WOOD FLASH NOTE

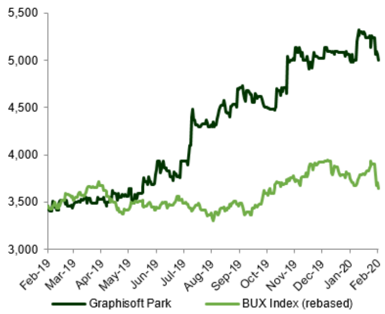
WOOD & COMPANY

27 February 2020

Graphisoft Park HOLD

Graphisoft Park: 4Q19 in line; focus on buyback; valuation attractive

BBG Ticker	GSPARK HB
Market Cap (USD mil)	163
Price	5,000
Price target	5,285
Upside	5.7%



Jakub Caithaml
E-mail: jakub.caithaml@wood.cz
Phone: +420 222 096 481

Graphisoft Park reported its 4Q19 results yesterday evening (27 February). The numbers were in line with expectations. On our 2019 figures, Graphisoft Park is trading at around 0.8x P/NAV and a 7.8% FFO yield.

In the near term, the focus lies on the share repurchase programme the company plans to launch later this year. It could reduce the number of shares by around 20%.

Operationally, Graphisoft Park benefits from the strong leasing demand in the Budapest office market. As the vacancy across Budapest continues to decline and rents are rising, we believe the buildings in the Park are no longer rented at a premium to the market. This is clearly positive and, if this trend continues, we may see some organic rental growth on top of indexation in the coming years.

Fundamentally, the key upside driver would be the development of additional buildings. In the southern part of the Park, there is room to develop around 20k sqm of additional GLA – but there is no immediate plan to launch construction. The northern part of the Park is still blocked for development, as it needs to be decontaminated first. The polluter – the Capital City Gas Works – does not appear to be co-operative and it is unclear whether the rehabilitation works will commence in the foreseeable future.

As such, the prospective acquisition of Graphisoft Park by a larger player remains the key near- to medium-term trigger. That said, we note that, against the backdrop of the continued rerating of office stocks, Graphisoft Park clearly stands out on valuation. Following the buyback, the FFO yield could reach 10%; alternatively, a sizeable special dividend may be paid out. As such, for those who could invest in a name with such low liquidity, Graphisoft Park could present an attractive alternative to the expensive European office real estate names, a large number of which are some 2-3x more expensive on a P/FFO basis.

The results

The recurring results for 4Q19 are both in line with our estimates and with the performance of the previous quarter. The key change is the improvement in the capital structure. At the end of last year, Graphisoft Park took out a EUR 40m loan, aimed at financing a share buyback. Management plans to redistribute EUR 33m to its shareholders in the form of a structured share repurchase transaction, the details of which were announced earlier this year and can be accessed here.

The company generated EUR 12m of FFO I during the year. At the current share price, this translates into a FFO yield of c.7.8%. The NAV stands at EUR 19.4/share (0.79x P/NAV). The NAV was broadly stable over the year. The positive revaluations connected with the standing portfolio have been offset by a small write-off related to the land reserves in the northern part of the Park. The write-off was connected to further delays in the remediation works on the plot of the former gas factory. Whether and when these works will commence are unclear currently.

Graphisoft Park: 4Q19 review

EUR m	4Q18	1Q19	2Q19	3Q19	4Q19	qoq	yoy	WOOD	vs. W
Rental income	3.7	3.5	3.5	3.6	3.6	1%	-2%	3.6	1%
Service charge income	1.4	1.4	1.3	1.2	1.5	25%	4%	1.2	25%
Service charge expense	-1.2	-1.3	-1.2	-1.1	-1.3	21%	4%	-1.1	21%
Direct property related expenses	0.0	0.0	0.0	0.0	0.0	-50%	-13%	0.0	-50%
Net rental income	**3.9**	**3.6**	**3.6**	**3.7**	**3.8**	3%	-2%	**3.7**	3%
Operating expenses	-0.5	-0.3	-0.4	-0.3	-0.4	41%	-27%	-0.3	41%
Other income (expense)	-0.4	0.0	0.0	0.0	0.0	n/a	-1.0x	0.0	n/a
EBITDA	**3.0**	**3.4**	**3.2**	**3.4**	**3.4**	1%	16%	**3.4**	1%
D&A and revaluation gains	1.1	0.0	0.0	0.0	-0.1	15%	-1.1x	0.0	15%
Operating profit	**4.1**	**3.3**	**3.1**	**3.4**	**3.4**	0%	-17%	**3.4**	0%
Interest income	0.0	0.0	0.0	0.0	0.0	n/a	n/a	0.0	n/a
Interest expense	-0.3	-0.3	-0.3	-0.3	-0.3	-4%	-4%	-0.3	-4%
FX differences - realized	0.0	0.0	-0.1	0.0	0.0	-42%	n/a	0.0	-42%
FX differences - not realized	-0.2	0.0	0.0	0.0	0.1	-3.1x	-1.3x	0.0	-3.1x
PBT	**3.6**	**3.0**	**2.8**	**3.0**	**3.1**	5%	-12%	**3.0**	5%
Current income tax	0.0	0.0	0.0	0.0	0.0	2.3x	63%	0.0	n/a
Deferred income tax	0.0	0.0	0.0	0.0	0.0	n/a	n/a	0.0	n/a
Profit for the period	**3.6**	**3.0**	**2.8**	**3.0**	**3.1**	4%	-12%	**3.0**	4%
FFO reconciliation	**4Q18**	**1Q19**	**2Q19**	**3Q19**	**4Q19**	**qoq**	**yoy**	**WOOD**	**vs. W**
Net rental income	3.9	3.6	3.6	3.7	3.8	3%	-2%	3.7	3%
Operating expenses	-0.5	-0.3	-0.4	-0.3	-0.4	41%	-27%	-0.3	41%
Other income / expense	-0.4	0.0	0.0	0.0	0.0	n/a	-1.0x	0.0	n/a
Net interest expense	-0.3	-0.3	-0.3	-0.3	-0.3	-4%	-4%	-0.3	-4%
Realized FX differences	0.0	0.0	-0.1	0.0	0.0	-42%	n/a	0.0	n/a
FFO I - pre-tax	**2.7**	**3.1**	**2.8**	**3.1**	**3.1**	1%	17%	**3.1**	1%
Current income tax	0.0	0.0	0.0	0.0	0.0	2.3x	63%	0.0	n/a
FFO I	**2.6**	**3.0**	**2.8**	**3.1**	**3.1**	1%	17%	**3.1**	0%
# of shares (ex.treasury and employee)	10.1	10.1	10.1	10.1	10.1	0%	0%	10.1	0%
FFO I / sh	**0.26**	**0.30**	**0.28**	**0.30**	**0.31**	1%	17%	**0.31**	0%
Annualized FFO yield*	6.9%	7.9%	7.3%	7.9%	8.0%				
NAV	190.8	191.1	189.5	190.9	195.3	2%	2%		
NAV/sh	18.9	19.0	18.8	18.9	19.4	2%	2%		
P/NAV*	0.81x	0.81x	0.82x	0.81x	0.79x				

*Source: Company data, WOOD Research; *on the current share price*

The guidance

Graphisoft Park also published its forecasts for 2020E and 2021E. The company expects steady growth in rental income, driven by indexation, underpinned by the strong leasing demand across the Budapest office market. This should be partly offset by a small increase in the overhead costs, related in part to the transaction costs connected with the buyback, and due in part to general wage pressure. The key change is then the higher interest expenses, related to the new loan. Management's guidance implies that the FFO should reach EUR 11.7m and EUR 11.9m in 2020E and 2021E, respectively. This is broadly in line with the level reached in 2019. However, on a per-share basis, the result should be substantially better. If all the shareholders decide to tender their shares at the current share price, the number of shares would drop by around 20%. In such a scenario, the guidance would imply a 2020E FFO of around EUR 1.5/share, up 20% yoy. At the current share price, this would translate into a c.10% FFO yield.

Developments

Fundamentally, the key driver would be developments. The company still has room to develop approximately a further 20k sqm of GLA in the southern area of the Park. According to our understanding, the plot is being inspected currently by archaeologists. That said, based on our conversations with the company, we believe there is no immediate plan to launch construction. As such, this is unlikely to affect the results in the next two-to-three years.

The northern area of the Park remains blocked for development, as it is awaiting decontamination. When and whether decontamination will be launched remain unclear.

The portfolio

In line with previous quarters, rents remain at around EUR 15/sqm, and the park remains nearly fully occupied (97%).

Graphisoft Park: GLA of the park at 82k sqm, monthly rents at EUR 15/sqm

	4Q15	4Q16	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
Occupancy	98%	100%	99%	99%	97%	95%	95%	96%	97%	97%	97%
Area/GLA* (sqm)	59,000	59,000	67,000	68,000	72,000	82,000	82,000	82,000	82,000	82,000	82,000
Rental income (EUR m)	2.34	2.38	2.87	2.86	2.82	3.44	3.70	3.51	3.54	3.58	3.61
Monthly rents (EUR/sqm)	13.5	13.5	14.4	14.2	13.5	14.7	15.8	14.9	14.8	15.0	15.1

*Source: Company data, WOOD Research; *we have retrospectively adjusted the area between 4Q15 and 4Q17 in order to roughly reflect the different reporting. Each year, we increased the area by 6k sqm, which is the difference between the 1Q18 GLA and the 1Q18 "Area" Graphisoft Park reported previously*

Budapest office market

Similar to other urban hubs in CEE, the office market in Budapest is faring well and seems to be offering solid long-term potential for investment and development – especially considering the strong leasing demand, the low construction activity in the past decade, and the c.100bps yield gap vs. Prague and Warsaw.

In the aftermath of the crisis, the market was hit with a wave of completions. These new office projects, which were launched when the economy was in an upswing and tenants were fighting for the little space that was available, came to the market when the economy was contracting and companies were scaling back. Excluding the owner-occupied buildings, the vacancy in the speculative office space in Budapest was in excess of 25% at one point. Combined with the precarious political climate and the weak economy at the time (the GDP was contracting in 2012 and recorded anaemic growth of 0.5% in 2013), development activity came to a halt.

To offer a perspective: Budapest has a similar population to Warsaw (within the city limits, both have a touch less than 2m people; while, for both, the entire urban area is home to over 3m people). Between 2012-17 (inclusive), a mere 280k sqm of new office space was completed in Budapest. In Warsaw, 300k sqm of new office space was completed every year during these six years.

Since 2014-15, economic growth has picked up in Hungary, as has the demand for office space in Budapest. Attracted by the fast recovery and the low corporate tax rate, new companies started to enter the market, and existing ones began to expand. While development activity has picked up lately (around 0.3m sqm of new office space has been completed in the past two years in Budapest), supply is still not keeping up with demand.

Currently, the vacancy for the 3.6m sqm office market is around 6%, mostly located on the fringes – in the key sub-markets only around 3-5% of the space is available for rent. Companies looking to lease larger area in a single building need to pre-lease – when looking for more than a couple of hundred sqm, it is almost impossible to find available space in the existing buildings.

As a result, the rents are going up. The prime rent is quoted at around EUR 25/sqm, up from c.EUR 20/sqm during 2009-15. The average asking rent on the market is at around EUR 13/sqm per month currently, up from c.EUR 10-11/sqm some five years ago. The new buildings in the Vaci corridor, a large office district in the northern part of the city, are being leased at around EUR 15-18/sqm, based on our conversations with realtors.

Yields

The prime office yield is fast approaching 5.0%, vs. 6.0% just two years ago. We see room for a further compression.

The investment market is dominated by local funds. Long-term orientated, these investors mostly buy and hold, which results in relatively limited liquidity, compared to Prague and Warsaw.

Historically, the office yield has been around 100bps higher than that in Prague. We believe that this is due mostly to the "safe haven" perception of the latter. In the past couple of years, a yield gap has also opened up relative to Warsaw. Here, we believe the key factors behind the difference include: 1) the higher liquidity in Warsaw (better transaction evidence, easier to exit); 2) the longer lease terms in Warsaw (7-10 year leases are becoming more common in the new buildings in Warsaw, while still relatively rare in Budapest); and 3) the more modern product (in Budapest, out of the existing office space, around 400-500k sqm was completed in the past eight years. Around 750k sqm was completed some 8-12 years ago. The remaining c.2.3-2.4m sqm is older than 12 years. In contrast, in Warsaw, around 2.5m sqm of new offices – nearly half of the total stock – was developed during the past 10 years).

The prime office yield – for many years, quoted at 6.0% in Budapest – is compressing fast. Currently, realtors quote 5.25%, but recent transactions in the Vaci corridor point closer to the 5.0-5.2% level. That said, if some of the beautiful historic office buildings in the prime CBD changed hands (such as the Eiffel Palace), we believe the yield would have been far south of 5.0%.

Clearly, only a handful of buildings can command these prime yields. We estimate that a 10-year old office, with a good location, in good condition, fully leased to blue-chip tenants, with a three-to-four year outstanding WAULT would most likely sell at around a 6.0-7.0%, down from c.7.0-8.0% some four-to-six years ago.

Year	BV (EUR m)	BVPS (EUR)	Net LTV	Equity ratio	FFO (EUR m)	FFOPS (EUR)	FFO ROE	P/BV	FFO yield	DPS (EUR)	Div. Yield
2016	24	2.3	65%	30%	7.2	0.71	31.1%	3.4x	9.0%	0.25	3.2%
2017	26	2.6	69%	25%	8.5	0.84	34.3%	4.3x	7.5%	0.30	2.6%
2018	168	16.6	28%	67%	9.9	0.98	10.2%	0.7x	9.0%	0.64	5.9%
2019E	175	17.4	38%	59%	12.0	1.19	7.0%	0.88x	7.8%	2.77	18.1%
2020E	181	18.0	37%	59%	11.1	1.10	6.2%	0.85x	7.2%	0.72	4.7%
2021E	187	18.6	35%	60%	11.1	1.10	6.0%	0.8x	7.2%	0.71	4.6%

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WOOD & COMPANY

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Czech Republic
namesti Republiky 1079/1a
Palladium
110 00 Praha 1
Tel +420 222 096 111
Fax +420 222 096 222

Poland
Skylight Zlote Tarasy
Zlota 59
00 120 Warszawa
Tel +48 22 222 1530
Fax +48 22 222 1531

UK
City Point, 11th Floor
1 Ropemaker Street
London EC2Y 9HT
Tel: +44 20 3530 0691

Italy
Via Luigi Settembrini, 35
20124 Milan
Italy
Tel +39 02 36692 500
Fax +39 02 67910 761

Kristen Andrasko
Head of Equities
+420 222 096 253
kristen.andrasko@wood.com
http://www.wood.com
Bloomberg page WUCO

Research

Co-Head of Research/Head of Research Poland
Marta Jezewska-Wasilewska
+48 22 222 1548
marta.jezewska-wasilewska@wood.com

Co-Head of Research/Head of Greek Research
Alex Boulougouris
+30 211 106 9447
alex.boulougouris@wood.com

Consumer/Industrials
Lukasz Wachelko
+48 22 222 1560
lukasz.wachelko@wood.com

Macroeconomics
Raffaella Tenconi
+44 203 530 0685
raffaella.tenconi@wood.com

Utilities/Mining/Pharma
Bram Buring
+420 222 096 250
bram.buring@wood.com

Russia/CIS Region
Ildar Davletshin
+44 203 530 0631
ildar.davletshin@wood.com

EMEA TMT & Industrials/Turkey
Atinc Ozkan
+90 542 202 3632
atinc.ozkan@wood.com

Macroeconomics
Alessio Chiesa
+44 75177 06102
alessio.chiesa@wood.com

Energy
Jonathan Lamb
+44 203 530 0621
jonathan.lamb@wood.com

Financials/Turkey
Can Demir
+44 203 530 0623
can.demir@wood.com

Poland/TMT
Piotr Raciborski
+48 22 222 1551
piotr.raciborski@wood.com

Metals/Mining
Andy Jones
+44 20 3530 0629
andy.jones@wood.com

Consumer/Real Estate
Jakub Caithaml
+420 222 096 481
jakub.caithaml@wood.com

Energy/Utilities
Ondrej Slama
+420 222 096 484
ondrej.slama@wood.com

Poland
Pawel Wieprzowski
+48 22 222 1549
pawel.wieprzowski@wood.com

Consumer/Industrials
Gabriela Burdach
+48 22 222 1545
gabriela.burdach@wood.com

Consumer
Jakub Mician
+420 222 096 320
jakub.mician@wood.com

Romania
Stefan Lungu
+44 203 530 0694
stefan.lungu@wood.com

Greece
Fani Tzioukalia
+30 211 106 9449
fani.tzioukalia@wood.com

Financials
David Lojkasek
+420 222 096 256
david.lojkasek@wood.com

Sales

Kristen Andrasko
+420 222 096 253
kristen.andrasko@wood.com

Jan Koch
+48 22 222 1616
jan.koch@wood.com

Piotr Kopec
+48 22 222 1615
piotr.kopec@wood.com

Ioana Pop
+44 20 3530 0693
ioana.pop@wood.com

Grzegorz Skowronski
+48 22 222 1559
grzegorz.skowronski@wood.com

Jarek Tomczynski
+44 203 530 0688
jarek.tomczynski@wood.com

Kostas Tsigkourakos
+30 694 082 5810
kostas.tsigkourakos@wood.com

Tatiana Sarandinaki
Brasil Plural in association with WOOD & Co.
+1 212 388 5613
tsarandinaki@wood-brasilplural.com

Sales Trading and Execution Services

Zuzana Mora
+420 222 096 283
zuzana.hronska@wood.com

Ermir Shkurti
+420 222 096 847
ermir.shkurti@wood.com

Vladimir Vavra
+420 222 096 397
vladimir.vavra@wood.com