Appeninn Holding Nyrt.
Hungary, Real Estate

B STABLE

Corporate profile

Appeninn Holding Nyrt. (Appeninn) is an exchange traded Hungarian real estate company. It was founded in autumn 2009 and listed on the Budapest stock exchange in June 2010 with a current free float of 52%. The company has predominantly been active in Budapest with a focus on buy-and-hold office and retail properties and some logistics. Its strategy has recently shifted towards developing a large domestic tourism exposure besides its commercial real estate (CRE) exposure. Appeninn's lettable area currently amounts to 86,000 sqm, spread over 37 properties.

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020P**	**2021E**	**2022E**
EBITDA/interest cover (x)	2.7x	1.8x	1.0x	0.9x
Scope-adjusted debt (SaD)/EBITDA	12.0x	17.0x	31.9x	42.1x
Scope-adjusted loan/value ratio	45%	39%	40%	47%

Rating rationale

Scope downgrades the issuer rating of Appeninn Holding Nyrt. to B/Stable and downgrades the senior unsecured debt instrument rating to B-.

Following a shareholder structure change in 2020, the company has shifted its strategy from buy-and-hold commercial real estate towards real estate development for tourism properties, which it also intends to operate.

Appeninn's B issuer rating is driven by the company's small overall size, limited geographic diversification and high tenant concentration, with the top three/top10 tenants accounting for 46%/65% respectively. Further drivers are the company's asset quality, with exposure to the second-tier market of Budapest and new developments in C locations, a relatively low weighted average unexpired lease term (WAULT) at three years, recently falling occupancy to 89% for its CRE exposure, and a dated portfolio, which suffers from maintenance underspending in our view.

Rating constraints include a forecasted decline in EBITDA margin, a decrease in Scope-adjusted EBITDA interest coverage to levels around 1x, and an increase in leverage, measured by Scope-adjusted debt/EBITDA, to 42x as a function of Appeninn's debt/state grant-funded tourism development.

Outlook and rating-change drivers

The Outlook for Appeninn is Stable and incorporates: i) stable rental income from its CRE portfolio; ii) the development of its tourism exposure according to its business plan with no significant delays in project completion; and iii) no further indebtedness in addition to its planned project loan uptake. Assuming a debt/state-grant driven development into tourism going forward, the Stable Outlook foresees Scope-adjusted EBITDA interest cover of around 1x and a Scope-adjusted loan-to-value ratio of below 50%.

A positive rating action would require a significant improvement in Appeninn's financial risk profile. This could be achieved through a slower pace of growth, with less strain on the balance sheet and credit metrics, and Scope-adjusted EBITDA interest coverage exceeding 1.7x on a sustained basis.

Ratings & Outlook

Corporate ratings	B/Stable
Senior unsecured rating	B-

Analysts

Thomas Faeh
+47 9305 3140
t.faeh@scoperatings.com

Related Methodology

Corporate Rating Methodology, February 2020

Rating Methodology European Real Estate Corporates January 2021

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

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

info@scoperatings.com
www.scoperatings.com

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A negative rating action would be possible in the event of an unsuccessful development phase, resulting in time overruns and delayed revenues from development projects. The subsequent performance of these assets below our base case assumption while company cash levels are depleted, leading to a deterioration in liquidity, could also put downward pressure on the rating.

Rating drivers

Positive rating drivers	Negative rating drivers
• Significant state grants subsidise real estate project development thereby reducing financial risk for the company • Exposure to second-tier investment market with healthy demand from tenants	• Relatively small property company (compared to Western peers), resulting in high sensitivity to unforeseen shocks and volatile cash flows • Weak diversification in terms of geographies and high tenant concentration risks • Short WAULT at three years leads to limited visibility on cash flows and a constant dependency on reletting, with high associated turnover costs • Small market shares in an increasingly competitive environment in combination with somewhat dated properties are likely to result in declining rental income or increased capex spending • Significant execution risk with the development of a tourism exposure and thereafter significant risks of managing and operating this exposure • Debt-funded development projects increase leverage as measured by Scope-adjusted debt (SaD)/EBITDA to over 40x, burdening the cash flow generation with barely coverable interest payments

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted EBITDA interest coverage exceeding 1.7x on a sustained basis	• A deterioration in liquidity

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020P**	**2021E**	**2022E**
Scope-adjusted EBITDA/interest cover (x)	2.7x	1.8x	1.0x	0.9x
Scope-adjusted debt (SaD)/EBITDA	12.0x	17.0x	31.9x	42.1x
Scope-adjusted loan/value ratio (%)	45%	39%	40%	47%
Scope-adjusted EBITDA in EUR k	**2019**	**2020P**	**2021E**	**2022E**
EBITDA	5,783	4,363	6,583	5,202
Operating lease payments in respective year	0	0	0	0
Other	-147	0	-3,500	-1,800
Scope-adjusted EBITDA	5,636	4,363	3,083	3,402
Scope-adjusted funds from operations in EUR k	**2019**	**2020P**	**2021E**	**2022E**
EBITDA	5,636	4,363	3,083	3,402
less: (net) cash interest as per cash flow statement	-2,121	-2,428	-3,115	-3,950
less: cash tax paid as per cash flow statement	-339	-280	-221	-65
Provisions and other	-168	619	0	0
Scope-adjusted funds from operations	3,007	2,275	-253	-614
Scope-adjusted debt in EUR k	**2019**	**2020P**	**2021E**	**2022E**
Reported gross financial debt	99,832	82,066	118,809	137,059
Deferred income and accrued expenses	355	974	974	974
Other financial obligations (tenant deposits)	302	1,495	1,495	1,495
Shareholder loans (50% equity)	5,252	8,202	9,789	12,180
less: cash, cash equivalents	-40,992	-21,902	-35,995	-11,746
add: cash not accessible	3,117	3,366	3,366	3,366
Other	0	0	0	0
Scope-adjusted debt	67,866	74,199	98,438	143,328

Business risk profile: B

Change of strategy

Until the change in ownership/management in 2020, Appeninn pursued a buy-and-hold CRE strategy, with the intention of carefully high-grading its portfolio and acquiring large retail properties in class A locations in the Baltics. The bond proceeds of HUF 20bn (EUR 55m) were intended to repay all existing debt and fund a moderate growth strategy, preserving financial metrics.

The new majority shareholders Mr Jellinek (24%) and Mr Attila Balazs (18.3%) initiated a change of management, who shifted strategy and turn Appeninn into a development company for tourism properties with the intention of owning and managing these after the successful completion of the building phase. The tourism exposure comprises a family hotel and family park at Lake Balaton (Balaland), a second hotel and marina at Lake Balaton, a hotel and Event/Exhibition centrum in the Tokaj wine region, a spa and thermal park in Lepence (north of Budapest) and the development of the Club Aliga property (also at Lake Balaton). Appeninn fully owns the Aliga projects (via two subsidiaries), 75% of the shares in Lepence, Szántód, and Tokaj projects and 51% in Balatonfüred, with the remainder owned by an established Hungarian hotel developer and manager (and in the case of Balatonfüred one additional minority shareholder).

Industry risk BB-

The change of strategy also affects our industry risk assessment. In its capacity as a CRE owner, the company is exposed to medium cyclicality, medium entry barriers and high substitution risk, translating into a BB industry risk. The shift towards real estate development exposes Appeninn to high cyclicality, medium barriers to entry and low substitution risk, warranting a B industry risk rating. This results in a blended industry risk of BB-. Going forward, the operation of its hotels and parks will also expose the company to the 'leisure and entertainment industry' (BB industry risk).

Small real estate company in a European context; execution risk in growth strategy

With about EUR 210m in total assets at year-end 2020 and 86,000 sqm in lettable CRE, Appeninn's size is limited. The company's development strategy will increase total assets to an estimated EUR 360m in the next three years. However, these assets' cash flow streams will differ to those of the CRE portfolio which are pure rental, in that they will be dependent on the successful operation of the underlying tourism facilities. The company's relatively small size implies heightened sensitivity to unforeseen shocks, greater cash flow volatility and higher key person risk, which are negative credit rating drivers.

Small market shares in a competitive environment

Despite focussing on Budapest, Appeninn does not hold significant market shares in the office, logistics and retail markets in which it is active, with market shares between 1.1% for office and 4.3% for logistics. The company's tourism exposure is estimated to have a market share of 0.7% in terms of hotel guest nights in 2023 once all hotels have opened (based on Hungary's hotel market in 2019). Appeninn's low market shares in its CRE segment means intensified competition from real estate investment funds and local specialist investors and in its hotel segment from competing leisure offerings.

Geographically concentrated in Budapest, with diversification into tourist areas

Appeninn's geographical outreach is spread across Hungary, with a strong focus on the capital city. According to management's plans, the portfolio development will assure an exposure to different regions (Lake Balaton, Tokaj, Lepence, and Budapest). Nevertheless, geographical diversification remains limited domestically.

High tenant concentration, mitigated by counterparty credit quality and deposits/guarantees

The company's current portfolio composition with, for instance, all of its retail outlets leased to one single counterparty, translates into relatively high tenant concentration. Its top three tenants account for 46% of rental income, while the top 10 tenants are responsible for over 65%. In our view, the likelihood of a single tenant default impairing Appeninn's cash flows is somewhat mitigated by the credit quality of its largest tenants. Appeninn also holds cash deposits or bank guarantees from all of its tenants.

Exposed to second-tier and third-tier investment market

Appeninn's current portfolio is concentrated in Budapest, which is a second-tier investment market. Its future development properties are in specialised tourism areas, which we view as third-tier investment markets. If the European economy cools, investors are likely to focus on tier-one markets and safe havens like Paris, London or Munich. This, in turn, could lead to substantial downward pressure on property values in tier-two markets and below, with the knock-on effects of increasing leverage, reduced financing availability and limited recovery expectations for debt investors.

Increasing vacancy and low WAULT provide limited visibility on cash flows

The company's office properties are concentrated in the city centre of Budapest, mostly in its desirable districts, which assured high occupancy rates in the past (at 97% in 2019). Covid-19 has led to some tenant turnover and vacancy has increased to 11% as of the latest reading. Elevated vacancy in connection with a relatively low WAULT of three years is negative from a credit perspective because it provides limited visibility on cash flows and a dependency on the constant reletting of properties with high turnover costs.

The economic age of Appeninn's portfolio, assessed at around 15 years, and underspending on maintenance capex (in our view) reduces the assets' attractiveness. In combination with a low WAULT and intensifying market competition, this could lead to declining rents or significant capex requirements.

Decreasing EBITDA margin as a function of elevated costs and development activities

Appeninn's profitability, as measured by its Scope-adjusted EBITDA margin, has been rather volatile historically. This can be explained by the significant growth of the CRE portfolio. It has achieved levels averaging above 65% for the last five years, including 2020. In 2020 operating cost increases were already putting pressure on the margin – a situation we foresee continuing in the future. In addition, the company's development activities will result in revenue lagging behind costs, taking EBITDA margins down to 20% levels.

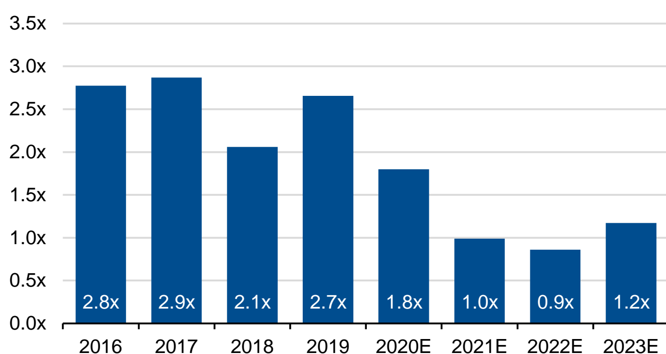
Financial risk profile: B

Our rating scenario assumes the following:

- Execution of management's strategy to clean up the CRE portfolio by disposing of one property in 2021 and replacing it with a class A property in Budapest
- Implementation of management's strategy to develop its tourism exposure, assuming that it will be predominantly funded via development loans and state grants, with a limited contribution from equity and shareholder loans
- Part of the tourism developments will start generating revenues during 2022, with the remainder coming on stream in 2023 as per management's timeline guidance. We have used our own assessment of the projects' cash flow generation, assuming some phase-in/ramp-up time.
- Outstanding senior unsecured bond (HUF 20bn, 3.5% coupon) will remain in the company's capital structure, subordinated to all bank debt and development loans to be issued
- No dividends paid for 2020-2023
- Project financing loans are considered a permanent, long-term part of the financing structure and are interest-bearing
- Shareholder loan (provided by minority shareholder) and subordinated shareholder loans (provided by minority shareholder and Lexan Aliga Kft) – all of which are payment-in-kind loans – are included in Scope-adjusted debt with 50% equity credit in line with our methodology regarding hybrid debt instruments

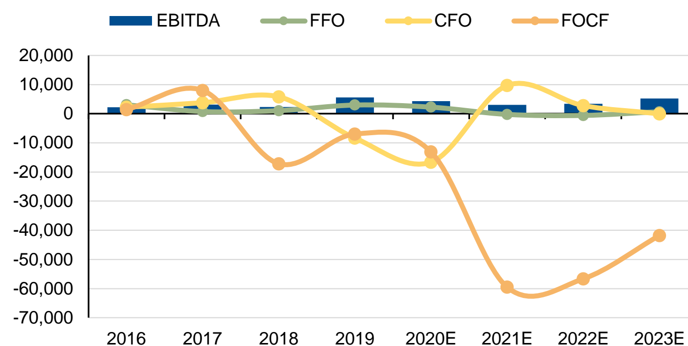
The company's debt protection – as measured by Scope-adjusted EBITDA interest cover – stood at a comfortable 2.7x in 2018 and has been above 2.2x for the traceable past. In 2020, interest coverage fell to 1.8x due to a rise in cost levels, especially for staff costs, something we foresee will continue. The development of Appeninn's tourism exposure will add further costs to a largely unchanged revenue-generating CRE portfolio. It will also add large amounts of interest-bearing debt, which will increase the company's interest burden. Diminished EBITDA in combination with higher nominal interest payments will lower Scope-adjusted EBITDA interest coverage to levels around 1x.

Figure 1: Debt protection (EBITDA interest coverage)



Source: Appeninn, Scope estimates

Figure 2: Cash flows



Source: Appeninn, Scope estimates

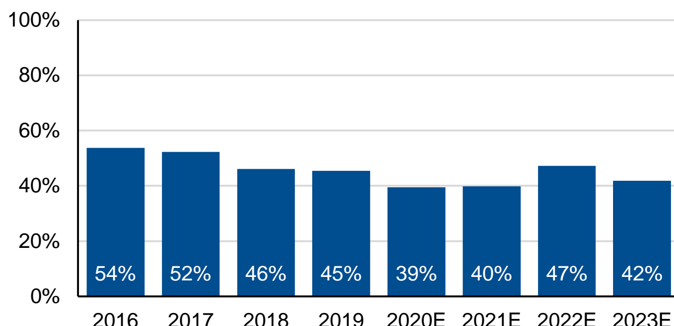
FFO to turn negative, highly negative FOCF due to ambitious development plans

Appeninn's cash flows as measured by funds from operations (FFO) have been positive historically, underlining the predictable rental income of its CRE portfolio and healthy interest coverage. We expect FFO to turn negative based on our forecast for the next two years, as a function of the above-described forces acting on debt protection. Free operating cash flows (FOCF) have already been negative given previous growth efforts, but will turn significantly negative to EUR-60m in 2021 and 2022 and remain a drag on the company's financial risk profile throughout the development phase.

Leverage remains moderate, helped by state grant/debt financing mix for developments

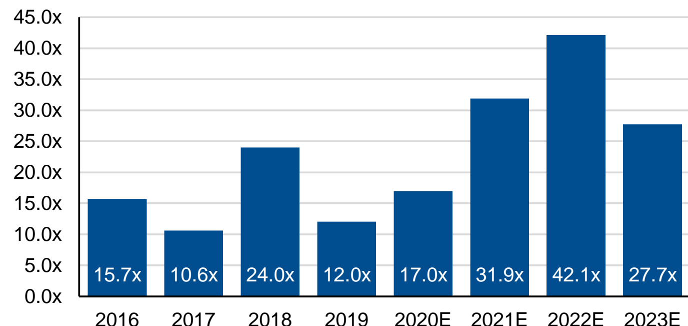
Appeninn managed to reduce its leverage, as measured by Scope-adjusted loan/value ratio, from 54% to 39% over the 2016-20 period, despite having doubled its portfolio in terms of market value. The value expansion was largely achieved through equity financing (properties paid-in-kind into the structure in return for shares and capital raises) and, to a lesser degree, through positive portfolio re-evalutions. Going forward, the company's development strategy adds significant asset values to the balance sheet, while keeping Scope-adjusted loan/value ratio at current levels of 40%-50% based on our forecasts. This is despite loading the balance sheet with a large amount of debt, thanks to significant non-refundable state grants in the financing mix, balancing the implied loan/value ratio of these projects.

Figure 3: Leverage measured by LTV



Source: Appeninn, Scope estimates

Figure 4: Leverage measured by SaD/EBITDA



Source: Appeninn, Scope estimates

Sharp increase in leverage measured by SaD/EBITDA

Leverage as measured by Scope-adjusted debt/EBITDA is moving to 42x from 17x at present, as a function of the debt-funded tourism development. The company is barely capable of bearing this level, as demonstrated by interest coverage.

Appeninn's liquidity is adequate, despite highly negative cash flows which, together with unrestricted cash, are not sufficient to cover limited short-term debt. Nevertheless, as all of the developments are pre-funded through state grants and construction loans, we do not foresee a liquidity issue arising from those contracts that need to be fulfilled.

Position	2021E		2022E	
Unrestricted cash (t-1)	EUR	18.5m	EUR	32.6m
Open committed credit lines (t-1)	EUR	0.0m	EUR	0m
Free operating cash flow (t)[1]	EUR	-59.5m	EUR	-56.6m
Short-term debt (t-1)	EUR	1.9m	EUR	4.2m
Coverage		**-21.4x**		**-5.8x**

Appeninn's management changed just six months ago. New management therefore naturally has limited internal knowledge of the company and of the real estate industry as a whole. Appeninn has brought in a new senior sales manager to improve the CRE portfolio, relies on external support to plan and execute on developments and will use its minority shareholder to operate the tourism exposure once completed.

Long-term and short-term debt ratings

Senior unsecured debt: B-

Our recovery analysis factors in the low WAULT in Appeninn's CRE exposure, its somewhat aged portfolio and the non-prime characteristics of its purpose-built tourism assets (whose liquidity we assume to be low, which would weigh on attainable advance rates in a distressed sale scenario). Recovery is based on a hypothetical default scenario at year-end 2022, in which we assume outstanding first-lien ranked debt (customer deposits) of EUR 1.5m, senior secured bank debt of EUR 81.9m and unsecured debt financing of EUR 55.2m. We assume that EUR 24.4m of subordinated shareholder loans are structurally subordinated to the senior unsecured debt class.

Given these parameters, we arrived at a 'below average' recovery for Appeninn's senior unsecured debt (EUR 55.2m), resulting in a one-notch downgrade from the issuer rating. This translates into a downgrade to a B- rating for senior unsecured debt.

[1] We exclude discretionary expansion capex from the liquidity calculation, as such investments are made only if external financing is available.

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

111 Buckingham Palace Road
London SW1W 0SR

Phone +44020-7340-6347

info@scoperatings.com
www.scoperatings.com

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