# JSC Lisi Lake Development
# Georgia, Real Estate

B+ STABLE

## Corporate profile

JSC Lisi Lake Development (LLD) is a pure-play residential real estate developer based in Georgia. LLD was founded in 2010 when it acquired a large undeveloped plot of land within a close vicinity from the center of Georgia's capital city of Tbilisi. The 400-hectare plot was pre-developed by the company through the addition of critical infrastructure such as roads, electricity, water supply as well as schools and community spaces. In 2011, LLD started building on the plot and selling premium residential living space. While the company continues to develop multiple project stages of Lisi Lake, its core project in Tbilisi, the group recently broadened geographically by starting a major residential project on the Black Sea shoreline in the greater Batumi area. The project will be a mixed-use development with a hotel, multiple restaurants and a yacht marina in addition to the residential units. In the near future, management also plans to further grow via new projects within Georgia

## Key metrics

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2016** | **2017** | **2018F** | **2019F** |
| EBITDA/interest cover (x) | 12.4x | 17.9x | 9.7x | 7.1x |
| Scope-adjusted debt (SaD)/EBITDA | 0.7x | 0.9x | 1.4x | 1.1x |
| Scope-adjusted FFO/SaD | 146% | 141% | 96% | 175% |
| FOCF/SaD | 178% | 68% | (-) FOCF | (-) FOCF |

## Rating rationale

**Scope assigns first-time issuer rating of B+ to JSC Lisi Lake Development, Stable Outlook**

The B+ issuer rating for JSC Lisi Lake Development, a Georgia-based premium residential real estate developer, is supported by the company's: i) conservative financing structure that relies on equity with negligible net debt; ii) above-average cash profitability that partially offsets external financing needs; and iii) strong local brand recognition and industry network that enables off-market deals, particularly on new attractive plots for large residential developments.

The issuer rating is negatively affected by LLD's current small size and scope compared to other European residential property developers and its full dependency on the sale of properties and/or land to end-customers. The pure-play developer business model implies a small share of recurring revenues, which risks high cash flow volatility should property sales drop. Diversification is deemed low given the substantial cluster risk posed by the Lisi Lake projects, which will comprise more than 75% of the value of all the issuer's investment properties for the next two years. The issuer rating is also limited by the fact that the company operates entirely in Georgia, generating risks related to a less resilient economy, inflation and foreign exchange rates as well as the low liquidity of the country's premium real estate market compared to that of the more mature markets in western Europe.

### Ratings & Outlook

Corporate Ratings B+/Stable


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### Related methodology

Corporates Methodology 2018

European Real Estate Corporates Methodology 2018


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## Business risk profile

Scope assesses industry risk for LLD to be high. As a pure-play developer, the company is exposed to the most cyclical part of the real estate industry. The agency's short-term credit view for the industry is stable but increasingly sensitive to changes in politics, economic conditions and interest rates. Scope also takes account of the higher volatility of Georgia's less mature market. The core activity consists of developing premium residential real estate in Tbilisi and other cities in Georgia. For the time being, the company has a very concentrated project pipeline with a focus on Lisi Lake projects and another major early-stage project on the Black Sea shoreline. However, there are plans to expand the number of projects, targeting other regions in Georgia.

With total assets of c. USD 144m at year-end 2017 and funds from operations (FFO) of USD 4m in 2017, LLD is a small company, but exhibits strong growth in its Georgian home market. Scope judges the issuer's average asset quality as credit-positive because all residential units are newly built at a premium quality and the company's land bank to date consists of prime Georgian locations only.

Size is expected to grow further in the next two years thanks to an expanding project pipeline. However, the company's limited size and market position also indicate a heightened sensitivity to unforeseen shocks and volatility in cash flows, particularly as LLD is highly exposed to inherent cyclicality in the real estate market, with almost 100% of revenues currently linked to development activity.

LLD's potential cash flow volatility is negatively affected by its very concentrated pipeline of two main projects (divided into several sub-projects and phases that can be managed and timed separately to a certain extent), the largest of which (Lisi Lake) represents the lion's share of expected revenue within the next 30 months. This very modest diversification may affect future cash flows if the projects suffer delays or cost overruns. However, Scope and other third-party market observers predict excess demand for premium residential real estate in Tbilisi in the coming years, provided there is no major external economic shock. Moreover, management intends to improve geographical diversification by investing in more Georgian projects, with the exception of further projects in Tbilisi. Scope views this strategy positively.

LLD's profitability has been above industry average and is relatively less volatile regarding its business model. EBITDA margin stood at more than 30% in the 2016 and 2017 business years, when significant sales volume was recorded. Scope believes this margin will decrease over time: the significant competitive advantage of having acquired the land bank at low prices in 2010 to 2011 is now shrinking as new projects are acquired at current market prices. Nevertheless, Scope sees substantial volumes of land at Lisi Lake that can be developed in later project stages. In a conservative scenario, the agency expects EBITDA margin to remain at or above 20% for the next two to three business years due to increasing competition.

## Financial risk profile

LLD's EBITDA interest cover stood at very comfortable levels of c. 12x in 2016 and 18x in 2017. This ratio has been unusually high due to negligible debt levels in recent business years as more than 90% of the balance sheet was equity-financed. Even after assuming an additional USD 15m in debt from the issue of a corporate bond in the second half of the 2018 business year, Scope expects EBITDA interest coverage to stay in a range of 7x to 10x. Nevertheless, operating profit at EBITDA level depends entirely on ongoing land and property sales owing to LLD's pure-play developer business model.

The company's cash flow generation was sufficient in the past two to three business years, during which substantial volumes of properties were sold to clients for the first time. Free operating cash flow was positive for the past four years despite the business expansion over the same period. Scope expects free operating cash flow to become slightly negative in the single-digit USD millions for the next two business years, owing to both the expectation of further growth and the nature of real estate development. Furthermore, LLD's credit rating at this point is constrained by its limited size and scope, which creates a very clustered project pipeline.

The company's loan/value ratio (LTV) has stayed at very conservative single-digit percentages in past business years, indicating very low net debt of less than USD 10m. Scope expects LTV to remain below 10% in the next two business years, even after assuming a USD 15m bond issue in the second half of the current 2018 business year.

While the company's strong financial metrics like SaD/EBITDA of around 1.0x, FFO/SaD of 141% and FOCF/SaD of 68% (2017) would typically imply a higher sub-score for the financial risk profile, Scope assesses the sub-score at BB due to the uncertainty over future sales and thus EBITDA levels. The inability to generate significant recurring revenue without selling properties limits the analytical value of leverage ratios based on projected operating income. The company is targeting more properties in asset classes that contribute recurring rental income in the near future such as hotels or office properties, starting with hotel revenues from Tsikhisdziri, but development will remain the core business according to the management. This diversification of revenues should mitigate cash-flow volatility in the future. However, in Scope's opinion, high cash flow volatility is typical for a developer, with projects not assessed and financed in annual tranches but over the whole development period.

## Liquidity

Operating cash flows have been sufficient in recent years and are expected to further increase. Scope also forecasts free cash flows in a range of USD -2.5m to USD -1m for the next years despite significant expansion plans. Furthermore, the issuer's short-term debt going forward is forecasted at less than USD 4m and is covered more than three times by unrestricted cash plus free cash flow.

## Outlook

The rating Outlook is Stable, supported by the Lisi Lake development pipeline and growing demand in Georgia's premium residential real estate market. The Outlook incorporates Scope's expectation that EBITDA margin will remain at more than 20% going forward and that the project pipeline can be developed and sold without a major drop in demand and/or prices that would impair operating cash flows.

A negative rating action is possible if the company's sales volume fell sharply or if a serious deterioration in Georgia's real estate market negatively affected LLD's overall business prospects.

Scope would consider a positive rating action if LLD managed to significantly improve its business risk profile by further diversifying its development portfolio and/or creating a substantial share of recurring cash flows independent from continual asset sales in order to mitigate potential cash-flow volatility and provide sufficient interest coverage from recurring EBITDA.

## Rating drivers

| Positive rating drivers | Negative rating drivers |
|---|---|
| • Good market position due to a large land bank, established brand and excellent network within the local real estate and financial industry<br>• Track record from the construction and sale of existing residential units in Lisi Lake<br>• A development portfolio and land banks in Tbilisi and Tsikhisdziri that are well located and should offer above-average liquidity<br>• Strong operating cash profitability thanks to the very low land bank acquisition costs, among other factors<br>• Single-digit LTV, even after the assumed issue of a USD 15m bond.<br>• Low SaD/EBITDA leverage of c. 1x to 1.5x and excellent liquidity thanks to strong cash generation and negligible short-term debt | • High dependency on the main development project in Lisi Lake despite recent diversification efforts<br>• Exposure to the still relatively volatile Georgian economy with inherent risks such as high inflation and (indirect*) foreign-exchange risk<br>• Pure-play developer lacking significant recurring income resulting in weak visibility regarding future SaD/EBITDA leverage<br>• Small compared to other international/European upscale residential developers<br>• Still-unproven access to capital markets |

## Rating-change drivers

| Positive rating-change drivers | Negative rating-change drivers |
|---|---|
| • Diversification of income, resulting in improved business risk profile | • A slump in sales volumes and thus operating income |

** the issuer is not exposed to material direct foreign exchange risks since the functional currency (construction costs as well as unit sales prices) is USD. Nevertheless, we hint at the potential risks that would arise from a sharp decline in value of the local currency (Georgian Lari) due to the resulting loss of purchasing power of local clients. We therefore deem this a potential indirect currency risk.*

## Financial overview

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| SaD/EBITDA | 0.7x | 0.9x | 1.4x | 1.1x |
| Scope-adjusted FFO/SaD | 146% | 141% | 96% | 175% |
| FOCF/SaD | 178% | 68% | (-) FOCF | (-) FOCF |
| **Scope-adjusted EBITDA in USD m** | **2016** | **2017** | **2018F** | **2019F** |
| EBITDA | 4.2 | 4.3 | 6.3 | 8.6 |
| Operating lease payments in respective year | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 |
| **Scope-adjusted EBITDA** | **4.2** | **4.3** | **6.3** | **8.6** |
| **Scope funds from operations in USDm** | **2016** | **2017** | **2018F** | **2019F** |
| EBITDA | 4.2 | 4.3 | 6.3 | 8.6 |
| less: (net) cash interest as per cash flow statement | -0.3 | -0.2 | -0.6 | -1.2 |
| less: cash tax paid as per cash flow statement | 0.0 | 0.0 | -0.6 | -0.8 |
| add: reconciliation for non-cash COGS in P&L | 0.3 | 1.6 | 3.4 | 9.4 |
| **Scope funds from operations** | **4.2** | **5.7** | **8.4** | **15.9** |
| **Scope-adjusted debt in USD m** | **2016** | **2017** | **2018F** | **2019F** |
| Reported gross financial debt | 4.2 | 9.0 | 22.8 | 19.6 |
| less: cash, cash equivalents | 1.5 | 5.1 | 14.3 | 10.7 |
| Cash not accessible | 0.0 | 0.0 | 0.0 | 0.0 |
| add: pension adjustment | 0.0 | 0.0 | 0.0 | 0.0 |
| add: operating lease obligations | 0.2 | 0.2 | 0.3 | 0.3 |
| **Scope-adjusted debt (SaD)** | **2.9** | **4.0** | **8.7** | **9.1** |

## Business risk profile

### Industry risk

**Cyclicality (high)**

Scope believes developer corporates face the highest cyclicality as demand is linked to economic growth. In addition, these companies mostly face a high time-to-delivery, as three to four years are needed to develop a new property from scratch. If demand declines during this time, risks on letting and disposal could increase tremendously because of either i) an economic downturn or ii) competing existing or newly built stock.

**Market entry barriers (low)**

Scope believes that the real estate industry generally has low barriers to entry. On the one hand, significant investment is needed to buy, maintain or develop properties. Thus, a company needs significant internal resources or good access to third-party capital. On the other hand, we observe a high level of fragmentation in the real estate industry and good general access to credit due to collateral-eligible assets. Both are indicators of low barriers to entry.

**Substitution risk (low)**

Substitution risk is generally low because the properties – mainly for residential spaces – represent a basic human need. Substitution risk for developers depends on the property type. To successfully develop made-to-measure projects, the developer’s skills and reputation are essential. As these are not easily replicable, substitution risk is deemed to be medium. However, generic property design and development can be easily substituted by any competitor or players from other industries due to the potential benefits gained from new infrastructure and/or more efficient processes.

**Figure 1: Industry risk assessment: European commercial real estate corporates**

| Cyclicality \ Barriers to entry | Low | Medium | High |
|---|---|---|---|
| High | CCC/B | B/BB | BB/BBB |
| Medium | B/BB | BB/BBB | BBB/A |
| Low | BB/BBB | BBB/A | AA/AAA |

Source: Scope

### Industry outlook (stable)

**European real estate outlook 2018:**

Super cycle drives credit quality, but risks increase

Scope’s 2018 outlook for the real estate sector is stable. This view is based on still-lively investor and tenant demand positively influencing business risk profiles. In addition, companies have made use of the ECB’s ongoing ultra-loose monetary policy (with an all-time high of capital market debt issuance at very low interest rates) to enhance their financial risk profiles. However, our assessment emphasises the further heightening of sensitivity to changes in politics, economic conditions and interest rates.

For more info please refer to the corporate outlook 2018 Corporate Outlook.

## Market positioning (B)

Market position expected to improve with growing number of projects

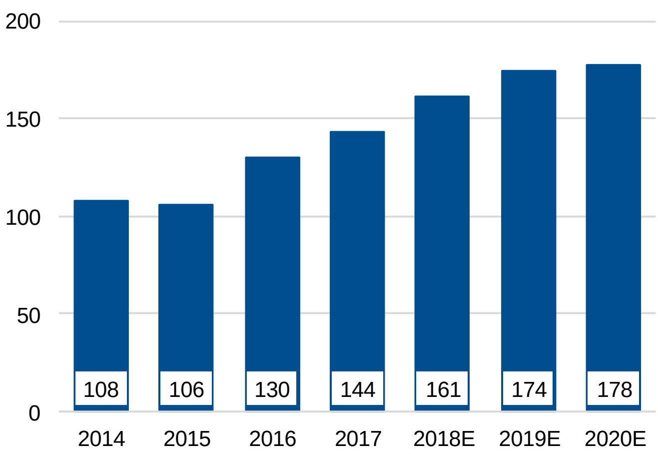
With a total asset value of USD 144m as of year-end 2017, LLD is a small residential property developer when compared to European peers. However, it operates in a fragmented market. We expect the group to grow considerably in the next business years because sales from Lisi Lake are expected to further increase to between USD 25m and EUR 40m in 2019 and 2020 respectively. We also expect additional sales revenues from Tsikhisdziri and further new projects in a range of USD 15m to USD 20m annually.

Market positioning is expected to improve further if the company successfully implements its diversification strategy. Management aims at increasing the number of projects to about 3-5 within the next 24 months, also implying increased awareness and improved geographical diversification in Georgia.

Despite the increasing focus on additional locations, LLD is expected to maintain its focus on its core project in Lisi Lake, building premium residential real estate and selling plots for individual villa construction. While there is a high cyclicality of the real estate development business, in the specific case of LLD, this risk is partially mitigated by the fact that the issuer still has a large land bank at Lisi Lake in Tbilisi and can develop in phases/blocks. Therefore, total construction time here is significantly shorter (c. 1 year) than the typical 3 to 4 years to develop a project from scratch.

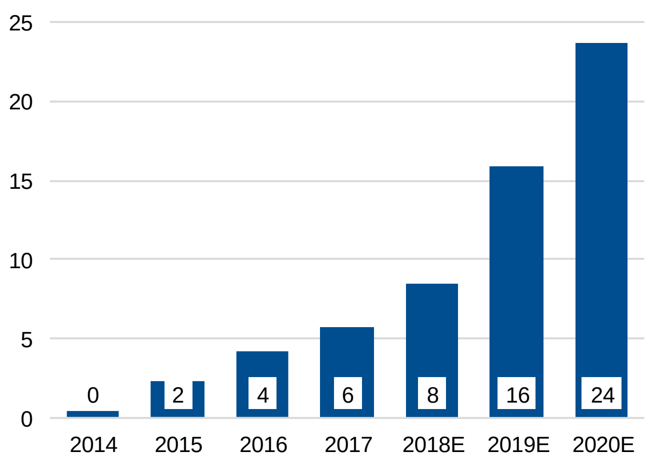
Small size is a negative rating driver because it implies greater sensitivity to unforeseen shocks, more cash-flow volatility, and higher key person risk relative to larger firms.

**Figure 1: Total assets (USDm)**




Source: LLD and Scope Ratings

**Figure 2: FFO development (USDm)**




Source: LLD and Scope Ratings

Taking into account its current size of c. USD 150m in balance sheet volume and the focus on one asset class (premium residences), Scope deems LLD to be a niche player.

Competitive position within its Georgian home market

However, Scope believes that LLD's positioning in Tbilisi, with access to an extensive land bank surrounding Lisi Lake, which overlooks the capital city, remains a unique selling point that cannot easily be duplicated. Moreover, LLD was able to establish an entirely new neighbourhood at Lake Lisi and attract well-funded local clients by being a first mover in the region's upscale residential development market. In addition, the residential area around the Lisi Lake offers families green surroundings near the city center, which is another USP in our view.

Demand for European-standard, premium living space in the Georgian capital and its direct surroundings is expected to stay robust and less prone to overall market volatility. We also hint at the positive competitive factor for LLD in that it acquired its extensive

Tbilisi land bank at very low prices in 2008, which provides significant margin headroom compared to competitors, which face similar construction costs but acquired land plots at more recent prices.

Regarding product strategy at Lisi Lake, LLD follows a three-pronged approach: clients can acquire a i) turn-key apartment, ii) a semi-fitted apartment where most of the interiors can be added individually, or iii) a pre-developed plot on which a single-family house can be built according to individual needs.

## Diversification

**Weak geographical diversification with a current focus on Tbilisi – nation-wide expansion under way**

In 2017, LLD expanded its geographical outreach to greater Batumi, a Georgian city on the Black Sea shoreline, regarded in the region as a holiday destination. However, excluding Lisi Lake and Tsikhisdziri, new projects will represent roughly 10% to 20% of revenues for the next 30 months as the largest project completion volume in this period will be from Lisi Lake and property sales. We nevertheless expect a more balanced geographical diversification going forward thanks to new projects elsewhere in Georgia.

At this point, LLD generates its entire income from real estate development and the sale of pre-developed plots. While the dependency on continual property sales without additional recurring income streams is credit-negative, we see the rising revenues from plot sales as risk-mitigating for two reasons: there is no construction/development risk in this segment, and the issuer can realise attractive cash margins thanks to the very low acquisition price for the land.

**Dependent on premium residential real estate development**

Other revenue sources such as rental income and managing fees are not contributing material levels of income. Although the lack of recurring revenue is not directly linked to the company's development activities, the company plans to generate recurring rental income from build-and-hold properties. This very modest diversification of revenue sources exposes the company fully to the cyclicality of the Georgian real estate market and is a credit-negative. Regarding future investments, we would regard any increase in recurring revenues as accretive for LLD's credit quality.

According to management, LLD intends to grow its project pipeline in Georgia without adding additional exposure in the greater Tbilisi area due to the already large share of Lisi Lake projects. We welcome this planned expansion because from a diversification standpoint it reduces cluster risks while increasing geographical diversification.

*Note that a margin compression/rise in construction costs versus the financial planning/realised completions of the issuer is already reflected in Scope's rating case*.

## Asset quality

### Prime residential locations in Georgia

**Above-average liquidity of assets in the Georgian market**

LLD's development portfolio is currently situated in Georgia's main real estate markets: Tbilisi (Lisi Lake) and the greater Batumi area (Tsikhisdziri). Nevertheless, both markets are not mature and may lack asset liquidity in times of market distress. The company has successfully built up brand recognition in Georgia as a developer of premium, modern residential space and therefore intends to keep this as its core activity. Even so, the company is targeting more asset classes that contribute recurring rental income such as hotels or offices, starting with hotel revenues from Tsikhisdziri.

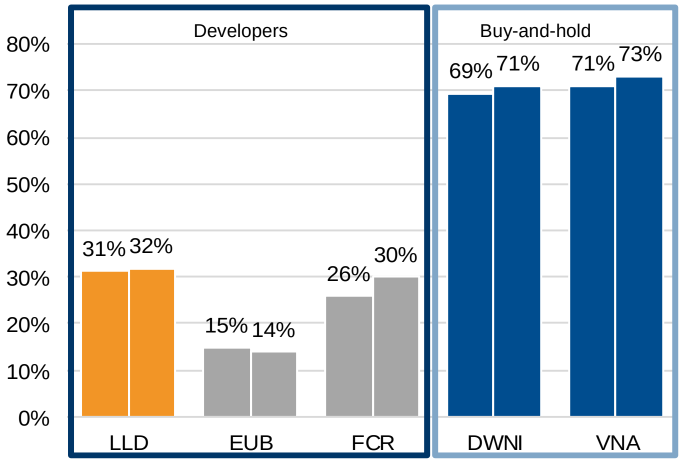
## Profitability

### Above-average profitability of c. 30% in the last years – EBITDA margin expected to remain >20%

**High EBITDA margin relative to developer peer group**

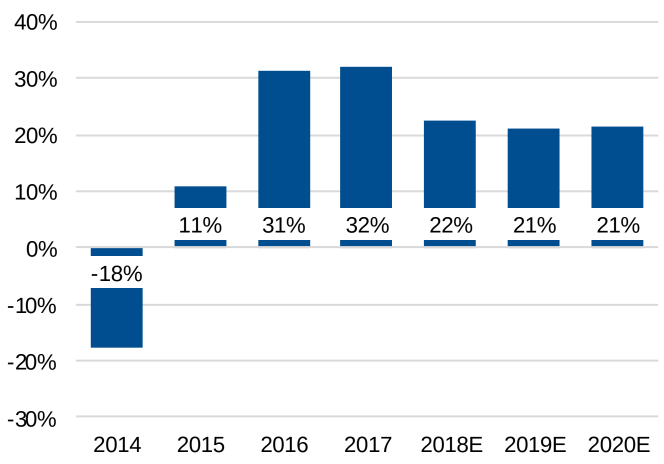
In the last three business years (2014-17), LLD recorded EBITDA margins in excess of 30%, despite the relatively small volume of units sold in comparison to the cost base, which included upfront investments in marketing and staff to establish the company. Nevertheless, in terms of EBITDA margin the issuer's profitability is weaker than that of a buy-and-hold real estate company, given that developers have a much larger top line.

**Figure 3: Profitability 2016 and 2017 vs peers[1]**




Source: Public information, Scope estimates

**Figure 4: EBITDA margin**




Source: LLD, Scope estimates

[1] LLD = JSC Lisi Lake Development I EUB = Euroboden GmbH I FCR = FCR Immobilien AG I DWNI = Deutsche Wohnen SE I VNA = Vonovia SE

## Financial risk profile

### Debt protection and cash flows

**EBITDA interest cover at 18x (2017) expected to remain substantially between 7x and 10x**

**High debt protection metrics**

LLD's EBITDA interest cover stood at a comfortable 18x at year-end 2017 and is expected to stay at a minimum of 7x going forward. However, the ratio will fluctuate depending on the on-time delivery and disposal of projects.

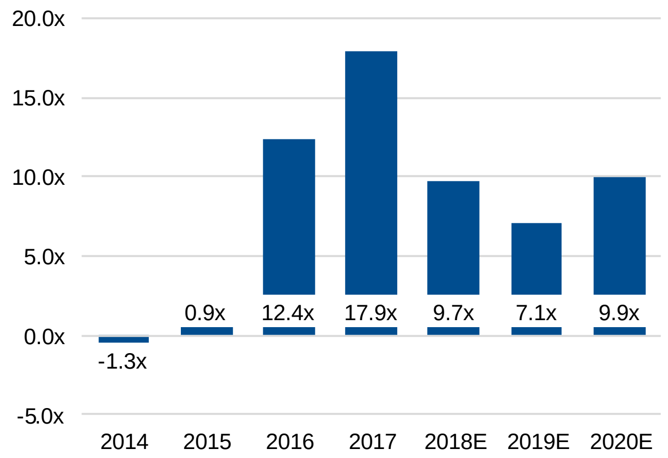
If projects are delayed significantly or sales slump, LLD may have to depend on external financing to cover interest payments. External financing is available to the company, in our view, given its large pool of unencumbered assets (properties and the land bank), which would facilitate additional secured financing.

**Low visibility of future cash flows due to low level of recurring revenues**

Free operating cash flows were positive through the early years of operation. We forecast neutral to slightly negative free operating cash flows for the next 2-3 years as we expect the company to start/acquire new projects on an ongoing basis, financed internally by property sale proceeds.

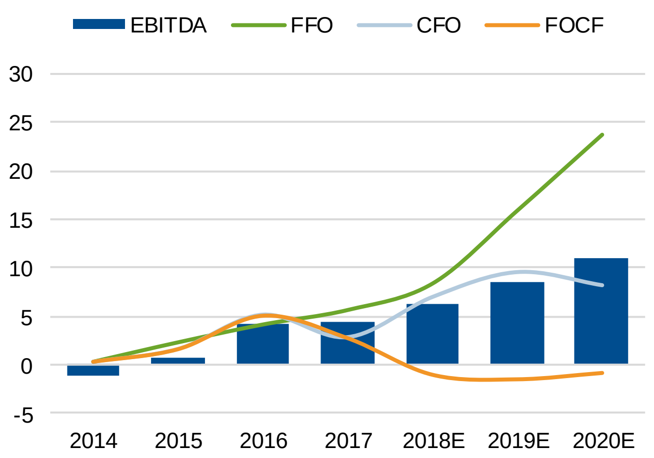
The Scope-adjusted-FFO in LLD's case takes into account the effect that a significant portion of the cost for land that is recognized as costs at the time of a property sale in the P&L is non-cash since there have been substantial positive non-cash revaluation gains within recent years. The non-cash portion of this land costs is therefore added back to our Scope-adjusted-FFO in order to provide a more realistic and cash-oriented metric here.

**Figure 5: EBITDA interest cover**




Sources: LLD, Scope Ratings

**Figure 6: Cash flow (USDm)**




Sources: LLD, Scope Ratings

### Leverage

**Very low balance sheet leverage at single-digit LTV – operating leverage subject to high potential volatility**

The company's LTV has been and is expected to remain in the low- to mid-single-digit range even after the assumed placement of a USD 15m corporate bond in the second half of the current business year. Scope-adjusted debt is expected to increase from c. USD 4m at year-end 2017 to between USD 5m and EUR 9m.

With a SaD/EBITDA of c. 1.0x in 2017, the company's operating leverage is considered very low for a real estate developer. However, LLD's ability to generate cash flow from operations is entirely dependent on its property sales volume due to a lack of recurring revenues. Therefore, we highlight that the inability to generate significant recurring revenues without continually selling properties limits the analytical value of leverage ratios based on projected operating income. As mentioned previously, the company intends to add more properties from asset classes that generate recurring income.

**Figure 7: loan/value ratio (LTV %)**

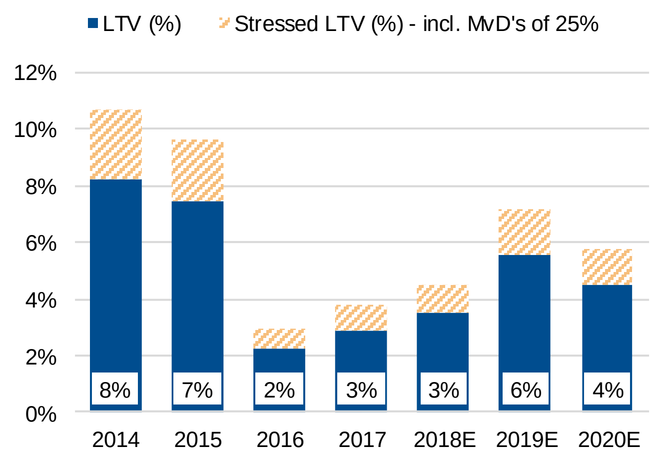
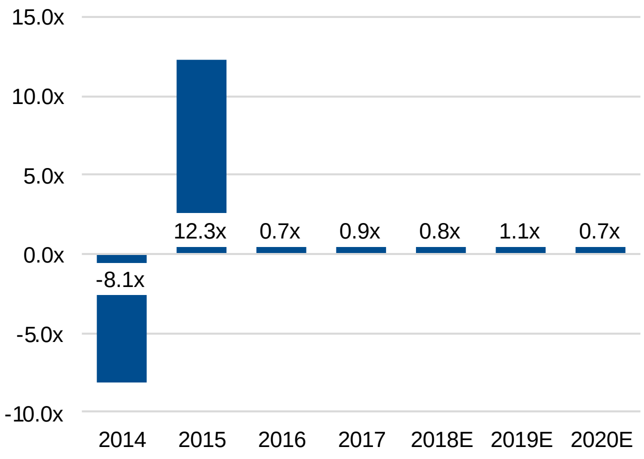



**Figure 8: SaD/EBITDA**




Sources: LLD, Scope Ratings

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Conservative liquidity management

## Liquidity and debt repayments (+/- 0 notches)

### Robust liquidity situation thanks to negligible short-term debt

LLD's liquidity mostly stood below 110%. While highly volatile in the past, it is forecasted to stay at comfortable levels in excess of 300% in the next 30 months. Due to low short-term debt levels in the next years we assess the group's liquidity situation as adequate.

## Supplementary rating drivers

### Financial policy (+/- 0 notches)

We view positively LLD's strategy to fund its assets predominantly by equity as it provides substantial financial headroom to withstand negative financial shocks without leading to substantial interest payments or principal repayments. In addition, we highlight that the new Georgian corporate tax regime has increased the incentive to retain net profits in the group instead of distributing to shareholders. The corporate tax rate of 15% is only attributable to net income when distributed to equity holders, meaning all corporate net profits can be reinvested tax-free if not distributed. This is credit-positive as it rewards high equity re-investment and thus a low leverage.

### Management and corporate governance (+/- 0 notches)

LLD profits from longstanding relationships with most external partners in construction and financing, and an extensive real estate and financial industry network in Georgia via its management, owners and supervisory board.

### Peer group (+/- 0 notches)

In our opinion, the issuer is relatively robust compared to competitors as real estate development is a rather fragmented industry in LLD's core market. There was no need for upward or downward notching as the peer group environment is normal, in our view.

### Parent support (+/- 0 notches)

The rated entity is the ultimate parent. We do not incorporate parent support as we are not aware of any explicit guarantees or binding agreements that can support LLD should it fall under financial distress. Even so, the company has a strong ownership structure with three anchor shareholders that each own c. 24% and have a long-term investment horizon.

## Outlook

The rating Outlook is Stable, supported by Lisi Lake's development pipeline and growing demand in Georgia's premium residential real estate market. The Stable Outlook incorporates Scope's expectation that the EBITDA margin will remain at more than 20% going forward, and that the project pipeline can be developed and sold without a major drop in demand and/or prices that would impair operating cash flows.

A negative rating action is possible if the company's sales volumes fell dramatically or if a serious deterioration in Georgia's real estate market negatively affected LLD's overall business prospects.

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