Alfa Equity Holding Kft. Hungary, Real Estate

SCOPE B+ STABLE

Corporate profile

Alfa Equity Holding Kft. (AEH), the holding company of a group of Hungarian and Slovakian property companies, is indirectly owned by Mr. Ohad Epschtein. The company is active in real estate rentals, property management and development. It has a portfolio of predominantly retail, logistics and office real estate rental assets valued at EUR 100m and a development pipeline of EUR 97m. AEH develops assets both for sale and for its own rental portfolio. The company has operated in Hungary for over 20 years and in Slovakia for around 10 years.

Key metrics

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA/ Scope-adjusted interest cover (x)	4.8x	5.0x	2.5x	2.3x
Scope-adjusted debt (SaD)/ Scope-adjusted EBITDA	15.4x	14.7x	14.9x	10.5x
Scope-adjusted loan/value ratio (%)	66%	62%	46%	43%

Rating rationale

Scope Ratings has today assigned a first-time issuer rating of B+/Stable to Hungarian real estate company Alfa Equity Holding Kft. (AEH). Senior unsecured debt has also been rated B+.

AEH's business risk profile (assessed at B+) reflects the company's relatively small size and market shares, with total assets of around EUR 100m at December 2020, a relatively short weighted average unexpired lease term (WAULT) of 3.1 years at June 2021, and a significant development pipeline of EUR 97m of gross development value over the coming five years. The lack of scale and disruption of some assets due to refurbishment (now completed) is reflected in a fairly low EBITDA margin of 40%-50% over the past two years. We expect margins to improve to above 50% in 2022-2023 on higher occupancy. These weaknesses are countered by a diverse portfolio by asset type, focused mainly on commercial real estate (retail, logistics and office), and a development pipeline with an emphasis on residential property, as well as good tenant diversity. The company's assets are in Budapest (Hungary) and Bratislava (Slovakia), providing an element of geographic diversity. Finally, the occupancy rate stood at 92% at June 2021, reflecting good asset quality, particularly in the logistics segment.

The financial risk profile (assessed at BB) reflects moderate leverage, as measured by the Scope-adjusted loan/value (LTV) ratio, expected at 40%-50% in 2022 and 2023. We expect leverage to remain at this level, since most investments over the coming two years will be in assets for sale rather than for rent. Investments over the next one year will largely be funded by the proposed EUR 27m bond. We believe the company will continue to rotate the portfolio and not pay dividends, to enable funding of its development pipeline, while maintaining leverage at a moderate level. AEH managed the Covid-19 crisis relatively well, with lower occupancy mainly in the office segment and some concessions in the retail segment. We expect a significant increase in revenue and EBITDA in 2022, helped by higher expected occupancy across the portfolio, 7871 sq m of additional net leasable area at Alfa Hub 11 (a logistics asset in Budapest) and the completion and sale of phase 1 of the

Ratings & Outlook

Corporate rating	B+/Stable
Senior unsecured rating	B+

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Related Methodologies

Corporate Rating Methodology
6 Jul 2021

Rating Methodology European Real Estate Corporates
15 Jan 2021

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Haller development (a residential development in Budapest). Interest rate and forex risk are low with most debt at a fixed rate and a natural currency hedge.

The overall rating is lowered by one notch based on our peer comparison and AEH's small size compared to rated peers.

Outlook and rating-change drivers

The Outlook is Stable reflecting a high pre-let ratio of 75% at the Alfa Hub 11 expansion and strong demand for AEH's residential real estate developments with current price expectations above budget. We expect the EBITDA margin for rental operation to improve to above 50% in 2022 and 2023 based on higher occupancy. The rating and Outlook assume that the proposed HUF 9.7bn bond is successfully placed and that the contracted asset swaps (Haller development) with related parties are confirmed by the banks and the relevant authorities.

A positive rating action would require AEH to achieve a larger size and Scope-adjusted EBITDA interest cover sustainably above 3x.

A negative rating action would be possible if the Scope-adjusted LTV increased above 60%, interest cover fell below 2x or liquidity worsened materially. Leverage could increase if the value of portfolio properties dropped due to a widening of yields or weakening rental cash flow. Liquidity could worsen if, for example, the company suffered project delays, tenant payment delays, or subsidiary profits were trapped because of covenant breaches at the bank borrowing entity level.

Rating drivers

Positive rating drivers	Negative rating drivers
• Diverse portfolio by asset type (mainly logistics, retail and office) with relatively low tenant concentration • Relatively modern assets with an average age of around seven years • Exposure to B location investment markets with asset quality reflected in high occupancy of 94% at Dec 2020 • Long debt maturity profile of over seven years and hence adequate liquidity proforma of the proposed bond issuance • Moderate leverage with Scope-adjusted LTV expected to remain below 50%	• Small company with net leasable area of 100,000 sq m (eight assets) and portfolio market value of EUR 100m • Relatively short WAULT of 3.1 years leaving the company exposed to market volatility • Significant development exposure, with gross development value of EUR 97m over the coming five years • Fairly low historic EBITDA margin of 40%-50% • All income-producing assets encumbered in favor of secured lenders

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Larger size and Scope-adjusted interest cover sustainably above 3x	• Scope-adjusted interest cover of below 2x or LTV above 60%

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA/interest cover (x)	4.8x	5.0x	2.5x	2.3x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA	15.4x	14.x	14.9x	10.5x
Scope-adjusted loan/value	66%	62%	46%	43%
Scope-adjusted EBITDA in EUR m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	6.4	5.7	7.3	13.0
Scope-adjusted EBITDA	**6.4**	**5.7**	**7.3**	**13.0**
Scope-adjusted funds from operations in EUR m	**2019**	**2020**	**2021E**	**2022E**
Scope-adjusted EBITDA	6.4	5.7	7.3	13.0
less: (net) cash interest as per cash flow statement	-1.3	-1.1	-2.2	-2.9
less: cash tax paid as per cash flow statement	-0.2	-0.2	-0.3	-0.9
less: disposal gains fixed assets	0	0	-1.9	-6.3
Scope-adjusted funds from operations	4.9	4.4	2.9	2.9
Scope-adjusted debt in EUR m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	105.6	88.6	90.8	77.7
less: cash and cash equivalents	-6.7	-4.9	-10.3	-7.1
Scope-adjusted debt	**98.9**	**83.7**	**80.5**	**70.7**

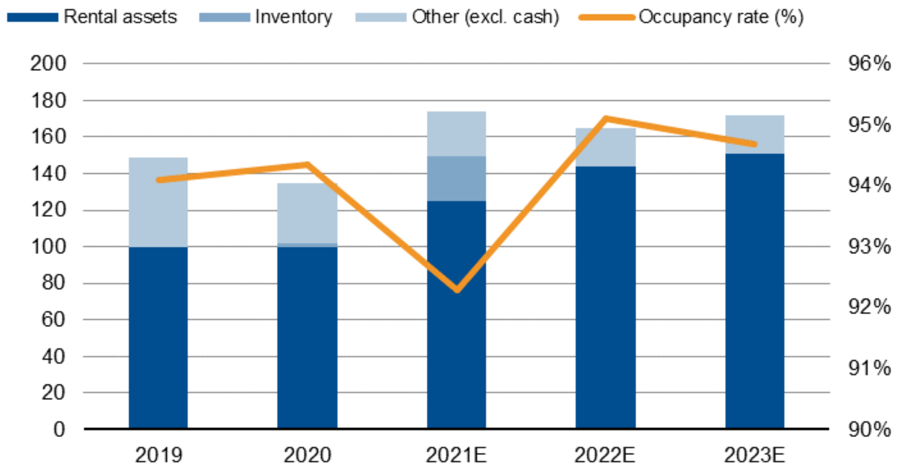
Business risk profile: B+

Industry risk of BB- reflects stable rentals and more risky development activities

AEH's activities comprise the leasing and management of commercial real estate buildings, as well as the development of real estate assets for sale and rental. The assigned industry risk of BB- is a blend of the relatively stable commercial real estate rental industry (industry risk of BB) and the riskier real estate development business (industry risk of B).

AEH's approach to property development is prudent in that all construction contracts are of a fixed price, turn-key nature. Current developments comprise two residential developments in Budapest and the upgrade/extension of an existing logistics asset also in Budapest. The extension of the logistics asset is 75% pre-let, whereas the current residential developments (Kassak Lajos and Haller phase 1) are around 40% pre-sold. Overall, we consider the development risk to be manageable.

Figure 1: Asset breakdown (EUR m) and occupancy rate (%)

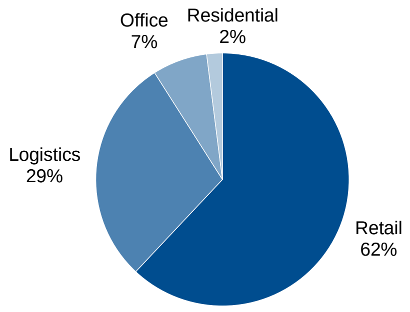


Source: Company, Scope

Relatively small property company with eight assets valued at EUR 100m

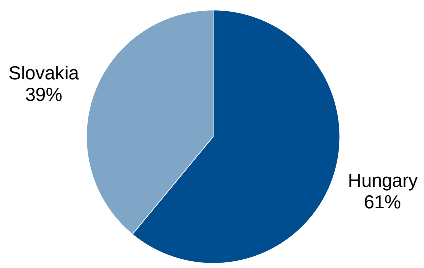
AEH is relatively small, with eight assets providing a net leasable area of 100,000 sq m and a rental portfolio valuation of EUR 100m (see Figure 1). This limited size is a negative rating driver since it implies enhanced sensitivity to unforeseen shocks, limited economies of scale and high key person risk. AEH has an ambitious five-year development pipeline with a gross investment value of EUR 97m. This will, over time, increase the company's size and diversity. Nevertheless, we view AEH as one of the smaller companies in the rated peer group, with low market shares in its locations and asset classes of operation. AEH operates in Budapest and Bratislava, two cities classified as B locations according to our rating methodology, implying that these markets are about average in terms of size, growth potential and asset liquidity (see Figure 3).

Figure 2: Asset breakdown by type (Dec. 2020)



Source: Company, Scope

Figure 3: Asset breakdown by location (Dec. 2020)



Source: Company, Scope

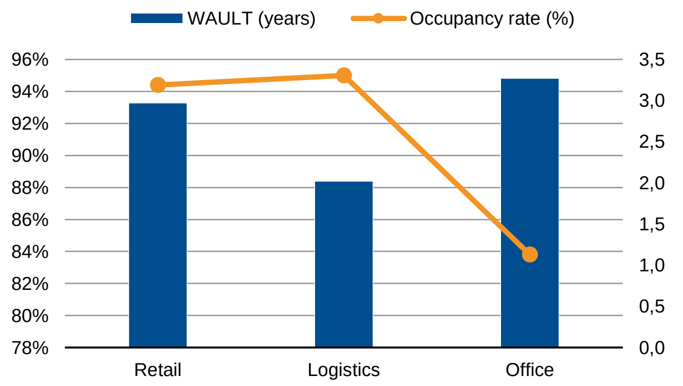
Good diversity by asset type and tenant

AEH has a diverse portfolio by asset type and an unusually good tenant diversity for a company of its size (see Figure 2). Although retail comprised 62% of assets at Dec 2020, underway and planned investments are in residential and logistics assets, which will further increase asset class diversity. The presence in multiple asset classes helped the company during the Covid-19 pandemic, with weaker demand for office and retail assets, but stronger demand for logistics assets.

Healthy occupancy rate but exposure to re-letting risk in the medium term

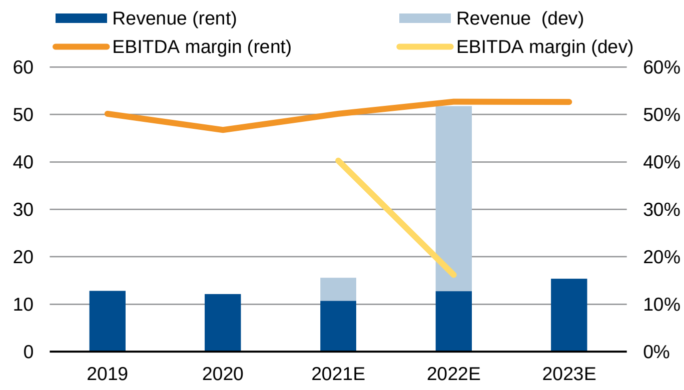
AEH's portfolio occupancy rate stood at 92% at June 2020 (94% at Dec 2020), signalling good overall asset quality, with notable strength in the logistics segment. The assets are also relatively new (or recently modernised) with an average age of 6-7 years. Conversely, the WAULT stood at only 3.1 years at June 2021 (2.6x at Dec 2020). This relatively low number exposes the company to reletting risk and potential cash flow volatility (see Figure 4).

Figure 4: WAULT and occupancy rate (Dec. 2020)



Source: Company, Scope

Figure 5: Revenue and EBITDA margin (EUR m)



Source: Company, Scope

Relatively low but improving EBITDA margin for rental operations

AEH's profitability, as measured by its Scope-adjusted EBITDA margin, was only 40%-50% in 2019, 2020 and H1 2021 (see Figure 5). Overall margins are likely to decrease in H2 2021 and 2022 given that the company will recognise significantly lower margin earnings from real estate development in these two years. We nevertheless expect margins from the rental business to improve in 2022 and 2023 because of expected higher occupancy rates (already improved in 2021) in the aftermath of Covid-19, and higher rent for assets that have undergone refurbishment (Alfa Hub 11).

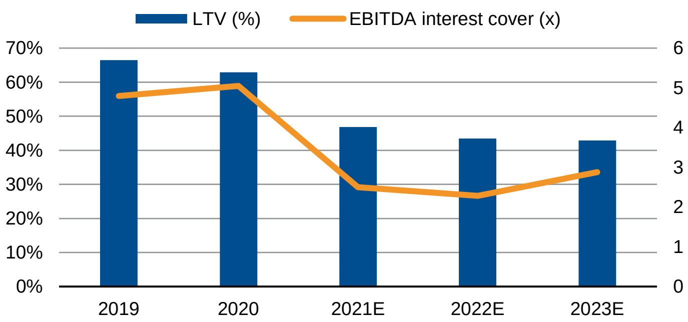
Financial risk profile: BB

Portfolio rotation to ensure LTV is maintained below 60%

We expect AEH to rotate its portfolio to maintain leverage within its LTV target of below 60%. This means that assets with limited potential for value addition could be sold to free up capital for new investments. Leverage has improved significantly in 2021, as EUR 27m of shareholder loans were converted into equity in the second half of the year (see Figure 6). We expect interest cover to weaken in 2021, however, as the proposed EUR 27m senior unsecured bond is likely to be more expensive than the existing secured bank loans and the converted shareholder loan.

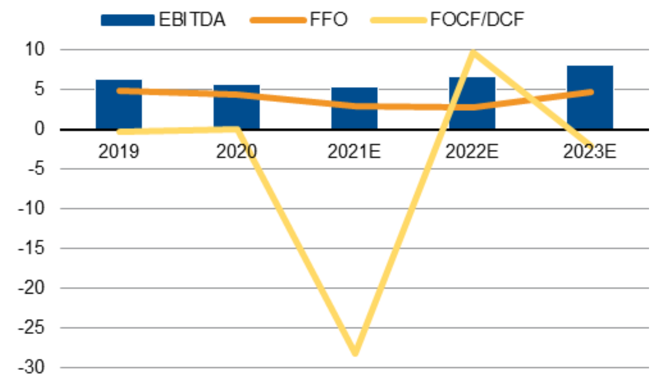
Around two-thirds of existing bank loans are at a fixed rate with an average tenor of around six years. Proforma of the issuance of the 10-year bond, the average loan tenor will increase to over seven years. Forex risk is currently minor, since both leases and debt are denominated in EUR, providing a natural hedge.

Figure 6: Scope-adjusted LTV and interest cover ratios



Source: Company, Scope

Figure 7: Scope-adjusted EBITDA and cash flow (EUR m)



Source: Company, Scope

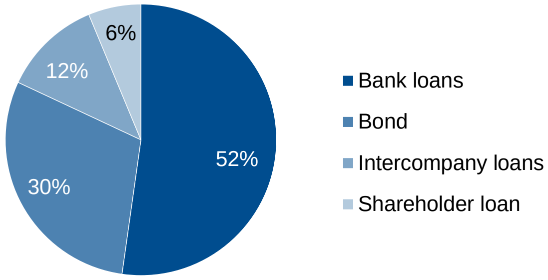
We consider AEH's liquidity adequate. In addition to the proposed bond, the company has secured a total of EUR 33m of construction bank loans, EUR 6m in the form of a signed facility agreements and EUR 27m in a signed binding term sheet (draw down subject to certain covenants and conditions precedent). Free operating cash flow is deeply negative in 2021, with significant investment in phase 1 and 2 of the Haller residential real estate development and the Alfa Hub 11 logistics renovation/expansion project, both located in Budapest. The two new loans and part of the proceeds of the bond will be used to help fund these two developments. We expect the situation to be very different in 2022, when phase 1 of the Haller development is completed and sold, which should provide significant working capital inflow and strong free operating cash flow (see Figures 7 and 8).

Figure 8: Liquidity

in EUR m	2021E	2022E
Short-term debt (t-1)	4.1	9.7
Unrestricted cash (t-1)	4.9	10.3
Committed credit lines (t-1)	0	4.8
Scope-adjusted Free operating cash flow (t)	-28.2	9.8
Coverage	**-5.7x**	**2.6x**

Source: Company, Scope

Figure 9: Sources of capital (proforma of bond issuance)



Source: Company, Scope

Long-term and short-term debt ratings

Income-producing assets encumbered in favor of secured lenders

AEH plans to issue a HUF 9.7bn (EUR 27m) senior unsecured bond. The bond's tenor is 10 years with 7% amortisation in 2024-2029, 8% in 2030 and 50% in 2031. The coupon is to be fixed and payable annually. Proceeds will be invested primarily in rental properties and inventory of residential units for sale.

In our hypothetical default scenario, we assumed that all AEH's income-producing assets are encumbered in favour of its secured lender. Nevertheless, we expect an 'average' recovery for AEH's HUF 9.7bn senior unsecured bond and therefore rate it in line with the issuer credit rating of B+.

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