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Research Update:

Germany-Based Adler Real Estate Outlook Revised To Positive On Refinancing; 'BB' Ratings Affirmed

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Table Of Contents

1967062 | 301742784

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Overview

- Adler Real Estate has issued two four- and six-year tranches of €800 million in senior unsecured bonds maturing in 2021 at a blended coupon rate of 1.73% and announced plans to repay €676 million of more expensive secured debt with the proceeds of the issue.
- We expect Adler's EBITDA interest coverage ratio will improve on the refinancing, with overall leverage decreasing in line with management's stated financial policy.
- We are revising our outlook on Adler to positive from stable and affirming our 'BB' long-term rating on the company.
- The positive outlook reflects a one-in-three possibility that we upgrade Adler over the next 12 to 18 months, if its efforts to improve operating and financial performance led to stronger-than-expected credit metrics.

Rating Action

On Dec. 12, 2017, S&P Global Ratings revised its outlook on German property investment company Adler Real Estate AG to positive from stable. The 'BB' long-term corporate credit rating was affirmed.

We also affirmed our 'BB+' long-term issue rating on the company's senior unsecured debt. The '2' recovery rating remains unchanged, reflecting our expectation of 70%-90% recovery (rounded estimate: 80%) in the event of a payment default.

Rationale

Our outlook revision reflects Adler's improved cost of funding after its issue of two tranches of a €500 million senior unsecured bond maturing in December 2021 and bearing coupon of 1.5% and a €300 million bond maturing in February 2024 and bearing coupon of 2.125%. We understand that management is currently repurchasing €676 million of its Schuldschein loans with the proceeds of the bond issues. As a result, Adler's cost of debt (cash interest) will likely improve to 2.7% in 2018 from 3.5%, and we estimate its expense-based interest rate will slightly exceed 3% in the same year. We project the S&P Global Ratings-adjusted EBITDA-to-interest ratio will improve to 1.7x in 2018 and 1.8x in 2019, from 1.3x in 2017 (when we exclude earnings from trading). We also understand that management's revised financial policy aims to reduce the

1967062 | 301742784

debt-to-debt plus equity ratio to less than 55% in the next few years. We expect improvement in debt-to-debt plus equity, as calculated by S&P Global Ratings, with this ratio to be in the 60%-65% range in 2017-2018, depending on the scale of positive revaluations of the company's portfolio. We expect a meaningful positive portfolio revaluation of 7%-8% in 2017, owing to increasing net rental income and yield compression and more moderate revaluation of between 3% and 4% in 2018 and 2019. Following a significant increase in house prices in primary locations over the past couple of years, we now expect price growth in Germany will spread to secondary locations, where most of Adler's assets are located. We also understand that valuations of most of Adler's assets are significantly below replacement costs, supporting further positive revaluation potential.

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. The average stay per tenant is long, at 10 years, with a low percentage of tenants leaving each year, in line with other German residential peers we rate.

Our assessment of Adler's business risk profile reflects our view that German residential properties should continue to benefit from lower volatility in rents and asset values compared with other European 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 understand that the company focuses mostly on renovation of existing properties in smaller locations but might invest in development projects on an opportunistic basis, as happened with the acquisition of Wasserstadt Mitte development project in central Berlin in November 2017. Still, we believe that development risk is limited, and the share of assets under development is less than 10% of its total portfolio.

The main constraint to the business risk profile is the smaller portfolio size than that of other rated German peers, the relatively high vacancy rate of 10%, exposure to smaller cities with limited opportunities for employment, and lower rents than the regional market average. We understand that Adler is currently in negotiations to dispose of some of its noncore assets, and this should lead to improvement in its occupancy ratio, by a couple of percentage points from the current 90%. We also expect improvement in occupancy because of Adler's strategy to decrease vacancies through active asset management and a better tenant proposition through integrating all property management services in-house.

Although Adler is focusing on smaller cities and secondary locations, its current 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-renting, since Adler's rent levels (€5 per square meter) are below the market average in its focus regions.

In our base case for Adler, we assume:

- Like-for-like rental income growth of 1%-2% through 2018-2019, supported by improving occupancy;
- An increase in the occupancy rate to 93%-94% in 2018-2019, reflecting the company's disposal of noncore assets with higher vacancy rates and investments for 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 42%-44% in 2018-2019; and
- Meaningful positive portfolio revaluation of 7%-8% in 2017, driven by increasing net rental income and yield compression and more moderate revaluation in 2018.

Based on these assumptions, we arrive at the following credit measures for Adler in 2018-2019:

- Debt-to-debt plus equity in the range of 65%-60%.
- An EBITDA interest coverage ratio of 1.7x-1.8x.

Liquidity

We assess Adler's liquidity as adequate. We anticipate that liquidity sources will likely cover liquidity uses by more than 1.2x for the 12 months started Oct. 1, 2017. We assess the company's debt covenant headroom as adequate. We don't consider Adler's liquidity to be strong because we think it's unlikely that it will be able to absorb high-impact, low-probability events without refinancing. Its position in capital markets is satisfactory, in our view.

We estimate Adler's principal liquidity sources on Sept. 30, 2017, as follows:

- About €116 million of cash and liquid market investments;
- €64 million of undrawn committed credit lines, maturing in more than 12 months;
- Our forecast of €20 million-€30 million in cash funds from operations for the next 12 months;
- About €800 million of senior bond issue proceeds from the recent issues; and
- About €200 million of proceeds from the sale, in the fourth quarter of 2017, of the Accentro division.

We estimate the following principal liquidity on the same date:

- About €98 million of short-term debt, including debt amortization;
- About €676 million of Schuldschein loans planned for redemption;
- Our forecast of €50 million of capital expenditures; and
- About €150 million of committed acquisitions and acquisitions that have already taken place since Sept. 30, 2017.

Outlook

The positive outlook indicates that we might upgrade Adler within the next 12 to 18 months, if its efforts to improve its operating performance, as well some additional refinancing, push the company's S&P Global Ratings-adjusted EBITDA interest coverage ratio to more than 1.8x and debt-to-debt to debt plus equity to less than 60%. The outlook is also underpinned 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 60% and an EBITDA interest coverage ratio materially higher than 1.8x. This might be supported by improving occupancy rates, and higher indexation, combined with some additional debt repayments. The company's commitment to its revised financial policy target of a debt-to-debt plus equity ratio below 55%, 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 stays higher than 60% and its EBITDA interest coverage ratio remained below 1.8x because improvements in operating performance and debt reductions were less pronounced. 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 ratings analysis: Neutral (no impact)

Recovery Analysis

Key analytical factors

- Our 'BB+' issue rating and '2' recovery rating on Adler's senior unsecured debt remain unchanged. The '2' recovery rating reflects Adler's valuable asset base, consisting of residential investment properties in Germany. However, our recovery prospects are constrained by the unsecured nature of the debt instrument and its contractual subordination to the current amount of secured debt. We expect that the company will use the proceeds from the bond issuance to refinance mainly existing secured debt.
- In our hypothetical default scenario, we envisage a severe macroeconomic downturn in Germany, resulting in market depression and exacerbated competitive pressures.
- We value Adler as a going concern. Our stressed valuation comprises the stressed value of the company's property portfolio.
- Recovery prospects for the senior unsecured notes are sensitive to change in the amount of senior secured debt or any other priority debt outstanding at default.

Simulated default assumptions

- Year of default: 2022
- Jurisdiction: Germany

Simplified waterfall

- Gross enterprise value at emergence: €2,041 million
- Net enterprise value at emergence after administrative costs: €1,939 million
- Estimated priority debt (secured debt): €800.3 million
- Net enterprise value available to senior unsecured bondholders: €1,138 million
- Senior unsecured debt claims: €1,486 million
- Recovery expectation: 70%-90% (rounded estimate: 80%)

Related Criteria

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, 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: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 1, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Related Research

- German Property Co. Adler Real Estate's Senior Unsecured Notes Rated 'BB+' , Nov. 20, 2017

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Adler Real Estate AG		
Corporate Credit Rating	BB/Positive/--	BB/Stable/--
Senior Unsecured	BB+	BB+
Recovery Rating	2(80%)	2(80%)

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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.capitaliq.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.