Forras Nyrt.
Hungary, Investment Holding

STABLE
B+

Corporate profile

The legal predecessor of Forrás Nyrt. was established in 1997. Since then the group and its current management have invested in several industry sectors like consumer goods (Pick – the largest integrated meat producer in Hungary, sold in 2005), real estate, pharmacy wholesale (West Pharma) and other industries. As of today, the overwhelming share of Forras' assets consist of a diversified real estate portfolio including land bank, leisure and commercial real estate. The group is majority owned by Arago Holding Zrt. (85%) and listed on the Budapest stock exchange. Forras intends to acquire specific target companies in the manufacturing industry with the proceeds of a planned issue of a HUF 20bn senior unsecured bond with 10-year tenor.

Key metrics

		Scope estimates		
Scope credit ratios	**2019**	**2020F**	**2021F**	**2022F**
Total cost coverage (x)	1.5x	1.3x	1.2x	1.3x
Loan-to-value (Scope-adjusted debt/portfolio's market value)	Neg.	<40%	c.60%	c.60%
Liquidity (internal + external)	No ST debt	Neg.	No ST debt	No ST debt

Rating rationale

Scope Ratings assigns a first-time issuer rating of B+/Stable to Hungarian investment holding company Forras Nyrt. Senior unsecured debt is rated B+.

The first-time issuer rating for Forras, a Budapest-based industrial and real estate investment holding company, is supported by its i) sufficient total cost coverage; and ii) balanced financing structure with only moderate external financial debt compared to its current total asset base.

The issuer rating is constrained by: i) the company's current lack of size and scope both in the industrials and real estate segments; ii) increasing exposure to the more cyclical manufacturing businesses; iii) a complex issuer structure incorporating a variety of different businesses, consolidation forms and financing structures; and iv) execution risks around the portfolio expansion and level of recurring dividend income from new undertakings.

Given our classification of the rated entity as an investment holding, all financial metrics are calculated on a separate account basis, not on consolidated figures.

Outlook and rating-change drivers

The rating Outlook is Stable and is based on the successful execution of the HUF 20bn senior unsecured bond placement and the successful acquisition of the targeted companies in the manufacturing industry, with corresponding sufficient positive cash contributions to Forras.

This is expected to translate into sufficient total cost coverage of around 1.0x going forward, according to our financial forecast. In addition, our Stable Outlook scenario assumes the continuation of the current dividend payout practice, with the largest part of the dividend payout (HUF 170m of HUF 200m) retained by Forras, increasing shareholder loan exposure.

Ratings & Outlook

Corporate ratings	B+/Stable
Senior unsecured rating	B+

Analysts

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Related Methodologies

Corporate Rating Methodology

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A negative rating action is possible if Forras' total cost coverage deteriorates to less than 0.8x on a sustained basis. This could be the result of lower-than-expected cash contributions from the newly acquired companies in the industrials sector caused by adverse industry trends and/or a more generous dividend payout to shareholders.

We would only consider a positive rating action if Forras managed to significantly improve its earnings visibility after a successful execution of its ambitious expansion plans while maintaining a total cost coverage of 1.3x on a sustained basis.

Long and short-term debt ratings

Forras plans to issue a HUF 20bn senior unsecured corporate bond under the MNB 'Bond Funding for Growth Scheme' in the third quarter of 2020. The bond will have a 10-year tenor. In our base case financial forecast we expect a 3.5% interest cost on the instrument.

The lion's share of proceeds from the bond are earmarked for the acquisition of majority and minority stakes in manufacturing businesses within the metal parts manufactoring sector in Hungary. In addition, management intends to refinance external bank debt of around HUF 2.5bn with the bond proceeds. We expect an average recovery in a hypothetical default scenario, flagging: i) the structural subordination of Forras' senior unsecured debt to any current or future secured or unsecured lending on subsidiary level; as well as ii) substantial uncertainty around the future value and liquidity of the company's industrial/manufacturing portfolio at the time of our hypothetical default scenario.

We therefore rate all current and future senior unsecured debt – including the planned HUF 20bn bond mentioned above – at the same level as the issuer rating.

Rating drivers

Positive rating drivers	Negative rating drivers
• Expected cost coverage ratio of around 1.0x going forward • Recurring cash flows from real estate portfolio smoothing the earnings picture • Hidden reserves in real estate portfolio translating into moderate leverage and access to additional liquidity if needed • Track record of over 20 years in the sourcing, development and sale of both manufacturing companies and real estate projects in different asset classes in Hungary	• Increasing exposure to the cyclical manufacturing industry • Very small player with lack of scale compared to other European industrial and/or real estate players • High target industry concentration in the industrial portfolio may translate into high cash flow volatility • Execution risks regarding acquisitions • Complex company structure including a variety of business models, industries and holding structures • Risk of structural subordination of Forras' senior secured creditors

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Higher visibility on future cash inflows after successful execution of expansion plans while maintaining a total cost coverage of 1.3x on a sustained basis	• Deterioration of total cost coverage to less than 0.8x on a sustained basis

Financial overview

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**	**2022F**
LTV (%) (single entity basis)	neg.	neg.	39%	59%	59%
Total cost coverage	**2018**	**2019**	**2020F**	**2021E**	**2022E**
Total cost coverage	**0.7x**	**1.5x**	**1.3x**	**1.2x**	**1.3x**
Scope-adjusted debt in HUF '000	**2018**	**2019**	**2020F**	**2021E**	**2022E**
Reported gross financial debt	1,228,542	1,029,763	21,198,807	21,368,807	21,538,807
less: cash and cash equivalents (accessible)	-4,004,254	-3,090,447	-14,205,419	-4,398,216	-4,694,499
add: financial guarantees	866,000	866,000	866,000	866,000	866,000
Scope-adjusted debt	**-2,775,712**	**-2,060,684**	**6,993,388**	**16,970,591**	**16,844,308**

Business risk profile: B

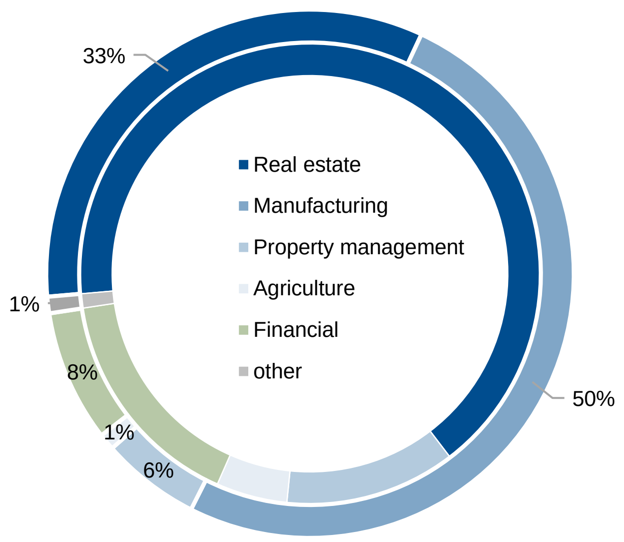
Blended industry risk: BB

Our industry risk assessment is based on a blended approach, combining real estate with a focus on commercial properties and capital goods, for which Forras is targeting acquisitions in a volume of HUF 15-20bn over the current and next business year.

The company's market position is very modest as its portfolio only has negligible market shares in the overall Hungarian real estate market at this point. Even following expansion into industrials, Forras will also have a niche position in its industrial business with limited size and scope, implying a high vulnerability to adverse shocks and limited bargaining power with customers.

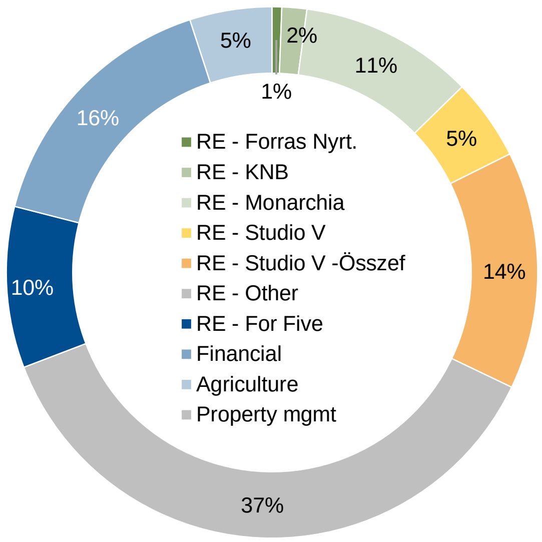
The different asset classes in Forras' real estate portfolio and the planned expansion into a second industry sector provide a certain degree of diversification. However, the company's income profile will still remain clustered around Budapest-based real estate and one sub-sector in industrials (CNC, metal parts manufacturing). The businesses to be acquired are expected to have an EBITDA margin of around 20%. Nevertheless, profitability may become more volatile as the company's earnings become increasingly cyclical compared to fairly stable real estate-centred recurring revenues in the past. The target companies expected to be successfully acquired in our financial forecast are predominantly suppliers to manufacturers of agricultural machinery. We therefore expect at least a temporary slump in demand and margins due to the current economic turmoil. We have incorporated this decreasing visibility of earnings into our forecast with reductions in profitability.

Figure 1: Shift of business focus 2019 vs 2021 (incl. manufacturing businesses)



Sources: Forras, Scope

Figure 2: Sector concentration by external revenues 2018



Sources: Forras, Scope

We view significant industry or asset concentration risk as a fundamental underlying weakness for an investment holding company. As of Q1 2020, Forras has concentration risks with regard to its portfolio of mostly Budapest-based real estate holdings and has little recurring revenues from other services like financials (e.g. its non-performing loan business). Figure 2 provides a split of external revenues. However, we expect the high concentration on real estate cash income to decrease to round 40% with the planned manufacturing sector acquisitions over the next two years.

We assess Forras' competitive position and overall business risk profile at B.

Financial risk profile: B+

Our rating scenario assumes the following:

- Rise in costs (e.g. staff) above cost growth forecasted by Forras at rate of +3.1% p.a.
- Income assumptions discounted below those in the company business plan (-15%, -15% and -5% for direct revenues of the rated entity and -30%, -15% and -5% for cash interest and dividend income from holdings for the years 2020E, 2021E and 2022E)
- Weighted average interest of around 3.5%
- Dividends of HUF 200m p.a. (only HUF 30 paid out in cash, HUF 170m retained)
- Successful placement of a HUF 20bn senior unsecured corporate bond as part of the MNB bond programme with a maturity of 10 years and a coupon of around 3.5%. in Q2 2020
- Successful execution of two company acquisitions in 2020 for agreed purchase prices of around HUF 7bn in 2020E and HUF 10bn in 2021E as planned by management and partly secured via purchase options

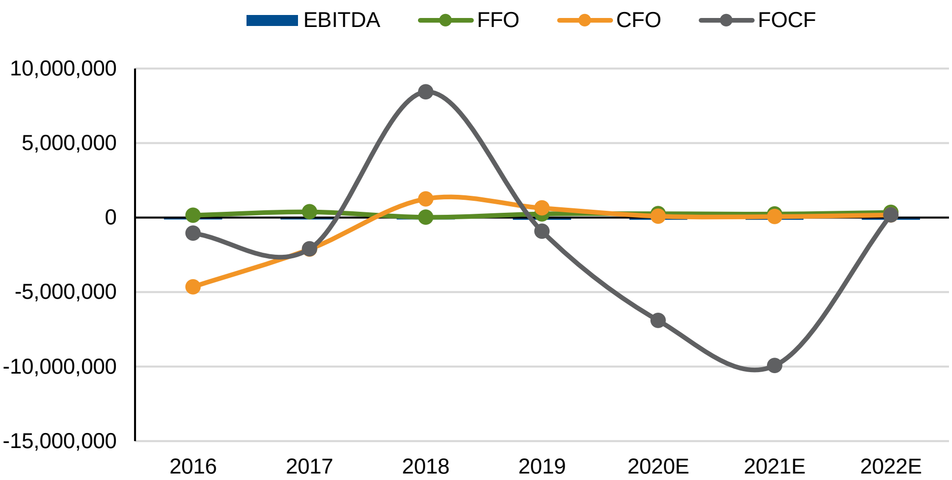
High cash outflows expected for business acquisitions in 2020E and 2021E

Forras' expansion should increase cash income. However, the planned debt-financed acquisitions totalling HUF 7bn for 2020E and HUF 10bn for 2021E will take their toll on free operating cash flow development during the investment period (2020E to 2021E). Free operating cash flows are expected to turn positive again starting in 2022E after the targeted acquisitions have been successfully executed.

Although there is sufficient total cost coverage of over 1.2x on a sustained basis at a holding company level, this also includes revenues from the sale of properties and participations. Considering recurring cash revenues and all costs on a holding company level, we forecast that Forras will be able to cover all operating and financing costs without additional asset sales going forward. Our expectation that the total cost coverage ratio will remain above 1.2x going forward already incorporates reductions in expected cash dividends and shareholder loan interest income. This represents the strongest support for the rating at this point.

The volume of external financial debt on the diversified real estate portfolio is small, as measured by a look-through LTV of around 15% as of year-end 2019. This should leave sufficient possibilities for secured (mortgage-) lending, thus mitigating liquidity concerns. On the other hand, we flag the risks of additional financial debts on subsidiary level, ranking structurally senior to Forras' senior unsecured creditors. We assess Forras' financial risk profile at B+, mostly as a result of the shrinking visibility of future cash earnings.

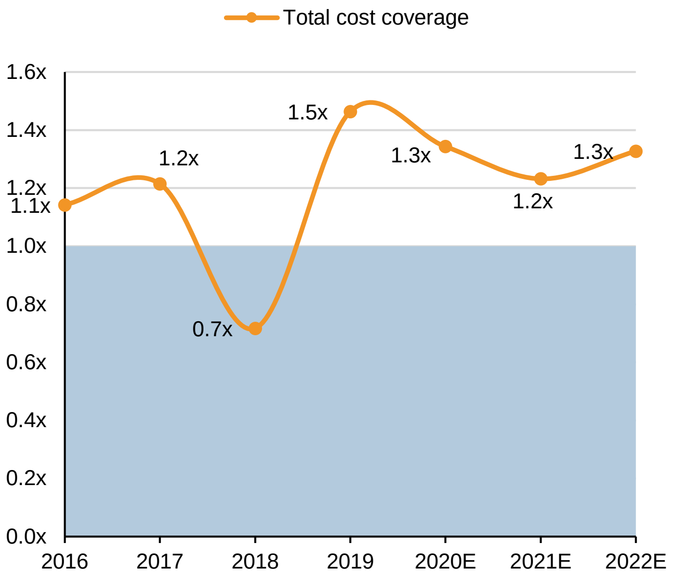
Figure 3: Cash flow overview (HUF '000)



Sources: Forras, Scope

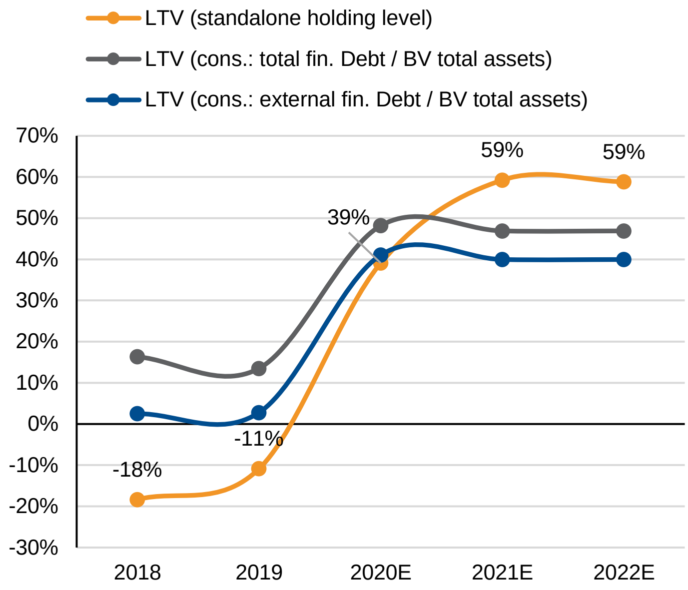
We expect total cost coverage to range from 1.2x to 1.3x going forward, sufficiently covering cash operating and cash financing costs.

Figure 4: Total cost coverage



Sources: Forras, Scope estimates

Figure 5: Leverage (loan-to-value ratio)



Sources: Forras, Scope estimates

LTV set to increase significantly with planned HUF 20bn bond

With the anticipated placement of the HUF 20bn corporate bond, we expect indebtedness to increase from net negative levels to around 60% going forward.

Decreasing visibility of future cash flows due to expansion

We anticipate a split of roughly 40/60 between real estate and industrial cash income as of year-end 2020E. We therefore expect the visibility of operating cash profits to fall considerably given this dynamic expansion into another sector remains to be successfully executed at this point.

Liquidity is adequate given the absence of material external financial debt until 2030, when the anticipated 10-year senior unsecured bond will mature. In detail:

Liquidity: adequate

Figure 8: Liquidity

in HUF m	2019	2020F	2021F
Short-term debt (t)	0	956	0
Unrestricted cash (t)	4,004,254	3,090,447	14,205,419
Free operating cash flow (t+1)	-921,515	-6,584,072	-9,607,203
Liquidity (internal)	No ST debt	-3,654.4x	No ST debt
Open committed credit lines (t)	0.0	0.0	0.0
Liquidity (internal+external)	No ST debt	-3,654.4x	No ST debt

Source: Scope estimates

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