Georgia Capital

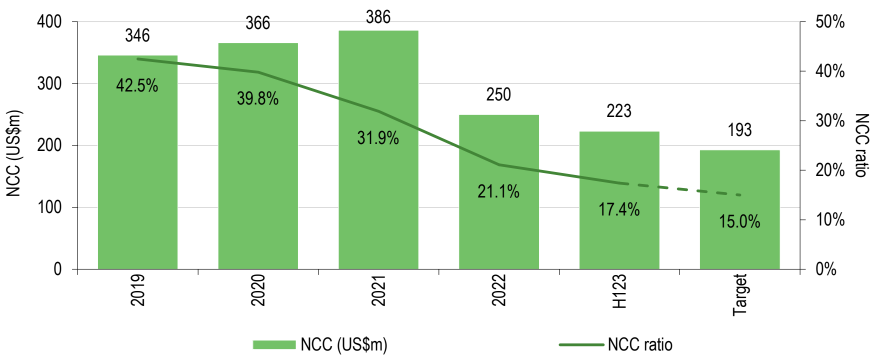
Successful bond refinancing improves risk profile

Investment companies
Private equity

7 September 2023

Georgia Capital (GCAP) delivered positive newsflow during August, including the successful pricing of its new sustainability-linked bond (with proceeds used to redeem the 2024 Eurobond), as well as its Q223 results release, with a robust 8.2% NAV total return (TR) in GEL terms posted during the quarter. We believe that the successful bond refinancing, coupled with continued deleveraging at holding level (net capital commitment ratio of 17.4% at end-June 2023) further reduces GCAP's risk profile. Despite the above, GCAP's shares are still trading at a relatively wide c 58% discount to its 'live' NAV estimate.

GCAP made further progress on its deleveraging agenda in H123



Source: Georgia Capital. Note: Net capital commitment (NCC) defined as net debt and guarantees issued at the holding level plus total planned investments, announced buybacks and a US$50m contingency/liquidity buffer divided by portfolio value.

Georgian economy remains strong

GCAP provides diversified exposure to Georgia, mostly through resilient, market-leading businesses in sectors such as healthcare, pharmacy, financials, renewable energy and education. The Georgian economy has proved its resilience throughout the COVID-19 pandemic and the war in Ukraine and maintains its solid momentum, with H123 GDP growth of 7.6% y-o-y (after 10.1% in 2022), assisted by a healthy combination of external demand, FX flows and local credit expansion. At the same time, inflation remains contained, standing below the 3% central bank target since April 2023. The International Monetary Fund forecasts 4.0% GDP growth in 2023 and 5.0% growth pa in 2024–28. Galt & Taggart and TBC Capital (local brokers) expect 2023 GDP growth of 6.8% and more than 7.2%, respectively.

A quality play on the local economy

We believe that GCAP's value proposition is underpinned by the following drivers: 1) 26% of its end-June 2023 NAV is attributable to the listed Bank of Georgia, a highly profitable bank (H123 ROE at 31.3%) and one of the local leaders, now trading at a moderate 1.0x book; 2) 92% of its portfolio is valued externally, with most of its private holdings valued by a third-party specialist; and 3) GCAP receives a steady income stream from dividends and buybacks from its holdings, with management expecting GEL150–160m of regular distributions in 2023 (GEL205–215m including one-off distributions), implying a 4.5–4.8% yield on its end-June 2023 portfolio value (6.1–6.4% including one-off distributions).

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Price		**980p**
Market cap		**£430m**
NAV*		**£916m**
NAV per share*		2,212p
Discount to NAV		55.7%
Yield		N/A
Ordinary shares outstanding*		41.4m
Code/ISIN		CGEO/GB00BF4HYV08
Primary exchange		LSE Standard
AIC sector		N/A
52-week high/low	980p	602p
NAV high/low	2,212p	1,478p

*As at end-June 2023.

Gearing

Net gearing at 30 June 2023 10.7%

Fund objective

Georgia Capital focuses on scalable private equity opportunities in Georgia. These opportunities have the potential to reach an equity value of at least GEL300m over the next three to five years and the company can monetise investments through exits as investments mature.

Bull points

- The majority of the portfolio is exposed to resilient and well-established businesses.
- Successful disposal of the water utility business in 2022 reinforces confidence in GCAP's exit capabilities and portfolio valuations.
- Regular dividend income from several portfolio companies.

Bear points

- High discount to NAV and a focus on deleveraging limits GCAP's activity in terms of new investments.
- A concentrated portfolio exposed to a frontier economy is inherently higher risk.
- GCAP has just started building its track record of investment realisations.

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Successful refinancing of the 2024 Eurobonds

On 1 August 2023, GCAP announced that it has successfully priced a US$150m, five-year sustainability-linked bond in the Georgian market. GCAP highlighted that it was the largest ever corporate bond offering in the local market, and attracted significant interest from local investors. While high-profile international financial institutions (European Bank for Reconstruction and Development, Asian Infrastructure Investment Bank, Asian Development Bank and International Finance Corporation) committed to a US$110m investment in GCAP's bonds, their tranche was scaled back to US$67m to allow local investors to acquire the remaining US$83m. It is also worth noting that holders of US$23m of the existing Eurobond transitioned their holdings to the new bond.

The bond bears a fixed coupon of 8.50% and was issued at par, which compares to a 6.125% fixed coupon for the previous bond (issued in March 2018). GCAP secured a quite attractive rate when compared to the local interest rates in Georgia (the current central bank refinancing rate is 10.25%), and the rate on GCAP's bonds is also close to the US corporate high yield bonds (the effective yield of the ICE BofA High Yield Index at 1 August 2023 was 8.23%). Importantly, given the lower volume of the new bonds versus the US$300m Eurobonds, GCAP will reduce its overall interest expenses. The new bonds were rated 'BB-' by S&P, which represents a one-notch upgrade compared to the previous Eurobonds.

Key financial covenants embedded in the bond include: 1) net debt to total equity must be less than 45%; 2) payments such as dividends or capital stock redemptions will be restricted to 50% of end-2022 retained earnings and 50% of consolidated net profit thereafter; 3) interest coverage should be at least 100%; and 4) dividend payments and other distributions from material subsidiaries can be restricted only up to 50% of net profit of the material subsidiary. The sustainability-linked target embedded in the bond terms involves a 20% reduction in scope 1, 2 and 3 emissions versus the 2022 baseline of 22,829 tonnes of carbon dioxide equivalent by 2027 (scope 3 emissions represent aggregate scope 1 and 2 emissions of GCAP's portfolio). This reduction will be an important milestone on GCAP's agenda to become net zero in terms of carbon emissions by 2050.

Exhibit 1: Comparison of 2024 Eurobonds versus new local bonds

Terms	2024 Eurobonds	New local bonds
Principal amount	US$300m	US$150m
Issue date	March 2018	August 2023
Maturity	6 years	5 years*
Coupon rate (fixed)	6.125%	8.5%
Rating	B1/CFR (Moody's), B+ (S&P)	BB- (S&P)
Sustainability-linked	No	Yes

Source: Georgia Capital. Note: *Callable after two years at a redemption price of 101.7%, 100.7% and 100.0% after 2nd, 3rd and 4th anniversary, respectively. The redemption price will increase by 0.3% of the principal amount if GCAP fails to provide the Sustainability Performance Target Limited Assurance report proving that the above sustainability performance target has been met in full for the fiscal year ended prior to the bond's early redemption.

New bond placement, dividend income and portfolio value growth support GCAP's deleveraging agenda

The issue proceeds, together with GCAP's liquidity already available before the bond placement, will allow the company to fully redeem its existing US$300m Eurobond (which was due to mature in March 2024). Following the pricing of the new bond, GCAP bought back Eurobonds with a principal amount of US$176.5m through a tender offer, which expired on 8 August 2023. The company intends to cancel these together with the US$106.9m bonds already held in treasury, leaving just US$16.6m outstanding (to be redeemed through a 'Make Whole Call' option in Q323).

At end-June 2023, GCAP's NCC ratio reached 17.4% (see front-page chart), slightly down from 19.7% at end-March 2023 and lower than the 27.0% at end-June 2022. The Q223 improvement was driven by a solid dividend income and an increase in portfolio value. This means that GCAP is gradually approaching its NCC target (through the cycle) of below 15%. Once this is achieved, GCAP is likely to expand its buyback programme (in line with its capital management policy).

Following the full redemption of the previous Eurobonds, GCAP estimates its net debt balance will be c US$110m (or c 8.6% of GCAP's total portfolio value at end-June 2023) versus US$124.1m at end-June 2023. We believe that the bond refinancing meaningfully reduces GCAP's risk profile, warranting a narrowing of the discount to NAV (currently 58% of its 'live' NAV estimate). Importantly, the bond is callable after two years, providing GCAP with the flexibility to pursue its recently reiterated target of reducing the holding-level balance of net debt and guarantees issued close to zero over the short-to-medium term. In this context, we note that GCAP's put option on the remaining 20% stake in its water utility business granted by FCC Aqualia (see our January 2022 note for details) will be exercisable in 2025 or 2026 (the stake was valued at GEL159m at end-June 2023 using an option valuation method). GCAP plans to continue pursuing on-market buybacks as part of its deleveraging strategy, which will also enhance liquidity in the local bonds.

GCAP's management expects GEL150–160m of recurring distributions in 2023

GCAP's holding-level net debt reduction is also being assisted by continued solid income streams from GCAP's portfolio holdings. It received GEL148m in H123, with Bank of Georgia's (BoG's) cash dividend and buyback 'dividend' being the major contributor (GEL114.4m), followed by the one-off dividend from the retail (pharmacy) business of GEL20.1m, as well as regular dividends from the P&C insurance (GEL8.4m) and renewable energy (GEL5.2m) businesses. Management expects FY23 recurring income to reach GEL150–160m, which together with additional one-off inflows should bring the full-year income to c GEL205–215m (or c US$62–65m). GCAP's management remains confident in the dividend outlook beyond 2023, which across its private holdings should be particularly driven by the insurance, renewable energy and retail (pharmacy) businesses.

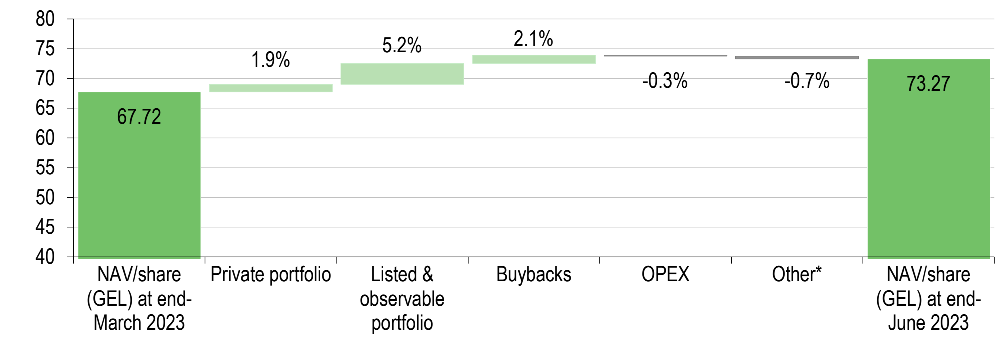
Further scope for deleveraging of some portfolio holdings

In terms of the deleveraging of its portfolio holdings, we note that the retail (pharmacy) and renewable energy businesses had adjusted net debt to EBITDA ratios of 1.7x and 7.1x at end-June 2023 (slightly above their over-the-cycle targets of up to 1.5x and up to 6.0x, respectively). The education business had a ratio of 1.0x (within its target of up to 2.5x), while hospitals had leverage of 4.1x, with clinics and diagnostics at 7.1x (above their targets of up to 2.5x). In terms of the maturity profile, we note that 12% and 35% of total gross debt across GCAP's private portfolio companies matures in 2023 and 2024, respectively. The debt maturing in 2024 includes in particular GEL112m for the hospitals business (c 53% of total gross debt of the hospital business) and a US$35m bond issued by the housing development business. We note that the hospitals and clinics and diagnostics businesses have been affected by the return to normal, post-COVID-19 operations since Q122, but GCAP's management highlighted that the revenues and earnings of these businesses started rebounding in Q223 (hospitals up 8.3% and 9.2% y-o-y, respectively, clinics and diagnostics up 18.7% and 38.1% y-o-y, respectively), suggesting a possible inflection point in performance.

Q223 NAV TR assisted primarily by Bank of Georgia

GCAP posted an 8.2% NAV TR in Q223 in Georgian lari terms (3.3% in sterling terms), mostly on the back of the continued share price appreciation of BoG, which, together with a minor revaluation of the minority stake in the water utility business, resulted in a 5.2% increase in GCAP's NAV during the quarter (see Exhibit 2).

Exhibit 2: Q223 NAV total return

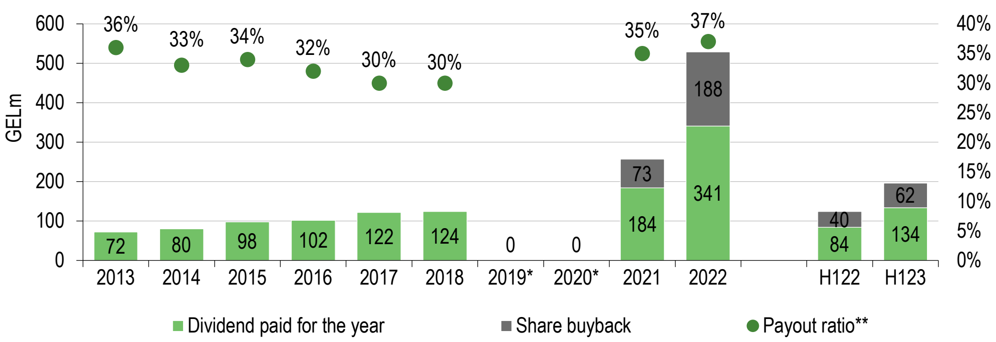


Source: Georgia Capital

BoG's share price was up c 6.4% in Q223 and appreciated further by c 17% since end-June 2023 on the back of its strong Q223 results published on 17 August. The company achieved a healthy annualised return on equity (ROE) of 34.6% during the quarter (bringing the H123 ROE to 31.3%), with a net interest margin of 6.6% (vs 5.3% in Q222) and an adjusted cost-income ratio of 26.9% (vs 32.5% in Q222). BoG also saw a solid increase in loan book of 7.6% during Q223 (or 6.4% on a constant currency basis) and in deposits of 7.3% (5.9% on a constant currency basis). The company booked cost of risk at 80bp (slightly up from 60bp in Q222), and its non-performing loan ratio stood at a moderate 2.4% at end-June 2023 (vs 2.6% at end-June 2022). Its CET-1 ratio and total capital ratio were 18.7% and 22.6% at end-June 2023, respectively (well above the regulatory requirements of 14.6% and 19.8%, respectively).

BoG continues to pursue its policy of distributions to shareholders, targeting a 30–50% dividend and share buyback payout ratio in the medium term. It paid a final dividend for 2022 of GEL5.80 and declared an interim dividend for H123 of GEL3.06 per share (or GEL134m), which on a last 12-month basis represents a c 8% dividend yield. On top of this, BoG spent GEL62m on share buybacks in H123, with a further GEL62m programme approved by the board (to be commenced later this year).

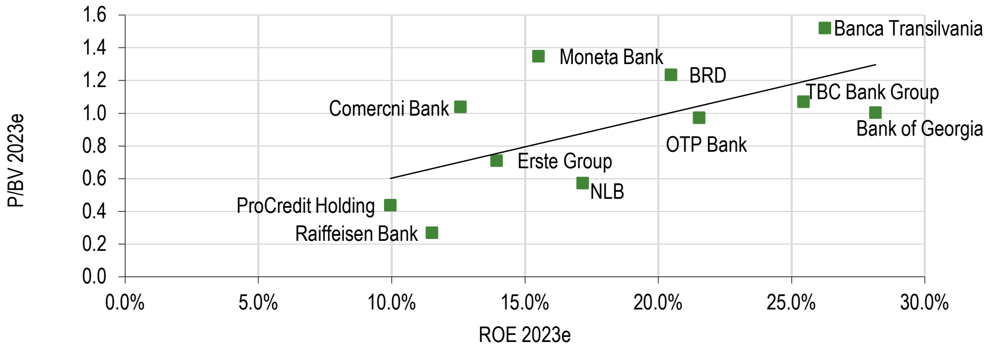
Exhibit 3: Bank of Georgia's historical distributions



Source: Bank of Georgia. Note: *No distributions in 2019 and 2020 due to the COVID-19 pandemic **For the purpose of total payout ratio calculation, total buyback amount is divided by outstanding shares before the beginning of the respective programme.

We note that, despite the recent share price rally, BoG's market valuation does not look very demanding based on the Refinitiv FY23 consensus ROE (c 28% currently) and book value per share (now implying a P/BV of 1.0x) compared to local peers (see below).

Exhibit 4: P/BV versus ROE – PCB's peers (2023e)



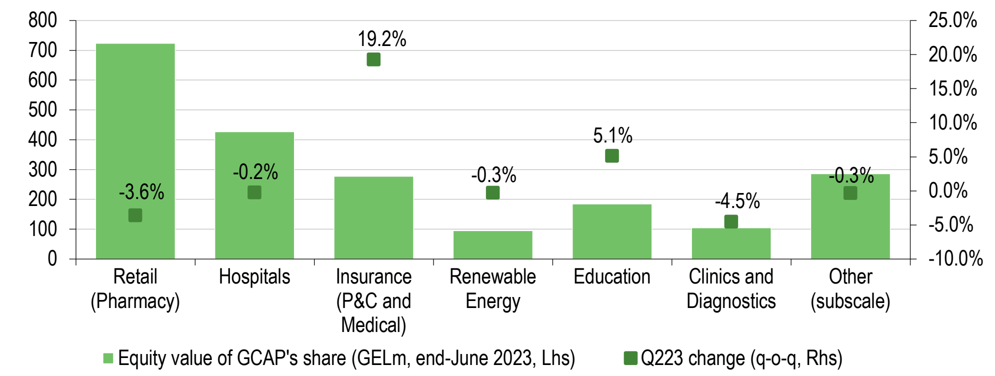
Source: Refinitiv consensus at 7 September 2023

Within GCAP's private holdings (whose revaluation raised GCAP's NAV by 1.9% in Q223), the major positive contributor was the insurance business, consisting of P&C and medical insurance businesses and making up c 9% of GCAP's end-June 2023 total portfolio value. The business was revalued by 19.2% in Q223, with revenue growth of 22.6% y-o-y assisted by a wide range of business lines, including motor, credit life, agricultural and border motor third-party liability. Despite a higher combined ratio in the P&C business (84.3% in Q223 versus 79.8% in Q222), the net income of the entire insurance business rose strongly by 28.0% y-o-y. The higher fair value also reflects a c GEL40m one-time positive effect from the introduction of the Estonian Taxation Model from January 2024, following which GCAP's insurance businesses will no longer be subject to the corporate income tax payment (given that GCAP is a domestic legal entity).

GCAP's education business also contributed positively, as it was revalued by 5.1% versus end-March 2023 on the back of a continued strong operating performance, with revenues up by 27.5% y-o-y in Q223 fuelled by a strong intake and utilisation ramp-up. EBITDA was up just 1.5% y-o-y due to the negative impact of the shift in academic days in the midscale schools, as well as a 44% y-o-y rise in operating expenses due to business expansion and cost inflation. Its valuation was assisted by a net debt decline to GEL13.4m at end-June 2023 from GEL17.9m at end-March 2023.

The above positive valuation effects were partly offset by a 3.6% reduction in the fair value of the retail (pharmacy) business based on higher net debt. The latter was due to a one-off dividend distribution to GCAP, as well as the buyout of the 20.6% minority stake concluded during the quarter (bringing GCAP's total stake to 97.6%). The retail (pharmacy) business posted Q223 revenue and EBITDA growth of 5.3% and 11.7% y-o-y, respectively amid the expansion of pharmacy chain and franchise stores, but with the top line somewhat dampened by lower product prices (due to Georgian lari appreciation) and the implementation of the External Reference Pricing model (still, same store sales were up 2.8% y-o-y in Q223). GCAP's NAV TR was further supported by its ongoing share buyback programme (translating into 2.1pp NAV accretion in Q223).

Exhibit 5: Fair value of GCAP's private holdings (end-June 2023 value and q-o-q change)



Source: Georgia Capital

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