MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades DEMIRE's ratings to B1, outlook negative

27 Jul 2022

Frankfurt am Main, July 27, 2022 -- Moody's Investors Service ("Moody's") has today downgraded DEMIRE Deutsche Mittelstand Real Estate AG's ("DEMIRE") Corporate Family Rating ("CFR") to B1 from Ba3 and downgraded the senior unsecured rating of its €600 million notes maturing in 2024 to B1 from Ba3. The outlook on the ratings has changed to negative from stable.

RATINGS RATIONALE

The downgrade of DEMIRE's ratings reflects the company's heightened credit risk from a repayment wall under the company's senior unsecured notes maturing in 2024 combined with much weaker capital market conditions with increasing interest rates and pronounced widening of credit spreads. We expect these to meaningfully elevate the company's future funding costs compared to current level of 1.66% and thus notably weaken DEMIRE's interest coverage at the point of refinancing from current level of 3.2x as of LTM March 2022.

In this context we expect the company to increasingly rely on alternative funding sources such as more cost-efficient secured bank lending over the next 12 to 24 months, which we expect will lead to a subsequent reduction of unencumbered assets and thus the protection level of unsecured bondholders.

The B1 corporate family rating also reflects the company's main credit challenges arising from a private-equity-dominated ownership structure, which has demonstrated an aggressive financial risk appetite. The company's lower-quality portfolio than that of its higher-rated peers, without any meaningful environmental credentials, increases investment needs to respond to changing occupier preferences and more stringent environmental regulation while a weakening economic environment will weigh on DEMIRE's operating performance and vacancy reduction plans.

DEMIRE's CFR remains supported by a relatively small but well-diversified commercial real estate portfolio, the focus of its operations in Germany, a historically more liquid real estate market with a robust funding environment; its integrated business model and active portfolio management supporting solid earnings as of the LTM ended March 2022, adequate liquidity as well as solid credit metrics at this point in time.

RATING OUTLOOK

Over the next 12-18 months, we expect DEMIRE to retain leverage and coverage metrics that are rather strong for the new rating category. However, the negative outlook reflects our expectation of a much tougher funding environment challenging the company's refinancing strategy and weighing on DEMIRE's fixed charge coverage ratio, the latest in 2024 when the senior unsecured notes mature. We expect the company to start shoring up liquidity and securing alternative financing options to reduce the refinancing wall in 2024.

The negative outlook further reflects a deteriorating operating environment for commercial real estate companies across Europe, on the back of tightening financial conditions, rising cost of capital leading to subdued commercial real estate investment activity and the expected negative pressure on capital values. A potentially sharper economic slowdown could also derive in higher number of business insolvencies, reduced demand for commercial real estate and negative pressure on rents.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

FACTORS THAT COULD LEAD TO A DOWNGRADE

DEMIRE's rating could come under greater negative pressure if an economic recession would materialize. Other factors that could lead to a downgrade include:

- The company fails to proactively manage its refinancing activities for the unsecured notes amid the currently disrupted capital markets, hereby elevating refinancing risk

- Moody's-adjusted fixed charge coverage falling significantly below 2x after refinancing of the 2024 bond.

- Evidence of further deterioration of financial conditions raising the risk of noncompliance with covenants

- Failure to maintain adequate liquidity

- Debt-funded shareholder distributions or acquisitions resulting in DEMIRE departing again from or relaxing its current financial policy

- Moody's-adjusted gross debt/total assets increasing to above 60%, accompanied by an increasing trend in net debt/EBITDA

FACTORS THAT COULD LEAD TO AN UPGRADE

A rating upgrade is unlikely due to the negative outlook and increased economic risks. However positive pressure could result from:

- Company's ability to early refinance its debt maturities and through a diversified mix between secured and unsecured instruments, so that the coverage of unsecured properties to unsecured debt does not materially deteriorate

- Moody's-adjusted fixed charge coverage at above 2.25x

- Company's ability to maintain leverage largely in line with its financial policy of maximum net loan-to-value (LTV) of 50% in combination with at least stable net debt to EBITDA levels

- Stable operating performance

LIQUIDITY

As of June 2022, DEMIRE had an adequate liquidity position, with €72.5 million available cash and an undrawn committed €6 million revolving credit facility (RCF) and we expect the company to be able to generate funds from operations of around €35 million (Moody's-defined) on an annual basis.

Additionally, a pool of around €710 million of unencumbered investment properties provides a source of alternative liquidity and refinancing optionality for the senior unsecured notes maturing in 2024.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

ESG considerations have a highly negative credit impact on DEMIRE. This reflects exacerbated governance risks due to the aggressive financial stance of its sponsors favouring shareholder distributions and leaving the company temporarily outside of financial policy during 2021. Credit risk is compounded by company's high exposure to environmental risks which represent investment requirements to respond to changing occupier preferences and more stringent environmental regulation and in order to avoid asset obsolescence risk.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was REITs and Other Commercial Real Estate Firms Methodology published in July 2021 and available at https://ratings.moodys.com/api/rmc-documents/74168 . Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

COMPANY PROFILE

Headquartered in Langen, Germany, DEMIRE Deutsche Mittelstand Real Estate AG (DEMIRE) is a publicly listed commercial real estate company with a focus on offices in secondary locations across Germany. The company's portfolio currently comprises 64 single properties, with a total lettable floor space of around 913,000 square metres (sqm) and an aggregate portfolio value of around €1.4 billion.

The company's annualised contracted rent amounted to €79 million as of March 2022, with a 4.7-year weighted average lease term (WALT). DEMIRE holds an 84.35% stake in Fair Value REIT-AG, which is fully consolidated and accounted for around €340 million in assets, or around 20% of DEMIRE's total assets, as of 31 March 2022.

DEMIRE is listed on the Frankfurt stock exchange and had a market capitalisation of around €360 million as of 25 July 2022. Apollo-managed funds and Wecken Group together hold around 90.75% of DEMIRE's shares.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

For ratings issued on a program, series, category/class of debt or security this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series, category/class of debt, security or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the issuer/deal page for the respective issuer on https://ratings.moodys.com.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1288235.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the UK and is endorsed by Moody's Investors Service Limited, One Canada Square, Canary Wharf, London E14 5FA under the law applicable to credit rating agencies in the UK. Further information on the UK endorsement status and on the Moody's office that issued the credit rating is available on https://ratings.moodys.com.

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