Lexholding Zrt.
Hungary, Investment Holding Company

SCOPE B+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	2021	2022	2023E	2024E
Total cost cover	1.4x	1.3x	1.1x	1.1x
Scope-adjusted loan-to-value ratio (LTV)	38%	41%	~40.0%	
Liquidity	>100%	>100%	>100%	>100%

Key rating factors

Lexholding's issuer rating benefits from a well-balanced and diversified portfolio and stable management and service fees that keep interest cover robust.

The issuer rating is constrained by a limited gross asset value and a complex structure with different businesses, cross-ownerships and financing structures (credit-negative ESG factor). While we do not explicitly adjust for transparency issues in our supplementary rating drivers, we do consider them in our assessment of the business and financial risk profiles.

In addition, although we do not make explicit adjustments for the limited portfolio size in our supplementary rating drivers, we do consider this factor in our overall assessment of the issuer's standalone rating by attributing significant weight to the business risk profile.

Outlook and rating-change drivers

The Outlook is Stable and reflects our view that the company should maintain recurring coverage of mandatory holding costs at above 1.0x in the medium term. Lexholding's senior unsecured bond issued under the Hungarian Central Bank's Bond Scheme has an accelerated repayment clause. The clause requires Lexholding to repay the nominal amount (HUF 15bn) within 90 days if the bond rating falls below B-, which could have a default implication.

A positive rating action might be warranted upon an improvement in portfolio sustainability and/or portfolio liquidity.

A negative rating action may be warranted if transparency remained limited in the medium term, mainly due to a complex organisational structure, and/or if total cost cover dropped to below 1.0x on a sustained basis. This could occur if the financial position of the dividend-paying undertakings deteriorated significantly, requiring a recovery programme and/or limiting their ability to pay dividends or management fees to Lexholding.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
10 Jun 2022	No Action	B+/Stable
8 Jul 2021	Affirmation	B+/Stable
6 Jul 2020	New	B+/Stable

Ratings & Outlook

Issuer	B+/Stable
Senior unsecured debt	B+

Analyst

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Related Methodologies/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
• Coverage of mandatory holding costs at above 1.0x, expected to be maintained after bond issuance • Expected increase in recurring cash inflows from management fees • Majority shareholder position providing influence over dividend policies	• High concentration and limited diversification of investments and income streams • Complex corporate structure and inter-company transactions (credit-negative ESG factor) • Low liquidity of undertakings

Positive rating-change drivers	Negative rating-change drivers
• Improvement of portfolio sustainability and/or portfolio liquidity	• Recurring total cost-coverage ratio sustained at under 1.0x • Limited transparency

Corporate profile

Lexholding Zrt. is an investment holding company majority-owned by Elek Nagy and his family. The company mainly invests in three areas: i) business services (pawnshops and art trading); ii) real estate; and iii) ground transportation (taxi operators).

The company applies a long-term investment approach, reflected in its active role in all of its investees' boards and the financial support it provides to them. However, this commitment does not rule out opportunistic disposals as the company is mainly focused on recurring dividend streams from its undertakings.

The investment holding company generates significant revenue through service and management fees associated with the provision of various services to its core holdings. The services offered by Lexholding Zrt. are HR, controlling, marketing, IT, and internal auditing.

We applied our newly published Investment Holding Companies Rating Methodology in assessing Lexholding's corporate credit quality. Lexholding's business model exhibits characteristics of both an investment holding company and a corporate group. The combination of minority and majority stakes in holdings as well as the receipt of dividend and management fees are characteristics of an investment holding company. On the other hand, the provision of shared services such as IT and HR indicates a corporate group structure.

Considering Lexholding's long-term investment approach for its strategic portfolio, with potential rotations of opportunistic assets such as commercial real estate and a limited influence on management decisions at the level of portfolio companies, the use of the investment holding methodology is appropriate in assessing Lexholding's credit quality.

Financial overview

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Total cost cover	1.4x	1.3x	1.1x	1.1x
Scope-adjusted loan/value ratio	38%	41%	~40.0%	
Liquidity	>100%	>100%	>100%	>100%
Recurring cash income in HUF m				
Dividends form holdings	1,069	1,198	620	620
Interest received from shareholder loans	191	459	560	643
Management and service fees	1,805	2,310	2,709	2,709
Recurring cash income	**3,065**	**3,967**	**3,889**	**3,972**
Total costs in HUF m				
Operating expenses	-1,450	-2,095	-2,510	-2,535
Taxes paid	0	0	0	0
Interest paid	-135	-465	-465	-465
Dividends paid	-300	-500	-500	-500
Total costs	**-2,215**	**-3,060**	**-3,475**	**-3,500**
Scope-adjusted debt in HUF m				
Reported gross financial debt	15,000	15,000	15,000	15,000
less: cash and cash equivalents	-1,899	-594	-608	-880
Other items (guarantee)	410	410	410	410
Scope-adjusted debt	**13,511**	**14,816**	**14,802**	**14,531**
Scope-adjusted gross asset value in HUF m				
Investments (as per balance sheet)	25,486	25,593	30,993	31,194
Short-term investments	10,203	10,648	5,648	5,648
Scope-adjusted gross asset value	**35,689**	**36,241**	**36,641**	**36,842**

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

Environmental		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)

Corporate structure

The credit-negative corporate structure exhibits a lack of transparency driven by intra-company transactions, cross-ownerships and a complex organisational structure. While this has not led to any supplementary rating driver adjustment so far, it is reflected in the conservative assessment of the company's financial risk profile. This point is a credit-negative ESG factor for the rating.

[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.

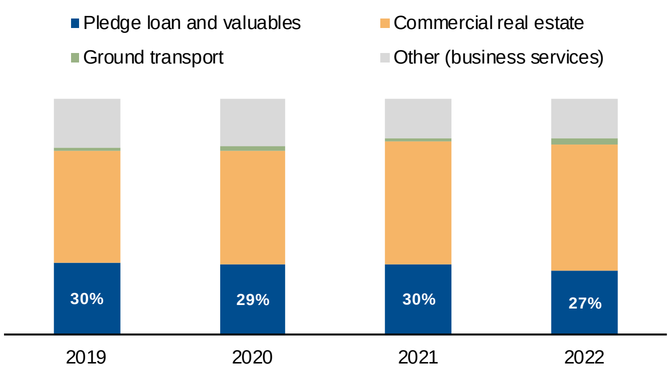
Business risk profile: B

Lexholding's weighted average industry portfolio risk is mostly exposed to business services and real estate. While two subsidiaries of BÁV Zrt., namely BÁV Pénzügyi Zrt. and PERUN Zrt., are classified as financial enterprises2, we classify BÁV Zrt. in business services as it offers additional services (i.e. art trading and safe deposit box services) and operates as an umbrella of five corporates.

The weighted average industry risk based on gross asset value (60% of its net investment value as of YE 2022) mainly reflects the mixed industry risk of commercial real estate developers (assessed at B) and that of commercial real estate (assessed at BB), resulting in a high-to-medium cyclicality, medium entry barriers and high-to-medium substitution risk. These sectors primarily consist of businesses that are either directly or indirectly connected with tenant industries.

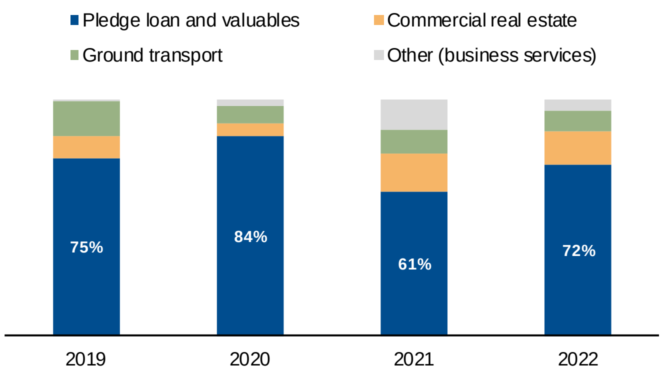
The weighted average industry risk based on income (about 70% of total cash inflows as of FY 2022) reflects characteristics of business services (assessed BBB) with medium cyclicality, medium entry barriers and medium substitution risk.

Figure 1: Weighted average industry risk based on gross asset value



Source: Lexholding, Scope estimates

Figure 2: Weighted average industry risk based on income



Source: Lexholding, Scope estimates

Lexholding's portfolio is significantly concentrated as core holding BÁV Zrt. represents 72% of the total income as of FY 2022. In the assessment of the portfolio's sustainability, we focus on dividend-paying entities to capture the maturity of core holdings and their cash flow generation potential. Concentration by income is high as the main dividend-paying undertaking contributes over 80% of total dividend income.

Lexholding's portfolio's dependence on BÁV-related ordinary dividends will also remain significant (above 80%) in the next few years, which limits Lexholding's ability to offset the impact of a dividend not paid by one of the undertakings and hence poses the risk of a volatile total cost cover.

Furthermore, the assessment of portfolio sustainability is hindered by non-income-generating assets, primarily comprised of commercial real estate development projects. These assets offer little visibility regarding their cash generation potential, as their pipelines have long time horizons and their execution in the current market conditions is challenging. The Hungarian commercial real estate market is experiencing increased prices and high inflation, further adding to the complexities faced by these projects.

[2] Under Act CCXXXXVII of 2013 on credit institutions and financial enterprises, financial services can only be provided by financial institutions, which include credit institutions (such as banks) and financial enterprises. The key distinction between credit institutions (banks) and financial enterprises is that the latter are not permitted to collect deposits, but they can engage in financial activities on a commercial scale.

Figure 3: Cash income[3] by division

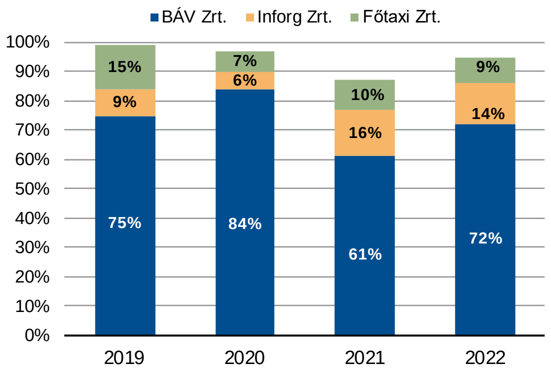


Figure 4: Management fees and service income FY 2022

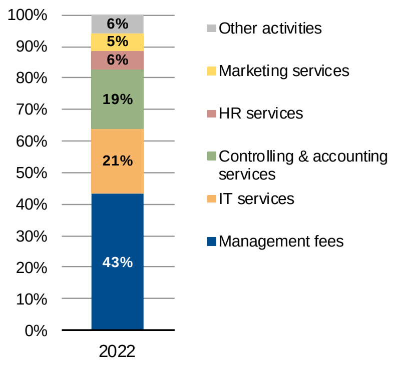
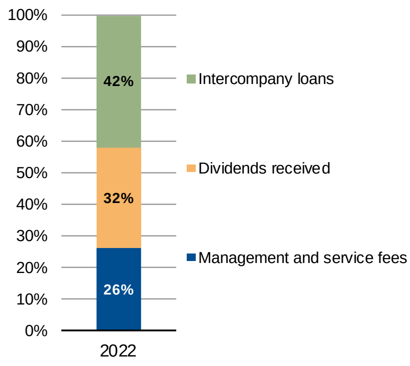


Figure 5: Income breakdown FY 2022



Source: Lexholding, Scope

Source: Lexholding, Scope

We do not consider the delayed investments in the planned modernisation and renovation of the existing real estate portfolio as inefficient management. Instead, these reflect cautious spending following the economic recession experienced in 2022. However, this could signal a soft covenant breach as the partial cash from bond proceeds earmarked for the renovation and modernisation of existing real estate has been parked in the real estate fund for two years.

Lexholding has initiated discussions with bond holders regarding the proposed change in the use of bond proceeds within the real estate division. The company has recently implemented a redefined investment strategy, which involves a portfolio of fully operational assets that are currently generating cash flow. We have evaluated this adjusted strategy and do not foresee any negative impact on the issuer rating of the company. In fact, the revised strategy offers several potential benefits: i) it eliminates development risk by focusing on existing assets; and ii) it enables immediate cash flow generation as opposed to renovation projects, where cash flow typically starts only after the completion of the pipeline, which usually takes three to four years.

In 2022, management fees and services constituted approximately 58% of Lexholding's cash income. The payment of management fees by the undertakings is mandatory and depends on their top-line performance rather than bottom-line profits. This provides some stability and predictability to Lexholding's cash flow. These fees are expected to further increase in the projected period as Lexholding intends to expand its provision of corporate functions to its undertakings.

Gross asset value concentration is modest as the top three holdings (BÁV, INFORG, Főtaxi) account for around 70% of total portfolio value and is the strongest component of the business risk profile.

The net investment value of the portfolio is expected to increase with anticipated investments of approximately HUF 5.0bn in the commercial real estate sector. While this will result in an increased dependence on the real estate sector within the portfolio, we do not expect it to lead to significant concentration.

The operations of Lexholding's core holdings are predominantly concentrated in the Hungarian market. This lack of geographical diversification exposes the company to risks associated with local economic conditions, regulatory changes and other market-specific factors, and hinders the business risk profile.

[3] Including management and service fees, dividends and interest on intercompany loans

Lexholding's investment strategy includes a substantial focus on unlisted assets. Investing in such assets can present challenges in terms of liquidity. Unlisted assets typically have limited trading platforms, making it more difficult to sell or exit positions quickly. This lack of liquidity can hinder Lexholding's ability to adjust its portfolio or to address unexpected cash flow requirements.

The Investment Holding Companies Rating Methodology also takes into account the company's investment philosophy as an additional factor in assessing its business risk profile. However, the track record of portfolio value development is limited due to Lexholding reporting under local generally accepted accounting principles using the book value of assets. This limits our visibility on the company's ability to develop its portfolio value. Additionally, the limited divestments during the analysed period restrict the assessment of management's competence and the company's ability to rotate assets.

Financial risk profile: BB+

Management fee income expected to further increase following high investee cost base

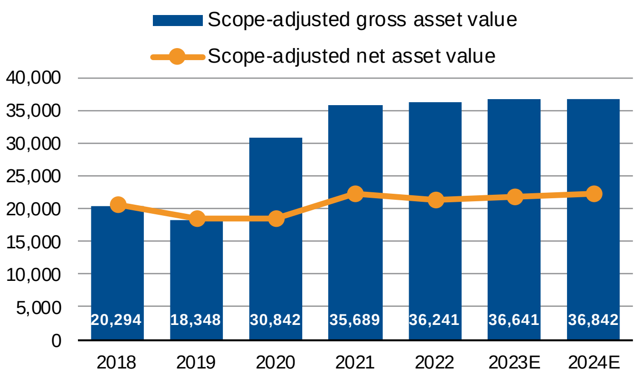
Cash income remained sufficient to cover operating expenses in FY 2022 because management and service fee income compensated all service-related expenses at the holding level. In FY 2022, cash dividend inflows amounted to HUF 1.7bn. Of those, we only take into account those that are recurring, which mainly come from BÁV Zrt. and Főtaxi.

We estimate that total cost cover will remain above 1.0x over the next few years, supported by: i) the relatively stable nature of management fees implemented at the level of core holdings; ii) broadly stable net interest on shareholder loans; iii) resumed dividend payments from core portfolio companies (i.e. pledged loans, ground transportation); and iv) no significant increase in dividend payouts shielded by bond covenants.

We apply a 50% haircut on management's anticipated dividend payments from BÁV Zrt. going forward, questioning the company's ability to pay more than HUF 1.0bn of annual dividends based on its operating performance.

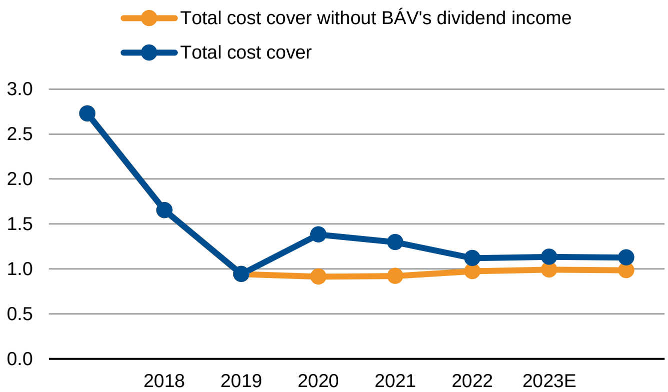
The holding costs (operating costs and dividends paid) are expected to increase as Lexholding intends to take over more of its undertakings' functions (compensated via a higher management fee).

Figure 6: Asset value development in HUF m



Source: Lexholding, Scope estimates

Figure 7: Total cost cover



Source: Lexholding, Scope estimates

Modest leverage

Lexholding's leverage as measured by its LTV remains comfortable at 41% as of FY 2022 (38% as of FY 2021). The LTV has slightly increased compared to the previous year, primarily due to the deployment of additional capital and an increase in the investment value of the company. As a result, the overall cash balance of the company has decreased. Almost 50% of cash proceeds from bonds is dedicated to commercial real estate projects. We expect LTV to remain at around 40% within the next two years.

The rating is mainly constrained by the limited visibility over the net asset value of Lexholding's investments, as gross asset value appears stable without reflecting changes in the core holdings' underlying asset quality. However, by considering net investment values instead of market values, we adopt a more conservative approach in assessing the market value of its core holdings. This conservative view excludes factors such as potential market volatility.

We do not forecast a major change in Lexholding's portfolio market value but based on our sensitivity analysis, market value would have to deteriorate by 40% to breach Lexholding's LTV target of 60% (at constant indebtedness).

Most core holdings, particularly the commercial real estate projects, do not rely on external third-party funding. Instead, they are supported by shareholder loans that are provided by Lexholding. This structure allows Lexholding to have direct control over the funding of its core holdings and reduces its reliance on external financing sources.

Adequate liquidity

Lexholding's liquidity continues to be adequate. Due to the absence of short-term debt, it benefits from positive free operating cash flow and a significant cash buffer of around HUF 0.6bn as of YE 2022. There are no refinancing risks that would necessitate the sale of any shareholdings.

Balance in HUF m	2023E	2024E
Unrestricted cash (t-1)	594	608
Open committed credit lines (t-1)	0	0
Free operating cash flow (t)	414	472
Short-term debt (t-1)	0	0
Coverage	**>100%**	**>100%**

Supplementary rating drivers: +/- 0 notches

Credit-neutral financial policy

There are no explicit adjustments for supplementary rating drivers. We highlight the lack of transparency and governance issues driven by cross-ownerships in the organisational structure.

Long-term debt rating

Senior unsecured debt rating: B+

We have affirmed the senior unsecured debt rating at B+ including the HUF 15.0bn bond (ISIN HU0000359955). This reflects Scope's expectation of a 'superior' recovery for senior unsecured debt in the hypothetical event of a company default. The recovery analysis is based on a hypothetical default scenario in 2025, which assumes outstanding senior unsecured debt of HUF 15.0bn with no senior secured loans.

Most bond proceeds have been deployed already with a focus on investments in real estate (HUF 7.5bn); the rest has been invested in the open-ended real estate fund (HUF 7.5bn).

We highlight the limited visibility on the net asset value of core holdings as current Hungarian accounting standards incorporate the cost of investments but do not capture the market value of these investments. This constrains the recovery assessment and therefore the debt rating.

Moreover, we limit the debt category rating to match the issuer rating due to the potential risk that Lexholding might issue higher-ranked debt, which could reduce the recovery prospects for senior unsecured debt holders.

Lexholding's senior unsecured bond issued under the Hungarian Central Bank’s Bond Scheme has an accelerated repayment clause. The clause requires Lexholding to repay the nominal amount (HUF 15bn) within 90 days after the bond rating falls below B-, which could have a default implication.

The clause requires Lexholding to repay the nominal amount (HUF 15bn) in case of rating deterioration (two-year cure period for a B/B- rating, repayment within 90 days after the bond rating falls below B-, which could have default implications). In addition to the rating deterioration covenant, the bond includes a dividend-related covenant (cap of 50% profit after tax and no dividend payout during the cure period) and an ownership-related covenant (Elek Nagy’s direct and indirect ownership drops below 50%+1 vote).

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