FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Arada's Unsecured Debt to 'BB'; Affirms IDR at 'B+'; Removes From UCO

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Fitch Ratings - London - 19 Jul 2023: Fitch Ratings has upgraded UAE-based property developer Arada Developments LLC's senior unsecured rating to 'BB' from 'BB-' and the sukuk trust certificates issued through Arada Sukuk Limited (ASL), to 'BB'/RR2 from 'BB-'/RR3. We have also affirmed Arada's Long-Term Issuer Default Rating (IDR) at 'B+' with a Stable Outlook. The senior unsecured ratings have been removed from Under Criteria Observation (UCO).

The upgrade of the instrument ratings follows changes under Fitch's Country-Specific Treatment of Recovery Ratings Criteria published in March 2023. Fitch moved the UAE to a Group B country, from Group C, which allows the cap for Arada's instrument ratings to be two notches above the IDR. Arada's IDR reflects a Standalone Credit Profile (SCP) of 'b' and a one-notch uplift for Sharjah government support, as assessed under Fitch's Government Related Entity (GRE) criteria.

The affirmation of the IDR reflects Arada's strong operational performance, which is benefiting from economic growth and good real estate market demand. Gross debt/EBITDA at end-2022 was modest at 3.1x. At the same time, Arada's geographic and project concentration is high.

KEY RATING DRIVERS

Progress on Developments Boosting Revenue: Arada is developing Aljada, the largest ever community development in the Emirate of Sharjah. As of 2Q23, around 9,000 units had been sold and 6,000 delivered. The project, launched in 2017, encompasses 2.2 million square metres (sq m) and will have 25,000 quality apartments, townhouses and villas, significant green space and supportive retail, school and other assets. Aljada has 14 build phases and is scheduled to complete in 2029. In 2021, Arada launched Masaar, an upscale forested community of 4,000 villas and townhouses on 1.8 million sq m. It is scheduled to complete in 2026 with handovers starting imminently.

Total company sales in 2022 reached AED3.5 billion (2021: AED2.4 billion), while deliveries of more than 4,000 units generated AED2.24 billion of revenue (2021: AED1.3 billion). In 1H23, sales reached AED4.3 billion.

Strong Market Demand: Arada is benefiting from a growing economy and strong housing demand. Fitch forecasts UAE economic growth at 3% and 2% in 2023 and 2024, respectively, following 7.5% in 2022. Structural reforms in the UAE, including liberalising visa regulations, and a Sharjah decree in 2022 allowing freehold ownership for all nationalities, are helping to support housing demand.

Relatively New Company: Arada was established in 2017 and has completed only one community development, Nasma Residences. The development's 1,117 townhouses and villas sold well and were delivered on time. Ongoing projects continue to sell well, but Arada must deliver units to generate cash flows. Material construction delays could weaken its financial metrics. Arada holds a strong market position in Sharjah, having recently delivered more than two-thirds of new residencies.

Bottom-up Rating Approach: As an integral part of Sharjah's development plans for the real estate sector, Arada benefits from government support. Fitch views the history of this support as 'strong', as evidenced by the government guaranteeing the company's debt to buy the Aljada land and subsequently converting the debt into a 16-year deferred payment plan. Under our GRE criteria, we view status, control and ownership, and socio-political implications of default, as 'moderate', but the financial implications of default as 'weak'. We therefore rate Arada on a bottom-up basis, adding a one-notch uplift to the SCP.

Arada also receives support for municipal or regulatory approvals, reducing execution risks and costs. However, government support is project based, and the government is not obliged to support future projects, or any outside Sharjah.

Expansion Beyond Sharjah: Arada is expanding into prime areas of Dubai, where it launched Jouri Hills at Jumeirah Golf Estates in late 2022, selling 169 villas valued at AED1.29 billion in 1H23. Arada is also developing the high-end Armani Beach Residences Palm Jumeirah (launching in late 2023) and entered into a JV to develop more than 1000 units in a new waterfront development in Dubai. These developments do not receive governmental support. Despite this diversification, we forecast Sharjah projects to generate more than 85% of total revenue on average.

Development Model Reduces Risk: Arada acquired land in Sharjah through deferred payments to reduce upfront cash outlays. Before starting construction, Arada targets minimum pre-sales of 60%. Buyers provide deposits (typically 10%), which together with instalments (based on building milestones) fund substantially all construction costs. Buyers pay the remainder (usually 70%) at handover. If a buyer defaults, Arada can keep the payments and sell the unit. Construction risk is mitigated by fixed-price, lump-sum contracts and 10% performance bonds from contractors. Unlike Dubai, Sharjah does not require developers to manage cash-flows through escrow accounts.

Moderate Leverage Metrics: High deliveries in 2022 meant EBITDA reached AED559 million (2021: AED210 million). Gross debt increased to AED1.7 billion (2021: AED920 million), but the higher EBITDA meant gross cash-flow leverage fell to 3.1x by end-2022 (end-2021: 4.4x). Fitch forecasts leverage will increase in 2023, but the magnitude will depend on the scope of land acquisitions and the related mix of debt and equity.

Nevertheless, we expect leverage to remain below the gross EBITDA leverage rating sensitivity of 4.5x. Fitch understands management will not go ahead with acquisitions without equity injections. Interest coverage is forecast to be 3.5x and 4.7x in 2023 and 2024, respectively. We treat government payables for the Aljada land as part of working capital.

Recovery Estimate Superior: Fitch applies a two-notch uplift to the senior unsecured rating compared with the IDR. The recovery estimate uses a liquidation approach, mainly supported by work in progress and investment properties, to which we apply a 50% discount. As the UAE is a 'Group B' country, the Recovery Rating is capped at 'RR2', resulting in a senior unsecured rating of 'BB'/RR2.

DERIVATION SUMMARY

Operating and regulatory environments vary significantly across EMEA, which limits comparability. Across Fitch's Housebuilder Navigator peers there are different risk profiles for different residential markets. In France, there is little upfront capital outlay for land, and purchaser deposits fund capex. In the UK and Spain, upfront land outlay and the bulk of the purchase price is paid upon completion. This is similar to UAE markets, although the UAE tends to be more volatile than Western European markets.

Arada operates almost entirely in the Emirate of Sharjah, which is smaller and less developed than Dubai and Abu Dhabi, but less volatile. Arada is the primary master-plan developer in Sharjah, which has had little community development, and it has a strong competitive advantage there, particularly owing to government support from the Sharjah government. This includes access to land, which is critical in the UAE markets.

Arada is also developing projects in Dubai, helping reduce its high geographic concentration. However, it does not receive Sharjah government support for these projects and must compete with other UAE companies, including much larger, established developers such as Damac Real Estate Development Limited, Emaar Properties PJSC (BBB/Stable) and Aldar Properties PJSC. The latter two are significant master-plan builders with material international operations. None of these developers has a material presence in Sharjah.

In contrast to Arada, Emaar and Aldar are conglomerates with significant portfolios of investment properties generating stable, recurring revenue. These account for around 50% of their total revenue. Arada's community projects include supporting assets, such as retail businesses and schools, which are retained and generate recurring revenue. Along with several other businesses owned by Arada, these are increasing and diversifying recurring cash flows, but these are expected to remain a small part of total revenue. Consequently, Arada will remain predominantly exposed to volatile development cash flows.

Arada is smaller and less established than UK-based Miller Homes Group (Finco) PLC (B+/Stable), or Spanish housebuilders AEDAS Homes, S.A. and Via Celere Desarrollos Inmobiliarios, S.A.U. (both rated BB-/Stable). These companies have relatively good geographic and project diversity compared with Arada, but do not benefit from government support and its related competitive advantages. However, Sharjah, and the UAE tend to experience more economic and real estate market volatility. The funding requirements for Arada and Spain and UK-based housebuilders are similar, relying on relatively small purchaser deposits (5%-10% for the UK, 10% for Arada, and up to 20% for Spain) to fund development costs.

KEY ASSUMPTIONS

Fitch's Key Assumptions within our Rating Case for the Issuer:

- Substantial new project launches and deliveries in 2023-2026 generating revenue growth of averaging around 40%.

- Growing EBITDA margins averaging 25%.

- New debt and equity issued in 2023 to fund working capital and capex.

-Capex of more than AED2 billion per year, mainly reflecting land acquisitions funded by debt and equity. We assume the land will not be acquired if equity is not raised, or will be funded through a deferred payment plan if located in Sharjah.

-Increasing dividend pay-outs averaging AED360 million for 2023-26

Recovery Assumptions

- As Arada's IDR is in the 'B' rating category, Fitch applies a bespoke recovery analysis in line with its criteria.

- The recovery analysis assumes Arada would be liquidated, in line with other home builders, as the primary value of the company is in the land, receivables and work in progress.

- We have assumed a 10% administrative claim.

- The liquidation estimate reflects Fitch's view of the value of balance sheet assets that can be realised in a sale or liquidation during a bankruptcy or insolvency proceeding and distributed to creditors.

- Inventory includes land, projects underway and investment properties, to which we have applied a 50% discount to reflect some uncertainties of recoveries in the Sharjah market. We have similarly applied a 50% discount to the receivables.

- The company has a committed AED300 million liquidity facility, which is assumed to be fully drawn.

- As all assets are located in the UAE, which is a 'Group B' country, the Recovery Rating is capped at 'RR2', resulting in a senior unsecured rating of 'BB'/RR2.

RATING SENSITIVITIES

Factors That Could, Individually Or Collectively, Lead To Positive Rating Action/Upgrade

- Positive free cash flow (FCF) generation on a sustained basis

- Sustained improvement in financial metrics leading to gross debt/EBITDA below 3.5x

- Improved corporate governance structure

- Reduced execution risk

- Improved liquidity position

Factors That Could, Individually Or Collectively, Lead To Negative Rating Action/Downgrade

- Change in government support, weakening Arada's business and financial profiles

- Gross debt/EBITDA above 4.5x

- Liquidity score sustained below 1x

- Negative FCF on a sustained basis

- Overall softening of Sharjah's real estate market resulting in low pre-sales levels and delayed project launches

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Tight Liquidity: At 31 December 2022, the company had AED798 million of unrestricted cash on the balance sheet, as well as access to an AED300 million committed liquidity facility. This comfortably covers AED99 million of bank debt maturing in 2023. Nevertheless, we forecast FCF to be negative, reflecting working capital outflows as the company develops, as well as capex (including land acquisitions) and dividends, which means the liquidity ratio will be below 1.0x. However, Fitch expects the company to issue additional equity and new unsecured debt in 2023, which will significantly improve liquidity.

Arada issued its debut sukuk in 2022, which, including two taps, totalled AED1.6 billion. This enabled the company to repay nearly all of its secured bank debt. The remaining secured bank debt of AED99 million will be repaid this year. With this minimal secured debt, Arada's unencumbered asset cover was well above 2.0x at end-2022.

ISSUER PROFILE

Arada is a master-plan community developer currently focusing on the Emirate of Sharjah in the UAE.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Arada Developments LLC has an ESG Relevance Score of '4' for Governance Structure due to the weak structure of the board of directors compared with most EMEA peers. The board comprises four members, including the two shareholders and the CEO with no independents. All members sit on the four committees: audit, investment, remuneration and risk. The lack of an independent board has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING			RECOVERY	PRIOR
Arada Sukuk Limited					
senior unsecured	LT	BB	Upgrade	RR2	BB-
Arada Developments LLC	LT IDR	B+ Rating Outlook Stable	Affirmed		B+ Rating Outlook Stable
senior unsecured	LT	BB	Upgrade		BB-

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Bram Cartmell
Senior Director
Primary Rating Analyst
+44 20 3530 1874
bram.cartmell@fitchratings.com
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf London E14 5GN

Samer Haydar
Director
Secondary Rating Analyst
+971 4 424 1240
samer.haydar@fitchratings.com

Fredric Liljestrand
Senior Director
Committee Chairperson
+46 85051 7809
fredric.liljestrand@fitchratings.com

MEDIA CONTACTS

Isobel Burke
London
+44 20 3530 1499
isobel.burke@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Sukuk Rating Criteria (pub. 13 Jun 2022)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

Country-Specific Treatment of Recovery Ratings Criteria (pub. 03 Mar 2023)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 12 May 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Arada Sukuk Limited	UK Issued, EU Endorsed

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