S&P Global Ratings

Adler Real Estate Outlook Revised To Stable From Positive On Slower Than Expected Deleveraging; 'BB' Rating Affirmed

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- Following Adler's first-half 2018 results and weakening credit metrics, we consider that the group will take longer than anticipated to reduce leverage and restore its credit profile fully in line with our 'BB' rating.
- Although Adler has not changed its financial policy, we believe its actions to reduce debt, including through asset disposals, and execute on its refinancing plans will take longer than we previously forecast.
- We are therefore revising our outlook on Adler to stable from positive, while affirming our 'BB' rating on Adler and our 'BB+' issue ratings on the company's debt.
- The stable outlook reflects our expectation of continued favorable demand for residential real estate in Germany translating into stable cash flow generation and positive revaluation for Adler's portfolio of residential properties.

FRANKFURT (S&P Global Ratings) Sept. 20, 2018--S&P Global Ratings today revised its outlook to stable from positive on German residential property company Adler Real Estate AG. We affirmed our 'BB' long-term issuer credit rating on Adler.

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.

The outlook revision follows the release of Adler's first-half 2018 results, showing the debt-to-debt-plus-equity ratio well above 65%: 70.9% at the end of the first quarter and 73.5% as of June 30, 2018 (excluding receivables from the ACCENTRO sale). The S&P Global Ratings-adjusted EBITDA interest coverage ratio for the rolling 12 months to June 30, 2018, was also weak at only 1.3x. We believe that Adler intends to execute on its publicly announced financial policy targeting a loan-to-value ratio of 55%, which translates into an S&P Global Ratings-adjusted debt-to-debt-plus-equity ratio of 59%-60%. We expect that Adler's leverage will improve within the 60%-65% in the next six to 12 months. Our base-case estimates over the coming 12 months are weaker than our previous forecasts, but remain within the thresholds for the current 'BB' rating.

In the second quarter of 2018, Adler closed its acquisition of 70% plus one share of Netherlands-based real estate company Brack Capital Properties N.V. (BCP). Adler issued €800 million of senior unsecured notes in April to finance the acquisition, and has fully consolidated BCP into its financial statements since then.

We understand that Adler intends to use the proceeds of its sale of ACCENTRO Real Estate AG (approximately €137 million still to be received) and the sale of its noncore assets to repay debt. In addition, we understand that Adler will undertake a strategic review of BCP's retail business, since it does not see it as core to its strategy and this portfolio could therefore be sold. However, we believe it is unlikely that Adler will close all asset sales this year and expect the repayment of debt will be postponed to 2019. We also understand that the company is executing its deleveraging plans, thereby positioning the company more comfortably within the credit ratio range (60% to 65%) consistent with our 'BB' rating.

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 62,000 units valued at about €4.8 billion as of June 30, 2018. Adler enjoys a high degree of tenant and asset diversity, which we believe compares favorably with that of most peers we rate and in the same business risk category. The average stay per tenant is long, at 10 years, with a low percentage of tenants leaving each year.

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 and Germany's strong macroeconomic fundamentals. We note that there is limited development risk in the portfolio because development is confined to the renovation of existing properties.

The main constraints to Adler's business risk profile are the smaller portfolio than that of other rated German peers, a relatively high vacancy rate (10%), exposure to small cities, and lower rent levels than the regional market average. While Adler focuses on small 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 Adler's portfolio has some potential for rent adjustment upon renewal and re-letting, since Adler's rent levels (averaging €5.40 per square meter) are below the market average in the respective regions.

The stable outlook reflects our expectation of continued favorable demand for residential real estate in Germany, translating into stable cash flow generation and positive revaluation of Adler's properties. We also consider that the company is contemplating various measures to restore its credit profile, including sizable asset disposals over 2018 and 2019. Over the next year, we anticipate Adler's S&P Global Ratings-adjusted ratio of debt to debt plus equity will be between 60% and 65% and its interest coverage ratio will improve to 1.7x-1.8x.

We could consider lowering the rating if, in particular, Adler's debt to debt plus equity stayed above 65% and its EBITDA interest coverage ratio below 1.3x, as a result of a delay in reducing leverage, including through disposals and other corporate measures, or lower-than-expected revaluation gains. A negative rating action might also follow if the company's operating performance were weaker than we anticipated. The company's ability to improve its vacancy rate will be a key area to monitor.

We would also take a negative action if the company were facing difficulty in refinancing its upcoming short-term debt maturities or complying with covenants, resulting in cash restrictions or a revision of our liquidity assessment.

An upgrade will hinge on Adler's willingness and ability to reduce the S&P Global Ratings-adjusted ratio of debt to debt plus equity to well below 60% and achieve an EBITDA interest coverage ratio materially higher than 1.8x. This might be supported by the sale of the noncore and retail portfolios in the short term, combined with significant refinancing, resulting in strong debt reduction.

RELATED CRITERIA

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