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. (founded in 2000). The company's main activity is renting and operating its own or leased real estate. It currently directly owns three properties in the city of Budapest.

Key metrics

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
Scope-adjusted EBITDA/interest cover (x)	1.7x	2.8x	1.6x	2.3x
Scope-adjusted debt (SaD)/Scope-adjusted EBITDA (x)	16.3x	10.9x	6.3x	13.6x
Scope-adjusted loan/value ratio (%)	65%	31%	18%	50%

Rating rationale

Scope Ratings has affirmed the B+/Stable issuer rating of SkyGreen Buildings Kft. as well as the BB senior unsecured debt rating.

The affirmation reflects our view on SkyGreen's robust financial risk profile, which has benefited from the mainly equity-financed portfolio expansion until 2019, including a low leverage (31% Scope-adjusted loan/value ratio as at FY 2019) and a Scope-adjusted debt protection of 2.8x. Given that further portfolio growth is set to be mostly financed with debt, including a EUR 90m bond that SkyGreen intends to issue in the coming months, we expect leverage, as measured by the Scope-adjusted loan/value (LTV) ratio, to increase to close to 50%. Nonetheless, SkyGreen has some buffer against potential market value declines induced by market shocks such as weakening tenant demand. The rating continues to be supported by SkyGreen's portfolio exposure to the second-tier investment market of Budapest, with stable tenant demand and high profitability. In the first half of 2020, SkyGreen disposed of its trophy asset, the Eiffel Square Office building, though this will be counterbalanced by the expected addition of a newly built office building located in the Váci Corridor, Budapest's prime office area.

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, currently comprising three properties in Budapest (two from the prior portfolio, and Váci Greens E, with completion expected by Q4 2020). An additional office building is expected to be added to the portfolio in Q1 2021 (ca. EUR 95m, minimum expected annual yield of 5.5%). The small portfolio also leads to a weak geographical and tenant diversification, with the top three tenants representing 50% of total rental income as at August 2020 (top 10: 84%). Scope expects tenant diversification to slightly improve once the newer portfolio assets are fully let in 2021.

We judge SkyGreen's liquidity to be adequate, as the short-term debt balance is not high. By the end of 2019, the company refinanced a EUR 40m facility with Raiffeisen Bank, due in 2021, with a new EUR 100m loan (tenor of seven years, coupon of 3-month Euribor + 2% margin). After the disposal of the Eiffel Square building, the company redeemed EUR 51m and a further EUR 4m after the disposal of Millenaris Avantgarde.

Ratings & Outlook

Corporate rating	B+/Stable
Senior unsecured rating	BB

Analyst

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Related Methodologies

Corporate Rating Methodology, February 2020

Rating Methodology European Real Estate Corporates January 2020

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After selling the Eiffel Square Office building, SkyGreen lent EUR 45.4m to its ultimate owner (at an interest rate of 5%), Green Ingatlanfejlesztő Investment Fund. The owners will repay the full outstanding balance whenever SkyGreen's operation requires it or by the end of 2020 according to the company. Funds management confirmed verbally that no further loans will be provided in the future.

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 public offering of securities (both equity and non-equity), the issuer must disclose the ultimate beneficiaries and legal documents.

Outlook and rating-change drivers

The Outlook for SkyGreen is Stable and incorporates: i) the disposal of Millenaris Avantgarde, and the partial bank loan redemption for EUR 4m; ii) the completion of the Váci Greens E acquisition by Q4 2020; iii) an equity contribution of EUR 5m before the end of 2020; iv) repayment of the intercompany loan (granted to Green Ingatlanfejlesztő Investment Fund) of EUR 45.4m in Q4 2020; and v) the successful placement of a HUF 32bn (ca. EUR 90m) secured bond in Q1 2021, with proceeds intended for additional real estate acquisitions (ca. EUR 95m, at a net initial yield of minimum 5.5%). Driven by the expected portfolio expansion, Scope-adjusted EBITDA interest cover is forecast at above 2x and LTV at around 50% in the next few years.

A positive rating action is remote but may be warranted if the company can significantly improve its business risk profile. This could be achieved by the company substantially growing in size, leading to a less concentrated portfolio and strengthening its market position, while sustaining an LTV of below 50%.

A negative rating action is possible if leverage notably increased, indicated by an LTV of over 60%. The LTV could increase if property values in the portfolio significantly drop due to a sudden shock in the Hungarian market or the company continues to finance new acquisitions with external financing and a lower equity share contribution.

Rating drivers

Positive rating drivers	Negative rating drivers
• Exposed to second-tier investment market with healthy demand from tenants • Strong occupancy (100% in old portfolio; 71% pre-let in new asset as of August 2020), but limited visibility with a short weighted average unexpired lease term of 3.8 years • High (EBITDA margin of between 70% to 90%), but vulnerable profitability given the concentrated portfolio • Adequate debt protection (EBITDA interest cover forecasted at above 2.2x) and moderate leverage (LTV of below 50%) driven by strong and predominately equity-financed portfolio growth	• Small property company with greater sensitivity to unforeseen shocks and more volatile cash flows • Small market shares in an increasingly competitive environment • Weak diversification across geographies and high tenant concentration • Cluster risk in 2023 due to chunky lease maturity profile that faces high competition in the medium term

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significant growth in size, while LTV maintained at around 50%	• LTV of more than 60%

Financial overview

			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**
Scope-adjusted EBITDA/interest cover (x)	1.7x	2.8x	1.6x	2.3x
Scope-adjusted debt/Scope-adjusted EBITDA (x)	16.3x	10.9x	6.3x	13.6x
Scope-adjusted loan/value ratio	65%	31%	18%	50%
Scope-adjusted EBITDA in EUR m	**2018**	**2019**	**2020E**	**2021E**
EBITDA	3.5	5.3	39.7	8.2
Operating lease payments in respective year	0.0	0.0	0.0	0.0
Other	0.0	0.0	-34.0	0.0
Scope-adjusted EBITDA	3.5	5.3	5.7	8.2
Scope-adjusted funds from operations in EUR m	**2018**	**2019**	**2020E**	**2021E**
Scope-adjusted EBITDA	3.5	5.3	0.0	8.2
less: cash interest as per cash flow statement	-2.1	-1.9	-2.8	-4.0
less: cash tax paid as per cash flow statement	0.0	0.0	-3.3	-4.0
Change in provisions	0.0	0.0	0.0	0.0
Scope-adjusted funds from operations	1.4	3.4	-6.1	0.2
Scope-adjusted debt in EUR m	**2018**	**2019**	**2020E**	**2021E**
Reported gross financial debt	57.9	62.7	42.6	131.2
add: finance leases	0.0	0.0	0.0	0.0
less: cash, cash equivalents	-1.1	-4.6	-13.9	-5.7
Scope-adjusted debt	56.8	58.1	28.8	125.4

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. Despite disposing of its main asset in 2020, the company has reaffirmed its strategy to buy and hold premium office buildings in prime locations in Budapest.

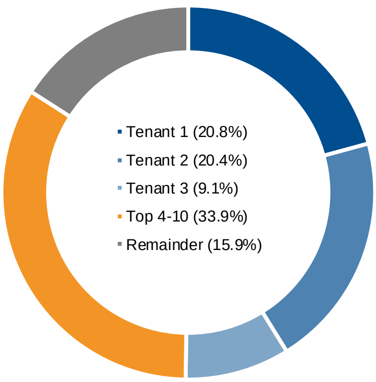
Small property company with greater sensitivity to unforeseen shocks and more volatile cash flows

SkyGreen is a company of limited size, with about EUR 0.2bn of total assets and EUR 3.4m of funds from operations as at December 2019. According to the management, only two significant additions are planned in the near future, including Váci Greens E (with expected completion in Q4 2020) and a further office building (c. EUR 95m) to be acquired in 2021. Together with the prospective building, gross lettable area in the portfolio would increase to around 75,000 sqm, from 49,000 sqm in December 2019. Even so, we expect SkyGreen to remain small. This is a negative rating driver because it implies greater sensitivity to unforeseen shocks, greater cash flow volatility, limited economies of scale and higher key person risk. However, the latter will be addressed by the outsourcing of services to, amongst others, CBRE, Cushman & Wakefield and CE Land Management.

Small market shares in an increasingly competitive environment

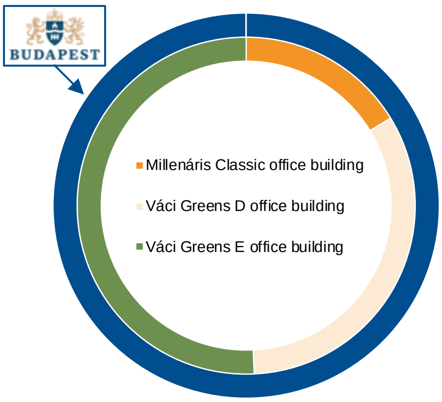
Despite a focus on Budapest, the company holds no significant share in the office market. This is valid not only for the whole city (around 1% market share) but also in the Váci Corridor (3% as of December 2019), the largest office submarket in Budapest with 31% of the city's class A stock. This intensifies competition from players of all sizes, the largest of which are real estate investment funds and special investors (mostly Hungarian). In March 2020, SkyGreen disposed of its trophy asset, the Eiffel Square Office building, but has still gained some more visibility in the Váci Corridor, where its main properties are located. Tenant demand in the Váci Corridor is now driven by high-profile banks and IT providers after previously being dominated by business process outsourcing providers and shared service centres.

Figure 1: Tenant diversification (share of rent)



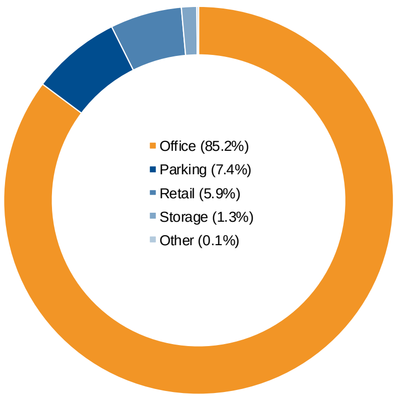
Sources: SkyGreen, Scope

Figure 2: Geographical distribution of property values



Sources: SkyGreen, Scope

Figure 3: Distribution of rental income by type of use



Sources: SkyGreen, Scope

Weak diversification across geographies and high tenant concentration

SkyGreen's limited size has also taken a toll on portfolio diversification by geography and tenant. Geographically, 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 current portfolio consists of three buildings located in Budapest, including Váci Greens E, whose acquisition is expected to be completed in Q4 2020, and considering the disposal of Millenaris Avantgarde, to be closed in October 2020. Further, the company aims to acquire a new property in the Váci Corridor for approx. EUR 95m, which should mainly comprise office areas and generate a minimum annual yield of 5.5%.

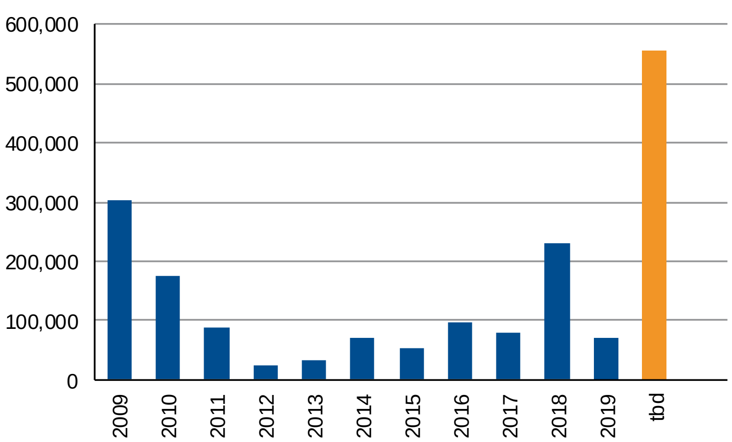
The limited number of properties in SkyGreen's portfolio combined with a focus on office space (85% of current rental income) leads to relatively high tenant concentration, with 50% of rental income as of August 2020 stemming from the top three tenants and 84% from the top 10. However, the likelihood of a single tenant's default impairing cash flow is somewhat mitigated by at least one-quarter of rental income being generated by 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 2023 due to chunky lease maturity profile

The high tenant concentration has led to a chunky lease maturity profile, with more than 85% of leases in the current portfolio (Váci D and Millenaris Classic) 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. The Budapest office market has been quite dynamic, with 70,545 sqm of new office space delivered in 2019, while the volume of new developments for 2020 is 230,100 sqm, with a further 325,250 sqm expected to be completed in 2021[1]. To address this competition, SkyGreen has renewed the portfolio and acquired newly developed properties that benefit from high visibility given their location in the Váci Corridor.

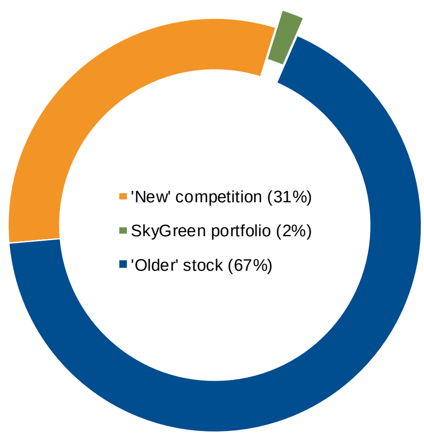
A more diversified portfolio would allow the company to spread future investments over a longer period, thus reducing the risk of weaker demand for most of the portfolio and the associated consequences as mentioned above.

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

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 1.7bn in 2019, the third-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

[1] BNP Paribas Real Estate. Budapest Office market 2020. https://www.realestate.bnpparibas.com/sites/default/files/2020-03/R-20-01%20FR%20%20Euro_Office_Budapest.pdf

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.

As of September 2020, properties are mostly focused around the Váci Corridor. The Millenaris properties (20%) are next to Millenaris Park (Buda North), and Váci Green D and E (80%) are within the Váci Corridor. All locations benefit from relatively strong demand, with the vacancy rate in Budapest reaching a historical low of 5.6% at the end of 2019, a consequence of the high demand for modern office space. Office take-up totalled 361,980 sqm, a slight decline compared to the 2018 level[2]. Market activity remains concentrated in the Váci Corridor, where 42% of the transactions have been concluded. Thus, we judge the portfolio's micro location to be good, with tenants continuing to seek new space within these areas.

Relatively high occupancy rate but exposed to re-letting risk in 2023 due to short WAULT in existing stock

On the one side, the company benefits from full occupancy in two of the existing properties in the portfolio, Millenaris Classic and Váci Greens D; however, their weighted average unexpired lease term (WAULT) is a short 2.9 years as at August 2020, pointing to the limited visibility of cash flows beyond that cliff. In any case, we believe the company can address this risk based on its decent track record on letting activity in the last few years.

On the other side, the newer building, Váci Greens E, has close to a 71% pre-letting rate, with lease terms averaging around five years (including signed and close-to-signed leases). The seller will provide with an 18-month guarantee on all rent and service charges for vacant areas (indemnification period starting six months after completion). We expect the newer building to reach higher occupancy levels (above 95%) in 2021, because pre-lets have become important in Budapest, where the appetite for brand new office areas is still high (35% of the annual take-up), and because the new office schemes delivered in 2019 had an 80% occupancy rate.

Newly built assets to refresh portfolio

New office buildings – currently under construction – will make the Budapest market more competitive. SkyGreen's current portfolio is mostly composed of newly built assets (incl. the Váci Greens E), and the company aims to add another new office building in 2021. This might benefit SkyGreen's portfolio as demand for modern office space is high and some of the stock under construction might be delivered late. The latter is due to construction capacity constraints in Hungary, where rising wages and construction costs are encouraging rental levels to grow and pushing down vacancy rates to historical lows (5.6% FY 2019).

High but vulnerable profitability given the concentrated portfolio

SkyGreen's profitability as measured by the Scope-adjusted EBITDA margin stood at above 75% in 2019 and is forecasted to remain above 80% from 2020 onwards. The forecasted development benefits from i) the addition of two newly built properties – one by the end of 2020 and the other in 2021, both with pre-let levels of above 70%; ii) the company's lean operational setup, with services provided by external parties and services adjusted to actual needs; and iii) the low property cost structure, which passes on most operating expenses to tenants (all leases are triple-net).

However, the portfolio's diversification is limited, with only few 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.

[2] BNP Paribas Real Estate. Budapest Office market 2020. https://www.realestate.bnpparibas.com/sites/default/files/2020-03/R-20-01%20FR%20%20Euro_Office_Budapest.pdf

The latter is exemplified by the rather short WAULT of 3.8 years (including prior portfolio and Váci Greens E) that would expose SkyGreen's profitability to medium-term volatility.

Financial risk profile: BB+

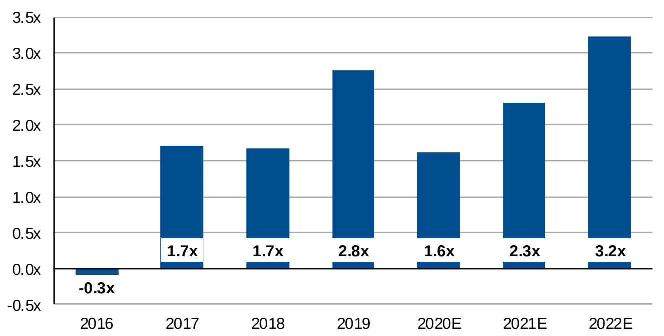
Debt protection expected to remain at adequate levels of above 2x

The company's debt protection, as measured by Scope-adjusted EBITDA interest cover, has stood comfortably above 1.7x in the past (2.8x in FY 2019). We anticipate debt protection to remain at adequate levels of above 2x from 2021 onwards because: i) newer properties will contribute with stable cash inflows; and ii) prior leverage is low (2020E: 18%) before 2019, property additions were predominately financed with capital increases (cash or in-kind contribution of assets). While debt protection also benefits from a low interest rate on the outstanding bond (three-month Euribor plus a 2% margin), the average interest rate and interest expenses will increase following the planned bond issuance in Q1 2021 (3% coupon).

We see only a minor risk from the floating-rate loan (based on three-month Euribor; provided by Raiffeisen Bank, EUR 47.4m as at August 2020), with the European Central Bank expected to trigger no significant increase in interest rates before YE 2021.

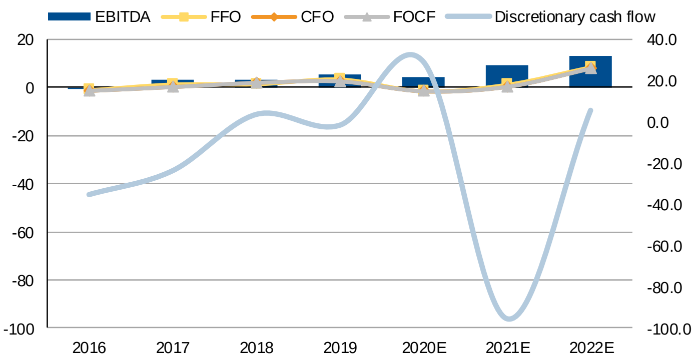
SkyGreen has so far issued all of its debt in euro. This creates a natural hedge against foreign-exchange risk because all rental contracts (and hence all rental payments) are also denominated in euro. Foreign-exchange risk could arise, however, with the prospective bond denominated in Hungarian forint,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

Figure 6: Scope-adjusted EBITDA interest cover (x)



Sources: SkyGreen, Scope estimates

Figure 7: Cash flows (EUR m)



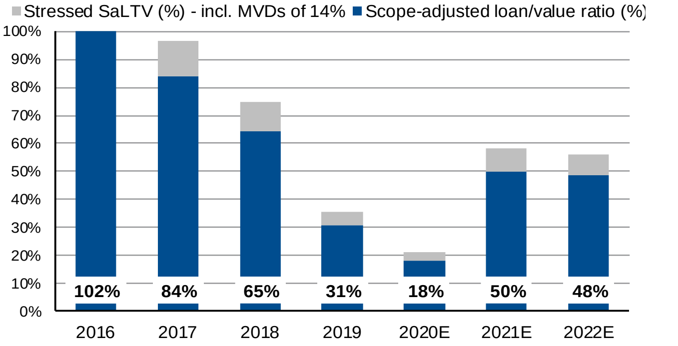
Sources: SkyGreen, Scope estimates

Negative free operating cash flow driven by portfolio reshuffle in 2020 and 2021

The company's cash flow has benefited from portfolio growth in recent years, including the acquisition of Millenaris Classic & Avantgarde, and Váci Greens D in H2 2019. Other new properties, including Váci Greens E and a new potential asset[3], will strengthen the portfolio upon completion and once they are fully let (pre-let 71% as of September 2020). However, cash flows in 2020 have weakened due to portfolio expansion and the disposal of the Eiffel Square building, which contributed around half of total rental income until 2019. Free operating cash flow (FOCF) will continue to be driven by portfolio growth and is expected to remain negative until at least 2021. Negative FOCF forecasted in 2020 has been partially financed via capital recycling, while the planned bond issuance in 2021 will finance newer portfolio properties.

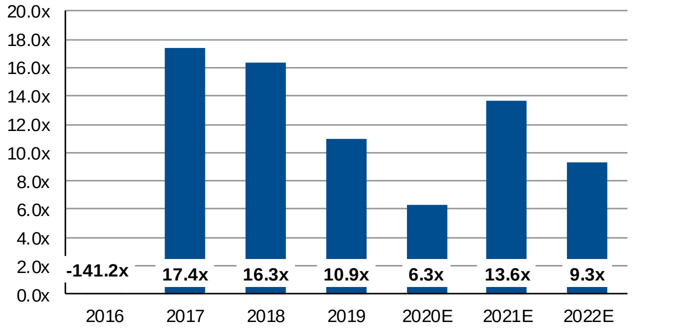
[3] Due Diligence ongoing. Binding offer expected in Q4 2020.

Figure 8: Scope-adjusted loan/value ratio (%)



Sources: SkyGreen, Scope estimates

Figure 9: Scope-adjusted debt/EBITDA (x)



Sources: SkyGreen, Scope estimates

Moderate leverage, expected to increase due to debt-financed portfolio growth

SkyGreen has reduced its leverage, as measured by LTV, to 31% as at YE 2019 from more than 100% at the company's inception in 2016. We forecast a further sharp decline in leverage in 2020 to around 20%, driven by debt redemptions following the disposal of Eiffel Square in H1 2020 and a further EUR 4m upon the closing of the Millenaris Avantgarde sale. However, our medium-term view on SkyGreen's leverage is muted, with LTV expected at around 50% in 2021, because further portfolio growth is set to be fully financed with debt. Nonetheless, SkyGreen has some buffer against potential market value declines induced by market shocks including weaker tenant demand.

Figure 10: Liquidity

in EUR m	2020E	2021E
Short-term debt (t-1)	-0.4	-0.4
Unrestricted cash (t-1)	1.1	4.6
Open committed credit lines (t-1)	0.0	0.0
Free operating cash flow (t)[4]	2.5	-1.4
Coverage	**9.1x**	**7.8x**

Source: Scope estimates

Adequate liquidity

We judge SkyGreen's liquidity to be adequate, as its short-term debt balance is not high. By the end of 2019, the company refinanced a EUR 40m facility with Raiffeisen Bank, due in 2021, with a new EUR 100m loan (tenor of seven years, coupon of 2%). After the disposal of the Eiffel Square building, the company redeemed EUR 51m and a further EUR 4m after the disposal of Millenaris Avantgarde.

Supplementary rating drivers

Corporate governance

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[4] We exclude discretionary expansion capex from our liquidity calculation because such investments are only made if external financing is available.

Long and short-term debt instrument ratings

Senior unsecured debt: BB

The company's financial debt includes a bank loan (EUR 47.4m as of August 2020) secured by the existing portfolio (Millenaris Classic and Váci Greens D). SkyGreen intends to issue a HUF 32bn (ca. EUR 90m) senior secured corporate bond under the Hungarian National Bank's Bond Funding for Growth Scheme. The planned bond has a 3% coupon with a tenor of 10 years. Proceeds from the bond are earmarked for the acquisition of new revenue-generating properties. The company intends to provide a first-ranking pledge on the newly acquired assets (Váci Greens E and the asset to be acquired in 2021).

Our recovery analysis assumes a potential default in 2022 and is based on SkyGreen's liquidation value. According to Scope's methodology and reasonable discounts on the company's asset base, an 'above average' recovery is expected for senior unsecured debt, allowing for a two-notch uplift on the company's issuer rating of B+. We therefore affirmed the senior unsecured rating category at BB. The recovery expectations for senior unsecured debt are subject to the final size and conditions of the planned higher-ranked secured bond, the collateral provided to secured bond holders, and the company's ability to execute its acquisition strategy.

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