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Research Update:

Germany-Based DEMIRE Outlook Revised To Negative On Planned Dividend Distribution; 'BB' Ratings Affirmed

August 25, 2020

Rating Action Overview

- DEMIRE Deutsche Mittelstand Real Estate AG (DEMIRE) has announced plans for a first time dividend distribution of approximately €57.6 million, which is close to its accumulated profit as of Dec. 31, 2019.
- We view such dividend distribution as aggressive in the current market environment and anticipate DEMIRE's debt to debt plus equity will increase in 2020 to closer to our 60% downside threshold for the rating.
- We are therefore revising our outlook on DEMIRE to negative from stable, and affirming our 'BB' long-term issuer credit and 'BB+' issue ratings on the company.
- The negative outlook reflects that we could lower the ratings in the next 12 months if the company's debt to debt plus equity rises to 60% or above as a result, for example, of weaker-than-anticipated operational performance or debt-financed transactions.

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Rating Action Rationale

As a result of the announced dividend, we expect DEMIRE's leverage will increase to close to our rating downside threshold for a 'BB' rating. The company's majority shareholder AEPF III S.a.r.l. (Apollo) aims for a first time dividend distribution of approximately €57.6 million, an amount close to DEMIRE's accumulated profit at Dec. 31, 2019. As a result, we expect DEMIRE's S&P Global Ratings-adjusted debt to debt plus equity will rise to about 58% at year-end 2020 versus 52.2% as of June 30, 2020, close to our rating downside threshold of 60%. We also forecast debt to EBITDA will increase to above 15x this year compared with 13.7x rolling twelve months (RTM) as of June 30, 2020. Although, we understand the final dividend distribution is still subject to annual general meeting approval, we view such distribution as aggressive from a financial policy point of view and given current market sentiments and uncertainties surrounding the COVID-19 pandemic. We understand that DEMIRE remains committed to its financial policy target of a reported loan to value ratio (LTV) of 50% over the medium term, translating into S&P Global Ratings-adjusted debt to debt plus equity of about 55%. Our outlook revision takes into account the tighter rating headroom, leaving the company limited ability to absorb unexpected market developments. That said, we expect DEMIRE's EBITDA interest coverage will continue improving closer to 3x by year-end 2020 versus 2.5x RTM as of June 30, 2020, thanks to its refinancing activities during 2019, improving its cost of debt to 1.8%.

COVID-19 is likely to hamper DEMIRE's earnings for 2020, but additional rental income from its 2019 acquisitions should offset this somewhat. Lockdown in Germany forced shops and hotels to close during second-quarter of 2020, and required adherence to various other social distancing measures to curb the spread of the virus. About 16% of DEMIRE's annual contractual rental income comes from retail assets that were not defined as essential stores and allowed to remain open. Its hotel assets account for a further 6.5%. We understand DEMIRE was able to collect above 85% of its monthly rent collection during the second quarter, and payments from July are now broadly back at pre-COVID-19 levels. Nonetheless, we continue to expect DEMIRE's like-for-like rental growth in 2020 will decline to 3%-5%. Overall, we only expect a marginal recovery of the retail sector in 2021, and remain cautious about the medium- to long-term demand trends for office properties in Germany as a result of increased remote working capacities for many tenants. We anticipate that the acquisitions DEMIRE made last year will benefit 2020 net rental income by approximately €7.5 million, partly mitigating the negative effect of COVID-19 on rents.

We continue to view DEMIRE's liquidity as robust. Taking into account the announced dividend distribution, we continue to view the company's liquidity position as adequate. This is supported by the company´s signed loan facilities of about €62.5 million post reporting date, low capital expenditure needs, and limited short-term debt maturities. We understand that, post-dividend distribution, the company will maintain sufficient headroom (>10%) under its outstanding financial covenants.

Outlook

The negative outlook reflects that we could lower the ratings of DEMIRE in the next 12 months if the company's debt to debt plus equity rises to 60%. This could happen as a result of, for example, weaker-than-anticipated operational performance, including potential negative asset revaluation, or debt-financed transactions.

Downside scenario

We could lower the rating if the company fails to keep its debt to debt plus equity below 60% and EBITDA interest coverage above 2x on a sustainable basis. We would also view debt to annualized EBITDA below 15x as negative. This could occur if DEMIRE allows its reported net LTV ratio to rise materially above 50%, contrary to its publicly announced policy.

We could also consider a downgrade if the company does not manage to realize its business growth strategy, or if it invests in less favorable secondary locations away from metropolitan hubs.

In addition, we could downgrade the company if its liquidity position deteriorates, for example, through acquisitions or a decrease in its cash flow base.

Upside scenario

We would revise the outlook to stable if DEMIRE proves resilience in the current market environment despite its dividend distribution, with S&P Global Ratings-adjusted debt to debt plus equity remaining well below 60% and EBITDA interest coverage well above 2x. We would also view positively the company´s ratio of debt to annualized EBITDA to be retained below 15x.

At the same time, we would also view positively if the company were to continue its growth strategy by investing in assets with favorable market fundamentals, funded by a balanced mix of debt and equity.

Company Description

DEMIRE is a Germany-based commercial real estate company focusing on office (64% of portfolio value as of June 30, 2020), retail (25%), and logistics/other assets (11%). As of June 30, 2020, the company's portfolio was valued at about €1.5 billion, comprising 84 properties. DEMIRE's strategy is to focus on midsize secondary locations in Germany bordering metropolitan areas.

The company is listed on the Frankfurt stock exchange. Its main shareholders are Apollo (through AEPF III S.a.r.l), which holds about 64%, and Wecken Group which has about 25%. The remaining 11% is free float.

Ratings Score Snapshot

Issuer Credit Rating: BB/Negative/--

Business risk: Fair

- Country risk: Very low
- Industry risk: Low
- Competitive position: Fair

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: FS-5 (no additional impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; Outlook Action

	To	From
DEMIRE Deutsche Mittelstand Real Estate AG		
Issuer Credit Rating	BB/Negative/--	BB/Stable/--
Senior Unsecured	BB+	BB+
Recovery Rating	2(85%)	2(85%)