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CREDIT OPINION
24 July 2020

Update

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RATINGS

DEMIRE Deutsche Mittelstand Real Estate AG

Domicile	Germany
Long Term Rating	Ba2
Type	LT Corporate Family Ratings
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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DEMIRE Deutsche Mittelstand Real Estate AG

Update to credit analysis

Summary

DEMIRE Deutsche Mittelstand Real Estate AG's (DEMIRE) Ba2 corporate family rating (CFR) reflects the company's relatively small but well-diversified commercial real estate portfolio primarily in secondary locations in Germany, focused on office properties but also including retail and logistics properties; its solid credit metrics for the current rating category; as well as its integrated business model and active portfolio management, improving asset quality and occupancy rate.

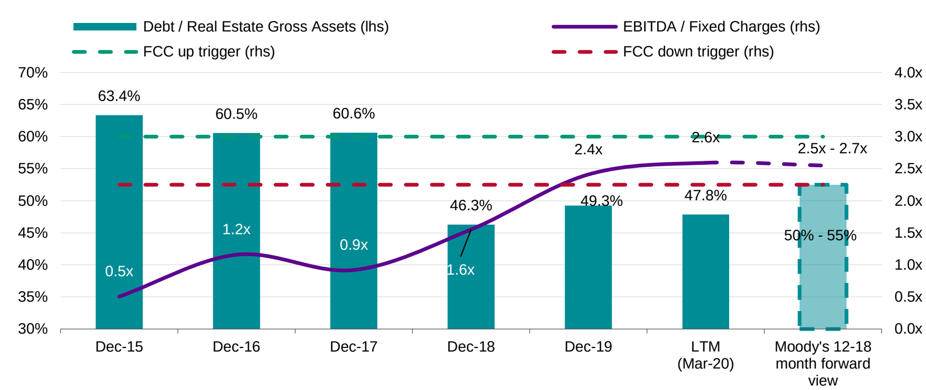
Main credit challenges are the tougher economic climate that will likely strain the rental cycle and investment sentiment; lower-quality asset portfolio than its higher-rated peers; and the company's limited track record amid recent strong growth and management changes in the last few years, balanced by the solid results delivered in 2019.

DEMIRE has reduced leverage and adequately improved its financial coverage within the current rating category. The stable outlook reflects our expectation that even under a scenario of declining rents and values, the company is likely to retain credit ratios commensurate with its current rating guidance.

Exhibit 1

We expect leverage to increase while coverage remains stable over the next 12-18 months

Moody's-adjusted leverage and fixed charge coverage ratio



Sources: Moody's Financial Metrics™ and Moody's Investors Service estimate

Credit strengths

» Relatively small but well-diversified commercial real estate portfolio primarily in secondary locations in Germany

» Solid leverage and coverage ratios for the rating category

» Integrated business model, with a strategy of actively managing the portfolio and improving asset quality and occupancy rate

Credit challenges

» Tougher economic climate that will likely exert pressure on the rental cycle and investment sentiment

» Lower-quality asset portfolio than its higher-rated peers

» Company's limited track record amid recent strong growth and management changes in the last few years, balanced by the solid results delivered in 2019

Rating outlook

DEMIRE has reduced its leverage and improved its financial coverage to adequate levels in the current rating category, so that the stable outlook reflects our expectation that even under a scenario of declining rents and values, DEMIRE is likely to retain credit ratios commensurate with its current rating.

The outlook further reflects our expectation that the company will build on its track record of executing its growth strategy while maintaining balanced financial policies.

Factors that could lead to an upgrade

A rating upgrade could result from:

» a sustained increase in occupancy rate across its portfolio

» an expansion of the asset portfolio if substantially funded with equity, resulting in an overall decline in leverage

» Moody's-adjusted gross debt/total assets sustained below 50%, with the development of a stronger track record operating with the current portfolio

» Moody's-adjusted fixed charge coverage (FCC) around 3.0x on a sustained basis

» a declining net debt/EBITDA trend from current levels

Factors that could lead to a downgrade

DEMIRE's rating could come under pressure if:

» leverage increases, with Moody's-adjusted gross debt/total assets above 55%

» FCC remains below 2.25x on a sustained basis

» there is a material deterioration in the commercial real estate market fundamentals in Germany or a sharp weakening in the currently very accommodating bank lending market in Germany

» the asset quality within the portfolio deteriorates or the vacancy rate in the existing portfolio increases

» there is a sustained increase in net debt/EBITDA from the current levels

Key indicators

Exhibit 2
DEMIRE Deutsche Mittelstand Real Estate AG

DEMIRE Deutsche Mittelstand Real Estate AG

USD Millions	Dec-15	Dec-16	Dec-17	Dec-18	Dec-19	LTM (Mar-20)	Moody's 12-18 month forward view
Real Estate Gross Assets	1,122.7	1,154.7	1,379.3	1,576.0	1,882.9	1,853.3	$1,700 - $1,800
Amount of Unencumbered Assets				51%	51%	68%	62.5% - 67.5%
Debt / Real Estate Gross Assets	63.4%	60.5%	60.6%	46.3%	49.3%	47.8%	50% - 55%
Net Debt / EBITDA	44.4x	13.9x	14.8x	10.9x	12.5x	12.2x	13.5x - 15.5x
Secured Debt / Real Estate Gross Assets	52.8%	50.6%	25.4%	20.0%	12.9%	11.7%	10% - 15%
EBITDA / Fixed Charges	0.5x	1.2x	0.9x	1.6x	2.4x	2.6x	2.5x - 2.7x

All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
Source: Moody's Financial Metrics™

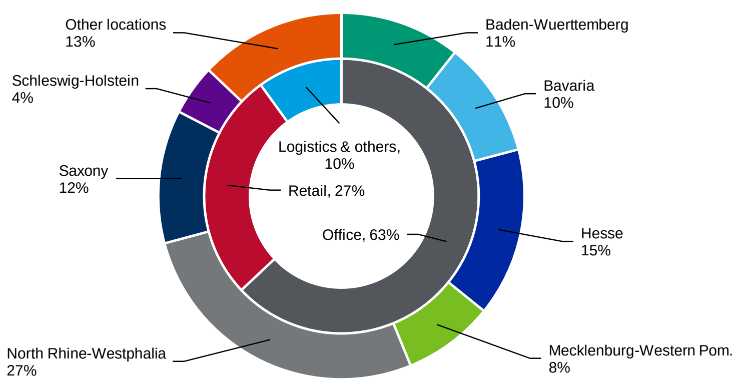
Profile

Headquartered in Langen, Germany, DEMIRE Deutsche Mittelstand Real Estate AG (DEMIRE) is a public listed commercial real estate company with a focus on offices in secondary locations across Germany. Considering the recent acquisitions, the company's portfolio comprises 87 single properties, with a total lettable floor space of around one million square metres (sqm) and an aggregated portfolio value of around €1.5 billion. The company's gross rental income amounts to €89.9 million, with a 4.8-year weighted average lease term (WALT).

DEMIRE holds a 79.4% stake in Fair Value REIT-AG, which is fully consolidated and accounts for €356 million in assets, or around 21% of DEMIRE's total assets as of 31 March 2020.

DEMIRE is listed on the Frankfurt stock exchange and had a market capitalisation of €448 million as of 20 July 2020. Apollo-managed funds and Wecken Group together hold around 89% of DEMIRE's shares.

Exhibit 3
DEMIRE's portfolio
By gross asset value (GAV)



As of 31 March.
Source: Company information

Detailed credit considerations

Small but well-diversified commercial real estate portfolio primarily in secondary German locations

DEMIRE's portfolio is spread across several key regions in Germany (see Exhibit 3). The top 20 properties represent around two-thirds of the total investment portfolio, with less than 10% of them located in the Big 7 German cities and the remainder in secondary locations.

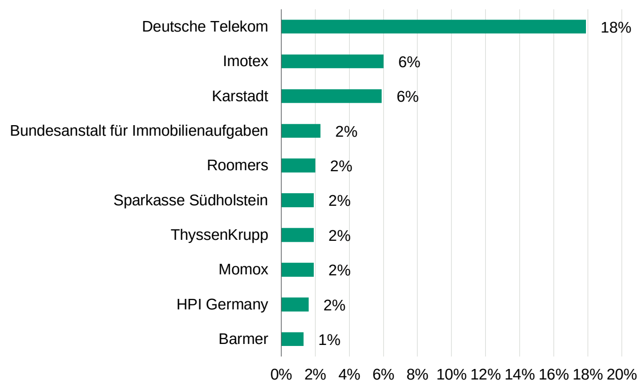
During 2019, the company grew its operational scale by acquiring 11 assets with a total investment volume of around €360 million (four office buildings, five retail assets let to Karstadt, as well as a distribution centre and a hotel). At the same time, several smaller nonstrategic assets were disposed.

Following these transactions, the current portfolio's annual gross rental income (GRI) amounts to €89.9 million, which is derived from more than 800 individual tenants across diverse business sectors. Deutsche Telekom AG (Deutsche Telekom, Baa1 negative) remains the largest tenant and accounts for around 17.9% of DEMIRE's GRI, followed by the fashion distributor Imotex with 6.0% and the German retailer Karstadt, currently under insolvency administration, representing 5.9%. All other tenants account for 2% or less of DEMIRE's GRI.

Rental income concentration towards Deutsche Telekom is one of the highest among the company's peers that we rate but mitigated by the strong credit standing of Deutsche Telekom. We understand that larger parts of the leases will become due in 2021 with parts of the spaces already subleased by Deutsche Telekom. DEMIRE is in negotiations with some of the subtenants and actively looking for alternative occupiers as otherwise its vacancy rates could increase. We positively note that the company managed to reduce the exposure from 30% at the beginning of 2019 to currently 18%.

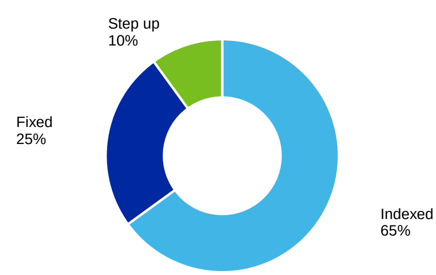
Tenant credit quality is moderate because of its secondary locations and B-type properties attracting small and medium-sized enterprises (SMEs). This is partly balanced by public-sector tenants comprising more than 10% of DEMIRE's tenant base and whose credit quality is strongly correlated with the sovereign's credit strength. Historical default rate of the portfolio is 1.3%. Rent collection rates across DEMIRE's portfolio have remained solid between 85% and 95% during the months of March to June.

Exhibit 4
Top 10 tenants
Total GRI of €89.9 million



Source: Company information

Exhibit 5
Lease types
By number of contracts



Source: Company information

Robust office market fundamentals are likely to deteriorate as the macroeconomic environment is hit by the coronavirus pandemic

The coronavirus pandemic is likely to put additional strain on the occupier and investment sentiment in the German commercial real estate sector. Against the backdrop of an economic contraction in 2020 and uncertainty around the pace of recovery in 2021, we expect the company to face more challenging operating conditions, including reduced letting activity, weaker rental growth prospects and pressure on capital values.

We see increased risks for office real estate landlords in the next 12-18 months. A recession in much of Europe will curb demand, while lower consumption and business confidence will drive layoffs and erode occupier sentiment. Risks to credit quality stem from rising vacancies as a result of tenant insolvencies, lower new occupier demand and declining rental income and property values. Germany (Aaa stable) will not be immune to the coronavirus-driven economic shock; however, the negative impact on companies like DEMIRE that are exposed to stronger economies like Germany will probably be more moderate. A highly liquid market and a robust funding environment further help mitigate the risks.

The German economy is supported by its advanced, diversified and highly competitive economy; its track record of social and political stability; its tradition of prudent fiscal policies; and ready market access because of its safe-haven status. The main credit challenges are the expected recession caused by the coronavirus crisis with its exposure to global business cycles, trade tensions and harsher environmental standards affecting the automotive industry in particular. In addition, negative effects from unfavourable demographic trends weigh on the German economy and Social Security systems.

During the past 10 years, secondary locations have exhibited trends similar to those of prime locations. However, capital and rental appreciation has been less pronounced than for prime office segments in the top seven cities.

Secondary locations offer a higher gross initial yield, which has also compressed in the past eight years, supported by growing investment volumes and positive momentum of the occupier markets prior to the coronavirus outbreak.

Vacancies in secondary locations have been less volatile during previous economic downturns. The increasing conversion of existing office space into residential or hotel properties and the redevelopment of office properties as mixed-use buildings are two trends that are further reducing the net available office space across the country. Moreover, secondary locations are generally characterised by little speculative building activity and higher tenant retention.

Integrated business model supports an improving occupancy rate across the portfolio

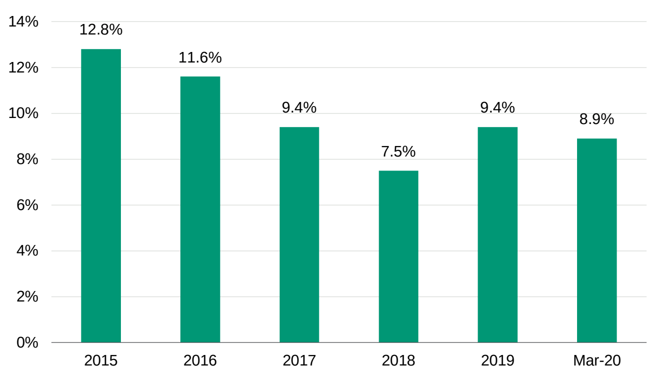
DEMIRE benefits from an integrated business model, comprising portfolio and asset management. Property and facility management services were outsourced to STRABAG SE in 2018, increasing the company's cost efficiency and operational scalability.

Through its integrated approach, the company is able to actively monitor properties' operating performance and maintain close relationships with tenants, which allows for proactive management of rental contracts and early marketing of expiring leases. This is reflected in the strong letting performance of DEMIRE.

The company has successfully managed to reduce its European Public Real Estate Association (EPRA) vacancy rate based on rental value to 8.9% as of March 31 from the high level of 14.7% in 2014. DEMIRE has managed to keep the WALT of its investment portfolio at good levels of around four to five years (see Exhibit 7).

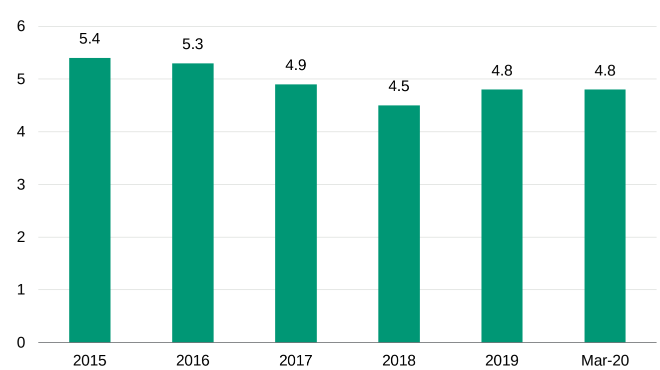
Despite the tough economic climate, leasing activities remained solid as of the end of June 2020. The company has secured new lease contracts for more than 46,000 sqm (equivalent to €3.2 million GRI). Contract renewals have been executed for around 15,800 sqm (equivalent to €1.1 million GRI). These leases offset the maturing lease contracts in 2020.

Exhibit 6
Development of vacancy



Source: Company information

Exhibit 7
Development of WALT
In years



Source: Company information

While DEMIRE successfully disposed smaller properties, we consider its average portfolio quality still below that of its higher-rated peers. This is reflected in a current gross rental yield of 5.9% with an average in-place rent for the total portfolio of €7.97 per sqm per month. This, in turn, could offer some buffer against the strain expected on economic activity.

The top 20 properties represent around 63% of the total portfolio by value, while the remaining 67 assets account for 37%.

Exhibit 8
Portfolio review
as of 31 March 2020

	No. of properties	GAV (€ m)	GRI p.a. (€ m)	EPRA Vacancy (in %)	WALT (years)
Office	60	968.5	53.9	12.1%	3.7
Retail	19	404.4	27.6	2.1%	6.3
Logistics & Other	8	158.4	8.4	7.2%	7
Total	**87**	**1,531.3**	**89.9**	**8.9%**	**4.8**

Source: Company information

Leverage will increase while interest coverage will remain broadly stable

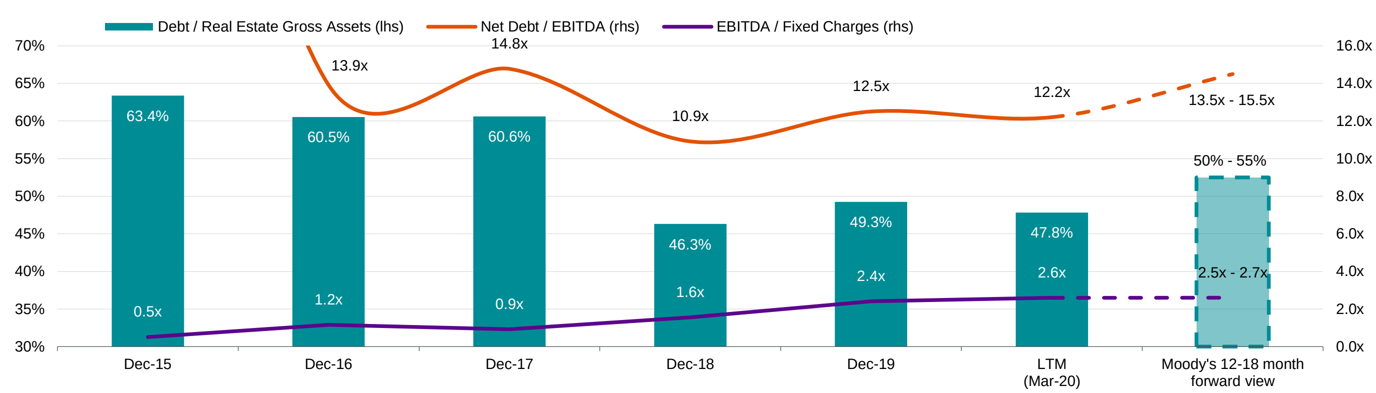
DEMIRE's capital increase in October 2018 combined with valuation gains over the last few years has significantly decreased its leverage, from 60.6% Moody's-adjusted gross debt/total assets in 2017 to below 47.8% as of the end of March 2020.

Considering the company's growth strategy and that its reported loan-to-value (LTV) was 45.4% at the end of the first quarter of 2020 (below its target level of 50%), we could expect further acquisitions over the next few months. This could increase its Moody's-adjusted gross debt to assets ratio. In addition, valuations, particularly in the retail segment, are likely to be strained. The negative rental outlook will also weaken the company's net debt to EBITDA ratio, which we expect to increase to a level above 13x.

More positively, the company managed to significantly increase the fixed charge coverage ratio over the last year from 1.6x as of 31 December 2018 to 2.6x as of 31 March. This reflects the positive EBITDA development, as well as a very successful refinancing, with the issuance of a €600 million bond in October 2019, which reduced financing costs significantly.

Despite the expected strain on rental income amid a challenging economic climate and the insolvency proceedings initiated by one its main tenants (Karstadt), we expect this ratio to be broadly stable over the next 12-18 months. DEMIRE has reduced its leverage and improved its financial coverage to an adequate level within the current rating category, so that even under a scenario of declining rents and values, the company is likely to retain credit ratios commensurate with its current rating.

Exhibit 9
Leverage will increase while coverage remains stable
In percentage and times



Source: Moody's estimate

ESG considerations

We associate a private equity ownership with a financial policy that is tolerant of high leverage, debt-funded M&A or shareholder distributions. However, DEMIRE's anchor shareholder, Apollo, has supported the company's strategic growth objectives (DEMIRE 2.0/ REALize Potenital) coupled with a reducing leverage trend. DEMIRE targets to raise its credit strength to an investment-grade level in the medium term. There have been no dividend distributions as of today.

The commercial property sector is very sensitive to changes in GDP growth, employment prospects and business confidence. A deep economic contraction caused by the coronavirus pandemic and rising unemployment alongside will likely worsen the operating environment for commercial real estate landlords. Accordingly, rents and capital values are expected to be strained with knock-on effects on the credit quality of our rated office and diversified property companies. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety.

Liquidity analysis

The company has good liquidity, which is supported by:

» cash and cash equivalents of €85.5 million as of 31 March

» an undrawn €6 million revolving credit line

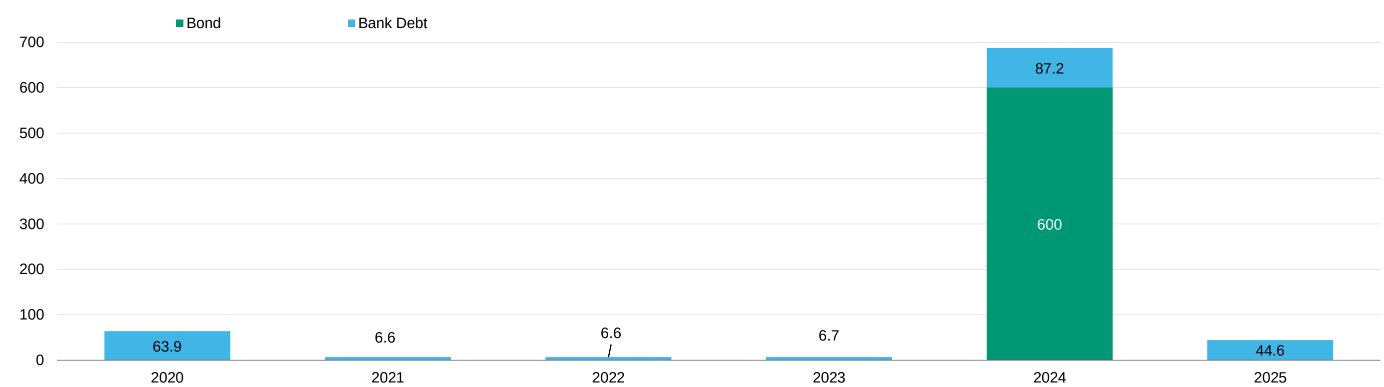
» expected funds from operations (FFO) as defined by Moody's of €20 million

» a pool of around €950 million unencumbered investment properties, which provides a source of alternative liquidity

We expect cash resources to cover all the company's cash outflows over the next 12-18 months, including debt repayments and capital spending. The company currently has a weighted average debt maturity of 4.1 years with an average cost of debt of 1.8%.

Under the bond documentation, the company is subject to the fulfillment of three financial incurrence covenants: a minimum interest coverage of 1.75x, a net LTV of maximum 60% and a maximum net secured LTV of 40%. As of 31 March 2020, DEMIRE was compliant with all the above with sufficient capacity.

Exhibit 10
No major refinancing needs until 2024 when the company faces a refinance wall
DEMIRE's debt maturity (in € millions)



As of 31 March.
Source: Company information

Structural considerations

The current Ba2 rating of the senior unsecured bond, in line with the long-term CFR, reflects that most of the debt is senior unsecured. Senior unsecured creditors are adequately covered with a ratio of unencumbered investment properties to unsecured liabilities of 1.3x. Bondholders are subordinated to secured debt of around €193 million.

Methodology and scorecard

The principal methodology we used was our REITs and Other Commercial Real Estate Firms rating methodology, published in September 2018. DEMIRE maps to Ba1 for the 12 months ended March 2020 and to Ba2 on a forward-looking basis, in line with the actual issuer rating assigned.

Exhibit 11

Rating factors

DEMIRE Deutsche Mittelstand Real Estate AG

Real Estate / REIT Industry Grid [1][2]	Current LTM 3/31/2020		Moody's 12-18 Month Forward View As of 6/30/2020 [3]	
Factor 1 : Scale (5%)	**Measure**	**Score**	**Measure**	**Score**
a) Gross Assets (USD Billion)	$1.9	Ba	$1.7 - $1.8	Ba
Factor 2 : Business Profile (25%)				
a) Market Positioning and Asset Quality	Ba	Ba	Ba	Ba
b) Operating Environment	Baa	Baa	Baa	Baa
Factor 3 : Liquidity and Access To Capital (25%)				
a) Liquidity and Access to Capital	Ba	Ba	Ba	Ba
b) Unencumbered Assets / Gross Assets	67.7%	Baa	62.5% - 67.5%	Baa
Factor 4 : Leverage and Coverage (45%)				
a) Total Debt + Preferred Stock / Gross Assets	47.8%	Baa	50% - 55%	Ba
b) Net Debt / EBITDA	12.2x	Caa	13.5x - 15.5x	Ca
c) Secured Debt / Gross Assets	11.7%	Baa	10% - 15%	Baa
d) Fixed Charge Coverage	2.6x	Baa	2.5x - 2.7x	Baa
Rating:				
a) Indicated Outcome from Scorecard		Ba1		Ba2
b) Actual Rating Assigned				Ba2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 3/31/2020 (L).
[3] This represents Moody's forward view, not the view of the issuer, and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Sources: Moody's Financial Metrics™ and Moody's estimates

Appendix

Exhibit 12

Peer comparison

(in USD millions)	DEMIRE Deutsche Mittelstand Ba2 Stable FYE Dec-18	FYE Dec-19	LTM Mar-20	Kungsleden AB Baa3 Stable FYE Dec-18	FYE Dec-19	LTM Mar-20	Summit Properties Limited Ba1 Stable FYE Dec-17	FYE Dec-18	FYE Dec-19	FastPartner AB Ba1 Stable FYE Dec-18	FYE Dec-19	LTM Mar-20
Gross Assets	$1,576	$1,883	$1,853	$4,018	$4,244	$4,094	$1,269	$1,790	$1,915	$2,669	$3,203	$3,210
Total Debt + Preferred Stock / Gross Assets	46.3%	49.3%	47.8%	48.0%	47.1%	46.9%	38.7%	38.5%	34.9%	51.9%	48.1%	48.7%
Net Debt / EBITDA	10.9x	12.5x	12.2x	11.0x	11.8x	11.6x	6.5x	11.4x	5.2x	11.8x	12.3x	12.7x
Secured Debt / Gross Assets	20.0%	12.9%	11.7%	29.1%	25.8%	25.9%	38.7%	19.5%	17.3%	30.0%	27.1%	28.3%
Fixed Charge Coverage	1.6x	2.4x	2.6x	4.0x	4.4x	4.4x	5.0x	4.4x	4.2x	3.5x	3.2x	3.3x

Source: Moody's Financial Metrics™

Exhibit 13

Moody's-adjusted debt breakdown

DEMIRE Deutsche Mittelstand Real Estate AG

(in EUR millions)	FYE Dec-15	FYE Dec-16	FYE Dec-17	FYE Dec-18	FYE Dec-19	LTM Ending Mar-20
As Reported Debt	**655.2**	**662.6**	**694.9**	**638.3**	**826.2**	**808.1**
Operating Leases	0.6	0.8	1.5	0.0	0.0	0.0
Hybrid Securities	-0.9	-0.5	-0.2	0.0	0.0	0.0
Moody's-Adjusted Debt	**654.9**	**662.9**	**696.3**	**638.3**	**826.2**	**808.1**

Source: Moody's Financial Metrics™

Ratings

Exhibit 14

Category	Moody's Rating
DEMIRE DEUTSCHE MITTELSTAND REAL ESTATE AG	
Outlook	Stable
Corporate Family Rating	Ba2
Senior Unsecured -Dom Curr	Ba2

Source: Moody's Investors Service

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