WOOD FLASH NOTE

11 August 2021

Graphisoft Park

BUY

Graphisoft Park: 2Q21 – stable results, guidance reiterated, valuation remains attractive

BBG Ticker	GSPARK HB
Market Cap (USD mil)	124
Price	3,700
Price target	5,237
Upside	41.5%

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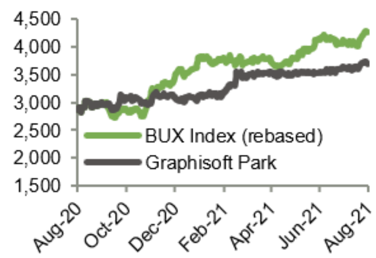

Graphisoft Park has delivered yet another set of steady results, and management has reiterated its financial guidance for the year. Trading at 0.73x P/NAV and a c.11% FFO yield, the stock remains significantly cheaper than the vast majority of its listed European office real estate peers. We maintain our view that the stock is attractively valued at the current levels, and could become an acquisition target, thanks to its compact size and quality portfolio. With a LTV of c.37%, the leverage is not particularly high, and following the c.10% cut in values since the beginning of the pandemic, the portfolio is not booked at aggressive levels, in our view. We reiterate our BUY rating.

The results

The 2Q21 numbers were in line with our expectations and brought no major surprises. Both the rental income and the major cost items were flat relative to recent quarters, and Graphisoft Park generated some EUR 3m of FFO I for the quarter, in line with our expectations. For the first half of the year, the FFO reached some EUR 6m, which translates into approximately an 11% FFO yield on the current share price, when annualised.

Graphisoft Park paid out a dividend of approximately EUR 10m in June 2021. As a result, its cash balance dropped to c.EUR 9m,and its net debt increased to EUR 89m (from EUR 82m at the end of 1Q21). The net LTV stands at 37% currently, up from 34% at the end of the previous quarter.

The company reported a stable value for the portfolio and recorded no tangible valuation movements in 2Q21.

The forecasts, published at the end of 2020 and reiterated in 1Q21, have been maintained. It expects broadly flat rental income and marginally higher opex, driven by the costs related to the ongoing reorganisation of the financial management and related IT infrastructure, necessitated by the growth of the Park in recent years.

Graphisoft Park: 2Q21 review

EUR m	2Q20	3Q20	4Q20	1Q21	2Q21	qoq	yoy	WOOD	vs. W
Rental income	3.6	3.5	3.6	3.6	3.6	0%	0%	3.6	1%
Service charge income	1.1	1.2	1.4	1.2	1.2	2%	11%	1.3	-5%
Service charge expense	-1.0	-1.1	-1.2	-1.1	-1.1	2%	13%	-1.2	-9%
Direct property related expenses	0.0	0.0	0.0	0.0	0.0	0%	9%	0.0	50%
Net rental income	**3.7**	**3.6**	**3.7**	**3.7**	**3.7**	0%	0%	**3.6**	3%
Operating expenses	-0.5	-0.3	-0.2	-0.3	-0.5	79%	-4%	-0.3	52%
Other income (expense)	0.0	-0.4	0.0	0.1	0.0	-1.0x	-1.1x	0.0	n/a
EBITDA	**3.3**	**3.0**	**3.5**	**3.6**	**3.3**	-8%	0%	**3.3**	-2%
D&A and revaluation gains	-0.4	-17.3	-4.5	-0.3	0.1	-1.1x	-1.1x	0.0	n/a
Operating profit	**2.9**	**-14.3**	**-1.1**	**3.2**	**6.6**	1.0x	1.3x	**3.3**	96%
Interest income	0.0	0.0	0.0	0.0	0.0	86%	n/a	0.0	n/a
Interest expense	-0.5	-0.5	-0.5	-0.5	-0.4	-2%	-7%	-0.5	-11%
FX differences - realized	-0.7	-0.3	-0.2	0.0	0.0	-11.0x	-1.0x	0.0	n/a
FX differences - not realized	-0.1	0.3	0.2	0.0	0.0	-6.3x	-1.6x	-0.2	-1.2x
PBT	**1.6**	**-14.8**	**-1.6**	**2.8**	**3.0**	7%	82%	**2.7**	11%
Current income tax	0.0	0.0	0.0	0.0	0.0	0%	60%	0.0	0%
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	**1.6**	**-14.8**	**-1.6**	**2.8**	**2.9**	7%	82%	**2.6**	11%
FFO reconciliation	**2Q20**	**3Q20**	**4Q20**	**1Q21**	**2Q21**	**qoq**	**yoy**	**WOOD**	**vs. W**
Net rental income	3.7	3.6	3.7	3.7	3.7	0%	0%	3.6	3%
Operating expenses	-0.5	-0.3	-0.2	-0.3	-0.5	79%	-4%	-0.3	52%
Other income / expense	0.0	-0.4	0.0	0.1	0.0	-1.0x	-1.1x	0.0	n/a
Net interest expense	-0.5	-0.5	-0.5	-0.4	-0.4	-3%	-9%	-0.5	-13%
Realized FX differences	-0.7	-0.3	-0.2	0.0	0.0	-11.0x	-1.0x	0.0	n/a
FFO I - pre-tax	**2.1**	**2.2**	**2.8**	**3.1**	**2.9**	-8%	35%	**2.8**	0%
Current income tax	0.0	0.0	0.0	0.0	0.0	0%	60%	0.0	0%
FFO I	**2.1**	**2.2**	**2.8**	**3.1**	**2.8**	-8%	35%	**2.8**	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	**0.21**	**0.22**	**0.28**	**0.31**	**0.28**	-8%	35%	**0.28**	0%
Annualized FFO yield*	7.9%	8.3%	10.6%	11.7%	10.7%				
NAV	165.6	150.6	148.7	152.3	144.9	1%	-24%		
NAV/sh	16.4	14.9	14.7	15.1	14.4	1%	-24%		
P/NAV*	0.64x	0.71x	0.72x	0.70x	0.73x				

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

Portfolio

The occupancy rate in the 82k sqm GLA portfolio stood at 94% at the end of 2Q21, in line with the level reported at the end of 1Q21. This is slightly lower than both the 97% seen at the beginning of the pandemic (end-2019), and the longer-term average of the portfolio (between 2015-19, the occupancy ranged between 95-100%). The buildings are rented at an average monthly rent of approximately EUR 15.8/sqm, based on the 2Q21 rental income.

Since the beginning of the pandemic, Graphisoft Park has, cumulatively, written off approximately 10% of the value of its standing properties, booking a EUR 24m loss in FY20 and an additional EUR 0.2m in 1H21. This is much higher than the revaluation result booked by the majority of the CEE landlords we follow, most of which wrote off around 4% of the value of their portfolios in 2020. Based on the rental income in place currently, the portfolio is booked at around a 6.7% gross rental yield. If adjusted for the occupancy (assuming the portfolio is 100% leased at the same average monthly rent level), the yield would stand slightly in excess of 7%.

During 2017-19, the portfolio was booked at around a 6.1% yield on the in-place rental income, on average (c.6.1% at the end of 2017, 6.3% at the end of 2018 and 5.8% at the end of 2019). Colliers estimates that the prime headline yield compressed from around 6% at the end of 2017, to around 5% by the end of 2019. This means that, in 2017, Graphisoft Park's portfolio was booked broadly at the prime yield level for Budapest. By the end of 2018, the gap increased to some 0.8ppts and it remained the same in 2019.

As there is no evidence of a significant weakening of investment demand and pricing for the prime segment of the market, the office yield is reported currently at around 5.25% in Budapest. With Graphisoft Park's properties booked at a c.6.7% yield, the gap over the prime yield is around 1.5ppts currently, the highest in recent history. While we appreciate that a number of new, modern office buildings have been developed recently, and that there is a risk that the effective rents at the Park may face downward pressure in the near term, we believe that the high gap illustrates the conservative approach to valuations that management decided to take, early on in the pandemic. That the properties are not booked aggressively, in our view, is an important part of our constructive view on the stock.

Graphisoft Park: monthly rents at EUR 15-16/sqm, booked at 6.7%

	4Q15	4Q16	4Q17	4Q18	4Q19	4Q20	1Q21	2Q21
GLA ('000 sqm)	59,000	59,000	67,000	82,000	82,000	82,000	82,000	82,000
BV, standing portfolio (EUR m)			187	235	249	218	218	218
Rental income, annualized (EUR m)	9.36	9.53	11.48	14.81	14.45	14.32	14.56	14.58
Average monthly rent	13.5	13.5	14.4	15.8	15.1	15.5	15.7	15.8
Average occupancy	98%	100%	99%	95%	97%	94%	94%	94%
Gross rental yield			6.1%	6.3%	5.8%	6.6%	6.7%	6.7%
Gross rental yield (adj for full occupancy)			6.2%	6.6%	6.0%	7.0%	7.1%	7.1%

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

The Budapest office market is comprised of 3.96m sqm currently. The vacancy has continued to trend up, and ended 2Q21 at 9.8%, up 0.8% qoq and over 4ppts higher than the 5.6% recorded at the end of 2019, according to the data compiled by the Budapest Research Forum. The total office space in Budapest increased by 7% – some 270k sqm of new office space was added between the end of 2019 and mid-2021.

Some 44k sqm of new office space was completed in the first half of the year, and we believe we may see the completions of an additional 50-60k sqm by the year-end. For 2022E, there is a little over 200k sqm in the pipeline, but we cannot rule out that some of these developments may be delayed and their completion may be pushed into 2023E. If all the projects proceed on schedule, the modern office space in Budapest would amount to approximately 4.3m sqm by the end of 2022E.

Especially throughout 2018 and 2019, it was very difficult to find larger, contiguous units in modern, centrally-located offices in Budapest, as the vacancy was low, and firms looking for large spaces often needed to resort to pre-leases in a development project. This situation has eased, and we believe we are likely to remain in an occupiers' market in the near term. While the headline rent is largely stable, the incentives have been increasing since the start of the pandemic – until the vacancy stabilises, we expect this trend to continue. We also expect to see continued bifurcation, with the central, core offices being relatively resilient, while the older, B-class stock in less attractive locations, could struggle to attract tenants.

The major realtors are yet to publish their reports on the 2Q21 trends. As of the end of 1Q21, JLL estimated the prime yield for offices in Budapest at around 5.25%.

The significant progress in the vaccination rate should help to bring people back to the offices, and offer better visibility on office space requirements going forward, we believe. Currently, around 59% of Hungarians have received at least one dose of the vaccine, and around 57% of the population is fully vaccinated, according to the data collected by Our World In Data. This is broadly in line with the average levels of the EU, where around 61% of the population has received at least one dose, and 52% has been fully vaccinated, up to now. In spring this year, Hungary was leading the EU on vaccination levels, thanks to its reliance on Russian and Chinese jabs. That said, towards the end of May, once the majority of those willing to be vaccinated had received their jabs, the progress decelerated rapidly. At the current pace of vaccinations, it would take Hungary until spring next year to vaccinate some 70% of its population fully.

That said, we note that, in the past two months, the number of new COVID-19 cases in Hungary has remained below 100 per day. In spring this year, the number of cases peaked at nearly 10k new cases per day in a country with a population of 10m.

Valuation and outlook

On a total return basis, in local currency terms, Graphisoft Park has generated some 25% since we upgraded the stock to BUY in September last year. In EUR terms, the gain is very similar, approximately 27%.

Graphisoft Park is trading currently at approximately an 11% FFO yield and around 0.73x P/NAV, on the latest reported figures. The company remains much cheaper than most of the listed European office real estate landlords, most of which are trading between 3-6% FFO yields, on the consensus estimates, and at around 0.8-1.3x P/Bs. On average, we see the office real estate peers trading at around a 4.7% FFO yield and 1.06x P/B, on the Bloomberg 1YF consensus estimates. We maintain our view that, thanks to its quality portfolio, blue-chip tenants and fairly compact size, Graphisoft Park could be an attractive acquisition target, especially given the further optionality to expand the southern area of the Park via further developments.

Specifically in CEE, we note the CPI and Aroundtown bid for Globalworth, which valued Globalworth at a c.12% discount to its year-end reported IFRS book value and a 20% discount to its year-end EPRA NAV. On the 2020 EPRA earnings per share of EUR 0.37, the joint bid valued Globalworth at 5.3%. We note that most of Globalworth's investors have held onto their shares, and not sold into the bid. Graphisoft Park is trading at much cheaper multiples than the bid valued Globalworth at.

We note that the Starwood bid for CA Immo valued the company at a 10% discount to the year-end EPRA NAV, a 10% premium to the IFRS book value, and a 3.9% pre-tax FFO I yield, on its 2020 earnings. Given that part of its standing portfolio, as well as the vast majority of the development pipeline of CA Immo, is in the key German cities, which have been enjoying very strong positive rental and yield dynamics in recent years, we do not want to suggest that the two stocks should deserve to trade at the same multiples. That said, we believe the wide valuation differential illustrates how cheap Graphisoft Park is, and reinforces our argument about the stock potentially being an attractive acquisition target. Graphisoft Park is trading at c.10x P/FFO, while the bid implied slightly more than 25x P/FFO for CA Immo. This means that Graphisoft Park is nearly 3x cheaper on earnings. We note that, at c.37%, Graphisoft Park's net LTV is higher than CA Immo's (31% as of the end of 1Q21), but the difference is not dramatic.

In the near term, the market-wide rising vacancy and pressure on effective rents might affect Graphisoft Park, and we believe the company may need to offer more attractive incentive packages to tenants whose lease terms are coming to an end. Also, the vacancy may continue to trend up. While, thanks to the 3.7Y unexpired lease term, the impact on earnings would be gradual, in any case, we cannot rule out that the rents could come under pressure in the near term. Importantly, however, the average office rents in Budapest have been growing steadily, from around EUR 11/sqm per month in 2015 to c.EUR 13-14/sqm currently. This means that the premium at which the Park used to be rented, relative to the levels attainable in the rest of the city, has declined substantially over time. Given the good state of the buildings and the unique work environment the Park offers, we believe it should be possible to retain a large majority of the tenants, without having to compromise significantly on the rents.

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
2017	26	2.6	69%	25%	8.5	0.8	34.3%	3.1x	10.4%	0.3	3.7%
2018	168	16.6	28%	67%	9.9	1.0	10.2%	0.5x	12.1%	0.6	7.9%
2019	179	17.7	25%	60%	12.0	1.2	6.9%	0.6x	11.5%	2.8	26.8%
2020E	160	15.9	34%	57%	10.4	1.0	6.1%	0.7x	9.9%	0.7	6.5%
2021E	169	16.8	32%	58%	10.3	1.0	6.2%	0.6x	9.8%	0.7	6.4%
2022E	175	17.4	30%	59%	10.2	1.0	5.9%	0.6x	9.8%	0.7	6.4%

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