CREDIT RESEARCH | KA Finance p.l.c.

3rf December 2020

Calamatta Cuschieri
YOUR PARTNER IN FINANCIAL SERVICES

Executive Summary

"Although the Group had minimal impact in terms of the Centris I operation, KA's major pandemic related issue stems from the delays experienced in terms of the Group's ongoing projects, more specifically referring to Centris II and the Swieqi apartment complex developments.

Upon taking into consideration, the liquidity constraints such delays have had on KA, the Group's interest coverage for FY20 is expected to deteriorate down to 1.5x. On this basis, we are issuing a **Neutral** credit opinion on the Issuer.

Moreover, KA's bond is currently trading at a YTM of 4.82%, which is higher to peers operating within the same industry. We are of the opinion that the uncertainty surrounding the COVID-19 pandemic, which has been clearly impacted KA's ongoing projects in terms of completion delays, we are issuing a **Hold** recommendation on KAF26-29, on the basis that we believe the company holds the necessary liquidity buffers to service its debt obligations."

Business Overview

KA Finance plc's principal activity is to raise finance for KA Holdings Ltd ("Guarantor" or "Holding Company") whose business is to rent its investment property to third parties. The Group currently operates a business centre in Mriehel (Centris I) and also generates rental income from a guest house and two apartments both located in Gzira.

Debt securities issued by the Group

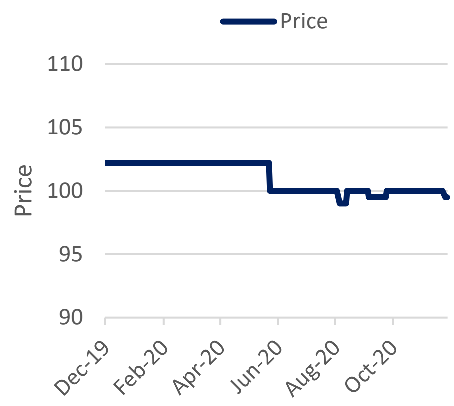
During FY19, the Group, through KA Finance plc (the "Issuer" or "KA"), issued an aggregate principal amount of €6m which was subscribed in full and admitted to the Prospects MTF. These bonds bear interest at the rate of 4.75% per annum and are secured by a special hypothec on Centris II and a general hypothec on all of the Guarantor's present and future assets.

Credit Opinion	Neutral
Country	Malta
Sector	Real Estate

4.75% KA Finance plc 2026-2029

Security	Secured
Nominal	€6mln
Ticker	KAF26-29
Price (30/11/20)	€99.50
Recommendation	**Hold**
Yield to Maturity	4.82%
Exchange	Malta Stock Exchange (MSE)
52-week range	€99.00 - €102.20

1-Year Price Movement



Source: Malta Stock Exchange

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Group's Developments

The Group is currently engaged in the below developments:

- **Centris II** – An office block in Mriehel, adjacent to the existing Centris I property, which will offer circa 5,500 sqm of office space and underground parking. Management explained that this development is currently in finishing stages, whereby the property is expected to be made available to prospective tenants at the start of Q2-2021.
- **Apartment Complex** – An apartment complex in Swieqi comprising of fifteen apartments and a communal pool. Management anticipate that three apartments will be made available for short lets by the end of FY20. The Group further anticipates to start generating rental income from the remaining apartments by end of Q1-2021.

- **Gzira Guesthouse** – A property located in Gżira which is envisaged to be converted into an eight room boutique hotel and was purchased in August 2018 for €0.3m. Management discussed that this property is currently being rented out as it is to third parties, whereby development works concerning this property are anticipated to commence at the start of Q3-2021.

COVID-19 implications on the Group's operations

The COVID-19 pandemic has presented very challenging conditions to global markets and naturally it has also negatively impacted the local property market. Management reported that the outbreak had minimal impact in terms of the Group's Centris I operation, with this being in line with the fact that the majority of the Group's tenants are of a sticky nature. In furtherance, management confirmed that up until October 2020, no tenant within the Centris I property has defaulted, and no tenant is expected to default moving forward. Nevertheless, the Group still had to provide several favourable credit terms to some specific tenants which were hit hard by the pandemic.

Moreover, management also discussed that apart from one tenant, the Group did not provide any form of discount to tenants throughout this crisis and also confirmed that in view of the current situation, the yearly increases (which is based on the inflation index) included in the tenants' contracts will still be honoured and will not be overturned moving forward.

In the face of the COVID-19 pandemic, the Group is expected to register €756K in revenues for FY20 representing a decrease of €678K from what was forecasted in the Group's Company Admission Document (CAD) prior the bond issue. Due to several pandemic related issues, the Group encountered numerous delays concerning the Centris II and Swieqi developments, whereby previously anticipated revenues attributed specifically to these properties have been delayed to FY21.

Additionally, while Centris II is expected to be made available to prospective tenants at the start of Q2-2021, the Swieqi property is expected to be partially completed by the end of this year and available for short lets. Although the Group is currently in the closing stages to secure its first tenant concerning Centris II, management confirmed that no letter of intents (LOIs) have been signed to date. In terms of the Gzira project, management further reported that this project is being shelved for the time being whereby development works are expected to commence at the end of Q2-2021.

In view of such delays, the Group recently issued an updated set of financial projections illustrating the changes in anticipated revenues for FY20, which in turn were utilised for the purpose of this credit analysis. Upon discussions with management, the Group's main COVID-19 implication stems from increased liquidity constraints, which is attributable to the delays experienced concerning Centris II and the Swieqi apartment complex.

However, in an attempt to further combat such situation, management explained that KA already has a liquidity contingency plan in place if the Group finds itself under increased pressure due to the aforementioned delays concerning their ongoing projects. In fact, management confirmed that the Group has entered into negotiations to obtain additional bank financing, which management anticipate to be within the region of €0.7m - €1.2m.

More importantly, management also confirmed that KA has the sufficient resources at its disposal to honour its existing bond interest payment obligations.

SWOT analysis

Strengths

- ✓ The Group's properties in Swieqi and Gzira are located in prime locations
- ✓ In terms of office space, the Group's business centres are located in a central location, which in commercial terms is regarded as being a sought after area
- ✓ The Group is successful in identifying appropriate projects for development and in applying its experience to develop those sites
- ✓ Minimal COVID-19 impact on the financial and operational performance of Centris I
- ✓ Long term contracts assigned to the tenants occupying Centris I, with one major tenant occupying almost 50% of the building
- ✓ The majority of the tenants occupying Centris I are of a sticky nature

Weaknesses

- × No geographical and sectoral diversification. The Group is only exposed to the local real estate industry
- × The real estate segment is highly dependent on the additional foreign direct investment (FDI) for the Maltese economy with property supply increasing drastically over recent years
- × Highly capital-intensive industry, resulting in relatively high leverage
- × Very low liquidity concerning the Group's bond
- × The COVID-19 pandemic has resulted into several delays concerning the Centris II and the Swieqi developments, which upon discussion with management, appears to have resulted into cash constraints for the Group

Opportunities

- Upon fully completing the Centris II and the Swieqi developments, the consequent leasing of the said properties, is expected to boost the revenue and profitability potential of the Group
- The recent Government aid package aimed towards containing the negative effects of the COVID-19 outbreak might benefit the overall operation of the Group

Threats

- ! The extent of the impact from COVID-19 is not yet fully known, thus there might be potential downturn if the situation deteriorates further
- ! Further escalation of the COVID-19 outbreak, might negatively impact the operations of KA through a decline in occupancy rates, potential default of tenants and delays in terms of the Group's future projects
- ! A potential downturn in the real estate industry in Malta
- ! Highly competitive commercial real estate industry in Malta
- ! Malta's impeded reputation following the recent political turmoil experienced during 2019 might have negative repercussions on the KA's overall operations
- ! A potential downturn in the Maltese economy, and more specifically within the local real estate industry, might hinder the Group's revenues and underlying profits

Financial summary

KA Finance p.l.c. - € (unless otherwise indicated)	FY17	FY18	FY19	FY20F
Income statement				
Rental Income	441,788	603,368	645,609	756,487
Other income	42,142	82,239	107,660	-
Total Revenue	483,930	685,607	753,269	756,487
Administrative expenses (less amortisation)	(50,922)	(85,484)	(155,150)	(182,418)
EBITDA	433,008	600,123	598,119	574,069
Amortisation	-	-	(625)	(626)
EBIT	433,008	600,123	597,494	573,443
Fair value gains on investment property	2,258,060	1,071,115	3,835,687	3,036,000
Finance costs	(89,492)	(129,386)	(108,490)	(104,041)
Profit before tax	2,601,576	1,541,852	4,324,691	3,505,402
Tax expense	(330,238)	(186,505)	(782,483)	(97,166)
Net income	2,271,338	1,355,347	3,542,208	3,408,236
Cash flow				
Net cash from operations (CFO)	184396	1,028,028	23,936	606,978
Capex	(1,010,822)	(988,508)	(3,750,394)	(2,501,328)
Free cash flows (CFO – Capex)	(826,426)	39,520	(3,726,458)	(1,894,350)
Balance sheet				
Cash and cash equivalents	42,282	12,361	2,310,847	442,391
Current assets	266,071	363,174	2,451,372	632,807
Non-current assets	10,836,736	12,896,359	20,651,360	26,750,900
Total assets	11,102,807	13,259,533	23,102,732	27,383,707
Current liabilities	1,726,637	1,675,098	1,349,047	2,007,412
Non-current liabilities	3,181,176	4,034,094	10,661,135	10,875,507
Total liabilities	4,907,813	5,709,192	12,010,182	12,882,919
Total Financial debt	2,051,995	1,982,554	8,102,823	8,192,167
Net debt	2,009,713	1,970,193	5,791,976	7,749,776
Total equity	6,194,994	7,550,341	11,092,550	14,500,788
Ratios				
Growth in Total Revenue (YoY Revenue Growth)	n/a	41.7%	9.9%	0.4%
EBITDA margin (EBITDA / Revenue)	89.5%	87.5%	79.4%	75.9%
Operating (EBIT) margin (EBIT / Revenue)	89.5%	87.5%	79.3%	75.8%
Net margin (Net income / Revenue)	469.4%	197.7%	470.2%	450.5%
Return on assets	20.5%	11.1%	19.5%	13.5%
Current ratio (Current assets / Current Liabilities)	0.2x	0.2x	1.8x	0.3x
Interest coverage ratio (EBITDA /Cash interest paid)	4.8x	4.6x	4.9x	1.5x
Gearing level 1 (Net debt / Net debt and Total equity)	24.5%	20.7%	34.3%	34.8%
Gearing level 2 (Total Liabilities / Total Assets)	44.2%	43.1%	52.0%	47.0%
Net debt / EBITDA	4.6x	3.3x	9.7x	13.5x

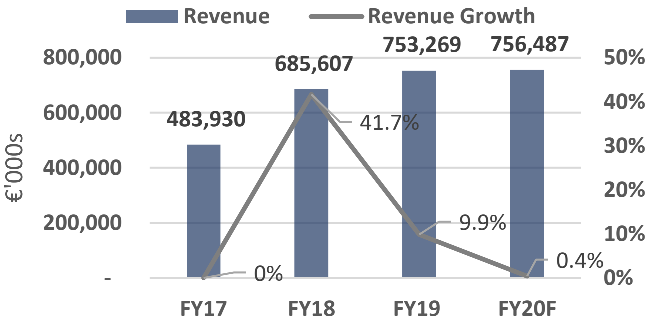
Source: KA's Audited Financial Statements

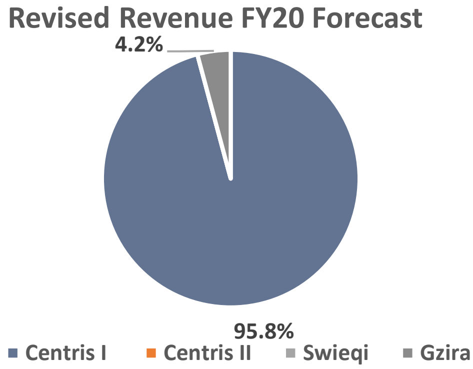
Investment considerations

- **Revenue**: Actual FY19 consolidated revenue amounted to circa €0.8m, representing an increase of 9.9% over FY18. Such improvement in revenue is mainly attributable to the Group achieving full occupancy at Centris I in combination to the yearly increases included in the tenants' contracts.

  Notwithstanding the challenges brought about by the COVID-19 pandemic, management noted that, as explained in prior sections of this report, there has been a minimal reduction in rental revenues from Centris I during FY20, which is deemed to be immaterial.

  As per the revised CAD revenue forecasts for FY20, the Group anticipates to generate a revenue figure of circa €0.8m, which reflects the continued rental income generated from Centris I and the commencement of operations of KA's Gzira property. More importantly, management recently reported that up until October 2020, KA has managed to generate circa 75% of FY20's revised projected revenue.

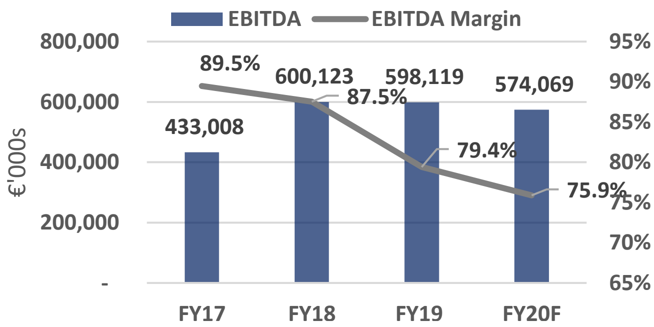




- **EBITDA:** During FY19, the Group incurred higher levels of professional fees concerning the issuing of their bond, resulting into a consequent drop in KA's EBITDA margin from 87.5% in FY18 to 79.4% in FY19.

  Administrative expenses are projected to amount to circa €0.2m during FY20, which upon discussions with management also include additional professional fees incurred relating to the Group's bond. However, in view of the delays experienced in the commencement of operation of the Centris II, Swieqi and Gzira properties, this projected administrative figure, represents a decrease of circa €74k from the figure forecasted in the Group's CAD prior the bond issue.

  In view of the above, and also in view of the fact that the Group experienced a marginal decline in revenues concerning Centris I during FY20, KA is expected to generate a lower EBITDA figure of €0.6m throughout this period, which translates into an EBITDA margin of 75.9%.

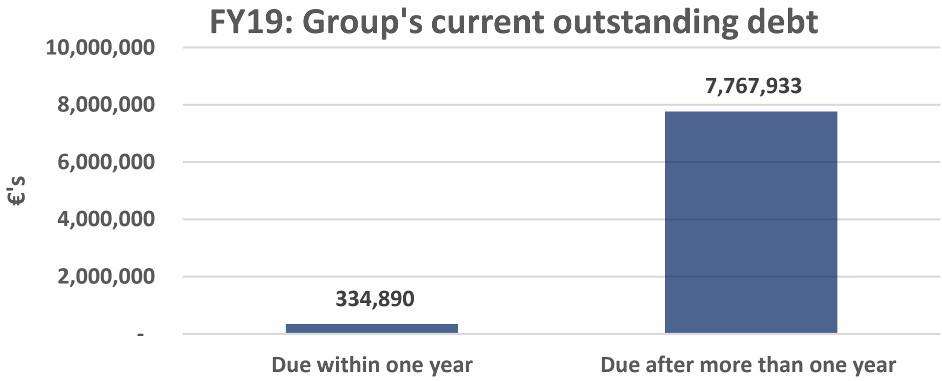


Source: KA's Audited Financial Statements

- **Finance costs:** Finance costs mainly consist of interest incurred on the Group's bank borrowings and the bond currently in issue. As a result of capitalised interest concerning investment property, the financing cost for FY19 (€108k) was lower than FY18 (€129k), however if capitalised interest costs are included, the adjusted financing expense would amount to €216k. The Group's finance costs for FY20 are anticipated to amount to €104k (which includes the capitalised interest adjustment).

- **Interest cover:** In FY19, the Group's interest coverage stood at 4.9x. However, it is key to note that the actual cash interest paid for FY19 does not reflect the bond interest cost given that the first coupon payment was made in August 2020.

Debt maturity profile



Interest Bearing Debt Analysis (€'s)	FY19
Current Liabilities	
Bank borrowings	232,602
Debt securities in issue	102,288
	334,890
Non-current Liabilities	
Borrowings	1,916,113
Debt securities in issue	5,851,820
	7,767,933
Total Financial Debt	**8,102,823**

Source: KA's Audited Financial Statements

- During FY19, KA issued a secured callable (2026-2029) €6m bond which was subscribed in full and admitted to the Prospects MTF. These bonds bear interest at the rate of 4.75% per annum and are secured by a special hypothec on Centris II and a general hypothec on all of the Guarantor's present and future assets.

- In terms of the Group's bond, KA implemented a covenant whereby the Issuer and the Guarantor are restricted from declaring dividend payments and make any repayments towards any outstanding related party loan throughout the term of the bond, which in nature safeguards bondholders, unless;
  - The interest coverage ratio is greater than 2.0x
  - The Debt-To-Total Capital Ratio is below 60%

- The Group's facilities comprise of a loan of €2.5m. This is secured by a general hypothec over KA's assets, a special hypothec on part of the Centris property and a pledge over insurance policies covering hypothecated property. This loan bears interest at 5.25% per annum and is repayable over 15 years through 180 monthly repayments of approximately €20k inclusive of interest. Starting from January 2020, the repayment principal of €242k is to be done every January on a yearly basis.

Further updates following the COVID-19 outbreak:

- The Group also secured two separate loans of €50k and €150k under the Malta Development Bank (MDB) COVID-19 guarantee scheme which were drawn down during Q3 2020. The drawdown of these loan do not violate any of the restrictive aforementioned covenant.

- Management also confirmed that the Group is currently in positive discussions to secure additional financing (€0.7m - €1.2m)

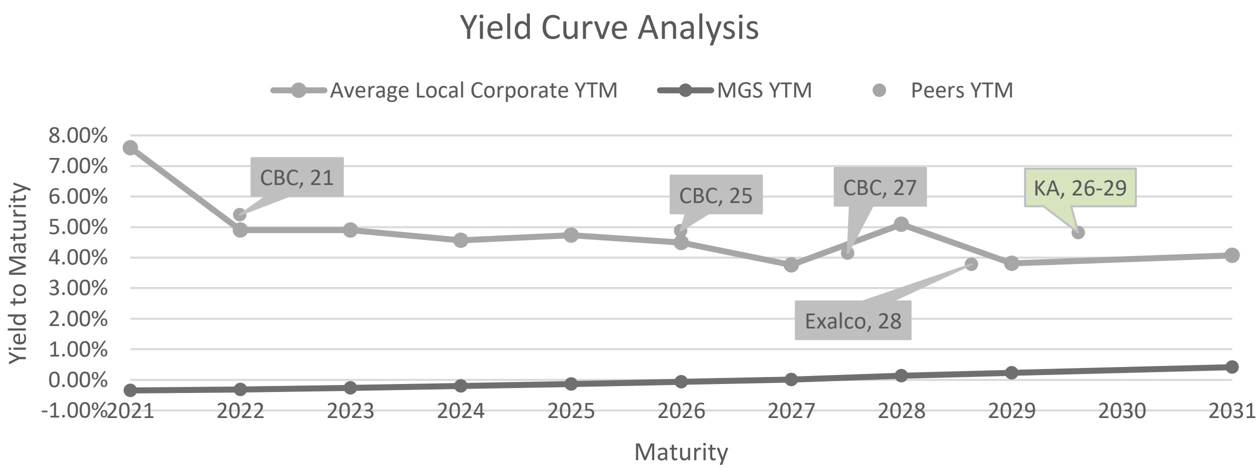
Analysis of outstanding issues

Security	Nom Value €000's	Yield to Maturity (%)	Interest coverage (EBITDA) (times)	Total Assets (€'millions)	Total Equity (€'millions)	Total Liabilities / Total Assets (%)	Net Debt / Total Equity (%)	Net Debt / EBITDA (times)	Current Ratio (times)	Return on Common Equity (%)	Net Margin (%)	Revenue Growth (YoY) (%)	Last Closing Price *
5.75% Central Business Centres plc Unsecured € 2021 S1T1	3,000	5.40%	1.4x	29.4	16.6	43.7%	70.6%	13.2x	0.3x	3.0%	45.6%	205.0%	100.50
5.25% Central Business Centres plc Unsecured € 2025 S2T1	3,000	4.88%	1.4x	29.4	16.6	43.7%	70.6%	13.2x	0.3x	3.0%	45.6%	205.0%	101.75
4.75% KA Finance plc Secured Callable Bonds 2026-2029 *	6,000	4.82%	4.9x	23.1	11.1	52.0%	52.2%	9.7x	1.8x	31.9%	548.7%	7.0%	99.50
4.4% Central Business Centres plc Unsecured € 2027 S1/17 T1	6,000	4.15%	1.4x	29.4	16.6	43.7%	70.6%	13.2x	0.3x	3.0%	45.6%	205.0%	101.50
4% Exalco Finance plc Secured € 2028	15,000	3.78%	3.9x	68.2	39.7	41.7%	47.1%	5.7x	1.0x	5.0%	44.7%	13.9%	101.50
Average (does not capture the financial analysis of the Group)		4.55%											

* Last price as at 01/12/2020

Investment rationale

We have compared the securities of KA Finance plc against similar issuers in the local market. Comparable companies were specifically identified on the basis of the industry in which they operate, more specifically their service offerings. The credit profile of the comparable companies was analysed in terms of leverage and the ability to meet debt obligations.



Source: Malta Stock Exchange, Central Bank of Malta, and Calamatta Cuschieri Investment Management

The above graph illustrates the average yearly yield of all local issuers as well as the corresponding yield of MGSs (Y-axis) vs the maturity of both Issuers and MGSs (X-axis), in their respective maturity bucket, to which the spread premiums can be noted. The graph illustrates on a stand-alone basis, the yield of comparable issuers having a maturity between 4-8 years (Peers YTM).

As clearly highlighted in prior sections of this report, following the COVID-19 outbreak in Malta, the Group had minimal impact in terms of the Centris I operation, with this being in line with the majority of the Group's tenants being sticky in nature. However, KA's major pandemic related issue stems from the delays experienced in terms of the Group's ongoing projects, more specifically referring to the Centris II and Swieqi apartment complex developments.

In view of this, and following comprehensive discussions with management, such delays have impacted the Group from a liquidity and cash generation perspective, whereby previously anticipated revenues attributed specifically to these properties, have been delayed from FY20 to FY21. In this regard, the Group recently issued an updated set of financial projections illustrating the changes in anticipated revenues for FY20. Following further discussions with the Group's executives, management reported that up until October 2020, the Group has managed to generate circa 75% of FY20's projected revenue.

In the face of such liquidity constraints, the Group is currently in positive discussions to secure additional financing (€0.7m - €1.2m) to ensure the smooth operational running of the Group while more importantly also ensuring that all of the Group's debt obligations, including the bond's coupon payment is honoured in a timely manner. However, it is important to point out that to date, such negotiations have not yet been concluded.

Although the Group is anticipating to start generating revenues from Centris II and Swieqi properties during FY21, the Group has not yet signed any LOIs with a prospective tenant concerning the Group's new office block. It is key to note that from a credit sanity perspective, Centris II has a crucial role to play in terms of the Group's EBITDA generation moving forward, as in line with previous projections, this is expected to be the main revenue driver for the Group.

Upon taking the above important attributes into consideration, and also after taking into account the updated projections provided by management, the Group's interest coverage for FY20 is expected to deteriorate down to 1.5x. On this basis, we are issuing a **Neutral** credit opinion on the Issuer.

KAF26-29

KA's bond is currently trading at €99.50, translating into a YTM of 4.82%. The average yield of the peers identified above, with maturity between 4 to 8 years, is of 4.3%. However, the best comparable to KA is CB25, which provides investors with a marginally higher YTM. Moreover, we are of the opinion that the uncertainty surrounding the COVID-19 pandemic, which has been clearly impacted KA's ongoing projects in terms of completion delays, we are issuing a **Hold** recommendation on KAF26-29, on the basis that we believe the company holds the necessary liquidity buffers to service its debt obligations.

Glossary and definitions

Income Statement	
Revenue	Total revenue generated by the Group/Company from its principal business activities during the financial year.
EBITDA	EBITDA is an abbreviation for earnings before interest, tax, depreciation and amortisation. It reflects the Group's/Company's earnings purely from operations.
Operating Profit (EBIT)	EBIT is an abbreviation for earnings before interest and tax.
Depreciation and Amortisation	An accounting charge to compensate for the decrease in the monetary value of an asset over time and the eventual cost to replace the asset once fully depreciated.
Net Finance Costs	The interest accrued on debt obligations less any interest earned on cash bank balances and from intra-group companies on any loan advances.
Net Income	The profit made by the Group/Company during the financial year net of any income taxes incurred.
Profitability Ratios	
EBITDA Margin	EBITDA as a percentage of total revenue.
Operating (EBIT) Margin	Operating margin is the EBIT as a percentage of total revenue.
Net Margin	Net income expressed as a percentage of total revenue.
Return on Common Equity	Return on common equity (ROE) measures the rate of return on the shareholders' equity of the owners of issued share capital, computed by dividing the net income by the average common equity (average equity of two years financial performance).
Return on Assets	Return on assets (ROA) is computed by dividing net income by the average total assets (average assets of two years financial performance).
Cash Flow Statement	
Free Cash Flows (FCF)	The amount of cash the Group/Company has after it has met its financial obligations. It is calculated by taking Cash Flow from Operating Activities less the Capex of the same financial year.
Balance Sheet	
Total Debt	All interest bearing debt obligations inclusive of long and short-term debt.
Net Debt	Total debt of a Group/Company less any cash and cash equivalents.
Financial Strength Ratios	
Current Ratio	The Current ratio (also known as the Liquidity Ratio) is a financial ratio that measures whether or not a company has enough resources to pay its debts over the next 12 months. It compares current assets to current liabilities.
Quick Ratio (Acid Test Ratio)	The quick ratio measures a Group's/Company's ability to meet its short-term obligations with its most liquid assets. It compares current assets (less inventory) to current liabilities.
Interest Coverage Ratio	The interest coverage ratio is calculated by dividing EBITDA of one period by cash interest paid of the same period.
Gearing Ratio Gearing Ratio Level 1 Gearing Ratio Level 2	The gearing ratio indicates the relative proportion of shareholders' equity and debt used to finance total assets. Is calculated by dividing Net Debt by Net Debt and Total Equity. Is calculated by dividing Total Liabilities by Total Assets.
Net Debt / EBITDA	The Net Debt / EBITDA ratio measures the ability of the Group/Company to refinance its debt by looking at the EBITDA.
Cash from Operations / EBIT	This ratio measures the ability of the Group/Company to convert its earnings into cash.
Other Definitions	
Yield to Maturity (YTM)	YTM is the rate of return expected on a bond which is held till maturity. It is essentially the internal rate of return on a bond and it equates the present value of bond future cash flows to its current market price.

Glossary and definitions

Credit Opinion

- **Positive** indicates expectations of a general improvement of the fundamentals / market sector / asset class / credit rating over the next 6 to 12 months.
- **Neutral** indicates expectations of a general stable trend of the fundamentals / market sector / asset class / credit rating over the next 6 to 12 months.
- **Negative** indicates expectations of a general deterioration of the fundamentals / market sector / asset class / credit rating over the next 6 to 12 months.

Issue specific recommendations

The recommendations below are with respect to existing debt securities issued on the Malta Stock Exchange.

- **Buy** indicates our favourable view from a total return perspective with respect to the credit considering yield-to-maturity / fundamentals / maturity bucket / credit rating over the next 6 to 12 months.
- **Hold** indicates our neutral view from a total return perspective with respect to the credit considering yield-to-maturity / fundamentals / maturity bucket / credit rating over the next 6 to 12 months.
- **Sell** indicates our negative view from a total return perspective with respect to the credit considering yield-to-maturity / fundamentals / maturity bucket / credit rating over the next 6 to 12 months.

N.B: Newly issued research recommendations supersede previously published research.

Disclaimer