4 October 2019 — Corporates

SkyGreen Buildings Kft. Hungary, Real Estate

SCOPE — B+ STABLE

Corporate profile

SkyGreen Buildings Kft. (SkyGreen) was founded in 2016 as Eiffel Square Building Kft. and is owned by Green Ingatlanfejlesztő Investment Fund. SkyGreen is the universal legal successor of New Multiples Kft (which was founded in 2000). The company's main activity is renting and operating its own or leased real estate. It currently directly owns four properties in the city of Budapest.

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**
EBITDA/interest cover (x)	1.7x	1.7x	3.5x	3.7x
Scope-adjusted debt/EBITDA	17.4x	16.3x	6.7x	10.2x
Scope-adjusted FFO/SaD	2%	2%	10%	7%
Loan/value ratio	84%	65%	32%	53%

Rating rationale

Scope assigns a first-time issuer rating of B+ to SkyGreen Buildings Kft., Outlook Stable.

The B+ issuer rating on SkyGreen benefits from the portfolio's exposure to the second-tier investment market of Budapest, stable tenant demand expressed by a fully let portfolio as at July 2019, and relatively high profitability. The company's credit metrics are also improving, with an EBITDA interest cover of greater than 3x and a loan/value ratio of below 50%, driven by the mainly equity-financed portfolio expansion in 2019.

Rating constraints include the company's limited size, which leads to greater sensitivity to unforeseen shocks and volatile cash flows, as well as the very concentrated portfolio, comprising only four properties in Budapest, with a chunky lease maturity profile.

Outlook

The Outlook for SkyGreen is Stable and incorporates i) the successful execution of the in-kind contribution from the Váci Greens D property for EUR 50.7m (HUF 16.2bn) in Q3 2019; and ii) the successful placement of a EUR 88m (HUF 28.5bn) bond in Q4 2019, with proceeds intended for real estate acquisitions in 2020 at a net initial yield of at least 5.75%. Driven by the aforementioned portfolio expansion, we forecast an EBITDA interest cover of around 3x and a loan/value ratio of between 45% and 50%.

A positive action would require the company to grow significantly in size, leading to a less concentrated portfolio in terms of assets and tenants, and a loan/value ratio sustained at below 50%.

A negative rating action is possible if leverage notably increased, indicated by a loan/value ratio of more than 60%, or if the bond asset ratio were to fall to below 1.7x.

Ratings & Outlook

Corporate ratings	B+/Stable
Senior unsecured rating	BB

Analysts

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Related Methodologies

Corporate Rating Methodology

Rating Methodology European Real Estate Corporates

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Bloomberg: SCOP

Rating drivers

Positive rating drivers	Negative rating drivers
• Exposed to second-tier investment market with healthy demand from tenants • Full occupancy as at August 2019 but limited visibility beyond the re-letting cliff in 2022 • High EBITDA margin of between 70% to 90%, but profitability pressures from concentrated portfolio • Improving debt protection (EBITDA interest cover forecasted at above 3x) and moderate leverage (loan/value of below 50%) driven by mainly equity-financed and strong portfolio growth	• Relatively small property company -compared to western European peers- with high sensitivity to unforeseen shocks and volatile cash flows • Small market shares in an increasingly competitive environment • Weak diversification across geographies and high tenant concentration • Cluster risk in 2022 due to chunky lease maturity profile that faces high competition in the medium term • Negative free operating cash flow driven by portfolio expansion in 2019 and 2020, mitigated by either secured financing (100% in equity for acquisitions in 2019) or the discretionary nature of planned investments

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significant growth in size, while keeping loan/value at around 50%	• Loan/value to increase above 60% • Unencumbered asset ratio to fall to below 1.7x

Financial overview

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**
EBITDA/interest cover (x)	1.7x	1.7x	3.5x	3.7x
Scope-adjusted debt/EBITDA	17.4x	16.3x	6.7x	10.2x
Scope-adjusted FFO/SaD	2%	2%	10%	7%
Loan/value ratio	84%	65%	32%	53%
Scope-adjusted EBITDA in EUR m	**2017**	**2018**	**2019E**	**2020E**
EBITDA	3.4	3.5	8.2	13.5
Operating lease payments in respective year	0.0	0.0	0.0	0.0
Other items	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	3.4	3.5	8.2	13.5
Scope-adjusted funds from operations in EUR m	**2017**	**2018**	**2019E**	**2020E**
EBITDA	3.4	3.5	8.2	13.5
less: (net) cash interest as per cash flow statement	-2.0	-2.1	-2.3	-3.7
less: cash tax paid as per cash flow statement	-0.1	0.0	-0.2	-0.4
Add: depreciation component, operating leases	0.0	0.0	0.0	0.0
Scope-adjusted funds from operations	1.3	1.4	5.7	9.4
Scope-adjusted debt in EUR m	**2017**	**2018**	**2019E**	**2020E**
Reported gross financial debt	59.8	57.9	146.3	145.8
less: cash, cash equivalents	-1.2	-1.1	-91.3	-9.1
Cash not accessible	0.0	0.0	0.0	0.0
add: operating lease obligations	0.0	0.0	0.0	0.0
Other items	0.0	0.0	0.0	0.0
Scope-adjusted debt	58.6	56.8	55.0	136.8

Business risk profile: B

Industry risk: BB

Industry risk for SkyGreen is modest, as the company is exposed to the highly cyclical real estate industry. The company's main segments comprise the leasing and management of commercial real estate buildings.

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

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.

For more information, refer to our corporate outlook for real estate (click here).

Small property company with greater sensitivity to unforeseen shocks and volatile cash flows

SkyGreen is a company of limited size, with about EUR 0.2bn of total assets and EUR 6m-8m in funds from operations. According to the management, only one significant portfolio addition is planned in the near future, to be financed through a future bond issuance. As such, SkyGreen's relatively small size constitutes a negative rating driver, because it implies a greater sensitivity to unforeseen shocks, greater cash flow volatility and higher key person risk. However, the latter will be addressed by the externalisation of services to, amongst others, CBRE, Cushman & Wakefield and CE Land Management.

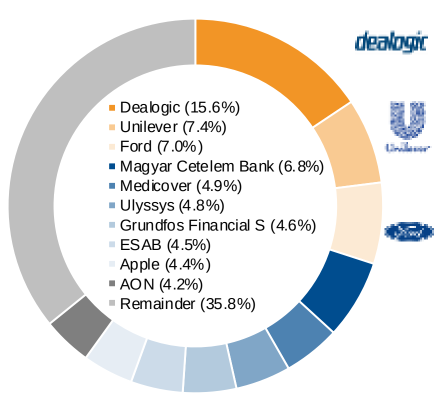
Small market shares in an increasingly competitive environment

Despite the company's focus on Budapest it holds no significant share in the office market. This is valid not only for the whole city (c. 1% market share) but also for the sub-markets, with c. 5% in the central business district, c. 3% in Buda North and c. 2% in Váci Corridor. This intensifies competition from market players of all sizes, the largest of which are real estate investment funds and special investors (mostly Hungarian). However, the company's main property, the Eiffel Square Office Building, is highly visible, located in the Pest's central business district (east of the Danube river) next to the Nyugati station (Western railway station), the second largest in the city, and the WestEnd City Center, one of the largest shopping malls in Central Europe.

Weak diversification across geographies and high tenant concentration

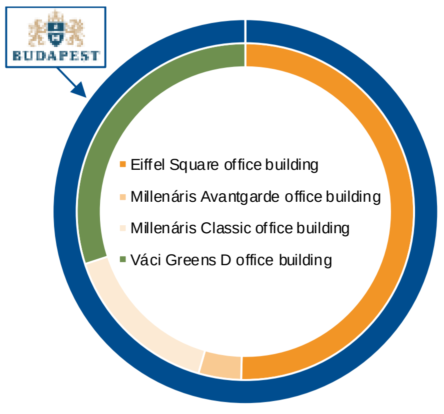
SkyGreen's limited size has also taken a toll on portfolio diversification by tenant and geography.

Figure 1: Tenant diversification (share of rent)



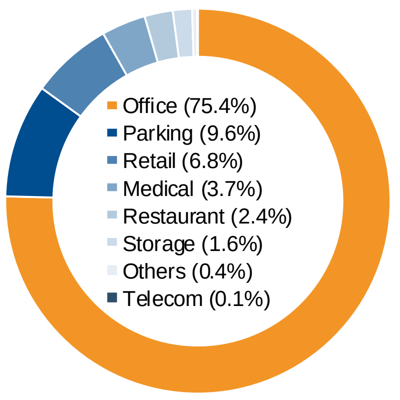
Sources: SkyGreen, Scope

Figure 2: Geographical distribution of property values



Sources: SkyGreen, Scope

Figure 3: Distribution of rental income by type of use



Sources: SkyGreen, Scope

The whole portfolio consists of four buildings located in Budapest (as at August 2019), with Váci Greens D added during the second half of August 2019 via an in-kind contribution by SkyGreen's sole shareholder. The company intends to maintain its geographical outreach within Budapest in the foreseeable future. Thus, performance will hinge on the macroeconomic environment of the Hungarian capital.

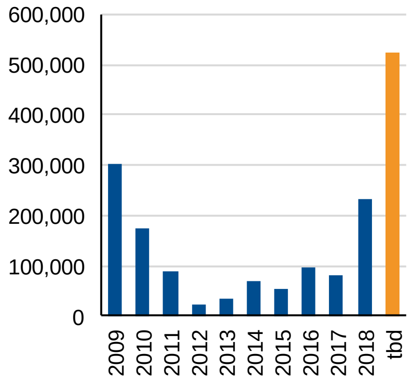
The limited number of properties in SkyGreen's portfolio and the focus on office space (75% of current rental income) leads to relatively high tenant concentration, with 30% of rental income as of July 2019 stemming from the top three tenants and 64% from the top 10. However, the likelihood of a single tenant default impairing cash flow is somewhat mitigated by their credit quality – at least one-quarter of rental income is from investment grade tenants. In addition, all tenants provide either a bank guarantee or cash deposit equating to three months' gross rent. SkyGreen has not used these guarantees or cash deposits to date.

Cluster risk in 2022 due to chunky lease maturity profile

However, the high tenant concentration has led to a chunky lease maturity profile, with 75% of leases maturing between 2022 and 2024. SkyGreen's ability to extend lease contracts and/or re-let vacated space is therefore exposed to competition from stock delivered to the market by that time. In addition, 12,000 sq m per annum to be renewed or re-let during that period represents around 12% of annual take-up of 80,000 sq m (10-year average according to JLL) in the Budapest office market. Considering both factors, SkyGreen needs to either spend enough capital expenditure to compete at market standard or agree on below-par rents. Both are likely to increase leverage as measured by the loan/value ratio due to i) the need to finance capex externally; or ii) property values decreasing as a result of a relatively lower estimated rental value.

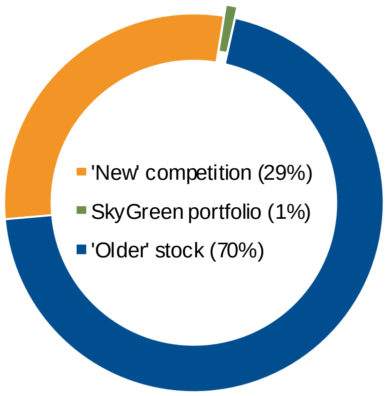
A more diversified portfolio would allow the company to spread future investments over a longer period, thus reducing the risk of weaker demand for most of the portfolio and the associated consequences as mentioned above.

Figure 4: Office completion in Budapest (sq m)



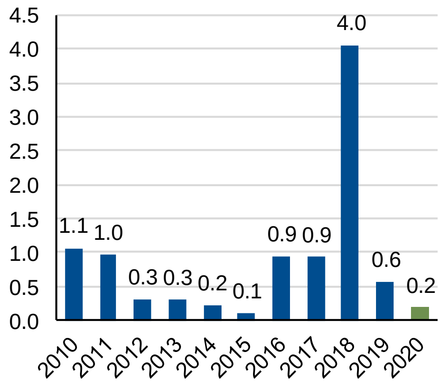
TBD – to be delivered (under construction)

Figure 5: Competitive office market in Budapest (2022)



Sources: DTZ, JLL, Savills, Scope

Figure 6: Lease start contracted rents (EUR m)



Sources: SkyGreen, Scope

Exposed to second-tier investment market with healthy demand from tenants

SkyGreen's sole portfolio location is the city of Budapest, a second-tier investment market. Even if the Budapest market gained more momentum (annual investment reached EUR 1.8bn in 2018, the second-highest volume since the record of EUR 2.0bn in 2007), we would still judge portfolio liquidity as relatively limited. In times of a cooling economy and/or rising interest rates, 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, a reduced availability of external financing, and limited recovery expectations for debt investors.

Properties are focused around the city centre. The Eiffel Square Building (50% of gross asset value) is located in the central business district, the Millenáris properties (20%) are next to Millenáris Park (Buda North), and Váci Green D (30%) is within the Váci Corridor. All locations benefit from relatively strong demand, as evidenced by vacancy rates at below the city average of 7% as at end-March 2019, a consequence of an above-average take-up in 2018. Thus, we judge the portfolio's micro location to be good, with tenants continuing to seek new space within these areas. On the other hand, we believe demand for high-profile leases with prime rents will be focused on the central business district – with the Eiffel Square Office building being the only asset in that area and benefitting from excellent visibility – especially if tenant demand declines.

Strong occupancy but limited visibility beyond re-letting cliff in 2022

The company benefits from almost full occupancy (99.6% as at August 2019), but faces a relatively short WAULT of 4.3 years as at YE 2018, pointing to limited visibility of cash flows beyond that cliff. In any case, we believe the company can address this risk adequately based on its decent track record on letting activity in the last few years, even with a massive upswing in letting during 2018 being predominately driven (60% of contracted volume) by the delivery of the Váci Green D property.

Somewhat aged portfolio facing high competition in the medium term

The portfolio is slightly aged with a weighted average economic age of around seven years as at YE 2018. With almost 20% of the current office stock delivered to the market since 2011 as well as another 522,261 sq m (13% of current office stock) under construction, SkyGreen's portfolio is likely to become comparatively less attractive once most of the leases end between 2022 and 2024. Competition will therefore intensify for SkyGreen, which could lead to declining rents or substantial capex needs. However, competitive pressure might be lower than expected, because capacity constraints in the Hungarian construction industry might lead to stock under construction being delivered late.

High but vulnerable profitability given the concentrated portfolio

SkyGreen's profitability as measured by the company's EBITDA margin stood at above 70% for 2018 and is forecasted to increase to above 80% from 2019 onwards. The forecasted development benefits from i) economies of scale through the addition of three properties in 2019; ii) the company's lean operational setup, with services provided by external parties and services adjusted to actual needs; and iii) its fully let property portfolio, which passes on most operational expenses to tenants (all leases are so-called triple-net leases).

However, the portfolio's diversification is limited, with four buildings under management and high tenant concentration. Moreover, profitability is vulnerable to a cooling Hungarian economy, which is likely to increase the number of corporate defaults or reduce the pick-up rate of vacant stock. The latter is exemplified by the rather short WAULT of 4.3 years and the steep lease maturity schedule, with three-quarters of leases maturing between 2022 and 2024. As a consequence, SkyGreen's profitability is exposed to medium-term volatility. Thus, we incorporate potential backdrops caused by single tenant defaults and/or a significant rise in vacancy into our assessment of the company's profitability.

Corporate governance

SkyGreen was founded in 2016 as Eiffel Square Building Kft. and is owned by an Investment Fund. The investors in the fund are private, in line with the current legal framework in Hungary. However, for each offer of securities to the public (including but not limited to securities, equity securities and non-equity securities) the issuer is expected to disclose its ultimate beneficiaries in its public offering / legal documents.

Financial risk profile: BB+

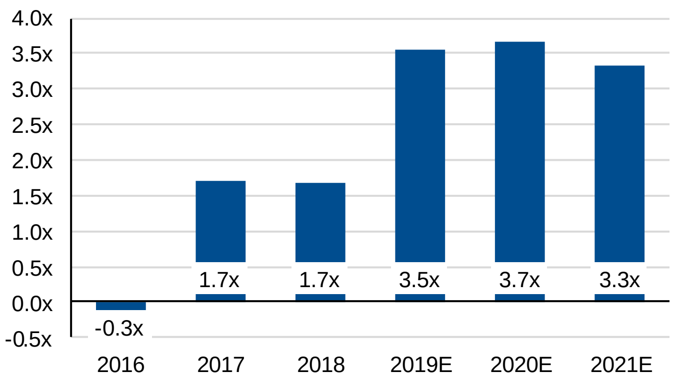
Our rating scenario assumes the following:

- No extension or re-letting of expired lease contracts/vacated lease area
- 3.2% inflation rate used for operational expenditure
- Interest to increase by 50bp for floating-rate and newly issued debt from 2019 onwards, based on a weighted average cost of debt of 3.23% as at YE 2018.
- 9% tax rate (tax loss carried forward EUR 3.9m for 2019)
- EUR 51m in-kind contribution from Váci Greens D in Q3 2019 (fully consolidated for the FY 2019)
- Bond issuance in Q4 2019 (EUR 88m; 2% coupon) to acquire a similar-sized property at a net initial yield of 5.8%
- Dividend payments of 50% of Hungarian GAAP result

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

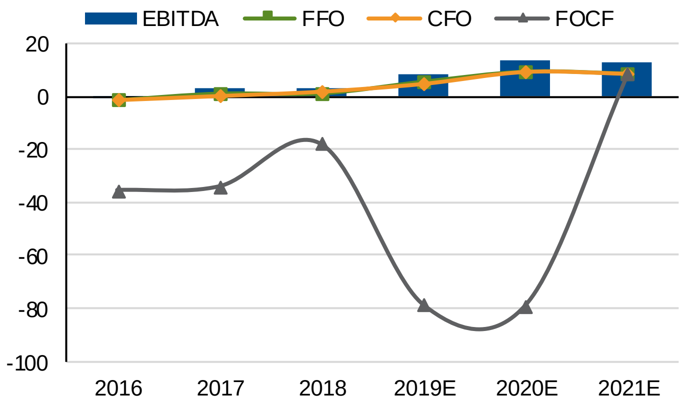
We forecast stable cash flows for the next few years, benefitting from portfolio growth since YE 2018 (acquisition of Millenáris Classic & Avantgarde and Váci Greens D in H2 2019) and further acquisitions anticipated by 2020. Free operating cash flow (FOCF) was and will be driven by portfolio growth, which will be negative at least until 2020. However, negative FOCF forecasted for 2019 was/will be fully financed by equity provided by the shareholder in 2019, which is judged to be positive.

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



Sources: SkyGreens, Scope estimates

Figure 8: Cash flows (EUR m)



Sources: SkyGreens, Scope estimates

Improving debt protection driven by mainly equity-financed and strong portfolio growth

The company's debt protection – as measured by EBITDA interest cover – has stood comfortably above 1.7x in the past. We anticipate a strong increase of debt protection to above 3.0x from 2019 onwards, as three property additions were predominately financed with capital increases (cash or in-kind contribution of assets). Interest expense on the targeted bond issuance of around EUR 88m in Q4 2019 (2% coupon) is anticipated to be covered by rental income from an equally sized acquisition, not executed as of now. Even if SkyGreen were to allow for negative carry for this bond, EBITDA interest expense would be forecasted to remain between 2.2x to 3.0x in the next few years.

We see only minor risk from the floating-rate loan (based on three-month Euribor; provided by Raiffeisen Bank, at EUR 6.7m as at YE 2018), with no significant increase in interest rates as triggered by the ECB expected until YE 2020 (Fed and ECB decisions confirm expected easing bias, accentuating financial imbalances[1]).

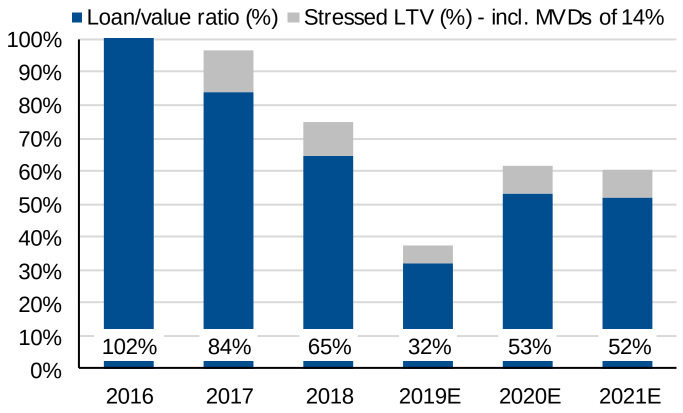
[1] Source: Scope, August 2019

All debt issued so far by SkyGreen has been denominated in euro. This creates a natural hedge against foreign-exchange risk because all rental contracts (and hence all rental payments) are also denominated in euro. Foreign-exchange risk could arise, however, with the prospective bond denominated in Hungarian forint, in the event that the rental income of property to be acquired with the bond's proceeds is denominated in another currency. Even so, we believe potential risk to be largely mitigated given the adequate headroom as expressed by the SkyGreen's interest expense cover.

Moderate leverage thanks to predominately equity-financed, strong portfolio growth

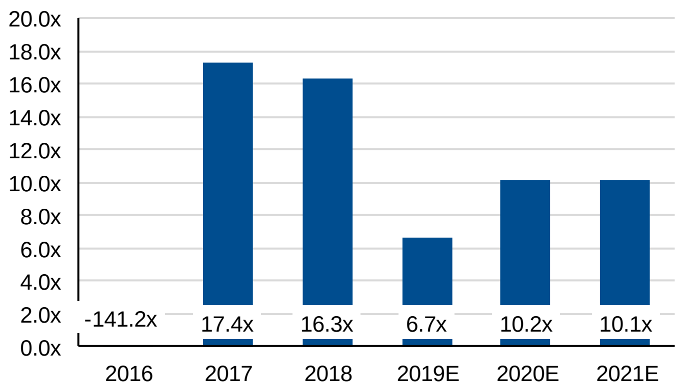
The company has reduced its leverage, as measured by the loan/value ratio, to 65% as at YE 2018 from more than 100% at inception in 2016. We forecast a further sharp decline in leverage in 2019 to around 30%, driven by a twofold increase in assets (three acquisitions) that are predominately financed with equity. However, our mid-term view on SkyGreen's leverage is somewhat muted, with loan/value expected at around 50% in 2020, because further portfolio growth is set to be fully financed with debt. Nonetheless, even with a leverage of around 50%, SkyGreen has some buffer against potential market value declines induced by either the ageing portfolio or weakening demand.

Figure 9: Loan/value ratio (%)



Sources: SkyGreen, Scope estimates

Figure 10: SaD/EBITDA (x)



Sources: SkyGreen, Scope estimates

We consider liquidity to be adequate. In detail:

Position	YE 2018		2019E	
Unrestricted cash	EUR	1.1m	EUR	3.0m[2]
Open committed credit lines	EUR	0.0m	EUR	0.0m
Free operating cash flow (t+1)[3]	EUR	4.9m	EUR	9.4m
Short-term debt	EUR	0.4m	EUR	0.4m
Coverage		**14.9x**		**30.7x**

We judge SkyGreen's liquidity to be adequate. although it is exposed to a 'maturity wall' in June 2021, upon which EUR 39.5m provided by Raiffeisen Bank Zrt. will mature. Refinancing the loan will depend on either property disposals or external financing. We believe refinancing risk should be manageable, due to i) a relatively low loan/value ratio for this loan, at 46% as at YE 2018 (loan is secured with a mortgage on the Eiffel Square Office Building, valued at EUR 85m); and ii) an unencumbered asset position of EUR 83.7m as at August 2019 (including Váci Greens D). These unencumbered assets also provide an indirect security for the EUR 88m senior unsecured bond to be issued in Q4 2019 (expected to be used to acquire a similar-sized property, lifting unencumbered assets to around EUR 172m).

[2] Excluding proceeds from planned bond issuance, as cash will be fully used for property acquisition(s).
[3] We exclude discretionary expansion capex from the liquidity calculation, as such investments are made only if external financing is available.

Our assessment of the company's liquidity prior to the refinancing of the EUR 39.5m loan in June 2021 is likely to be impaired in the event of a significant reduction in either the absolute amount of unencumbered assets or the unencumbered asset ratio (unencumbered asset to unsecured debt) from a forecasted 2.0x at YE 2020[4] (as at YE 2019: 5.3x[4]) through the issuance of new secured or unsecured debt.

Senior unsecured debt: BB

Our recovery analysis indicates an 'excellent recovery' based on the company's relatively high share of unencumbered assets, allowing for a two-notch uplift on the company's issuer rating. Consequently, we assign a debt class rating of BB.

Recovery is based on a hypothetical default scenario in FY 2020 with a company liquidation value of EUR 132m. This value is based on a haircut applied to the assets of roughly 40%, reflecting a market value decline of 14%, as well as liquidation costs of around 21% for the assets and 10% for insolvency proceedings. This compares to secured financing of a forecasted EUR 39m and senior unsecured debt of EUR 80m.

Please note: In Q4 2019, SkyGreen plans to issue a EUR 88m senior unsecured bond with a 2% coupon and a ten-year tenor.

Outlook

Outlook: Stable

The Outlook for SkyGreen is Stable and incorporates i) the successful execution of the in-kind contribution from the Váci Greens D property for EUR 50.7m (HUF 16.2bn) in Q3 2019; and ii) the successful placement of a EUR 88m (HUF 28.5bn) bond in Q4 2019 with proceeds intended for real estate acquisitions in 2020 at a net initial yield of at least 5.75%. Driven by the aforementioned portfolio expansion, we forecast EBITDA interest cover of around 3x and a loan/value ratio of between 45% and 50%.

A positive action would require the company to grow significantly in size, leading to a less concentrated portfolio, and a loan/value ratio sustained below 50%.

A negative rating action is possible if leverage notably increased, indicated by a loan/value ratio of more than 60%, or if the unencumbered asset ratio were to fall below 1.7x.

[4] Unsecured debt is adjusted by cash available as at YE 2019.

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