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Research Update:

German Real Estate Company DEMIRE Assigned Preliminary 'BB' Rating; Outlook Stable

Primary Credit Analyst:
Nicole Reinhardt, Frankfurt (49) 069 33 999 303; nicole.reinhardt@spglobal.com

Secondary Contact:
Franck Delage, Paris (33) 1-4420-6778; franck.delage@spglobal.com

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Overview

- Germany-based commercial property company DEMIRE Deutsche Mittelstand Real Estate AG owns and manages a property portfolio valued at about €1 billion, consisting mainly of offices and retail properties.
- We consider that the company's portfolio will generate stable operating cash flows, supported by its focus on predominantly midsize cities bordering German metropolitan areas.
- We are assigning our preliminary 'BB' long-term corporate credit rating to DEMIRE and a 'BB+' preliminary issue rating to the company's proposed bond.
- The stable outlook reflects our view that the underlying macroeconomic fundamentals and positive demand trends in DEMIRE's main locations remain solid, supporting occupancy and rental income generation.

Rating Action

On July 10, 2017, S&P Global Ratings assigned its preliminary 'BB' long-term corporate credit rating to Germany-based real estate company DEMIRE Deutsche Mittelstand Real Estate AG. The outlook is stable.

At the same time, we assigned our preliminary 'BB+' issue rating to DEMIRE's proposed €270 million senior unsecured notes. The recovery rating on the notes is '2', indicating our expectation of substantial recovery (70%-90%; rounded estimate 85%) in the event of a payment default.

The final rating will depend on our receipt and satisfactory review of all final transaction documentation of the company's proposed senior unsecured bond issuance of approximately €270 million. Accordingly, the preliminary rating should not be construed as evidence of the final rating. If we do not receive final documentation within a reasonable timeframe, or if final documentation departs from materials reviewed, we reserve the right to withdraw or revise our rating. Potential changes include, but are not limited to, utilization of bond proceeds, maturity, size, and conditions of the bonds, financial and other covenants, and security and ranking of the bonds.

Rationale

Our preliminary rating on DEMIRE reflects our view of the company's relatively small scale and portfolio size compared with those of other rated peers in the commercial real estate segment, with exposure to one single economy, Germany.

As of March 31, 2017, the company's property portfolio consists of 98 buildings with a gross asset value of €994 million, including 16 assets held for sale amounting to €35.7 million. DEMIRE's strategy is to focus on midsize secondary locations in Germany, bordering metropolitan areas. Its portfolio comprises mainly office premises (68% of total gross rental income as of March 31, 2017), retail assets (24%), one logistics property (5%), and other real estate assets (3%).

DEMIRE is one of Germany's 10 largest commercial property companies in terms of market capitalization in a highly fragmented property market. Although we view market dynamics, such as rental growth potential and demand-supply trends in metropolitan areas as more favorable, we believe that the majority of midsize cities in which DEMIRE operates are close to metropolitan areas with similar market dynamics, such as Darmstadt or Bonn. We consider about 80% of DEMIRE's portfolio to be located in cities with good infrastructure and favorable macroeconomic fundamentals, including low unemployment rates, and GDP growth in line with the German average. We believe that about 15%-20% of the portfolio is located in less favorable areas, such as Trappenkamp and Lichtenfels, where it may take longer to find replacements for departing tenants. DEMIRE has some concentration in its main tenant Deutsche Telekom AG (BBB+/Stable/A-2), which represents about 30% of its annual rental income. We understand that Deutsche Telekom subleases some of its exposure.

DEMIRE reported an EPRA (European Public Real Estate Association) occupancy ratio of 89.1% as of March 31, 2017, which is somewhat below that reported by most rated peers in the European office and retail market. However, we take into account recent efforts in occupancy improvements and, in line with the company's strategy, we expect this ratio will improve further over the next two years, including newly acquired premises.

We assess DEMIRE's overall portfolio as being of average quality, with some capital expenditure needs of approximately €10 million-€12 million annually. DEMIRE benefits from a long average lease length of more than 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.

DEMIRE has relatively high leverage, with the S&P Global Ratings-adjusted ratio of debt to debt plus equity higher than 60%, and EBITDA interest coverage is weak at below 2x. We consider DEMIRE's debt leverage to be relatively high compared with industry standards, and project that the company's credit metrics will improve over the next 12 months, thanks to the proposed bond issuance and related refinancing plans. We estimate that leverage will decrease to below 60% and EBITDA interest coverage will increase beyond 2x by the end of 2018.

DEMIRE is committed to deleveraging, and its financial policy stipulates a maximum net loan-to-value ratio of 50% in the medium term. We treat the company's outstanding mandatory convertible bond of about €15 million as debt because the substantially lower conversion price of €5--compared with the

share price of €5.84 at issuance--precludes any equity content. This is due to dilution risk and potential incentives for the company to buy back shares following the share issuance, the more the share price declines from the price on the day of issuance. The current stock price is below €4.

In addition, we note that DEMIRE has a redeemable minority interest of about €62 million as of first-quarter 2017, related to close-end funds of its subsidiary Fair Value REIT AG (FVR), where FVR owns in most cases about 50% or more of the funds. We do not adjust our credit metrics for the minority interest, since we understand that termination of the partners of the funds is complicated and it may take several years until settlement payments are made. The termination right relates solely to the respective fund and not to DEMIRE or its subsidiary FVR. Also, DEMIRE has no direct control over how the termination rights are exercised, and a majority decision is required for any sale of the assets within the fund. In addition, the funds have been in place for more than 20 years and only a small amount has been terminated so far.

We adjust our calculations for any exercised termination and include these amounts in our debt figure. We may change our view if we believe the likelihood of the termination of a large portion of the minority interest had increased, leading us to include the full redeemable minority interest amount in our adjusted debt figure.

Our preliminary rating on DEMIRE incorporates a positive notch based on our comparable ratings analysis. In our view, DEMIRE's financial risk profile is moving toward the stronger end of our aggressive category, assuming the successful issuance of the unsecured bond as well as refinancing plans. We forecast that the company will significantly deleverage in the next few years, in line with its plan. The proposed bond issuance will also extend its debt maturity profile beyond five years and reduce the cost of debt further toward 4%. Our assessment also reflects DEMIRE's growth strategy, which should enhance and diversify its portfolio further.

In our base case, we assume:

- Low GDP growth for Germany of 1.6% in 2017 and 1.5% in 2018, with unemployment remaining below 5%.
- Approximately 5%-6% like-for-like rental income growth, stemming mainly from improved occupancy of DEMIRE's existing portfolio, higher rents from some new leases, and favorable supply-and-demand conditions in the German commercial market; this also includes some benefits from an increase in the consumer price index of close to 2% over the next 12 to 24 months, given that most of DEMIRE's lease contracts are index linked.
- Annual acquisitions of about €100 million-€200 million. In line with the company's strategy, we estimate that the income-producing portfolio will expand to about €2 billion in the next few years.
- Low single-digit like-for-like portfolio revaluation of DEMIRE's properties, reflecting the company's focus on midsize secondary locations where real estate prices are increasing at a slower rate than in large metropolitan areas. We also take into account some revaluation uplift from improving occupancy levels.

- Average cost of debt of about 4.0%, including the proposed senior unsecured debt issuance.

Based on these assumptions, we arrive at the following credit measures:
- EBITDA margins of about 60%-65% over the next 12 to 24 months;
- S&P Global Ratings-adjusted EBITDA interest coverage of just below 2x for the next 12 months, followed by a pronounced improvement to well above 2x in the following years; and
- A debt-to-debt-plus-equity ratio of about 60%-63% in 2017 and close to 58% in 2018.

Liquidity

We assess DEMIRE's liquidity as adequate. We estimate that the company's liquidity sources will likely cover liquidity uses by about 1.4x for the next 12 months. Our analysis is pro forma the issuance of the senior unsecured notes.

We forecast DEMIRE's liquidity sources as of March 31, 2017, are:
- Unrestricted cash balances of about €43.5 million;
- Our forecast of cash funds from operations of about €25 million-€30 million;
- Committed asset sales of about €41 million, including closing of the sale in first-quarter 2017 of about 16 small properties, and the sale of investments in Squadra Immobilien; and
- €270 million in proceeds from the issuance of senior unsecured notes.

We forecast that the company will have the following liquidity uses as of March 31, 2017:
- About €260 million in refinancing, including €100 million of senior unsecured notes, a €32 million mezzanine loan, as well as about €125 million representing mortgage debt and a Lombard loan, following the issuance of the senior unsecured bond;
- About €12 million-€14 million of capital expenditure, most of which we understand is not committed; and
- About €4 million of dividend payments related to FVR and the minority interest.

DEMIRE has covenants under the documentation for its outstanding mortgage debt and promissory notes. We expect that, pro forma the bond issuance, the company will maintain adequate headroom (greater than 10%) under all remaining covenants and the covenants related to the proposed bond in the future.

Outlook

The stable outlook reflects our view that DEMIRE's property portfolio should generate stable cash flows over the next 12 months. This is because the majority of DEMIRE's properties in secondary locations are near metropolitan areas across Germany, where demand trends are favorable, and occupancy should improve further in line with the company's strategy.

In addition, we expect that the company will successfully access the bond capital markets in the next few months to refinance some of its maturing debt. We forecast EBITDA interest coverage will improve close to 2x in the next 12 months, and debt to debt plus equity will decrease to approximately 58% by the end of 2018.

Upside scenario

We could raise the rating if DEMIRE increased its EBITDA interest coverage to 3x or higher on a sustainable basis while reducing leverage, with the ratio of debt to debt plus equity falling to about 50%. This could occur due to unexpectedly high rental growth, significant reduction in portfolio vacancies, or debt repayment.

In addition, an upgrade would depend on the scale and scope of DEMIRE's portfolio improving toward that of rated peers in the investment-grade category, with vacancy levels well below 10%, including newly acquired assets, and locations with solid underlying macroeconomic fundamentals.

Downside scenario

We could lower the rating if the company fails to achieve a debt-to-debt-plus-equity ratio below 60% and EBITDA interest coverage close to 2x by the end of 2018. This situation could materialize if DEMIRE were to alter its current publicly announced policy to reduce leverage, undertook additional debt-financed acquisitions, or was unable to refinance outstanding debt with the proposed bond's proceeds.

We could also lower the rating if the company's business strategy did not materialize, resulting in a decline in the overall portfolio size to well below €1 billion or investment in less favorable secondary locations away from metropolitan hubs. Ratings downside could also develop if the vacancy rate remained above 10%, due for example to weak demand or the acquisition of highly vacant premises.

Ratings Score Snapshot

Corporate Credit Rating: BB(Prelim)/Stable/--

Business risk: Fair
- Country risk: Very low risk
- Industry risk: Low risk
- 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: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Recovery Analysis

- The issue rating on DEMIRE's proposed senior unsecured €270 million notes is 'BB+', one notch above the corporate credit rating. The recovery rating is '2', reflecting the valuable asset base consisting of investment properties. However, 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%. We expect that the company will use the proceeds from the bond issuance to refinance mainly existing secured debt. We also take into account the company's strategy to add further unsecured debt to its capital structure.
- 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 and valuation assumptions

- Year of default: 2022
- Jurisdiction: Germany

Simplified waterfall

- Gross enterprise value at emergence: €690 million
- Net enterprise value at emergence after administrative costs: €655.5 million
- Estimated priority debt (mortgages and other secured debt): €411 million
- Net enterprise value available to senior unsecured bondholders: €244 million
- Senior unsecured debt claims: €270 million
- Recovery expectation: 70%-90% (rounded estimate 85%)

*All debt amounts include six months' prepetition interest.

Related Criteria

- 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: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

New Rating

DEMIRE Deutsche Mittelstand Real Estate AG	
Corporate Credit Rating	BB(prelim)/Stable/--
Senior Unsecured	BB+(prelim)
Recovery Rating	2(85%)(prelim)

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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