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Research Update:

German Property Company Adler Real Estate AG Assigned 'BB-' Rating; Outlook Positive

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Overview

- Property investment company Adler Real Estate AG owns and manages residential real estate in Germany worth €2.4 billion.
- Adler maintains relatively high debt leverage, with debt to debt plus equity higher than 60%, and an interest coverage ratio below 1.5x.
- We are therefore assigning our 'BB-' long-term corporate credit rating to the company.
- The positive outlook indicates that we may raise the rating within the next six to 12 months if the company's deleveraging efforts bring the S&P Global Ratings-adjusted interest coverage ratio to about 1.5x.

Rating Action

On Dec. 16, 2016, S&P Global Ratings assigned its 'BB-' long-term corporate credit rating to German property investment company Adler Real Estate AG. The outlook is positive.

Rationale

The rating reflects our view of Adler's weak debt-protection metrics, which are somewhat offset by the company's sound position in residential property market in Germany. In our view, Adler has a sound portfolio of residential properties in the north and west of Germany, mainly in smaller cities. Adler is one of the largest property companies in Germany, managing a portfolio of about 50,000 units valued at about €2.4 billion. Adler enjoys a high degree of tenant and asset diversity, which we believe compares favorably with that of most peers we rate in the same business risk category, for example office or retail property investment companies.

Our assessment of Adler's business risk reflects our view that German residential properties benefit from lower volatility in rents and asset values than in other countries and the commercial real estate sector as a whole. We think that demand from German households for midsize apartments with midmarket rents will remain stable in the portfolio's main geographic locations. We believe that rents will continue to increase steadily in the next two to three years, due to low levels of new construction. We note that there is limited development risk in the portfolio because development is confined to the renovation of existing properties. The average stay per tenant is long, at 10 years, with a low percentage of tenants leaving each year.

The main constraint to the business risk profile is the smaller portfolio size than that of other rated German peers, relatively high vacancy rate (10.7%), exposure to smaller cities with limited opportunities for employment, and lower rent levels than the regional market average. Adler's presence in cities with over 200,000 inhabitants is just about 30%, compared with 60%-70% for such German residential companies as Grand City Properties, Conwert, and Vonovia. We understand that a relatively low occupancy rate is a result of Adler's acquisition of an underperforming portfolio and that its strategy is to increase vacancy through active asset management, investments in renovation, and a better tenant proposition through integrating all property management services in-house.

While Adler is focusing on smaller cities and secondary locations, its strategy is to choose apartment portfolios in cities with low unemployment and established employers in the region, or close to large metropolitan areas. We understand that there is some potential rent adjustment at renewal and re-letting, since Adler's rent levels (€5 per square meter) are below market average in the respective regions. However, we also note that most of Adler's tenants have low to middle incomes and are quite sensitive to rent increases.

Adler's debt leverage is high relative to the industry's standards, in our view. We project the S&P Global Ratings-adjusted ratio of debt to debt plus equity will be slightly higher than 65% (adjusted for Adler's shares in Conwert), and the adjusted EBITDA-to-interest ratio slightly below 1.3x by the end of 2016. We expect these ratios will improve and be in the range of 60%-65% and 1.3x-1.8x, respectively, in 2017. We exclude gains from the sale of apartments from our EBITDA calculation, since we treat such revenue as volatile and nonrecurring. That said, we understand that the company's cash flow generation benefits from this activity, since its subsidiary, Accentro, is the largest company in Germany specializing in selling properties to individuals.

Adler is committed to deleveraging and its financial policy is centered around a loan-to-value ratio below 60%. We adjust Adler's debt leverage for its large shareholding in another German property company, Conwert, and expect that Adler's gross debt and interest payments will reduce because proceeds from the sale of this stake will likely be used for debt reduction in 2017. We treat the company's €175 million mandatory convertible bond as equity, since mandatory conversion will take place in December 2018. Most of the company's capital structure comprises secured debt, and the share of rental income from unencumbered assets is below 50%.

Our comparable rating analysis constrains the rating on Adler by one notch. This mostly reflects our view that Adler's financial risk profile is at the lower end of our aggressive category because of its higher leverage than peers we rate in the 'BB' category. It also reflects Adler's exposure to smaller cities and the relatively lower availability of employment and, consequently, asset attractiveness compared with larger urban areas to which Adler has exposure of only 30%.

In our base case for Adler, we assume:

- Like-for-like rental income growth of 2%-3% through 2017-2018, supported by improving occupancy;
- An increase in the occupancy rate to 93%-95% in 2017-2018, reflecting the company's active asset management and investments in renovation;
- Gradually improving profitability on the back of the company's efforts to integrate property management services, with the EBITDA margin in the range of 38%-40% in 2017-2018; and
- Positive portfolio revaluation of 3%-5%, driven by increasing net rental income and yield compression.

Based on these assumptions, we arrive at the following credit measures for Adler in 2017-2018:

- Debt to debt plus equity in the range of 65%-60%.
- An EBITDA interest coverage ratio of 1.3x-1.6x.

Liquidity

We assess Adler's liquidity position as adequate under our criteria for real estate companies. We anticipate that liquidity sources will likely cover liquidity uses by about 1.9x for the 12 months started Oct. 1, 2016. We assess debt covenant headroom as adequate. We don't consider the company's liquidity to be strong because the value of its liquidity reserves might fluctuate in line with changes in the price of underlying shares. Additionally, it is unlikely that Adler will be able to absorb high-impact, low probability events without refinancing. Its position in capital markets is satisfactory, in our view.

Principal liquidity sources as of Sept. 30, 2016:

- About €533 million of cash and liquid market investments, including Conwert shares;
- €71 million of undrawn committed credit lines, maturing in more than 12 months; and
- Our forecast of €18 million-€25 million in cash funds from operations for the next 12 months.

Principal liquidity uses:

- About €314 million of short-term debt, including debt amortization. However, we understand that this figure includes a €200 million margin loan taken to acquire the stake in Conwert. This loan matures after 2017, but is classified as short term in the company's financial statement due to the company's intention to repay it in 2017, according to management.
- Our forecast of €20 million-€25 million of capital expenditures for property, plant, and equipment, and property investment.

Outlook

The positive outlook indicates that we may raise the rating within the next six to 12 months if the company's deleveraging efforts bring the S&P Global Ratings-adjusted interest coverage ratio to about 1.5x and debt to debt to debt plus equity ratio to less than 65%. The outlook is also supported by our view of favorable trends in Germany's residential property market.

Upside scenario

An upgrade will hinge on Alder's willingness and ability to maintain an adjusted ratio of debt to debt plus equity lower than 65% and an EBITDA interest-coverage ratio materially higher than 1.3x. This would be demonstrated by achievement of the planned debt reduction, which will improve the company's interest coverage in the future. The company's commitment to using more than €400 million in proceeds from the disposal of the Conwert shares in early 2017 to reduce debt will be crucial to the improvement of the company's credit metrics.

Adler's commitment to its financial policy target of a loan-to-value ratio below 60%, and a prudent approach to acquisitions, would also be important considerations.

Downside scenario

We could consider revising the outlook to stable if, in particular, Adler's debt to debt plus equity ratio stayed at about 65% and its EBITDA interest coverage ratio remained at about 1.3x, as a result of lower deleveraging from asset sales and/or unexpected acquisitions. Similar action might follow if improvements in operating performance were weaker than we anticipated. The company's ability to improve its vacancy rate and profitability will be key areas to monitor.

Ratings Score Snapshot

Corporate Credit Rating: BB-/Positive/--

Business risk: Satisfactory
- Country risk: Very low
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: bb

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: bb-

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 01, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

New Rating

Adler Real Estate AG	
Corporate Credit Rating	BB-/Positive/--

Additional Contact:
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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.globalcreditportal.com and at spcapitaliq.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.