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Research Update:

Germany-Based Adler Real Estate Outlook Still Positive On Brack Capital Properties Acquisition; 'BB' Ratings Affirmed

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Overview

- German residential property owner Adler Real Estate has announced its agreement to acquire a 41.04% stake in Brack Capital Properties (BCP), and has launched a public tender offer with the target to acquire an overall stake of up to 70% plus one share in BCP.
- The acquisition would moderately improve Adler's business risk profile, while credit metrics in the next 12 months would remain broadly in line with our previous base case.
- We are therefore affirming our 'BB' ratings on Adler and our 'BB+' rating on its unsecured debt.
- The outlook remains positive, reflecting our view that we might upgrade Adler within the next six to 12 months, depending on successful execution of the transaction, together with an improvement of EBITDA interest coverage firmly above 1.8x and debt-to-debt-plus-equity well below 60% over the next few months.

Rating Action

On Feb. 20, 2018, S&P Global Ratings affirmed its 'BB' long-term issuer credit rating on German property investment company Adler Real Estate AG. The outlook remains positive.

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

The affirmation of the ratings and maintenance of the positive outlook follows Adler's announcement of the acquisition of up to 70% plus one share of Netherlands-based real estate company Brack Capital Properties N.V. (BCP). Adler has already agreed to acquire a 41.04% stake in BCP, and has subsequently launched a tender offer to acquire an additional 25.8% of shares. With commitments from management of BCP to acquire to tender or sell about 5% of their shares, Adler is targeting a stake of up to 70% plus one share.

We understand Adler aims to gain effective control and to fully consolidate

BCP upon the transaction's close. The transaction will be primarily funded through a two-year, €585 million bridge loan, which it has already secured. To repay the bridge loan in the next few months, Adler intends to use the proceeds of its recent sale of ACCENTRO Real Estate AG and the sale of its noncore assets (which it is currently selling), with the residual debt amount termed out thereafter. In addition, we understand that Adler will undertake a strategic review of BCP's retail business, as Adler does not see it as core to its strategy, and the portfolio can therefore be sold.

BCP, which S&P Maalot currently rates 'ilAA-', owns a real estate portfolio in Germany of about €1.4 billion, consisting of 52% of income-producing residential properties, 34% of income-producing retail assets, and 14% of ongoing development projects. We view BCP's residential portfolio as being of average quality overall, with notably a higher exposure to large cities than Adler's, with about two-thirds of BCP's residential portfolio located in 'A' rated locations.

The deal will increase Adler's scale from €2.6 billion to €3.6 billion, excluding the retail assets it expects to divest over the next few months. We think that BCP's assets are a good fit with Adler's asset profile, and the combined portfolio should strengthen Adler's presence in cities like Leipzig, Hannover, and Dortmund, which enjoy healthy economic and demographic trends. The transaction would also somewhat increase Adler's geographic diversity within Germany. BCP's assets are located in high-demand areas in major cities, which will complement Adler's assets, which are located in secondary, smaller cities. The overall occupancy rate is expected to improve to 93% from 89% after the transaction, and taking into account the sale of Adler's noncore assets. Overall, the transaction should therefore strengthen Adler's business risk profile moderately.

That said, the transaction would not be sufficiently transformative, as Adler's business risk profile would remain constrained by its smaller relative scale than that of other rated German peers, lower rent levels than the regional market average, and still significant exposure to smaller cities with less macroeconomic dynamics than in metropolitan areas. For these reasons, although we expect the transaction would improve Adler's residential portfolio, our assessment of its business risk profile would remain unchanged.

In our base case for Adler, we assume:

- Like-for-like rental income growth of about 2%-3% through 2018-2019, supported by improving occupancy and low lease renewals;
- An increase in the occupancy rate to 93% in 2018, reflecting the company's sale of the noncore assets and consolidation of BCP's assets, which enjoyed higher occupancy rate of about 96% as of Sept. 30, 2017;
- Gradually improving profitability on the back of the company's efforts to integrate property management services and the disposal of their noncore assets. We assume the EBITDA margin will improve into the 52%-53% range in 2018-2019, benefiting from the acquisition of BCP.
- Meaningful positive portfolio revaluation of 10% in 2017, driven by increasing net rental income and yield compression and still significant

revaluation in 2018 of 5%-6%.
- The sale of the noncore Adler assets to happen in the next few months, as a well as the sale of BCP's retail assets.
- Receipt of the remaining proceeds of the ACCENTRO sale in 2018 for €160 million.
- We also assume full consolidation of BCP financials based on the assumption that Adler will acquire a majority stake on BCP with effective control.

Based on these assumptions, we arrive at the following credit measures for Adler:
- Debt to debt plus equity improving toward 60% in 2018-2019.
- An EBITDA interest coverage ratio of about 2.0x over the same period.

In our view, the overall transaction results in credit metrics that are broadly in line with our previous base case. We believe that Adler could reach our target ratios for an upgrade by the end of the year, which supports the positive outlook. On the other hand, we believe the transaction is subject to material execution risks, including especially the success of the tender offer, the sale of noncore assets at both the Adler and BCP level, and successful refinancing of the bridge loan. We would also want to see the acquisition translate into some positive momentum in Adler's financial metrics, which at year-end 2017 are expected to be still weaker than our previously assumed target ratios of about 64% debt to debt plus equity and 1.4x interest cover ratio. This might be derived from management's synergy expectations, which could result in stronger EBITDA generation than we currently anticipated from 2019.

We also affirmed the 'BB+' issue rating and '2' recovery rating on Adler's unsecured bonds. This means that we believe that recovery prospects for the bondholders should remain above 70% under the proposed terms of the transaction. This assumes that the bridge loan financing will be unsecured and will rank pari passu with the unsecured bond. It also assumes that all the different steps of the transaction close as expected with proceeds from the different sales of assets at Adler and BCP being used to repay existing debt. A more detailed recovery analysis will be undertaken on closing. For more details, on our current recovery analysis on Adler, please refer to the article titled "Germany-Based Adler Real Estate Outlook Revised To Positive On Refinancing; 'BB' Ratings Affirmed," published on Dec. 12, 2017.

Liquidity

After the transaction, we would expect the enlarged Adler's liquidity to remain adequate, as the company's pro forma liquidity sources should still exceed its uses by more than 1.2x for the 12 months following the deal's close, according to our estimates.

Our assessment takes into account the bridge loan financing, which has already been agreed for €585 million and which will have a 12-month maturity with two six-month extension options. We understand that the company intends to access capital markets in the next couple of months to refinance the bridge facility.

We also assume that the company will use the proceeds of the sale of the different noncore business at both Adler and BCP to repay existing debt.

Outlook

The positive outlook reflects our view that we might upgrade Adler within the next six to 12 months. An upgrade would be contingent on the successful execution of the different steps of the transaction, which should provide some additional certainty on the improvement of Adler's credit metrics over the next 12 months. In line with our previous outlook on Adler, we consider that an upgrade would require an increase in our adjusted EBITDA interest coverage ratio to more than 1.8x and a reduction of debt to debt to debt plus equity to less than 60%. The outlook also remains underpinned by our view of favorable trends in Germany's residential property market.

Upside scenario

An upgrade will hinge on Adler's willingness and ability to maintain an adjusted ratio of debt to debt plus equity well below 60% and an EBITDA interest coverage ratio materially higher than 1.8x. This might be supported by higher occupancy rates pro forma for the acquisition of BCP residential assets and the sale of the noncore assets, combined with the debt repayments as a result of the different disposals. We will closely monitor improvement of the credit metrics in the next few months considering all the changes in the company. Given the execution risks involved in a complex transaction, we believe that it may take more than three months for us to assess to what extent the credit metrics have improved.

An upgrade is also contingent on Adler delivering in line with expectations, notably regarding the sale of the noncore assets in its current portfolio and the sale of BCP's retail assets, which should also help evolve Adler's track record of strategy execution.

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, if the steps of the transaction do not close in line with expectations, or if Adler's performance does not improve as expected.

Ratings Score Snapshot

Issuer 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)

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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 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

Related Research

- Germany-Based Adler Real Estate Outlook Revised To Positive On Refinancing; 'BB' Ratings Affirmed, Dec. 12, 2017

Ratings List

Ratings Affirmed

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

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.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.