn | HUF | 1.9bn |
| Short-term debt | HUF | 0.8bn | HUF | 0.8bn |
| **Coverage** | | **39.6x** | | **27.6x** |

BIF's liquidity is adequate, supported by available undrawn credit lines of HUF 12.4bn as at October 2019. All financial debt is long term (10 years), leading to low refinancing risk in the coming years. Moreover, the company benefits from reserves of around HUF 9.3bn (treasury shares) and an unencumbered asset position of HUF 19.6bn as of October 2019; all of which provide indirect security for the HUF 20bn senior unsecured bond to be issued (we expect the unencumbered asset ratio to remain above 2x after the bond issuance).

**Senior unsecured debt: BB-**

Our recovery analysis for senior unsecured debt indicates an 'above average' recovery based on BIF's relatively high share of unencumbered assets, allowing a one-notch uplift on the company's issuer rating. We therefore assign a debt class rating of BB-.

Recovery is based on a hypothetical default scenario in FY 2020 with a company liquidation value of HUF 39.0bn. This value is based on a haircut of roughly 40% applied

[3] We exclude discretionary expansion capex from our liquidity calculation because such investments are only made if external financing is available.

to the assets, reflecting a market value decline of 14%, liquidation costs of around 21% for the assets and 10% for insolvency proceedings. This compares to secured financing of a forecasted HUF 20.8bn, a fully drawn credit line of HUF 12.4bn and senior unsecured debt of HUF 20.0bn.

## Outlook

**Outlook: Stable**

The Outlook for BIF is Stable and incorporates the successful placement of a HUF 20bn bond in Q1 2020 with 10 years' maturity and a coupon of 1.8% under the Hungarian national bank's Bond Funding for Growth Scheme. Bond proceeds will be used to co-finance investments of around HUF 45bn in the next three years, mainly to develop existing properties. Although we forecast an increase in the company's indebtedness, we anticipate EBITDA interest cover at levels above 1.7x and an LTV increasing at levels around 40%.

A positive rating action would require a significant improvement in BIF's business risk profile. This could be achieved by the company growing in size and strengthening its market position, increased geographical and tenant diversification of the portfolio, and more cash flow visibility through longer WAULTs while sustaining the LTV ratio below 50%.

A negative rating action would be possible if leverage increased notably, indicated by an LTV of over 60%, or a fall in the unencumbered asset ratio to below 1.7x.

## 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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