Research Update:

Germany-Based Real Estate Company DEMIRE Downgraded To 'BB-' From 'BB' On Weaker Leverage Prospects; Outlook Stable

March 15, 2021

Rating Action Overview

- DEMIRE Deutsche Mittelstand Real Estate AG has announced plans for a further dividend distribution of the full 2020 profit (about €65 million).
- We anticipate that the company will breach its own financial policy target of a reported loan-to-value (LTV) of maximum 50%, and that S&P Global Ratings-adjusted debt to debt plus equity will increase to above 60% and debt to EBITDA will rise above 15x.
- We are therefore lowering our long-term issuer credit rating on DEMIRE to 'BB-' from 'BB' and the company's senior unsecured debt to 'BB' from 'BB+'.
- The stable outlook is based on our view that the company's property portfolio will generate stable cash flow over the next 12 months, with moderate impact from the COVID-19 pandemic, and its credit metrics will remain commensurate with the rating.

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Rating Action Rationale

The proposed dividend transaction will push leverage above our downgrade threshold and DEMIRE'S own maximum leverage target. The company's majority shareholders, AEPF III S.a.r.l. (Apollo) and Wecken Group, who together own 90.7% of DEMIRE's share capital and act in concert, aim for a further dividend distribution for the full accumulated profit for 2020 of approximately €65 million. The company paid a dividend of about €57 million in 2020, representing 2019's full profit. As a result, we expect DEMIRE's S&P Global Ratings-adjusted debt to debt plus equity and debt to EBITDA will reach our downgrade thresholds of 60% and 15x, respectively. We estimate that the company will exceed its own financial leverage target of a maximum reported LTV of 50%, reaching 53%-55% following the transaction (it was 49.9% as of Sept. 30, 2020). We view the distribution as highly aggressive from a financial policy point of view and given current market sentiments and uncertainties surrounding the COVID-19 pandemic. Following recent developments, we have revised our adjustment of surplus cash to the company's credit metrics and will no longer deduct cash from debt, because we believe that accessible cash will not likely be earmarked for debt repayment under the financial sponsor ownership, in line with our criteria. Therefore, we forecast the company's adjusted ratio of debt to debt plus equity (gross debt) will rise to 62%-64% pro forma the transaction. We also forecast gross debt to EBITDA will increase to 16x-18x this year. Nevertheless, we expect DEMIRE's EBITDA interest coverage will continue being solid, at 2.6x-2.8x over the next 12 months, thanks to its low cost of debt at 1.8%. We continue to closely monitor any further aggressiveness of the company's shareholders, which could negatively affect its creditworthiness, and could reassess DEMIRE's financial policy because of the influence from its shareholders. Our forecast takes also into account the company's acquired stake of the CIELO office building in Frankfurt at the beginning of this year, financed from existing liquidity.

We continue to anticipate modest impact from COVID-19 to DEMIRE's earnings in 2020 and 2021. The second lockdown in Germany forced shops and hotels to close in November 2020, through first-quarter 2021. The company's retail assets represent about 25% of total portfolio value, and 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 the company collected about 96% of its annual rent in 2020. Furthermore, we note the vacancy reduction of DEMIRE's portfolio throughout the year, mainly owing to ongoing letting activities from office assets, which will likely affect the like-for-like rental income growth for 2020 overall marginal positive. We nevertheless remain cautious about the medium-to-long-term demand trends for office properties in Germany because of increased remote working capacities for many tenants or decreasing demand for office space from COVID-19-affected businesses.

We continue to view DEMIRE's liquidity as adequate. This accounts for announced dividend distributions and recent transactions. Supporting our view are the company's signed loan facilities of about €51 million at the beginning of 2021, low committed capital expenditure needs, and limited short-term debt maturities. Although headroom tightened to just about 10% (pro forma dividend distributions) to its LTV bond covenant of a maximum 60%, we understand that the company will restore its headroom under its financial covenants.

The issue rating on DEMIRE's senior unsecured bond is 'BB'. In line with the corporate issuer rating, we lowered the issue rating of DEMIRE's senior unsecured nominal €600 million notes due 2024 by one notch, but it remains one notch above the issuer credit rating. We believe recovery prospects continue to reflect the valuable asset base consisting of investment properties. Therefore, the recovery rating remains '2' (recovery expectations of 70%-90%; rounded estimate 85%).

Outlook

The stable outlook is based on our view that DEMIRE's property portfolio will generate stable cash flow with moderate impact from the pandemic while maintaining credit metrics commensurate with the rating over the next 12 months. We forecast that our ratio of debt to debt plus equity (gross debt) will increase to 62%-64%, gross debt to EBITDA will rise to 16x-18x, and EBITDA interest coverage will stay at 2.6-2.8x over the next 12-24 months.

Downside scenario

We could lower the rating further if the company fails to keep its debt to debt plus equity (gross debt) below 65%, and EBITDA interest coverage falling to 1.5x or below sustainably. We would also view it negatively if gross debt to annualized EBITDA deviates materially from our base-case scenario. This could be due to DEMIRE's further deviation from or unfavorable amendment of its financial policy, so that we would revise our assessment of the influence of its owners, which we currently assess at FS-5. In addition, we could downgrade the company if its liquidity position deteriorated, for example, through more dividend distributions or acquisitions.

Upside scenario

We would raise the rating if DEMIRE improves its leverage and restores the adherence to the committed net LTV target of 50% with proven track record, with S&P Global Ratings-adjusted debt to debt plus equity (gross debt) remaining well below 60% and EBITDA interest coverage well above 2x. We would also view positively the company's ratio of debt (gross) to annualized EBITDA staying significantly below 15x; and DEMIRE continuing its growth strategy by investing in assets with favorable market fundamentals, funded by a balanced mix of debt and equity. In addition, a change in the ownership structure could lead to a positive rating action, for example, if the free float of the company's shareholder structure increases materially, while management maintains a conservative financial policy.

Company Description

DEMIRE is a Germany-based commercial real estate holding company focusing on office (65% of portfolio value as of Sept. 30, 2020), retail (25%), and logistics/other assets (10%). On Sept. 30, the company's portfolio was valued at about €1.5 billion and comprised 82 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 58.6%; and Wecken Group, which has about 32.1%--both act in concert. The 7.2% is free float and the remaining 2.1% belongs to treasury shares.

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)

- Liquidity: Adequate (no impact)
- Financial policy: FS-5 (no additional impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

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: 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Related Research

- Germany-Based DEMIRE Outlook Revised To Negative On Planned Dividend Distribution; 'BB' Ratings Affirmed, Aug. 25, 2020

Ratings List

Downgraded; Outlook Action

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

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings