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RATING ACTION COMMENTARY

Fitch Downgrades Arada's Unsecured Debt to 'BB-'; Removes From Under Criteria Observation

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Fitch Ratings - London - 05 Apr 2024: Fitch Ratings has downgraded UAE-based property developer Arada Developments LLC's senior unsecured rating and the sukuk trust certificates issued through Arada Sukuk Limited (ASL) to 'BB-'/'RR3' from 'BB'/'RR2'. The ratings have been removed from Under Criteria Observation (UCO). We have also affirmed Arada's Long-Term Issuer Default Rating (IDR) at 'B+' with a Stable Outlook.

The downgrade of the instrument ratings follows changes under Fitch's 'Corporate Recovery Ratings and Instrument Ratings Criteria' published in October 2023. The new criteria lowered the cap for unsecured instruments for issuers with a 'B+' IDR to 'RR3' from 'RR2'. This change was made to smooth the instrument rating transition between 'B+' and 'BB-' IDRs.

Arada's 'B+' IDR reflects its 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.

KEY RATING DRIVERS

Recovery Estimate Good: Fitch applies a one-notch uplift to the senior unsecured rating compared with the IDR. The recovery estimate uses a liquidation approach, mainly supported by the attributable value of work in progress and investment properties, to which we apply a 50% discount. As Arada's IDR is 'B+', the Recovery Rating is capped at 'RR3', resulting in a senior unsecured rating of 'BB-'/RR3.

Development Progress 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 apartments, townhouses and villas, significant green space and supportive retail, a 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 3,000 villas and townhouses on 1.8 million sq m. It is scheduled to complete in 2026.

Total company sales in 2022 reached AED3.5 billion (2021: AED2.4 billion), while deliveries of more than 4,000 units generated AED2.48 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 2% and 3.6% 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 support housing demand.

Relatively New Company: Arada was established in 2017 and has completed 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 and material construction delays could weaken financial metrics. Arada holds a strong market position in Sharjah, having recently delivered more than two-thirds of new residences.

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's IDR 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.

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

- Arada's IDR is in the 'B' rating category, Fitch therefore 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 mainly land and projects underway, 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 investment properties and receivables.

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

- As Arada's IDR is 'B+', the Recovery Rating is capped at 'RR3', resulting in a senior unsecured rating of 'BB-'/RR3. The recovery output percentage on current metrics and assumptions was 70%.

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

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 covered 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 was below 1.0x. However, Fitch expects the company to issue additional equity and new unsecured debt, 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 was repaid in 2023. With this repayment, all of Arada's debt is now unsecured.

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.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			RECOVERY	PRIOR
Arada Sukuk Limited					
senior unsecured	LT	BB-	Downgrade	RR3	BB
Arada Developments LLC	LT IDR	B+ Rating Outlook Stable	Affirmed		B+ Rating Outlook Stable
senior unsecured	LT	BB-	Downgrade	RR3	BB

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Sukuk Rating Criteria (pub. 13 Jun 2022)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 13 Oct 2023) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 03 Nov 2023)

Government-Related Entities Rating Criteria (pub. 12 Jan 2024)

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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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch’s website.

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