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Research Update:

Baltic Horizon Fund Assigned 'MM3' Mid-Market Evaluation Rating

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Overview

- Baltic Horizon Fund (BHF), a closed-end real estate investment fund registered and supervised in Estonia, is planning to issue €30 million of five-year senior unsecured notes to be listed on the NASDAQ Exchange, Tallinn.
- We are assigning a mid-market evaluation (MME) rating of 'MM3' to BHF. The MM3 rating reflects our view that BHF has good capacity to meet its financial commitments relative to other mid-market companies, subject to adverse economic conditions or changing circumstances, which may prove more challenging than for higher-rated companies.
- We expect BHF to continue to generate stable cash flows under supportive market conditions and maintain EBITDA interest coverage above 4.5x and a debt-to-debt-plus-equity ratio of less than 55% over the next two years.
- We are also assigning an MME rating of MM3 to BHF's proposed senior unsecured notes, to be finalized subject to the final terms of the proposed transaction.

Rating Action

On April 24, 2018, S&P Global Ratings assigned its 'MM3' mid-market evaluation (MME) rating to Estonian closed-end investment fund Baltic Horizon Fund and an 'MM3' rating to Baltic Horizon Fund's proposed €30 million senior unsecured notes.

Rationale

BHF is a closed-end real estate investment fund registered in Estonia and focused on commercial property in Estonia, Latvia, and Lithuania. It owns a portfolio of 11 properties valued at €224 million in the office, retail, and leisure sectors in Tallinn, Riga, and Vilnius. BHF's portfolio comprises a total rentable area of about 106,000 square meters, occupied by 206 tenants. BHF is dual-listed on the NASDAQ Market Tallinn (NHCBHFFT) and NASDAQ Market Stockholm AIFM (NHCBHFFS). BHF is managed by Northern Horizon Capital, a Danish alternative asset manager with about €1 billion under management.

We assess BHF's business and credit risk based on our view of country risk in the Baltic States, industry risk in the real estate sector, and our analysis of BHF's operational strengths and risks, competitive position, cash flow, and leverage.

We begin by benchmarking BHF's operations against publicly rated real estate companies. This highlights BHF's relatively small scale, which magnifies the potential impact of tenant concentrations, declining valuations, and other business risks. In this light, we view BHF's competitive position as being weaker than its larger peers rated on our global scale. However, an MME is our credit opinion relative to other mid-market companies. Thus, we also benchmark BHF against other mid-market real estate investment funds focusing on the Baltic region, specifically: EfTen Capital, Eastnine, East Capital, INVL, Capital Mill, and Lords LB.

We believe all of these companies face similar risks associated with their smaller scale, but that BHF's portfolio, in terms of number of holdings, asset quality, tenant concentration, sector and country diversification, and valuation, compares favorably. BHF's loan-to-value (LTV) ratio target of 50% and forecast LTV ratio of 52%-53% also compares favorably. BHF's focus on capital cities, rather than secondary and tertiary cities, may perhaps lower yields, but also lowers risk. It should make the portfolio more resilient and enable BHF to sustain higher, more consistent occupancy rates. Finally, BHF is not engaged in any transformational acquisitions, divestitures, large or speculative developments, or strategy changes. Thus, relative to other mid-market companies, we believe BHF demonstrates good capacity to meets its financial commitments.

We see the following additional factors as supportive of BHF's operations:

- The company's portfolio is composed of recently built or renovated premium offices and retail premises well-located in the Baltic capital cities, either in central business districts, resilient neighborhood catchments, or locations strategically important to tenants.
- It has achieved a high occupancy rate of 98%, with high-quality tenants and good average lease duration (weighted-average lease term of 4.9 years).
- The level of demand in the Baltics remains high because the region is a desirable outsourcing destination/hub for multinationals (back office, human resources, and shared service centres) supported by the qualified labor and more-attractive labor costs (below the European average). The local dynamic of business and government tenants seeking to relocate from Soviet-era buildings also supports demand.

We see BHF as exposed to the following risks:

- BHF has a relatively concentrated tenant base, with the top 10 tenants representing 48% of rental income, mitigated by tailored properties that may limit turnover.
- BHF relies on favorable macroeconomic trends and dynamics driven by high demand and low supply and a thus far disciplined policy toward leverage, any/all of which may moderate or reverse.

We assess BHF's financial risks based on our analysis of cash flows, leverage, and financial ratios including debt service coverage, LTV, and debt-to-debt-plus-equity. BHF has a portfolio of high-quality, longer-term leases that have an average remaining term of about five years, several 10-year anchor leases, and limited break options. We consider notice periods and security sufficient to help it manage vacancy risk.

Management can therefore predict revenues for planning. Although the scalability of the cost base and cash flow margins are somewhat constrained by BHFs smaller size, margins are robust and stable. They should enable BHF to generate ample free cash flow and debt service coverage. BHF has used leverage in a disciplined manner that we consider to be relatively conservative; it targets an LTV ratio of 50%. It has also diversified its funding sources by accessing the public equity markets and has thus far demonstrated reliable access to new equity funding for acquisitions. BHF has thus been able to grow and diversify its portfolio while keeping LTV and debt-to-debt-plus-equity ratios at 50%-55%.

We expect BHF to sustain its historically high debt service coverage and intermediate debt-to-debt-plus equity ratio (below 55%).

We assess the company's financial credit profile as intermediate. Our assessment takes into account our forecasted weighted average adjusted interest coverage as well as leverage metrics.

Our base case assumes:

- Average GDP growth of about 3%-4% in the Baltic region in 2018 and 2019.
- Rental income like-for-like growth of about 2%, underpinned by our projection of broadly stable occupancy rate around 98%. This is supported by favorable market conditions in the Baltic capitals.
- EBITDA margins ranging between 60%-65% over the next two years.
- BHF will remain committed to an LTV ratio of about 52%-53% and a debt-to-debt-plus-equity ratio of no more than 55%.
- Like-for-like portfolio valuation will be broadly flat in 2018-2019.

Based on these assumptions, we arrive at the following credit measures:

- Fully adjusted weighted average EBITDA/interest coverage well above 4.5x in 2018-2019.
- Debt-to-debt-plus-equity ratio of 50%-55% in 2018-2019.

We recognize BHFs strong management team and good governance. Management demonstrated a robust planning and analysis process and an equally solid track record of attaining strategic, operational, and financial goals while anticipating and managing risks. The current management team has had a long tenure without turnover and it displays a depth of experience and understanding of its business, markets, and the Baltic region.

Liquidity

We view BHF's liquidity profile as adequate, based on our projection, as of Dec. 31, 2017, that the group's ratio of potential sources of liquidity to uses will comfortably exceed 1.2x in the coming year.

Including the planned €30 million bond issue, we estimate BHF's principal liquidity sources as follows:

- Reported cash and short-term investments of €24.6 million on Dec. 31, 2017;
- Forecasted cash FFO of about €10 million over the next 12 months;
- Share issuance of about €2.4 million.

We forecast principal liquidity uses to be:

- Scheduled debt repayment of about €0.4 million in 2018;
- Working capital outflow up to €1 million;
- About €1 million of capex expenditure and €3 million development costs;
- Postimaja acquisition of about €35 million;
- Potential dividend payments to unitholders of €7.5 million-€8.5 million.

Uncommitted acquisitions are not included in our liquidity assessment. We also expect covenant headroom to remain adequate.

Upside Scenario

We see the likelihood of an upgrade in the short term as remote, but could consider raising our MME rating if (i) BHF were to increase its scale so as to materially diminish the impact of operational risks posed by individual properties and tenants, (ii) without compromising asset/tenant quality or occupancy rates (iii) while maintaining its LTV target and (iv) maintaining credit metrics in line with our current expectation that debt-to-debt-plus-equity will remain below 55% and EBITDA/interest will continue exceeding 4.5x. Similarly, we would expect BHF to maintain at least adequate liquidity (sources/uses >= 1.2x).

Downside Scenario

We could consider lowering BHF's rating if we see evidence of deterioration in rental income and cash flow resulting in EBITDA/interest below 4.5x. We would also view negatively an increase in speculative development activity or debt-to-debt-plus-equity exceeding 55%. This could occur if property valuations deteriorate, or if BHF suffers reduced access to equity funding for acquisitions/development or implements a change in financial policy favoring higher leverage. The ratio of sources and uses of liquidity falling below 1.2x could also put downward pressure on the rating.

Ratings Score Snapshot

Mid-Market Evaluation Rating: MM3

Business risk:
- Country risk: 4. Moderately high risk
- Industry risk: 2. Low risk
- Competitive position: 5. Below peers (global, publicly rated peers)

Financial risk:
- Cash flow/Leverage: Intermediate

Anchor: MM3 (issuer), MM3 (proposed senior unsecured notes).

Modifiers
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Strong (no impact)

Issue Ratings

To assign an MME rating to a particular debt instrument as well as the obligor, we evaluate the instrument's recovery prospects in the event of a default, using a customized version of our recovery rating process for corporate debt.

We may assign a "+" modifier if (i) an instrument is secured and (ii) we believe it has particularly high recovery prospects, which we define as 70% or more. We may also assign a "-" modifier to any instrument we believe has particularly low recovery prospects, which we define as 30% or less. Otherwise, we assign no modifier and assign the same rating to the instrument as to the obligor.

We do not assign "+" modifiers to unsecured instruments such BHF's proposed offering. We also believe that in a scenario of falling rents, rising investment yields and lower property valuations that might precipitate defaults in the real estate sector, BHF bondholders are likely to recover more than 30%, even under considerable stress and bearing in mind the possibility of additional prior-ranking secured borrowing. We therefore assign an equal MM3 rating to BHF's proposed senior secured notes.

Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Corporates - Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Mid-Market Evaluation Rating Methodology, Nov. 20, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Ratings List

New Rating

Baltic Horizon Fund	
Mid-Market Evaluation	MM3
Senior Unsecured	
€30 mil. notes	MM3

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.