SunDell Estate Nyrt.
Hungary, Real Estate

SCOPE | B STABLE

Corporate profile

SunDell is a publicly listed, majority owner-managed real estate developer, focussed on the mid-price residential segment in Budapest. It is listed on the Budapest stock exchange and holds Hungarian REIT status. Its activities cover the entire development process from site evaluation and project planning to implementation and marketing. The company is planning to diversify into other asset classes, such as retail and commercial, and also to build up recurring income streams from a rental portfolio.

Key metrics

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**
Scope-adjusted EBITDA interest cover (x)	0.2x	9.7x	3.0x	4.6x
Scope-adjusted debt (SaD)/SaEBITDA (x)	209.4x	0.7x	7.5x	4.3x
Scope-adjusted loan/value ratio (%)	49%	7%	28%	36%

Rating rationale

Scope assigns SunDell Estate Nyrt. an issuer rating at B/Stable and a debt category rating on senior unsecured debt of B+.

The rating reflects the SunDell's limited size, resulting in cluster risks, albeit mitigated by moderate financial leverage going forward. Most importantly, the ratings are based on the assumption of a successful placement of a HUF 10bn senior unsecured bond in Q4 2020, leading to the complete refinancing of all other financial debt with part of the bond proceeds.

With regard to SunDell's business risk profile, rated B-, and in particular its market position, the company is currently a small real estate developer with Scope-adjusted assets of around EUR 60m and an exclusive geographical focus on the Budapest residential development market. SunDell nevertheless has moderate local market shares and visibility in its core market, also thanks to a track record of HUF 12bn (EUR 35m) of projects developed and sold in the past five years. Diversification is weak due to a limited number of projects and the concentration on one asset class in one local market, namely residential development in Budapest. While we expect the company to increase its market share in this segment, diversification is expected to remain a constraint on SunDell's business risk profile for the next 18 months at least. Although plans to increase recurring income streams by building up a permanent rental portfolio are credit-positive, they remain largely un-executed at this point in time.

Asset quality is credit-positive for the company's business risk profile. SunDell is focussed on medium-priced residential projects in Budapest. These projects enjoy relatively robust demand thanks to their affordability, which is also supported by several government incentives to promote home ownership, especially among families.

Ratings & Outlook

Corporate ratings	B/Stable
Senior unsecured rating	B+

Analyst

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Related Methodologies

Corporate Rating Methodology

Rating Methodology European Real Estate Corporates

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Moreover, the post-bond issuance financing structure, with no financial debt except the senior unsecured bond at a moderate Scope-adjusted loan/value ratio (LTV) of below 40% (based on Scope-adjusted debt/Scope-adjusted assets) would allow SunDell to better withstand potential market value declines and/or generate revenues by renting out unsold stock if necessary. Profitability is expected to stay volatile due to the clustered project pipeline, but at above-average levels compared to peers, with an approx. 20% internal rate of return and approx. 25% Scope-adjusted EBITDA margin going forward, depending on the timing of project completions.

However, we expect profitability to remain at a lower level, with an Scope-adjusted EBITDA margin of around 13% for 2021 due to the smaller volume of completions, before returning to the 25% range from 2022 onwards.

SunDell's financial risk profile, rated BB, benefits from an Scope-adjusted EBITDA interest coverage significantly exceeding 1x going forward, as well as an expected gradual reduction of volatility in cash profits via the larger and thus more granular project portfolio as well as the ramp-up of recurring revenue from leased properties. It is also supported by moderate leverage with a LTV below 40% based on Scope-adjusted debt/Scope-adjusted assets for the next two business years. The high volatility of cash flows caused by the clustered project pipeline and a lack of recurring revenues at this point is credit-negative for SunDell's financial risk profile.

Liquidity is adequate in our financial base case. The company will not have any short-term financial debt maturing until the first 30% amortisation tranche of the 10-year, HUF 10bn bond, which is planned to come due in 2025, according to the management's planning and our financial base case.

Outlook and rating-change drivers

The Outlook for SunDell is Stable and incorporates the assumption of a LTV below 40% and Scope-adjusted interest cover of over 1.7x together with the successful execution of sales at expected prices from its growing project pipeline. Furthermore, the Outlook incorporates a successful placement of a 10-year, fixed interest HUF 10bn senior unsecured bond in 2020.

A positive rating action would require SunDell to keep credit metrics in line with our base case on a sustained basis while substantially improving its business risk profile, e.g. by increasing its recurring revenue streams.

A negative rating action could be warranted if SunDell's LTV moves above 60% or interest cover drops to less than 1.7x on a sustained basis. This could be caused by the underperformance of development projects, e.g. as a result of lower prices for residential real estate in its core market of Budapest.

Rating drivers

Positive rating drivers	Negative rating drivers
• Track record of over HUF 12bn (EUR 35m) in residential projects in the past five years in Hungary • Moderate leverage with a LTV of around 28%-36% going forward • Gradual build-up of recurring revenues from rental portfolio, smoothing future cash flows	• Small sized company in a fragmented market leading to more volatile cash flows and limited economies of scale • Concentrated development pipeline (currently six active projects) with geographical cluster risk on Budapest • High exposure to the cyclicality of the Budapest residential real estate market with almost all revenues directly dependent on the company's development activities, i.e. unit sales • Clustered financing structure with only one financial creditor at present (planned to be refinanced via bond)

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Credit metrics in line with our base case on a sustained basis while substantially improving its business risk profile, e.g. by increasing its recurring revenue streams	• LTV of 60% or more on a sustained basis • Scope-adjusted EBITDA interest cover of less than 1.7x on a sustained basis

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**
Scope-adjusted EBITDA/interest cover (x)	0.2x	9.7x	3.0x	4.6x
Scope-adjusted debt/Scope-adjusted EBITDA (x)	209.4x	0.7x	7.5x	4.3x
Scope-adjusted loan/value ratio (%)	49%	7%	28%	36%
Scope-adjusted EBITDA in HUF m	**2018**	**2019**	**2020E**	**2021E**
EBITDA	25.9	2,127.3	836.0	1,605.1
Operating lease payments in respective year	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	**25.9**	**2,127.3**	**836.0**	**1,605.1**
Scope funds from operations in HUF m	**2018**	**2019**	**2020E**	**2021E**
Scope-adjusted EBITDA	25.9	2,127.3	836.0	1,605.1
less: cash interest as per cashflow statement	-121.8	-218.7	-275.0	-350.0
less: cash tax paid as per cashflow statement	-0.4	-0.1	0.0	0.0
Δ Provisions	0.0	11.7	0.0	0.0
Scope funds from operations	**-96.2**	**1,920.2**	**561.0**	**1,255.1**
Scope-adjusted debt in HUF m	**2018**	**2019**	**2020E**	**2021E**
Reported gross financial debt	7,520	6,181	10,000	10,000
less: cash, cash equivalents	-2,092	-4,663	-3,694	-3,102
Cash not accessible	0	0	0	0
add: operating lease obligations	0	0	0	0
Scope-adjusted debt	**5,428.3**	**1,517.8**	**6,305.7**	**6,897.7**

Business risk profile: B-

Industry risk: B

Industry risk for SunDell is very high as it operates in the riskiest sub-segment (project development) of a highly cyclical industry (real estate).

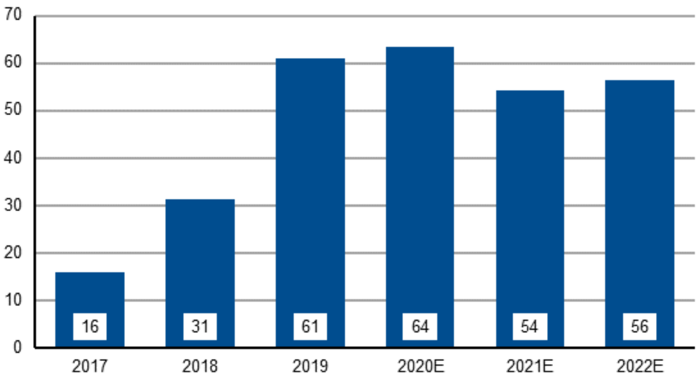
Company benefits from robust demand for medium priced residential units in Budapest

With a total asset value of around EUR 60m, SunDell is a small property company in a highly fragmented market, despite anticipated growth in the next two years based on a 1,300+ unit project pipeline as of October 2020. Notwithstanding the increasing focus on larger and smaller projects in additional locations, we expect SunDell to maintain its focus on mid-priced residential real estate units in Budapest.

Concentrated development pipeline of six ongoing projects

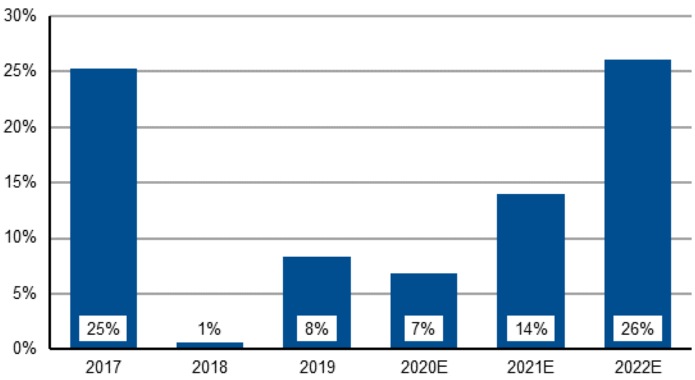
The company's relatively small size is a negative rating driver, because it implies a heightened sensitivity to unforeseen shocks, greater cash flow volatility and higher key person risk.

Figure 1: Scope-adjusted total assets (EUR m)



Sources: SunDell Estate, Scope

Figure 2: Scope-adjusted EBITDA margin (%)



Sources: SunDell Estate, Scope

Asset quality is credit-positive. While there is practically no diversification among asset classes, we see significantly higher liquidity for newly built, mid-priced residential units in the city of Budapest (13th and 14th district) than for retail and office assets, especially in the context of the ongoing Covid-19 situation.

The recently introduced political incentives to further promote private home ownership in Hungary should also support demand for this kind of asset. Besides the recent adjustment of the VAT on new homes from 27% down to only 5%, further incentives are in discussion, e.g. a cash refund of the remaining 5% VAT for families buying their first home. Financing conditions for private homeowners will most likely also remain supportive as the MNB incentivises commercial lenders to finance private home ownership.

With Scope-adjusted EBITDA margins of 1% to 25% in recent years, we see average profitability in some years with higher project completions, accompanied by below-average profitability in the 2019-2020 period of high expansion, a three-way merger, stock listing and REIT conversion. In 2018, the absence of substantial project completions caused by the clustered pipeline led to negligible but positive Scope-adjusted EBITDA, again demonstrating the inherently high volatility of cash profitability for a small property developer with no or little recurring cash flows.

EBITDA margins of around 25% expected in the medium term

We expect Scope-adjusted EBITDA margins to remain below average at around 13% for 2021, due to the early stage of large projects and only small project completions. Starting in 2022, we expect Scope-adjusted EBITDA margins to stabilise at around 25%, without taking significant recurring revenues into account. These profitability assumptions include our haircuts to expected sales revenues as well as the assumption of increased costs.

SunDell plans to significantly boost recurring income streams from its growing rental portfolio over the course of the next five years, which could lead to sustainably higher Scope-adjusted EBITDA margins in the medium to long term. However, we have not given credit to these plans yet, as the lease portfolio still needs to be successfully ramped up.

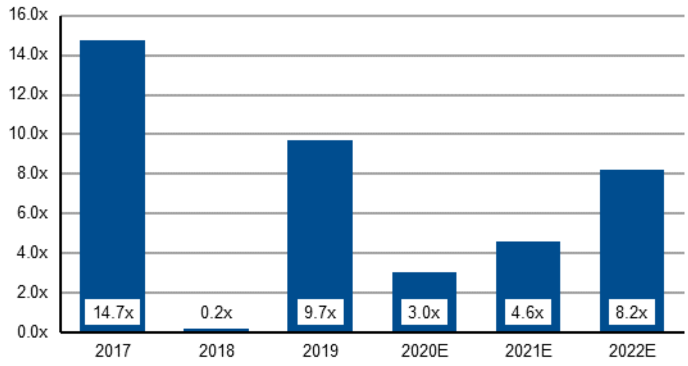
In general, we expect profitability to stay volatile for some time. This is due to SunDell's full dependence on successful project completions at this point and exposure to only one real estate sub-segment in a single location.

Financial risk profile: BB

Scope-adjusted EBITDA interest cover expected to stay substantially above 1.7x

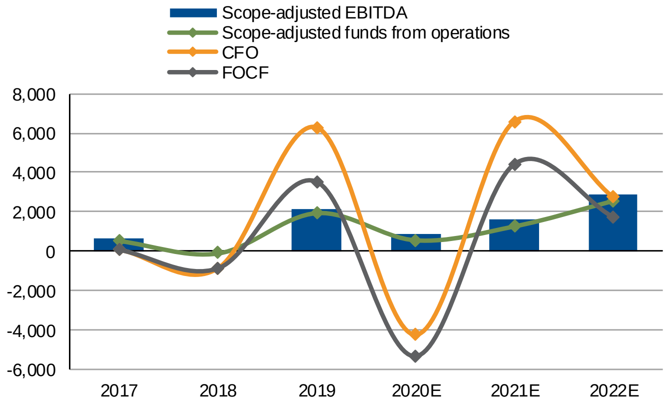
SunDell's Scope-adjusted EBITDA interest cover is expected at 3.0x to 8.2x for the business years 2020 to 2022. However, we flag the uncertainty around future cash inflows and execution risk for the future financing strategy, which will also determine interest costs, debt levels and the speed of project completions.

Figure 3: Scope-adjusted EBITDA interest cover (x)



Sources: SunDell Estate, Scope estimates

Figure 4: Cash flows (HUF m)

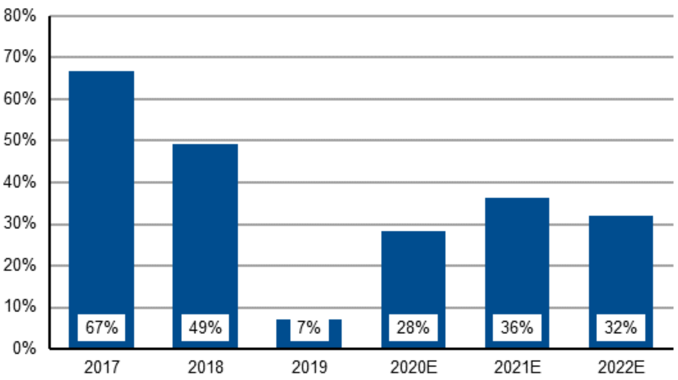


Sources: SunDell Estate, Scope estimates

LTV expected to remain below 40% going forward

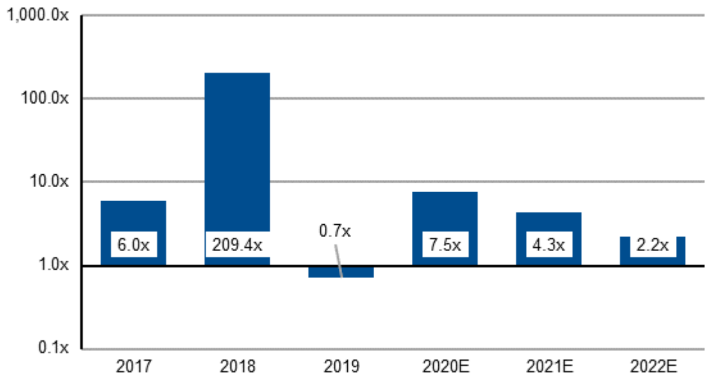
The company's cash flow generation has been very volatile, with negative free operating cash flow driven by the expansion of business, especially in 2020. We expect free operating cash flow to return to positive territory in the coming years, thanks to material planned project completions. Nevertheless, owing to further anticipated growth, as well as to the nature of real estate development, cash in- and outflows are not necessarily matched during the lifetime of future projects. Furthermore, SunDell suffers from its still limited size, which also amplifies the volatility inherent in its business model.

Figure 5: Scope-adjusted loan/value ratio (%)



Sources: SunDell Estate, Scope estimates

Figure 6: Scope-adjusted debt/EBITDA



Sources: SunDell Estate, Scope

At the end of the current business year 2020, we expect SunDell's LTV to be 28%. Going forward, we forecast that the LTV will increase to 20% to 40%. This is fairly conservative for a developer and leaves enough headroom for the company to either: i) lease properties at sufficient cap rates to cover financing costs in the event of a moderate downturn in the properties' fair values; or ii) tap external financing sources to cover construction costs if needed.

We consider liquidity to be adequate. In detail:

Position (HUFm)	2020E	2021E
Short-term debt (t-1)	3,781.0	0.0
Unrestricted cash (t-1)	4,663.2	3,694.3
Free operating cash flow (t)	-5,372.2	4,421.9
Open committed credit lines (t-1)	0.0	0.0
Liquidity (internal and external)	**0.2x**	**No short-term debt**

Long-term debt instrument ratings

B+ senior unsecured debt rating assigned

We expect SunDell to successfully issue the planned HUF 10bn senior unsecured bond in 2020 and to refinance all other outstanding bank debt in a volume of around HUF 2.6bn. The amortisation schedule of the 10-year, fixed interest instrument assumes repayment in three tranches of 30%, 30% and 40% at the end of the years 2025, 2027 and 2030, respectively. The proceeds are earmarked for the refinancing of financial debt (HUF 2.6bn) and investments in new development projects (HUF 7.4bn). Our base case financial forecast assumes that the company will not incur any additional senior secured or unsecured financing within the next two years, implying that the HUF 10bn senior unsecured corporate bond represents the entire financial debt of the company going forward.

We assumed a hypothetical default scenario for the year 2022 and applied reasonable discounts to the company's asset base. We expect an excellent recovery rate for senior unsecured creditors in this liquidation scenario, thus allowing for an uplift of up to two notches on the company's issuer rating. However, we decided for a one-notch uplift due to the remaining risks of potential changes in the financing structure, i.e. introduction of secured debt ranking senior to the unsecured financial debt and the high sensitivity of the expected recovery rate to the assumed advance rates on completed and uncompleted developments.

This translates into a B+ debt class rating for senior unsecured debt.

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