S&P Global
Ratings

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DEMIRE Deutsche Mittelstand Real Estate AG

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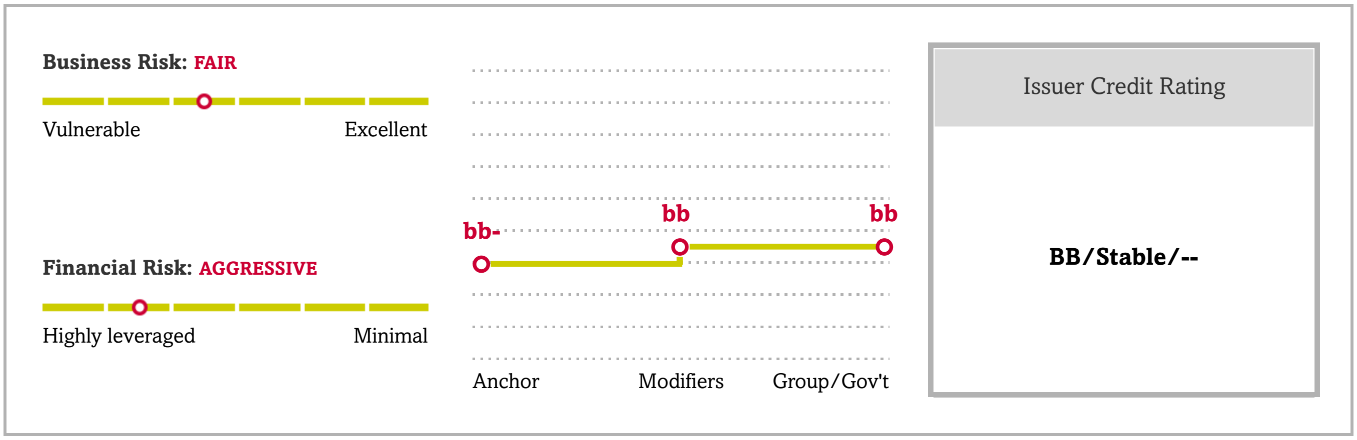
DEMIRE Deutsche Mittelstand Real Estate AG



Credit Highlights

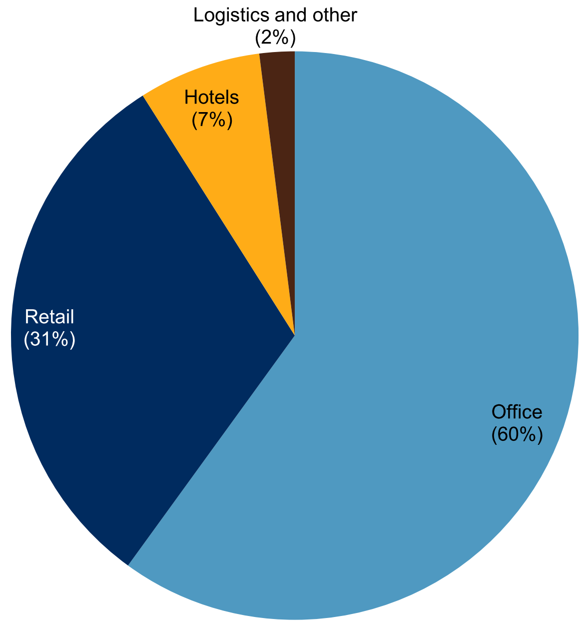
Overview

Key strengths	Key risks
Stable strategy of long-term investments, mainly in office properties, and very limited exposure to development activities.	Portfolio of about €1.5 billion is still small compared with peers, and it has a vacancy rate of close to 9%.
Focus on secondary locations in Germany, most of which offer good demand for commercial real estate.	Some tenant concentration--the top 3 tenants represent 30% of annual gross rental income (GRI).
Moderate leverage, with a net loan-to-value (LTV) target of below 50%.	Financial-sponsor-owned under majority shareholder Apollo, which could push the company toward more-aggressive leverage.
	Overall economic uncertainty with regards to the COVID-19 pandemic and the medium-to-long-term impact on demand for commercial real estate.

COVID-19 is likely to shadow DEMIRE's earnings for 2020 but the impact will be somewhat offset by the additional rental income it will generate this year from its 2019 acquisitions. The German lockdown caused shops and hotels to close during the second quarter of 2020 and was accompanied by other social distancing measures to curb the spread of the pandemic. As a result, S&P Global Ratings expects DEMIRE's like-for-like rental growth in 2020 to decline to about 3%-5%. About 16% of its 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 that DEMIRE was able to collect above 85% of its monthly rent collection during the past three months. Most of the rent deferrals stem from its retail and hotel assets. 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.

Chart 1

Segment Split Of DEMIRE's Portfolio By GRI
As at March 31, 2020



Source: S&P Global Ratings.

DEMIRE has further optimized its capital structure, reducing financing costs and extending its average debt maturities. In October 2019, DEMIRE issued €600 million of senior unsecured notes, at 1.875%, maturing in 2024. The company has used most of the proceeds to refinance the outstanding €370 million senior unsecured bond (nominal €400 million) and €150 million of promissory notes (Schuldschein) early. Both were due in 2022. As a result, the company's cost of debt reduced significantly, to 1.8% at year-end 2019 from 3% before the transaction. Meanwhile, its average debt maturity has been extended to around 4.1 years from 2.8 years. We understand that the company combined the remaining proceeds with existing cash and used them to finance asset acquisitions worth around €115 million.

Outlook: Stable

The stable outlook is based on our view that DEMIRE's property portfolio will generate stable cash flows over the next 12 months, supported by last year's acquisitions, its average lease maturity of over four years, and new leases signed during the year which should offset partly any negative impact of COVID-19.

We forecast EBITDA interest coverage will increase to 3.0x-3.3x, thanks to recent refinancing activities and debt to debt plus equity will stay at around 52%-55% over the next 12-24 months.

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. This could occur if DEMIRE were to allow its reported net LTV ratio to rise above 50%, contrary to its publicly announced policy. It could also occur if the company undertook more debt-financed acquisitions, although this is not part of our base-case scenario.

We could lower the rating if the company did not manage to realize its business strategy, causing the overall portfolio to decline back to €1 billion or below, or if it invested in less favorable secondary locations, away from metropolitan hubs.

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

Upside scenario

We consider an upgrade is currently unlikely. However, we would view positively a change in the ownership structure, for example, if the free float of the company's shareholder structure increases materially, while maintaining a conservative financial policy in line with a higher rating. This would translate into S&P Global Ratings-adjusted debt to debt plus equity of below 55% and EBITDA interest coverage of more than 2.4x.

Our Base-Case Scenario

Assumptions

- Significant GDP decline in Germany of 6.2% in 2020 in light of the pandemic, before rebounding to growth of 4.4% in 2021, with unemployment rising to around 4.5% over the next two years.
- Slightly negative consumer price index (CPI) growth in Germany of 0.1% in 2020, before rebounding to positive 1.0% in 2021.
- Overall like-for-like rental income decrease of about 3%-5% in 2020. This incorporates the potential rent concessions to tenants affected by COVID-19, mainly in the retail and hotel segments. We expect the company to generate flat like-for-like rental income growth in the following years.
- Limited net asset rotations in the next 12 months.

- Marginal dip in like-for-like revaluation for DEMIRE's properties for full-year 2020, particularly driven by retail and hotel assets, with flat valuation gains the following year.
- Average cost of debt to remain stable at approximately 1.8%.

Key Metrics

DEMIRE Deutsche Mittelstand Real Estate AG--Key Metrics*

	--Fiscal year ended Dec. 31--				
(mil. €)	**2018a**	**2019a**	**2020e**	**2021f**	**2022f**
Net rental income	58.5	65.5	63-65	64-67	66-69
EBITDA	38.2	55.5	51-54	52-55	53-56
EBITDA margin (%)	65.3	84.6	81-82	82-84	82-84
Debt to EBITDA (x)	12.3	13.5	13.9-14.2	13.5-14	12.8-13.2
EBITDA interest coverage (x)	1.4	2.3	3-3.3	3.1-3.4	3.2-3.5
Debt to debt plus equity (x)	44.6	53.1	53-55	53-55	52-54

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast.

The company's leverage is expected to remain moderate, in line with its financial policy. We forecast that DEMIRE will maintain a reported net LTV ratio of below 50% (adjusted debt to debt plus equity of below 55%), in line with its financial policy. For any portfolio growth in the next couple of years, we expect the company to use a balanced mix of debt and equity. For the next 12-24 months, we forecast debt to debt plus equity will remain below 55% despite our assumption that revaluation for DEMIRE's portfolio could slightly fall in 2020. In addition, DEMIRE has announced to buy back up to 2 million shares during the month of July, which should result in around €9 million cash outflow. We understand that the company does not plan any further share buy-backs and the impact of this transaction is limited, though we will observe closely any further financing activities and update our forecast accordingly.

EBITDA interest coverage should further improve during 2020. In 2020, EBITDA interest coverage will benefit strongly from the significant reduction in overall cost of debt to 1.8% from 3%, following the company's refinancing activities at the end of 2019. We forecast that DEMIRE's rolling 12 months EBITDA interest coverage will reach at least 3x by the end of this year. It was 2.4x on March 31, 2020.

Company Description

DEMIRE Deutsche Mittelstand Real Estate AG is a Germany-based commercial real estate company focusing on office (64% of portfolio value as of March 31, 2020), retail (26%), and logistics/other assets (10%). On March 31, 2020, the company's portfolio was valued at about €1.5 billion and comprised 87 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 which holds about 64%, and Wecken Group which has about 25%. The remaining 11% is free float.

Table 1

DEMIRE Deutsche Mittelstand Real Estate AG--Portfolio Summary

Total portfolio value (bil. €)	1.5
No. of properties	87
Average rental income* (€/sqm/month)	8.1

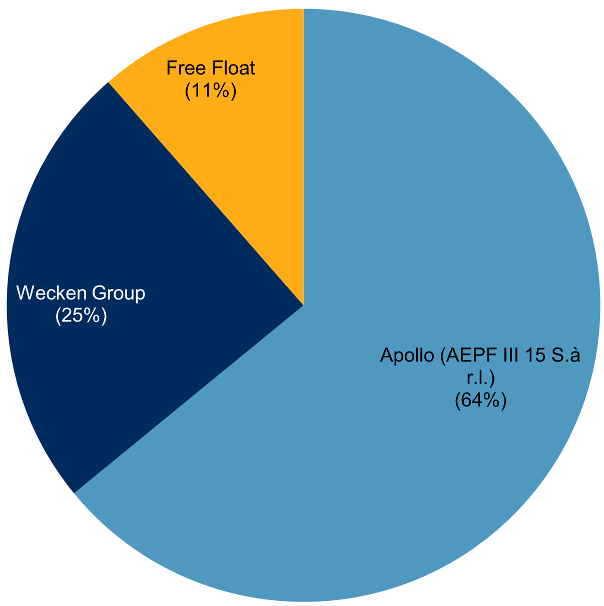
Table 1

DEMIRE Deutsche Mittelstand Real Estate AG--Portfolio Summary (cont.)	
Gross rental yield (%)	5.9
EPRA vacancy (%)**	8.9
Weighted average lease term (years)	4.8

Source: based on company's data as of March 31, 2020 *Contractual rent excluding service charges. **Excluding properties held for sale. EPRA--European Public Real Estate Association.

Chart 2

Apollo's Majority Stake In DEMIRE Remains



Source: S&P Global Ratings.

Peer comparison

Table 2

DEMIRE Deutsche Mittelstand Real Estate AG--Peer Comparison					
Industry sector: Real Estate Investment Trust or company					
	DEMIRE Deutsche Mittelstand Real Estate AG	**Alstria Office REIT-AG**	**Globalworth Real Estate Investments Ltd.**	**Summit Properties Ltd.**	**Diok Real Estate AG**
Ratings as of July 3, 2020	BB/Stable/--	BBB/Positive/--	BBB-/Stable/--	BB+/Stable/--	B/Stable/--
	--Fiscal year ended Dec. 31, 2019--				

Table 2

DEMIRE Deutsche Mittelstand Real Estate AG--Peer Comparison (cont.)

Industry sector: Real Estate Investment Trust or company

	DEMIRE Deutsche Mittelstand Real Estate AG	Alstria Office REIT-AG	Globalworth Real Estate Investments Ltd.	Summit Properties Ltd.	Diok Real Estate AG
(Mil. €)					
Revenue	65.5	162.9	159.9	82.1	6.2
EBITDA	55.5	139.1	128.0	64.5	2.6
Funds from operations (FFO)	17.7	114.5	80.4	50.8	(4.9)
Interest expense	24.0	27.0	41.5	15.0	5.7
Cash flow from operations	8.8	121.7	80.3	54.7	(3.8)
Capital expenditure	5.6	116.6	92.8	0.1	0.1
Dividends paid	0.0	92.3	104.5	2.3	0.0
Cash and short-term investments	102.1	298.2	280.9	262.1	3.5
Debt	748.6	1,219.3	1,064.3	334.2	162.2
Equity	660.8	3,175.6	1,914.7	964.4	39.7
Debt and equity	1,409.4	4,394.9	2,979.0	1,298.6	201.9
Valuation of investment property	1,510.2	4,458.2	3,049.0	1,400.4	205.6
Adjusted ratios					
Annual revenue growth (%)	12.0	(3.6)	10.0	21.8	321.5
EBITDA margin (%)	84.6	85.4	80.1	78.6	41.9
Return on capital (%)	4.6	3.3	5.2	4.7	2.0
EBITDA interest coverage (x)	2.3	5.2	3.1	4.3	0.5
Debt/EBITDA (x)	13.5	8.8	8.3	5.2	62.3
Debt/debt and equity (%)	53.1	27.7	35.7	25.7	80.3

Business Risk: Fair

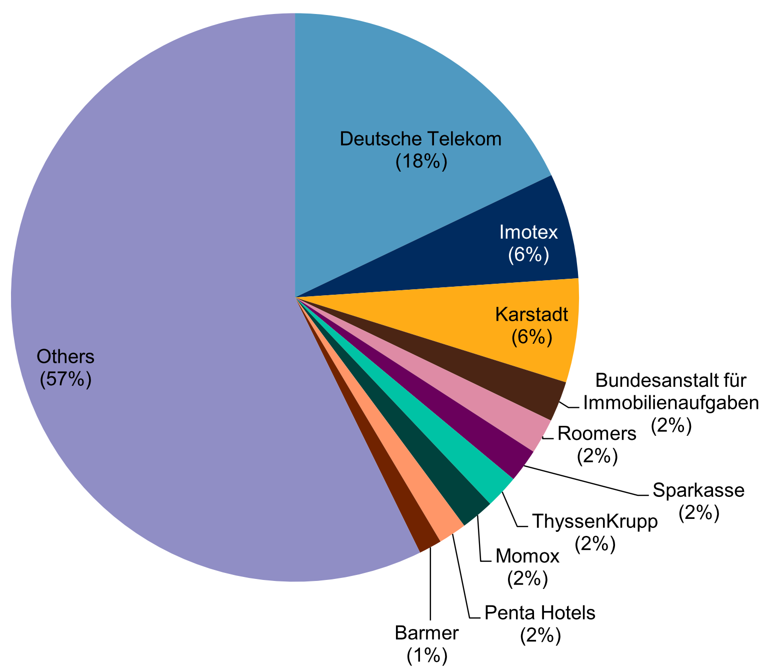
DEMIRE's business risk profile is based on the company's relatively small scale and portfolio size compared with rated peers in the commercial real estate segment, and its exposure to a single economy--Germany. The company's property portfolio comprised 87 buildings with a combined gross asset value of about €1.5 billion on March 31, 2020.

The company focuses mainly on secondary locations across Germany. Generally, we view rental growth potential and demand-supply trends as more promising in metropolitan areas than in secondary or suburban locations. That said, most of the midsize cities in which DEMIRE operates are close to metropolitan areas which have also benefited from solid demand in recent years, such as Darmstadt or Bonn. We consider about 80% of DEMIRE's portfolio to be in cities with good infrastructure and favorable long-term macroeconomic fundamentals, including low unemployment rates, and GDP growth in line with the German average. About 15%-20% of the portfolio is in areas we consider less favorable, where it may take longer to find replacements for departing tenants.

DEMIRE has some concentration on its main tenant Deutsche Telekom AG (BBB/Stable/A-2), which represents about 18% of its annual rental income. We understand that the exposure is spread across several lease contracts and that Deutsche Telekom subleases some of its exposure. It has also reduced its exposure over the past year, from over 30%. DEMIRE is also exposed to the department store chain GALERIA Karstadt Kaufhof, its third-largest tenant, which comprises 6% of annual rental income over five assets. In April 2020, GALERIA filed for a protective administrative insolvency and has recently announced the closure of 56 of its 172 stores in Germany, including one store in DEMIRE's portfolio. Although we anticipate that there is a good chance that DEMIRE will likely experience loss of rental income and increased vacancy in those assets, the overall impact on the company should remain moderate thanks to new leases signed in other segments, such as logistics or for its office portfolio.

Chart 3

DEMIRE's Tenant Break-Down By GRI
As at March 31, 2020



Source: S&P Global Ratings.

DEMIRE reported a European Public Real Estate Association (EPRA) vacancy ratio of 8.9% as of March 31, 2020, which is slightly high, but in line with most rated peers in the German office market.

We assess DEMIRE's overall portfolio as being of average quality, with capital expenditure (capex) needs of €10 million-€15 million in the coming years, including tenant improvements. DEMIRE benefits from a solid average lease length of close to five years. In our view, the company's strategy to increase its income-producing portfolio to about €2 billion in the medium term should help enhance its asset and tenant diversification.

Financial Risk: Aggressive

Our assessment of DEMIRE's financial risk profile factors in the ownership structure, under which the company is majority-controlled by financial sponsor Apollo. Although we see that Apollo supports DEMIRE with equity and underpins its publicly stated financial policy of net LTV below 50%, it is not clear how long the shareholder will maintain its investment. The financial-sponsor assessment also indicates that we consider the company could be pushed to adopt more-aggressive leverage or redevelopment of cash flow proceeds than listed companies that have a material free float, for example.

In October 2019, the company successfully issued €600 million of senior unsecured notes, due October 2024, at a yield of 1.875%. The proceeds were used to repay the outstanding 2.875% €400 million senior unsecured notes early, and the promissory notes (Schuldschein) of €150 million, both due 2022. Following the transaction, the company improved its cost of debt to 1.8% at year-end 2019 from 3% at year-end 2018. In addition, the average debt maturity has been extended to 4.1 years, compared with 2.8 years before the transaction. It has no large debt maturities coming up until 2024. Overall, 97% of the company's debt exposure is currently fixed or hedged.

Taking into account the recent refinancing activities and the impact we anticipate COVID-19 will have on DEMIRE, we forecast debt to debt plus equity will remain moderate at below 55% and EBITDA interest coverage will improve to slightly above 3x over the next 12-24 months. We expect the company will take an adequate mix of debt and equity to support any further portfolio growth, which will remain in line with our forecast ratios. As mentioned earlier, we do not include into our forecast any further share buy backs, other than the announced share buy back from July of roughly €9 million, in line with the company's strategy.

Our rating on DEMIRE continues to incorporate one notch of uplift from the anchor, based on our comparable ratings analysis. In our view, this reflects DEMIRE's growth strategy, which should enhance and diversify its portfolio further while keeping vacancy rates below 10%.

We also view favorably the company's execution on financial policy targets translating to adjusted debt to debt plus equity of below 55%.

Financial summary

Table 3

DEMIRE Deutsche Mittelstand Real Estate AG--Financial Summary					
Industry sector: Real Estate Investment Trust or company					
	--Rolling 12 months--				
	March 31, 2020	**Dec. 31, 2019**	**Sept. 30, 2019**	**June 30, 2019**	**March 31, 2019**
(mil. €)					
Revenue	65.8	65.5	64.8	62.4	62.4
EBITDA	55.7	55.5	52.3	49.7	41.7

Table 3

DEMIRE Deutsche Mittelstand Real Estate AG--Financial Summary (cont.)

Industry sector: Real Estate Investment Trust or company

	--Rolling 12 months--				
	March 31, 2020	**Dec. 31, 2019**	**Sept. 30, 2019**	**June 30, 2019**	**March 31, 2019**
Funds from operations (FFO)	24.1	17.7	32.3	28.4	18.7
Interest expense	22.8	24.0	24.4	24.8	26.2
Net income from continuing operations	75.9	75.5	53.5	53.8	49.2
Cash flow from operations	20.5	8.8	25.4	18.4	16.6
Capital expenditure	6.1	5.6	25.1	25.9	25.6
Cash and short-term investments	85.5	102.1	65.6	130.8	187.2
Debt	731.1	748.6	685.5	603.5	466.2
Equity	667.1	660.8	618.1	616.1	589.0
Debt and equity	1,398.2	1,409.4	1,303.6	1,219.6	1,055.2
Adjusted ratios					
Annual revenue growth (%)	5.3	12.0	15.2	10.7	13.6
EBITDA margin (%)	84.8	84.6	80.7	79.7	66.9
Return on capital (%)	4.1	4.2	4.1	4.3	3.9
EBITDA interest coverage (x)	2.4	2.3	2.1	2.0	1.6
Debt/EBITDA (x)	13.1	13.5	13.1	12.1	11.2
Debt/debt and equity (%)	52.3	53.1	52.6	49.5	44.2

Reconciliation

Table 4

DEMIRE Deutsche Mittelstand Real Estate AG--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (mil. €)

	--Fiscal year ended Dec. 31, 2019--						
DEMIRE Deutsche Mittelstand Real Estate AG reported amounts (mil. €)							
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**
Reported	807.0	613.4	72.1	155.2	50.9	55.5	45.8
S&P Global Ratings' adjustments							
Cash taxes paid	--	--	--	--	--	(0.7)	--
Cash interest paid	--	--	--	--	--	(37.0)	--
Reported lease liabilities	19.2	--	--	--	--	--	--
Accessible cash and liquid investments	(91.9)	--	--	--	--	--	--
Share-based compensation expense	--	--	0.0	--	--	--	--
Nonoperating income (expense)	--	--	--	1.3	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	(37.0)
Noncontrolling interest/minority interest	--	47.4	--	--	--	--	--

Table 4

DEMIRE Deutsche Mittelstand Real Estate AG--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (mil. €) (cont.)

Debt: Contingent considerations	12.6	--	--	--	--	--	--
Debt: Other	1.8	--	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	(16.8)	(16.8)	--	--	--
EBITDA: Valuation gains/(losses)	--	--	0.1	0.1	--	--	--
Depreciation and amortization: Asset valuation gains/(losses)	--	--	--	(83.0)	--	--	--
Interest expense: Other	--	--	--	--	(26.8)	--	--
Total adjustments	(58.3)	47.4	(16.7)	(98.4)	(26.8)	(37.7)	(37.0)

S&P Global Ratings' adjusted amounts

	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	748.6	660.8	55.5	56.8	24.0	17.7	8.8

Liquidity: Adequate

We assess DEMIRE's liquidity as adequate. We estimate that the company's liquidity sources will likely cover uses by at least 1.2x for the next 12 months as of March 31, 2020.

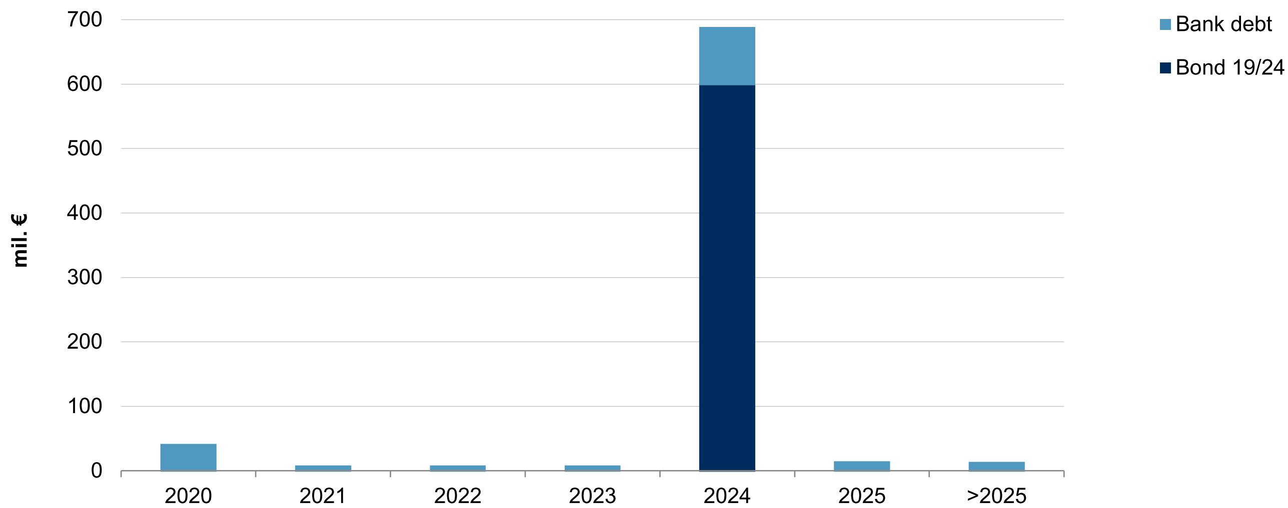
Principal Liquidity Sources	Principal Liquidity Uses
• Unrestricted cash balances of about €85.5 million as of March 31, 2020. • Our forecast of cash funds from operations (FFO) of €20 million-€25 million. • About €24 million mortgage loan which has already been signed. • About €13 million sales proceeds from committed asset disposal.	• About €52 million of short-term debt maturities, of which we understand €28 million have been refinanced already. • About €4 million of committed capex for the next 12 months. • About €5 million of dividend payments related to its subsidiary, FVR, and minority interest. • Up to €9 million of share buy backs.

Debt maturities

DEMIRE's weighted average debt maturity is 4.1 years as of March 31, 2020.

Chart 4

DEMIRE's Debt Maturity Profile



Source: S&P Global Ratings.

Covenant Analysis

Compliance expectations

We expect that the company will maintain adequate headroom (greater than 10%) under all outstanding financial covenants.

Requirements

DEMIRE has covenants under the documentation for its outstanding mortgage debt and corporate bond, mainly relating to the interest coverage ratio (greater than 1.75x), net LTV (less than 60%), and net secured LTV (less than 40%).

Issue Ratings - Recovery Analysis

Key analytical factors

- The issue rating on DEMIRE's senior unsecured nominal €600 million notes due 2024 is 'BB+', one notch above the issuer credit rating. The recovery rating is '2', reflecting the valuable asset base consisting of investment properties.
- Our recovery prospects are constrained by the unsecured nature of the debt instrument and its contractual subordination to the current amount of secured debt (such as mortgage loans). For asset-intensive companies, such as real estate companies, we cap our recovery rating on senior unsecured debt at '2'. We expect recoveries will be about 85% or more.
- In our hypothetical default scenario, we envisage a severe macroeconomic downturn in Germany, resulting in

market depression and exacerbated competitive pressures.

- We value the group as a going concern. Our stressed valuation figure comprises the stressed value of the company's property portfolio.
- Recovery prospects for the senior unsecured notes are very sensitive to a small change in the amount of senior secured debt or any other priority debt outstanding at default. Since there is no limitation on the incurrence of additional debt in the bond documentation, recoveries could be much lower if the amount of secured debt at default differs from our projections.

Simulated default assumptions

- Year of default: 2024
- Jurisdiction: Germany

Simplified waterfall

- Gross enterprise value (EV) at emergence: €1,064 million
- Net EV at emergence after administrative costs: €1,011 million
- Estimated priority debt (mortgages and other secured debt): €201 million
- Net EV available to senior unsecured bondholders: €810 million
- Senior unsecured debt claims: €596 million
- Recovery expectation: 70%-90% (rounded estimate: 85%)

*All debt amounts include six months' prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating

BB/Stable/--

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)

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

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- 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: 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, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	Significant	**Aggressive**	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	**bb-**	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of July 8, 2020)*	
DEMIRE Deutsche Mittelstand Real Estate AG	
Issuer Credit Rating	BB/Stable/--
Senior Unsecured	BB+
Issuer Credit Ratings History	
17-Jul-2017	BB/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable

Ratings Detail (As Of July 8, 2020)*(cont.)

across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.