4 August 2022

Corporates

Forrás Nyrt.
Hungary, Investment Holding

SCOPE

B STABLE

Key metrics

			Scope estimates	
Scope credit ratios	2020	2021	2022E	2023E
Total cost coverage	1.0x	0.5x	0.8x	1.7x
Scope-adjusted loan/value ratio	-13%	49%	40%	47%
Liquidity	>100%	>100%	>100%	>100%

Rating rationale

The issuer rating on Forrás, a Budapest-based industrial and real estate investment holding, is supported by i) its record of over 20 years in the sourcing, development and sale of manufacturing companies and real estate projects over several asset classes in Hungary; ii) the significant profit potential from the 20 recently (2021) acquired solar parks and those newly built and operational since June 2022; and iii) hidden reserves in the real estate portfolio that translate into moderate leverage and an additional liquidity source.

The issuer rating is mainly constrained by total cost coverage, which is expected to remain below 1.0x until 2023, when it improves in line with increasing dividend income from the newly acquired solar parks and other acquisitions in the sector. Other rating constraints are the company's lack of size and scope in the industrial and real estate segments, and its potentially high cash flow volatility due to the investment focus on solar power production. The complex corporate structure incorporating a variety of businesses, consolidation forms and financing structures, combined with key person risk (ESG factor: credit-negative) and a lack of long-term investment strategy, limits visibility on future cash flow.

Outlook and rating-change drivers

The rating Outlook is Stable and is based on the successful execution of the envisaged investments into companies from the renewable energy, property development and manufacturing sectors, financed by the HUF 21.7bn senior unsecured bond. We forecast the expanded portfolio to translate into sufficient total cost coverage of more than 1.0x from 2023. However, total cost coverage will remain subject to low visibility and volatility of cash income.

A negative rating action is possible if total cost coverage deteriorated further to less than 0.5x on a sustained basis. This could be the result of smaller-than-expected cash contributions from the newly acquired companies in the industrial sector caused by adverse industry trends or further delays in capital deployment. A negative rating action could also occur if liquidity were to worsen.

We may consider a positive rating action in case of higher visibility regarding recurring cash income from interest and dividends while total cost coverage remains above 1.0x.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
27 June 2022	Downgrade	B/Stable
29 June 2021	Outlook change	B+/Negative
22 June 2020	Initial rating	B+/Stable

Ratings & Outlook

Issuer	B/Stable
Senior unsecured debt	B

Analyst

Istvan Braun
+49 302 7891 378
i.braun@scoperatings.com

Related Methodology and Related Research

Corporate Rating Methodology; July 2022

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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Positive rating drivers	Negative rating drivers
• Hidden reserves in real estate portfolio translating into moderate leverage and access to additional liquidity if needed • Record of over 20 years in the sourcing, development and sale of manufacturing companies and real estate projects in different asset classes in Hungary • Cost coverage improving after the solar portfolio acquisition	• Very small player compared to European peers • High target industry concentration in the solar portfolio, which may translate into high cash flow volatility • Complex company structure including a variety of business models, industries and holding structures • Lack of long-term investment strategy making recurring cash flows difficult to forecast

Positive rating-change drivers	Negative rating-change drivers
• Higher visibility regarding recurring cash income while total cost coverage is sustained at substantially above 1.0x	• Total cost coverage sustained at less than 0.5x • Worsening liquidity

Corporate profile

The legal predecessor of Forrás Nyrt. was established in 1997. Since then, the group has invested in several industries including consumer goods, real estate and wholesale pharmacies (West Pharma). Forrás' assets today consist of diverse real estate assets including a land bank, leisure assets and commercial real estate. Additionally, Forrás purchased 20 solar parks in the year 2021, with 0.5 MW capacity each, and nine 0.5 MW parks in the construction phase, expected to be operational at the end of June 2022. Forrás is listed on the Budapest stock exchange. Arago Holding Zrt. owns 85% of the group.

Financial overview

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Total cost coverage	1.0x	0.5x	0.8x	1.7x
Scope-adjusted loan/value ratio	Net Cash	49%	40%	47%
Liquidity	>100%	>100%	>100%	>100%
Total cash income in HUF m				
Cash interest and dividends received	644.2	404.2	778.6	1,924.9
Rental income and fees	11.0	12.3	11.0	11.9
Recurring income	**655.3**	**416.5**	**789.6**	**1,936.8**
Total expenses in Total cash income in HUF m				
Operating expenses	-211.2	-185.1	-244.7	-257.0
Taxes paid	-13.3	-6.4	-53.9	-156.0
Interest paid	-406.1	-689.0	-689.0	-689.0
Dividends paid	-30	-30	-30	-30
Total expenses	**-660.6**	**-910.5**	**-1,017.7**	**-1,132.0**
Scope-adjusted debt in HUF m				
Reported gross financial debt	22,865.2	22,797.6	22,797.6	22,797.6
Less: cash and cash equivalents	-25,155.0	-3,531.9	-9,395.3	-3,508.0
Other items (guarantee)	0	0	0	0
Scope-adjusted debt	**-2,289.8**	**19,265.8**	**13,402.4**	**19,289.6**
Scope-adjusted gross asset value in HUF m				
Long-term investments (as per balance sheet)	13,015.8	25,691.8	28,983.2	36,418.3
Short-term investments	4,170.8	13,514.7	4,874.9	4,874.9
Scope-adjusted gross asset value	**17,186.6**	**39,206.5**	**33,858.2**	**41,293.3**

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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% voting rights) could be disadvantageous for external creditors like bondholders (and minority equity shareholders) in cases of disputes or liquidation. There is also key person risk: Tamás Leisztinger, Arago's main shareholder, makes all major operational decisions and sets the investment strategy on the holding level, though a board of directors provides support. The issuer also operates with a complex group 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.

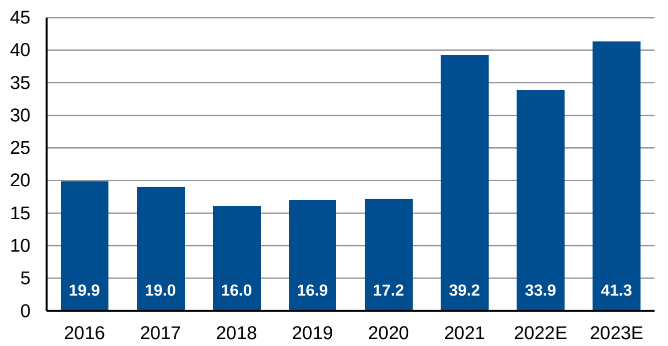
Business risk profile: B

Blended Industry risk profile: BB

With acquisitions in the metal parts manufacturing sector yet to take place, Forrás' blended industry risk remains primarily driven by the existing real estate portfolio and the newly acquired solar energy assets. The blended industry risk of Forrás is assessed at BB, based on 30% of its gross asset value being commercial real estate (assessed at BB) at YE 2021. The real estate portfolio generates most of the holding company's revenue, accounting for 56% of the recurring cash income.

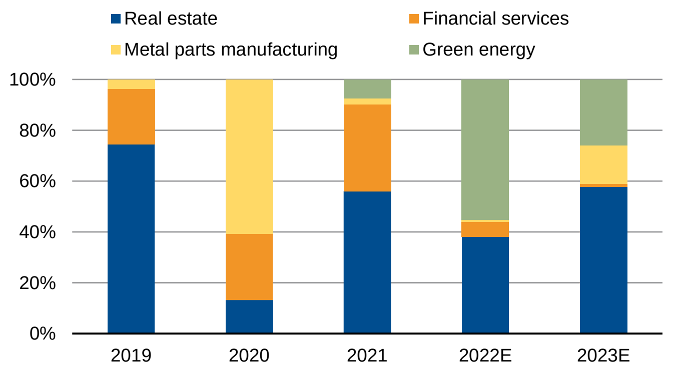
Acquisitions in 2021 and 2022 led to a much larger exposure to the unregulated renewables sector (assessed at BB) in terms of income, and Forrás has been operating on the sector's free market since early 2022. While this sector generated only 7% of the recurring cash income in 2021, the proportion is expected to significantly increase beyond 2023, with solar set to become the second largest profit generator after real estate.

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



Sources: Forrás, Scope estimates

Figure 2: Cash income by sector and year



Sources: Forrás, Scope estimates

Moderate asset diversification

Significant industry or asset concentration risk is a fundamental weakness for investment holding companies. Based on the analysis of the financial income of Forrás, the holding entity has relatively concentrated cash interest and dividend income as of year-end 2021. Since 2021, Studio V (active in property management) and Kreditor (active in non-performing loans) have contributed the lion's share of the holding company's recurring cash interest income. The newly acquired solar companies are also set to start paying interest on their shareholder loans. In terms of dividends, substantial cash contributions are expected from the renewables portfolio from 2022.

The issuer also expanded its investment focus to the metal parts and computer numerically controlled machining segments in western Europe, predominantly in the German-speaking countries. This will have a positive effect on diversification by assets and geographies once acquisitions have been executed.

Limited liquidity of holdings constrains business risk profile

As of YE 2021, Forrás holds the vast majority of its gross asset value in private/unlisted companies and real estate. The issuer intends to maintain this approach, which is credit-negative in terms of liquidity. However, we consider a scenario of urgent liquidation to be remote given the low leverage of the real estate portfolio on a look-through basis (Scope-adjusted loan/value ratio of below 20%). Nevertheless, liquidation could still happen if the financial performance of the to be acquired industrial assets deteriorated severely. In such a hypothetical situation, we deem the demand for such (likely loss-making) small industrial assets as 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.

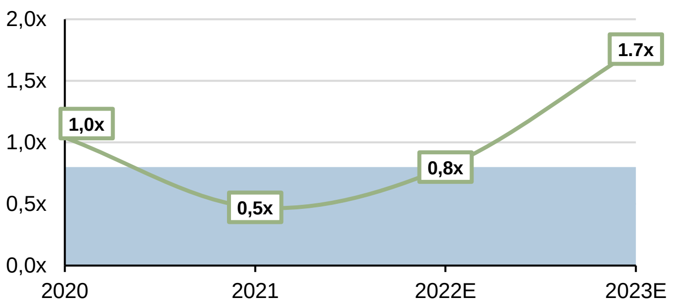
Forrás also holds a portfolio of Hungarian blue-chip shares with a total face value of HUF 8.6bn (as of YE 2021). Management states that they own this portfolio as an alternative to cash. However, due to highly fluctuating share prices, this portfolio's market value is subject to rapid, significant changes.

Financial risk profile: B

Total cost coverage expected to increase above 1.0x only beyond 2022

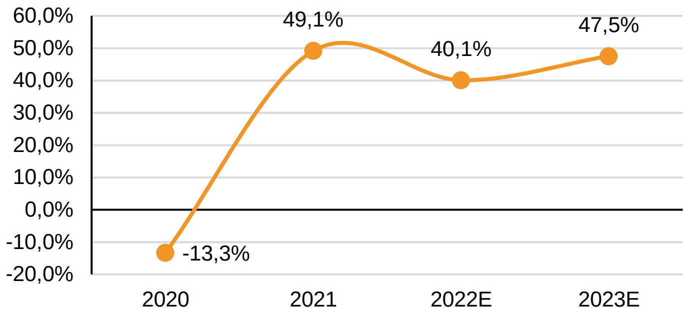
Total cost coverage is expected to remain below 1.0x until 2023, upon which it will start improving gradually in line with increasing dividend income from the newly acquired solar portfolio and further acquisitions in the segment. Future cash inflows largely depend on the target companies' ability to generate profit, and we account for this potential volatility. We also flag that interest and dividend income from the current investment portfolio cannot fully cover interest on the HUF 21.7bn bond.

Figure 3: Total cost coverage



Sources: Forrás, Scope estimates

Figure 4: Scope-adjusted loan/value ratio



Sources: Forrás, Scope estimates

LTV to increase along with the deployment of bond proceeds

After the successful placement of the HUF 21.7bn corporate bond and the almost full use of its proceeds in 2021, the Scope-adjusted loan/value ratio will continue to be above 40%, from net negative at year-end 2020.

Adequate liquidity

Liquidity is adequate, benefiting from HUF 3.5bn in cash available as of YE 2021 and positive free operating cash flow of HUF 0.5bn forecasted for 2022. Forrás has negligible short-term debt as of YE 2021.

Balance in HUF m	2022E	2023E
Unrestricted cash (t-1)	3,531.9	9,395.3
Open committed credit lines (t-1)	0.0	0.0
Free operating cash flow	545.1	-5,422.2
Short-term debt (t-1)	59.6	59.6
Coverage	**>100%**	**>100%**

Long-term debt ratings

Senior unsecured debt rating: B

In October 2020, Forrás issued a HUF 21.7bn senior unsecured bond under Hungary's Bond Funding for Growth Scheme. 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 renewable energy and real estate assets, and the rest was invested in shares in companies listed on the Hungarian stock exchange.

Senior unsecured debt is rated at the same level as the issuer rating. We computed an 'average' recovery for senior unsecured debt holders in a liquidation scenario. Further, all current and future secured and unsecured debt issued by Forrás' subsidiaries ranks structurally senior to the holding company's senior unsecured debt, constraining the debt rating.

Appendix:

In order to assess an investment holding company's financial strength we use financial data provided in the standalone (holding company) accounts as the source for calculating key financial credit metrics. We do not include financial data from consolidated financials in our calculations of key credit ratios for the following reasons: i) cash flows or liquidity of portfolio companies as shown in consolidated accounts may not be accessible at the holding company level and ii) an investment holding company may not have any influence over a portfolio company's dividend policy. We use the following key credit metrics to gauge the financial risk profile of an investment holding company:

- Total cost coverage;
- Leverage (LTV);
- Liquidity.

We use total cost coverage as the key indicator. We define the total cost coverage ratio as cash inflows versus non-discretionary cash outflows at the holding company level.

Cash inflows at holding company level included in our calculation are:

- Cash inflows from portfolio companies such as dividends or cash payments triggered by profit-sharing agreements;
- Cash-interest inflows from treasury activities such as investments in debt securities;
- Distributions from other investments such as investment funds or money market funds;
- Any other recurring cash-effective payments received from portfolio companies such as management fees.

Cash proceeds from divestments in portfolio companies are only included as a cash inflow if we expect these to recur annually.

Non-discretionary cash outflows included in our calculation are:

- Cash outflows from debt servicing (cash interest) and, if applicable, non-cash interest accruing on debt instruments;
- Dividend payments made by the investment holding company to its shareholders. We are aware that the nature of dividend payments is more akin to a discretionary cash outflow. For the purpose of calculating total cost coverage, we treat dividend payments as non-discretionary until the investment holding company publicly declares significant changes to its dividend payments.
- General holding company costs such as administrative expenses, staff costs and taxes.

We calculate an investment holding company's leverage by taking into account the portfolio's market value relative to the adjusted debt position (Scope-adjusted debt) at holding company level. The debt position not only includes short-term and long-term financial debt, but also adjustments for pension provisions, operating leases and other off-balance sheet items such as guarantees.

We use the LTV ratio as a supplementary ratio within our financial risk assessment. This is to avoid market prices of listed assets mechanically changing financial ratios, including the financial risk profile. We believe that changes in the market prices of listed assets are only important if an investment holding company faces debt maturities over the course of the next 12-24 months. Purely focussing on LTV can be misleading because this ratio does not capture the dimension of an investment holding company's debt maturity profile. If an investment holding company can cover its non-discretionary cash outflows, as mentioned above, there is no need for additional funding. Therefore, the dependence and relevance of price changes for listed assets can only be judged with regard to debt maturities over the course of the next one to two years.

We assess the liquidity of an investment holding company in the same way as for any other non-financial corporate, taking into account the holding company's ability to pay its short-term debt using free operating cash flow, unrestricted cash and marketable security positions, unused committed bank facilities, and unused committed factoring lines.

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

10 avenue de Messine
F-75008 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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