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CREDIT OPINION
10 July 2017

New Issue

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RATINGS

DEMIRE Deutsche Mittelstand Real Estate AG

Domicile	Germany
Long Term Rating	(P)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

New Issuer

Summary Rating Rationale

DEMIRE's (P)Ba2 Corporate Family Rating (CFR) reflects (i) the company's relatively small but well diversified portfolio of commercial real estate assets in secondary locations in Germany, which is focused on office but also includes retail and logistics properties. The rating also reflects (ii) robust fundamentals for commercial real estate in Germany, and (iii) the company's business model, including the strategy to actively manage the property portfolio.

These positive factors are offset by (i) the company's high financial leverage, with Gross Debt to Assets of 60.3% (March 2017), and a limited pool of unencumbered assets, (ii) the somewhat opportunistic business model regarding the relatively low quality asset portfolio compared to other Moody's rated real estate companies (iii) the company's relatively small size and limited track record on strategy execution driven by recent strong growth, management changes and still relatively high overhead cost.

Credit Strengths

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

» Robust German office market fundamentals alongside a favourable macroeconomic environment

» Integrated business model, with strategy to actively manage the portfolio and improve asset quality

Credit Challenges

» High financial leverage, and limited pool of unencumbered assets

» Somewhat opportunistic business model, which strongly relies on successful reduction of vacancy rate and increase in rental income of the relatively low quality asset portfolio compared to other Moody's rated real estate companies

» Relative small size and limited track record on strategy execution driven by recent strong growth, management changes and still relatively high overhead cost

Rating Outlook

The stable outlook reflects our expectation that the company will maintain leverage, as measured by Moody's adjusted debt / real estate gross assets, below 60%. The outlook also reflects our positive view on the German commercial real estate market and ongoing favourable German bank lending environment.

Factors that Could Lead to an Upgrade

DEMIRE is weakly positioned in the Ba2 rating category. However, a rating upgrade could result from a successful increase in occupancy rate in its value-add portfolio and an expansion of the asset portfolio if substantially funded with equity, resulting in an overall decline of leverage. An upgrade would also require a reduction in leverage towards 50% Moody's adjusted debt / gross assets, the development of a further track record operating with the current portfolio and a fixed charge coverage (FCC) of above 2.5x on a sustainable basis.

Factors that Could Lead to a Downgrade

The rating could come under pressure if the company fails to de-lever from current levels of around 60% Moody's adjusted debt / gross assets, or fixed charge coverage remained below 2.0x on a sustained basis, and/or if there is a material deterioration in the German commercial real estate market fundamentals or a sharp weakening in the currently very accommodating German bank lending market. The rating could also come under pressure if the asset quality within the portfolio deteriorated and/or if the vacancy rate on the existing portfolio increased.

Key Indicators

Exhibit 1

Key Indicators

DEMIRE Deutsche Mittelstand Real Estate AG

	3/31/2017(L)	12/31/2016	12/31/2015
FFO Payout	107.2%	227.0%	
Amount of Unencumbered Assets			
Debt / Gross Assets [2]	60.3%	60.5%	63.4%
Net Debt / EBITDA	12.9x	13.9x	44.4x
Secured Debt / Gross Assets	50.3%	50.6%	52.8%
Gross Assets (USD Million)	$1,178.5	$1,154.7	$1,122.7
Development Pipeline			
EBITDA Margin (YTD)	71.9%	59.3%	42.4%
EBITDA Margin Volatility			
EBITDA / Fixed Charges (YTD) [3]	1.7x	1.2x	0.5x
Joint Venture Exposure (YTD)			

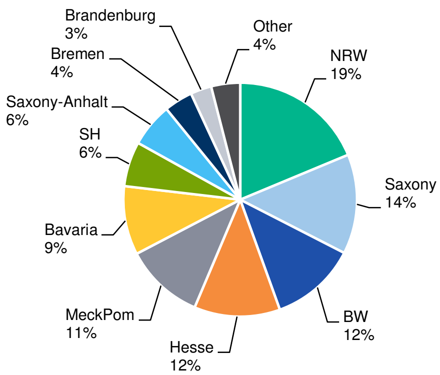
(1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics™, (2) Debt includes a portion of hybrid securities considered to have debt like features as explained in Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations revised December 2010, (3) Fixed Charges includes capitalized interests explained in Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations revised December 2010.
Source: Moody's Financial Metrics (MFM)

Detailed Rating Considerations

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

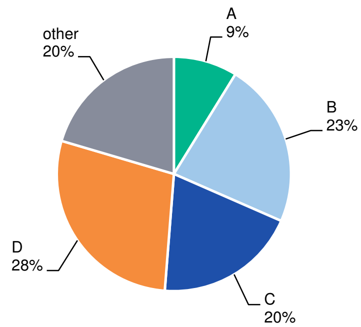
DEMIRE's 85 individual properties total to around 1.0 million square meters (sqm) and are valued at around €1.0 billion gross asset value (GAV) and are spread across several key regions in Germany. Less than 10% are located in the seven largest German cities ("A" cities), while the remainder is located in secondary locations. These comprise the 118 next largest cities (B, C and D cities, according to Bulwiengesa definitions, together around 70%) and other smaller cities (not ranked, 20%).

Exhibit 2
Breakdown of assets by German State



Source: Company data, as of March 31, 2017

Exhibit 3
Breakdown of assets by City classification



City classification according to Bulwiengesa definition
Source: Company data, as of March 31, 2017

The portfolio currently generates an annual gross rental income (GRI) of around €71.7 million from approximately 800 individual tenants, of which Deutsche Telekom (Baa1) is by far the largest tenant and accounts for around 30% of DEMIRE's gross rental income (GRI). All other tenants account for 3% or less of DEMIRE's GRI. The tenants are mostly low risk public sector clients and German medium-sized corporates ("Mittelstand"). Tenant concentration to Deutsche Telekom is one of the highest within Moody's rated peers. However, this is mitigated by the strong credit standing of Deutsche Telekom, the long weighted average lease maturity of 5.8 years, as well as the breakdown into 28 single leases on 18 properties.

Secondary locations are offering a higher gross initial yield and have developed positively in past eight years, with vacancy rates having come down further from already low levels.

Robust German office market fundamentals alongside a favourable macroeconomic environment

We expect continued strong demand for German offices for at least the next 18 months, driven by a strong labour market and economic growth. The strong demand for offices has resulted in the lowest vacancy levels in Germany's office market since 2005, according to Bulwiengesa and DG Hyp. Vacancy rates in secondary locations (6%, as of 2015) are even slightly lower than at the top 7 locations (7.6%) and have been less volatile. The increasing conversion of existing office space into residential or hotel and the redeveloping of office properties as mixed-use buildings, are two trends further reducing net available office space across the country.

We expect the German office investment market to continue its strong performance for at least the next 18 months putting continued downward pressure on yields and driving values up. We are positive on the market and expect robust economic data and a flight to Germany as a safe haven to attract a big inflow of foreign capital that will further pressure yields down. According to PMA, German commercial property investment transaction volumes continued to reach very high levels of more than €50 billion in 2016, despite a marginal decline versus the also very strong year 2015 (€53 billion versus €56 billion). Whilst the top 7 cities account for more than half of the total transaction volume, the share of secondary locations has remained relatively stable (44% as of 2016) and followed similar trends as the top 7 cities during the past ten years.

We view favourably Germany's solid macroeconomic environment and its government's stable Aaa rating reflects (1) its advanced, diversified and highly competitive economy; (2) its track record of social and political stability; (3) its tradition of prudent fiscal policies; and (4) ready market access due to its safe-haven status. We expect German real GDP to grow by 1.6% in 2017 and 2018, against the backdrop of a solid labour market (unemployment rate expected to remain at low levels of 4.1%). We believe that these trends should be supportive of DEMIRE's efforts in attracting new tenants and growing its asset value.

Integrated business model, with strategy to actively manage the portfolio and improve asset quality

DEMIRE follows a fully integrated business model, which comprises of property & asset management, letting and facility management. With this approach, the company is able to actively monitor and manage the technical facilities of its properties and keep a regular relationship with tenants, including a proactive management of rental contracts and an early marketing of expiring contracts.

We note that the company has successfully managed to reduce its vacancy rate, as calculated by the methods of the European Public Real Estate Association ("EPRA vacancy rate"), from high levels of 14.7% in 2014 to currently 10.7% (as of March 2017, pro forma for signed but not yet closed asset sales). This implies a relatively high vacancy rate of one logistics asset within DEMIREs portfolio, while the vacancy rate within DEMIRE's office assets is around 6.6%, still slightly above average market levels of around 6% for office markets in secondary locations in Germany. DEMIRE has also managed to keep the weighted average lease term (WALT) of its portfolio at a stable level of 5.3 years over the past two years, with new contracts typically signed with a seven year term.

High financial leverage, and limited pool of unencumbered assets

DEMIRE's leverage, as measured by Moody's adjusted gross debt / total real estate assets, was 60.3% as of 31 March 2017 and we expect this ratio to improve gradually to 56-58% within the next 12-18 months, predominantly by servicing the bank debt. This, however, is still elevated and represents the high end of our range of 50–60% for a Ba subfactor score according to our rating methodology.

DEMIRE's fixed charge coverage (FCC, defined as Moody's adjusted EBITDA / (interest expense, capitalized interest and preferred dividends)) was 1.7x in the last twelve months to 31 March 2017. We expect this ratio to improve to around 1.8x to 2.1x over the next 12-18 months, assuming a successful bond placement and a related reduction in interest expense. This will position the company solidly within our range of 1.7-2.2x for a Ba subfactor score according to our rating methodology. DEMIRE's relatively low fixed charge coverage provides very little buffer should the company experience earnings declines, for example in case of increasing vacancy rates.

Virtually all of DEMIRE's property assets are currently encumbered, except for €3 million. With this, DEMIRE currently maps at Caa in our methodology grid. Pro forma of the contemplated bond transaction of €270 million and signed but not closed asset sales, the amount of unencumbered property assets will increase to €216 million or 22% of total assets, mapping to a B score in our methodology grid. We consider unencumbered assets as an important source of liquidity for real estate companies.

In assigning the rating we have taken into account the company's financial policy which includes various objectives to de-lever and de-risk the company, such as a reduction of the leverage to less than 50% loan-to-value (LTV; 62.5% as of March 2017). Moreover, we understand that any sizeable acquisition of properties would be funded in line with the company's medium term LTV target, resulting in an overall de-leveraging of the group.

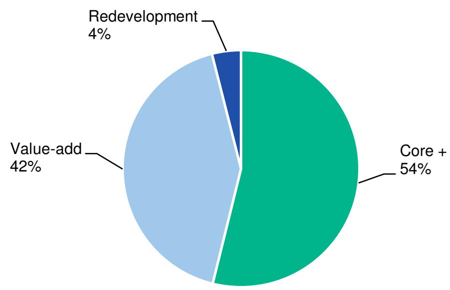
We also understand that management aims to optimize the financing structure of the group by reducing funding cost and make it more flexible. This includes a medium-term targeted funding mix that allows around 50% of the assets to be unencumbered. The contemplated bond issuance and the refinancing of existing loans and bank debt will materially reduce funding cost and increase financial flexibility, considering that around 22% (€216 million) of its assets will be unencumbered after the transaction.

Under the current capital structure, a significant amount of debt matures in 2018 and 2019. As a result, the company faces some refinancing risk and this is reflected in a B subfactor score for Debt Maturities based on last twelve months to March 2017 data. However, the company's debt is expected to be partly refinanced pro-forma for the bond issuance, and the average debt maturity will increase to 5.3 years. We therefore expect the Debt Maturity subfactor to improve to "A" in the forward looking grid pro-forma for the bond issuance.

Somewhat opportunistic business model, which strongly relies on successful reduction of vacancy rate and increase in rental income of the relatively low quality asset portfolio compared to other Moody's rated real estate companies

Exhibit 4

Slightly more than half of DEMIRE's assets are in the "core +" cluster

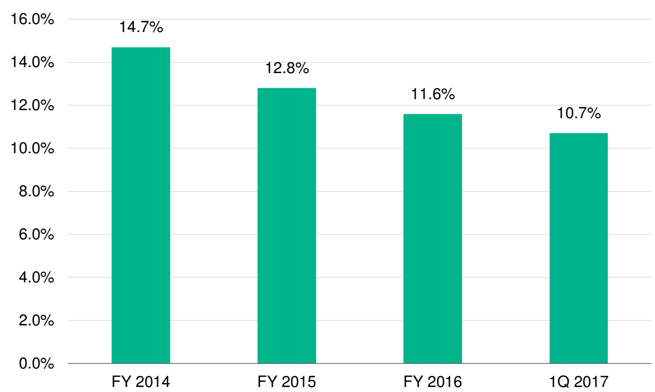


Breakdown by GAV, figures in € or %
Source: Company data

DEMIRE has divided its asset portfolio into three clusters, assets with secure income and long-term visibility ("core +"; 54% of GAV), assets which need to be actively managed to capture growth upside ("value-add", 42% of GAV), and redevelopments, where extensions, refurbishments and selective developments are being done (4% of GAV). While the core + assets have a low vacancy rate of around 5.4% and a WALT of 6.6 years, making the portfolio relatively secure and visible, the WALT of the value-add portfolio is much shorter (3.8 years), and the vacancy much higher, at 16.7%. The latter suggests upside potential in terms of rental income going forward, but also indicates a high degree of risk in a substantial part of the portfolio, in terms of potential increases in vacancy rates and/or pressure on rental prices. This requires continued successful active management of assets. The portfolio's WALT has been relatively high and stable since 2015 and we do not expect it to increase further from current levels.

Exhibit 5

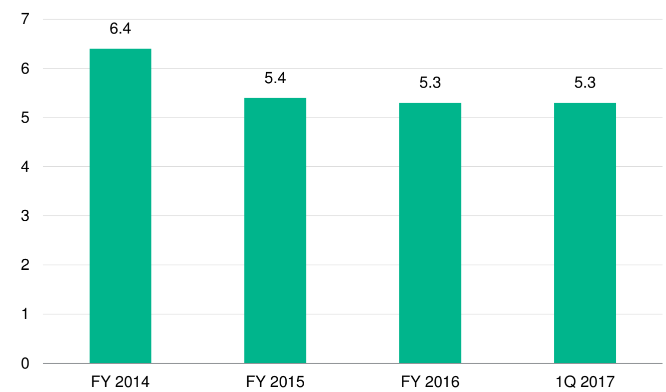
Vacancy rate has been improved, but still remains relatively high



Calculation of vacancy rate based on EPRA approach
Source: Company data

Exhibit 6

WALT has been relatively high and stable since 2015



Source: Company data

We consider the quality of DEMIRE's asset portfolio as relatively low compared to other Moody's rated real estate companies, which mostly focus on primary locations. The quality of DEMIRE's asset portfolio and related risks for investors is reflected by relatively high returns, with a Gross Rental Income (GRI) Yield of 7.3%, comprising of 7.1% for the Core + assets and 7.5% for the value-add assets, and high vacancy rates, especially at value-add. These high returns are, however, partially offset by relatively high overhead cost and higher refinancing cost, which are reflected in a relatively low fixed charge coverage rate (FCC).

We understand that the company aims to increase the GRI to €80.3 million from currently €71.7 million, mainly driven by a reduction of the vacancy rate and, at a lesser extent, increasing rental rates. Both of this might, however, become challenging in case of changes in the general macroeconomic environment. We also note that a decrease of the vacancy rate requires an ongoing and active management of the assets.

Relative small size and limited track record on strategy execution in spite of recent strong growth, management changes and still relatively high overhead cost

With its €1.0 billion asset portfolio, DEMIRE is smaller than most of its peers, which typically manage portfolios of a low to mid-single-digit € billion size. As a result of this, and also in context of DEMIRE's strong growth over the past few years, its overhead cost are relatively high, at close to 30% of GRI, compared to slightly less than 20% in average of its peers, comprising of Aroundtown, Alstria, Hamborner REIT and TLG (all unrated by Moody's).

DEMIRE has very strongly grown its asset base by almost three times over the past few years, from €333 million (book value of investment properties as of December 2014) to €958 million (March 2017, €984 million including assets held for sale). In addition, the company has done some capital recycling transactions, to reduce the number of single properties within the portfolio to 85 (as of March 2017, pro forma for signed but not closed asset disposals), from 171 as of December 2016, and increase the average investment size. With this high asset growth and turnover, however, the company has still limited track record in terms of strategy execution on an asset portfolio of the existing size.

DEMIRE's Executive board consists of two members, Markus Drews (42, CEO) and Ralf Kind (46, CFO). Whilst both are very experienced in the real estate industry, with each around 20 years professional real estate experience, their track record within the firm is limited (Mr. Drews joined in 2014, and Mr. Kind earlier in 2017). The new management has put in place a strategy to further grow the company. The successful execution of this strategy will require stability in terms of the management board.

Management's strategy includes to grow the asset portfolio further to in excess of €2bn. While this would allow to realize economies of scale, execution risks relate to the expansion of the acquisition pipeline (currently around €144 million), the selection of assets that fit to the company strategy in terms of quality and pricing (the company expects a gross initial yield of at least 6%), and the funding.

Liquidity Analysis

We view DEMIRE's liquidity as adequate. As of 31 March 2017, sources of liquidity include available cash in of €25 million, €11.6 million undrawn committed facilities (out of €16.5 million total committed facilities), a secure and stable €72 million gross annual rental income stream, and €108 million pool of currently unencumbered assets (€3 million properties, €44 million cash and cash equivalents, €61 million trade and financial receivables and other unencumbered assets). The amount of unencumbered assets is expected to improve by €213 million to €326 million pro-forma for the bond issuance.

Despite the low amount of committed Credit Facilities and pro-forma for the bond issuance and subsequent refinancing, DEMIRE has sufficient internal sources to cover the cash requirements of the next 18 months. We expect the major demands on cash from operations in the next 18 months to come from €14 million on capital expenditures, €5 million on dividend payments at its listed subsidiary and €31 million on debt repayments. DEMIRE's Credit Facilities are not expected to be drawn over the next 18 months and are subject to a Debt Service Coverage Ratio covenant which is expected to have headroom of at least 40% over the next 6 quarters.

Corporate Profile

Headquartered in Langen (Germany), DEMIRE is a public listed commercial real estate company with focus on office (68% of asset portfolio as of 1Q2017), retail (24%) and logistics properties (5%) in secondary locations across Germany. As of March 31, 2017, the company's portfolio comprised 98 single properties with a total lettable floor space of approximately one million square meters and an aggregated portfolio value of €994 million. DEMIRE holds a 77.7% stake in Fair Value REIT-AG, which is fully consolidated and accounts for €289 million portfolio value, or approximately 30% of DEMIRE's portfolio. DEMIRE's weighted average lease term (WALT) amounted to 5.3 years. As of LTM March 2017, the company generated rental income of €94 million and had 78 employees as of March 31, 2017.

The company is listed on the Frankfurt stock exchange, and had a free float of 56.58%, as of 28 April 2017. Main shareholders are Wecken & Cie (26.53%), Obotritia Capital (11.89%) and Sigrid Wecken (5.0%).

Rating Methodology and Scorecard Factors

The principal methodology we used was Moody's Global Rating Methodology for REITs and Other Commercial Property Firms, published July 30, 2010. DEMIRE maps at Ba3 on a LTM March 2017 basis. With the proposed issuance of the €270 million notes, however, the scores for the company's liquidity and funding as well as its access to capital will improve. This leads to a forward-looking grid-indicated rating of Ba1, one notch above the actual rating assigned. The difference is explained by the company's still limited track record and the financial leverage, which is at the high end of our expectations for a Ba subfactor score for Debt/Gross assets.

Exhibit 7

Rating Factors

DEMIRE Deutsche Mittelstand Real Estate AG

REITs and Other Commercial Property Firms Industry Grid [1][2]	Current LTM 3/31/2017		Moody's 12-18 Month Forward View As of 6/28/2017 [3]	
Factor 1: Liquidity and Funding (24.5%)	**Measure**	**Score**	**Measure**	**Score**
a) Liquidity Coverage	B	B	Ba	Ba
b) Debt Maturities	Ba	Ba	A	A
c) FFO Payout	107.2%	B	25% - 30%	Aa
d) Amount of Unencumbered Assets	9.5%	Caa	28% - 30%	B
Factor 2: Leverage and Capital Structure (30.5%)				
a) Debt / Gross Assets	60.3%	B	55% - 60%	Ba
b) Net Debt / EBITDA	12.9x	Caa	12x - 14x	Ca
c) Secured Debt / Gross Assets	50.3%	B	30% - 35%	B
d) Access to Capital	B	B	Ba	Ba
Factor 3: Market Position and Asset Quality (22%)				
a) Franchise / Brand Name	Ba	Ba	Ba	Ba
b) Gross Assets(USD Million)	$1,178.5	Ba	$1100 - $1200	Ba
c) Diversity: Location / Tenant / Industry / Economic	Ba	Ba	Ba	Ba
d) Development Pipeline	5.0%	A	5%	A
e) Asset Quality	Ba	Ba	Ba	Ba
Factor 4: Cash Flows and Earnings (23%)				
a) EBITDA Margin (YTD)	71.9%	A	60% - 70%	A
b) EBITDA Margin Volatility	7.5%	Ba	5% - 7.5%	Ba
c) EBITDA / Fixed Charges (YTD)	1.7x	B	1.8x - 2.1x	Ba
d) Joint Venture Exposure (YTD)	0.0%	Aa	0%	Aa
Rating:				
a) Indicated Rating from Grid		Ba3		Ba1
b) Actual Rating Assigned				(P)Ba2

(1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. (2) As of 3/31/2017(L); Source: Moody's Financial Metrics™. (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.
Source: Moody's Financial Metrics (MFM)

Ratings

Exhibit 8

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

Source: Moody's Investors Service

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