# Wingholding Zrt.
# Hungary, Real Estate

## Corporate profile

Wingholding Zrt. (WING) is one of the largest privately-owned real estate groups in Hungary, with investment activities, subsidiaries specialising in real estate services, and a development pipeline. WING is one of Hungary's leading developers of office space and logistics, with other projects including industrial and commercial facilities, hotels and special-use properties. The current rental portfolio comprises more than 455,000 sq m. In recent years, WING has expanded into real estate investment. The group also offers integrated real estate services through its subsidiaries: NEO Property Services Zrt. is a market leader in property and facility management, and Aspectus Architect plans, designs and organises permits for the group's developments. In addition, Gladiator and Arcadia Real Estate Fund Management are group-owned entities that are managing real estate funds on the Hungarian real estate market.

## Key metrics

| | | | Scope estimates | |
|---|---|---|---|---|
| Scope credit ratios | 2017 | 2018 | 2019F | 2020F |
| EBITDA/interest cover (x) | 4.2x | 4.6x | 5.5x | 5.6x |
| Scope-adjusted debt (SaD)/EBITDA | 7.9x | 7.4x | 6.9x | 8.1x |
| Scope-adjusted FFO/SaD | 10% | 11% | 12% | 10% |
| Free operating cash flow (FOCF)/SaD | (-) FOCF | (-) FOCF | (-) FOCF | (-) FOCF |

## Rating rationale

The rating is driven by the robust quality of tenants and assets in the company's core office property portfolio; the low loan-to-value (LTV) ratio of the overall portfolio; and diversification into several asset classes including offices, logistics, hotels and residential development. Predictable and recurring tenancy income from premium offices makes up a high share of total rental income, at around 60%. The remainder is split between industrial, hotel, special-purpose, and retail and residential segments.

The rating is constrained by the company's small size compared to western European competitors. Geographical concentration also poses cluster risks, as more than 65% of the portfolio is located in Budapest. Regarding financial policy, no formal shareholder remuneration policy is in place and the volatility of cash dividend outflows in recent years has been high. This adds uncertainty over future liquidity from a creditor's point of view. We therefore also assume significant cash dividends to be paid to shareholders for the coming years of about 35% of funds from operations (FFO).

This pay-out ratio is in line with common sector practices and is not regarded as aggressive since it has been sufficiently covered by the cash generation of the operating business in recent years and is expected to stay well covered in the next business years.

Our base case rating scenario assumes the following:

- Like-for-like growth of rents by 2.5% annually
- No material disposals of own commercial development properties after 2019. However, opportunistic sales at well above book value may still occur. Revenues from the sale of individual residential units are recorded in the issuer's top line and are expected to increase to HUF 20bn in 2020E and HUF 27bn in 2020E.
- Expansion capex of HUF 50bn-60bn p.a. for upcoming years

### Ratings & Outlook

| | |
|---|---|
| Corporate Ratings | BB/Stable |
| Senior Unsecured Rating | BBB- |

### Analyst

Denis Kuhn
+49 69 6677389 83
d.kuhn@scoperatings.com

### Related Methodologies

Corporate Rating Methodology, January 2019

Real Estate Rating Methodology, February 2019

### Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Tel. +49 69 6677389 0

### Headquarters

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

- Inflation of costs at 2.5%-3.0% above the issuer's internal planning for 2020-21
- Dividend cash outflows of c. 35% of FFO for the next three business years
- Placement of a HUF 29bn senior unsecured bond within the corporate bond program of the National Bank of Hungary (MNB) within Q4 2019

### Business risk profile: BB

Geographical diversification is weak, with assets currently concentrated in the Budapest area. We nevertheless expect some improvement in the next two business years as the company plans to strengthen its geographical footprint outside of Hungary. The above-average credit quality of tenants partially mitigates the relatively high concentration on office properties in Budapest. Tenant concentration is modest, with the top three accounting for 27% of rental income as of 2018.

Asset quality is good due to the portfolio's low average economic age of less than five years. This results in relatively high attractivity to tenants, low capex needs, and above-average liquidity in the market for investment properties.

Profitability based on EBITDA margin ranges between 45% and 65% and should stay within this range in the course of the current expansion. This will depend on the extent to which revenues stem from either recurring rental income (which usually benefits EBITDA margin) or asset sales (which benefits liquidity and cash conversion but limits EBITDA margin by inflating revenues). These robust margins are attributed to the company's business model, which focuses on recurring cash flows from a growing rental portfolio, and to its asset-light services. Additional income from service subsidiaries is not material at this point, but the in-house capabilities underline the issuer's strategy to offer built-to-suit commercial developments at an international standard.

The aforementioned is evidenced by high and stable occupancy rates that stood at 84% as at end-December 2018 and a weighted average lease term of 5.9 years. Both provide good visibility over future cash flow generation from recurring rental income.

Trading activity is limited to opportunistic sales and is not necessary to the company's business model – in essence, a build-to-hold approach. We nevertheless expect further asset sales in the future, as seen in recent years. Moreover, the group maintains a sufficient land bank, with which it can start new projects within a reasonable timeframe and mitigate volatility in land prices, which we regard as credit-positive.

This results in a BB business risk profile for the issuer.

### Financial risk profile: BB+

The company has been growing quickly in the past years, reaching total assets of more than HUF 200bn (EUR 0.7bn) and funds from operations of HUF 18bn (EUR 56m) as of year-end 2018. We expect further growth until year-end 2021, to HUF 280bn of total assets and HUF 36bn of funds from operations, which would be double the levels as of year-end 2017. This implies lower volatility and higher overall visibility of rental revenues than in past years, but also substantial negative free operating cash flows due to the rapid expansion and a sharp rise in debt volume.

EBITDA/interest coverage has been robust at around 4.5x in recent years. We forecast this figure to stay within 4.5x-5.5x, assuming increasing EBITDA and gross financial debt as well as a slightly higher interest level from this point onwards.

Despite this significant growth, the company's absolute size still limits its access to (international) capital markets, in our view. However, its ambitious growth plans, with net expansion capex of EUR 375m through to 2020, should help to support visibility towards tenants and investors, if successfully executed. However, this aggressive growth leads to persistently negative free operating cash flow and dependence on external financing, which limits the company's financial risk profile sub-score.

We believe WING can manage operating leverage in a range of 7x to 8.5x (SaD/EBITDA) in the two upcoming business years, assuming fast expansion of the rental and development portfolio, **but no substantial additional debt-financed M&A**. Based on this scenario, we expect LTV to stay at around 55%, which underlines our credit view that the company's financial risk profile is currently slightly stronger than its business risk profile. We assess a BB+ financial risk profile for WING.

### Liquidity

WING's liquidity is judged to be adequate.

**In detail (position: YE 2018 I 2019E):**

Unrestricted cash and equivalents: HUF 22.4bn I HUF 14.9bn

Open committed credit lines: HUF 650m I HUF 650m

Free operating cash flow (t+1)*: HUF -19.8bn I HUF -24.2bn

Short-term debt: HUF 21.0bn I HUF 16.2bn

Coverage: 0.9x I -0.6x

*Free operating cash flow includes significant discretionary expansion capex for new projects that require full financing before they can start. In any case, if no new (fully financed) projects are launched, internal liquidity is sufficiently covered by cash and positive free operating cash flow.

### Unsecured debt

As at May 2019 WING's outstanding secured debt amounted to around HUF 140bn. The secured financings benefit from a pledge on investment properties, whose value equates to the bank loans' outstanding nominal and interest payable until the debt's maturity. This should positively impact recovery rates in a default scenario.

According to our methodology and reasonable discounts on the company's asset base (as described below), we also expect an 'above average recovery' for all unsecured debt issued. This is thanks to the hidden reserves on investment properties, which result in an LTV, based on market values, of around 50% as of year-end 2018. The above-average recovery projection on unsecured debt allows for an **uplift of two notches above the company's issuer rating of BB, resulting in a senior unsecured debt rating of BBB-.**

Recovery is based on a hypothetical default scenario in FY 2020 with company liquidation value amounting to HUF 227bn. This value is based on a 26% haircut applied to WING's real estate assets, incorporating market value declines commensurate with the assumed BB rating case as well as liquidation costs of approx. 25% for assets and 10% for insolvency proceedings. This compares to secured bank financing of a forecasted HUF 170bn in 2020E (first rank).

## Outlook

The rating Outlook is Stable and incorporates our view of continued growth in the issuer's property portfolio. This is likely to result in negative free operating cash flows and an increase in financial debt, but should be balanced by higher recurring rental cash flows and improved diversification. Leverage as measured by LTV is anticipated to stay below 60% throughout the next two business years.

We assume no significant sales of commercial assets after 2019 in our base case financial model. However, management has hinted at potential selective disposals if the opportunity to sell at significantly above book value arises.

### Rating-change drivers

A negative rating action might be warranted if the company's LTV (based on market values) exceeds 60% on a sustained basis.

A positive rating action might occur if the issuer improves its business risk profile while achieving an LTV of below 50% on its portfolio.

## Rating drivers

| Positive rating drivers | Negative rating drivers |
|---|---|
| • Core(+) office portfolio of around EUR 0.7bn by market value with high-quality tenants mostly in Budapest<br>• Leading market position in Hungary with experienced management and long track record (20+ years)<br>• Low LTV (based on market values) | • Limited scale compared to western European peers<br>• Hungarian office property market less liquid and more volatile than western European core office markets<br>• Development business adding risks to core business |

## Rating-change drivers

| Positive rating-change drivers | Negative rating-change drivers |
|---|---|
| • Further improvement of business risk profile while achieving an LTV of less than 50% | • An increase in LTV to more than 60% |

## Financial overview

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2017** | **2018** | **2019F** | **2020F** |
| EBITDA/interest cover (x) | 4.2x | 4.6x | 5.5x | 5.6x |
| Scope-adjusted debt (SaD)/EBITDA | 7.9x | 7.4x | 6.9x | 8.1x |
| Scope-adjusted FFO/SaD | 10% | 11% | 12% | 10% |
| Free operating cash flow/SaD | (-) FOCF | (-) FOCF | (-) FOCF | (-) FOCF |
| **Scope-adjusted EBITDA in EUR m** | **2017** | **2018** | **2019F** | **2020F** |
| EBITDA | 10,010.6 | 21,611.3 | 23,521.0 | 33,145.0 |
| Operating lease payments in respective year | -128.0 | -188.0 | -200.0 | -210.0 |
| Other items | 401.8 | -5,835.8 | -3,060.0 | -10,585.0 |
| Scope-adjusted EBITDA | 10,412.4 | 15,775.5 | 20,461.0 | 22,560.0 |
| **Scope-adjusted funds from operations in EUR m** | **2017** | **2018** | **2019F** | **2020F** |
| EBITDA | 10,412.4 | 15,775.5 | 20,461.0 | 22,560.0 |
| less: (net) cash interest as per cash flow statement | -2,492.6 | -3,395.4 | -3,731.0 | -4,048.0 |
| less: cash tax paid as per cash flow statement | -236.2 | -536.7 | -531.6 | -575.9 |
| add: dividends received from shareholdings | 829.9 | 565.2 | 600.0 | 650.0 |
| Scope-adjusted funds from operations | 8,513.5 | 12,408.6 | 16,798.3 | 18,586.0 |
| **Scope-adjusted debt in EUR m** | **2017** | **2018** | **2019F** | **2020F** |
| Reported gross financial debt | 89,744.1 | 137,035.6 | 144,698.5 | 174,085.5 |
| less: cash, cash equivalents | 19,430.8 | 38,626.0 | 22,396.7 | 14,858.0 |
| add: credit lines | 646.0 | 646.0 | 646.0 | 646.0 |
| add: pension adjustment | 0.0 | 0.0 | 0.0 | 0.0 |
| add: operating lease obligation | 2.0 | 1.4 | 1.5 | 1.5 |
| less: guarantees/off-balance-sheet liabilities | 11,418.8 | 17,436.0 | 18,411.0 | 22,150.1 |
| Scope-adjusted debt | 82,380.1 | 116,492.9 | 141,360.3 | 182,025.1 |

## 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

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

### London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

### Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

### Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

### Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
**www.scoperatings.com**


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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director: Torsten Hinrichs, Guillaume Jolivet