ADLER Real Estate AG
Germany, Real Estate

SCOPE **BB** STABLE

Corporate profile

ADLER Real Estate AG is one of Germany's largest property companies. In recent years, the company has grown rapidly by making acquisitions. ADLER owns almost 50,000 residential units. These are mostly located in northern and western Germany and offer affordable homes to tenants with medium to low incomes. ADLER is set to become an integrated property group offering its tenants all relevant services from a single source.

Key metrics

			Scope estimates	
Scope credit ratios	2016	2017F	2018F	2019F
EBITDA/interest cover (x)	1.4x	1.3x	1.7x	1.7x
SaD/EBITDA (x)	15.4x	17.9x	15.9x	18.6x
loan/value ratio (%)	61%	58%	54%	57%

Rating rationale

Scope upgrades Adler's issuer rating to BB and senior unsecured debt to BB+, Outlook Stable

The upgrade reflects the company's successful restructuring of debt, expected to improve credit metrics, and the disposal of the volatile trading business (Accentro) to a private partnership, which should stabilise cash flows further.

In Scope's view, Adler benefits from the German residential real estate market, which has low cyclicality and stable tenant demand. In the nine months to September 2017, Adler improved slightly in terms of rent (+1.4% – core portfolio) and market share (net growth by 3,192 residential units). Even so, this does not alter Scope's moderate view on the company's market position. With around 50,000 residential units and EUR 3.4bn of assets (end-September 2017), Adler is medium-sized compared with German peers. As such it benefits from a decent diversification of geographies and tenants, which Scope believes enhances the ability to offset cash flow volatility arising from economic cycles, industry dynamics, regulatory changes, and the loss of individual tenants.

The EUR 180m disposal of ACCENTRO Real Estate AG in December 2017 is judged by Scope to be slightly positive for business and financial risk profile of the company, as it reduces the exposure to the more volatile trading business. This aspect compensates for the loss of the ability to generate cash through this segment.

Scope views negatively Adler's exposure to markets with a high price elasticity of tenants. Demand in most of the company's core markets – with the exception of Berlin, Wolfsburg and Leipzig – is expected to reduce over the next decade, which should also limit the potential for rent increases. In addition, according to Adler, one-third of its tenants rely on governmental subsidies to pay rent. While this boosts the stability of rental income, it also further limits the ability to increase rent. This is evidenced by the core portfolio's like-for-like rental increase of only 1.4% for the year ending 30 September 2017, compared with 3% for peers with better-quality portfolios.

Ratings & Outlook

Corporate Rating	BB/Stable
Senior unsecured	BB+/Stable

Analysts

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Related methodologies

European Real Estate Corporates, January 2017

Corporate Ratings, January 2017

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Bloomberg: SCOP

EBITDA margin excluding sales was 37% for the year endling 30 September 2017, up from 20% in 2014. Though supported by economies of scale and rental growth, the figure was still slightly weaker than peers' (50%). However, despite lower portfolio growth, the company expects to sustain the overall increase in profitability, targeting an EBITDA excluding sales of between 45% and 50% in the long term. This should benefit from:

- an expected rise in occupancy to above 90% by YE 2018, driven predominately by the disposals of assets with below-average occupancy rates: ACCENTRO (2,000 units – executed end of 2017) and the non-core portfolio (3,300 units – planned for 2018).
- improved economies of scale via the internalisation of key operational functions, including property, facility and energy management; the centralisation of IT infrastructure; and the introduction of shared services.

These two aspects also reduce the operational expenses that cannot be passed on to tenants.

EBITDA interest expense improved to a moderate 1.7x at end-September 2017 from 1.4x at YE 2016. This was due mainly to the redemption of high-yielding liabilities, financed by a portion of the EUR 422m generated by the Conwert disposal in January 2017. Adler reduced its weighted average cost of debt to 2.7% (3.5% in15.7 Q3 2017) by repaying EUR 605m of promissory notes at end-November, covered by a EUR 800m bond issuance. The liability restructuring is estimated to increase funds from operations by EUR 11m and reduce annual amortisation by EUR 1m from 2018 on. Scope expects Adler to repay high-yielding liabilities quickly, which would reduce interest expense further. The repayment of promissory notes and high-yielding debt should, in Scope's view, maintain debt protection above an EBITDA interest cover of 1.7x.

The loan/value ratio reduced to nearly 60% as at YE 2016 for the first time since Adler changed strategy in 2012, thanks to EUR 199m of fair-value adjustments and a reduction of Scope-adjusted debt (SaD) by EUR 118m in 2016. This is well ahead of Scope's expectations as of last year; on the other hand, the agency judges the German market to be overpriced (see Corporate Outlook 2018), and loan/value is increasingly sensitive against the changes expected for interest rates. Nonetheless, Scope views positively management's public commitment to reduce loan/value to a sustainable level of below 55%, underpinned by a further EUR 148m reduction of interest-bearing liabilities in the first nine months of 2017. As a result, Scope expects loan/value to decrease below 60% at YE 2017. In addition, should the non-core portfolio be disposed of in 2018, the resulting reduction of SaD by over EUR 150m would likely maintain the loan/value levels going forward.

SaD/EBITDA was 15.4x at YE 2016, experiencing a further sharp decline from 21x in 2015. Due to Scope's expectation of a more subdued investment policy and a slightly improving EBITDA, the agency forecasts leverage (measured by SaD/EBITDA) to remain stable for the coming years at around 15x (excluding one-off effects).

Adler's liquidity is adequate based on Scope's expectation that liquidity sources will exceed uses by about 6x in the 12 months to YE 2018. This follows the improved liquidity during 2016 due to the company's new strategy, focusing more on organic growth instead of dynamic. The latter previously led to negative free operating cash flows.

Outlook

The Outlook for Adler is Stable and incorporates Scope's expectation of gradually increasing rental income for the core portfolio, driven by a rise in occupancy to above 93% by YE 2019 and like-for-like rental growth in line with inflation forecasts of between 1.5% to 2.0%. This is further backed by:

- improving profitability (EBITDA margins of more than 45% according to Scope's methodology) and
- balanced cash flow from investment, including a continuation from FY 2016 of subdued capex spending as well as the disposal of the non-core portfolio.

Scope expects credit metrics to be more stable going forward, with an EBITDA interest cover of around 1.7x and loan/value ratio of below 60%.

A negative rating action is possible if debt protection as measured by EBITDA interest cover decreased below 1.5x or if the company's access to external financing weakened.

A positive rating action is tied to a further improvement in the financial risk profile, i.e. if EBITDA interest cover increased above 1.9x and loan/value ratio reduced below 55%, both on a continuing basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Low industry risk as only exposed to German residential real estate • Good geographic and tenant diversification offsetting cash flow volatility • Medium-sized company with good access to debt and capital markets • EBITDA interest cover at a stable 1.7x anticipated going forward • Positive trend of free cash flow generation thanks to more cautious growth strategy and portfolio optimization	• Assets are mainly situated in less liquid 'B' and 'C' locations and display some CAPEX requirements • Exposed to markets with declining demand/limited scope for rent increases • Improving profitability with an EBITDA margin of 37% for the twelve months to September 30th 2017, still below industry peers. • Still comparably high, however improving leverage, with loan/value below 60% and SaD/EBITDA of 18x anticipated for YE 2017.

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• EBITDA interest expense of greater 1.9x and reduction of loan/value to below 55% on a continuing basis	• Reduction of EBITDA interest expense to below 1.5x or weakening of access to external financing

Financial overview

			Scope estimates	
Scope credit ratios	**2016**	**2017F**	**2018F**	**2019F**
EBITDA/interest cover (x)	1.4x	1.3x	1.7x	1.7x
SaD/EBITDA	15.4x	17.9x	15.9x	18.6x
Scope-adjusted FFO/SaD	2%	2%	3%	2%
FOCF/SaD	(-) FOCF	22%	9%	(-) FOCF
Scope-adjusted EBITDA in EUR m	**2016**	**2017F**	**2018F**	**2019F**
EBITDA	103.3	81.5	94.8	89.7
Operating lease payment in respective year	5.6	5.6	5.6	5.6
Other	21.0	11.9	0.0	0.0
Scope-adjusted EBITDA	**129.9**	**99.0**	**100.4**	**95.2**
Scope funds from operations in EUR m	**2016**	**2017F**	**2018F**	**2019F**
EBITDA	103.3	81.5	94.8	89.7
less: (net) cash interest as per cash flow statement	-93.5	-73.1	-58.4	-56.4
less: cash tax paid as per cash flow statement	-1.2	-4.3	-0.3	-0.3
add: depreciation component operating leases	4.6	4.6	4.6	4.6
add. Dividends received from shareholdings	8.7	14.9	3.7	0.0
Other	23.9	10.6	0.0	0.0
Scope funds from operations	**45.8**	**34.2**	**44.4**	**37.6**
Scope-adjusted debt in EUR m	**2016**	**2017F**	**2018F**	**2019F**
Reported gross financial debt	2,159.7	2,045.5	1,933.7	1,893.7
deduct: cash, cash equivalents	-123.9	-305.6	-372.7	-160.1
add: pension adjustment	3.8	3.6	3.6	3.6
add: operating lease obligation	20.1	20.1	20.1	20.1
add: restricted cash, cash equivalents	13.4	13.4	13.4	13.4
Scope-adjusted debt	**2,001.0**	**1,777.0**	**1,598.1**	**1,770.7**

Business risk profile

Low industry risk

While the real estate industry is often associated with cyclical features compared to industries with inelastic demand patterns, these vary heavily depending on the individual business model. The residential sector benefits from lower cyclicality because demographic changes occur much more slowly than economic turmoil. Scope believes that the real estate industry generally has low barriers to entry. On the one hand, significant investment is needed to buy, maintain or develop properties. Thus, either (i) significant internal resources or (ii) good access to third-party capital is needed. On the other hand, we observe a (i) high level of fragmentation of the real estate industry and (ii) good general access to credit due to collateral-eligible assets. Both are indicators that the barriers to entry are relatively low. However, given diverse real estate regulations in Europe – especially in the residential sector – knowledge of local taxes and laws is important. Furthermore, technical know-how is essential for almost the whole value chain. This includes the performance of technical due diligence before buying a property or the realisation of refurbishment measures or ongoing maintenance. Thus, property companies need to maintain in-house (or purchase external) know-how in order to remain up-to-date or to enter more markets. As a result, we would assess market entry barriers for residential real estate corporates as high. Substitution risk is low as the properties – mainly for residential spaces – represent one of the basic human needs.

Figure 1: Industry Risk Assessment: European Residential real estate corporates

Cyclicality \ Barriers to entry	Low	Medium	High
High	CCC/B	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Source: Scope

Stable Sector Outlook

Scope's 2018 outlook for the real estate sector is stable. Our view is based on still-lively investor and tenant demand positively influencing business risk profiles. In addition, companies have been able to make use of the ECB's ongoing ultra-loose monetary policy (with an all-time high of capital market debt issuance at very low interest rates) to enhance their financial risk profiles. However, our assessment emphasises the further heightening of sensitivity to changes in politics, economic conditions and interest rates.

For more info please refer to the Scope's 2018 Corporate Outlook (click here).

Medium sized German residential real estate company with low market shares

Adler is a medium sized property company in the fragmented European Real Estate market with a consolidated market value of assets of EUR3.4bn and funds from operations of EUR46m both for YE2016. In contrary to fast growth experienced since 2012, the last financial year represented a shift in the company's strategy with the focus set on consolidation and organic growth instead of further dynamic growth. Dynamic growth up to 2015 allowed Adler to reach a size that should further support i) access to external financing / capital markets and ii) economies of scale to a certain extent. Adler's market share is negligible for the German market (0.1%). The same applies for Adler's core market of Lower Saxony where Adler holds a share of 0.4%. Due to the still fragmented German Real Estate market these little market shares are not considered a negative driver.

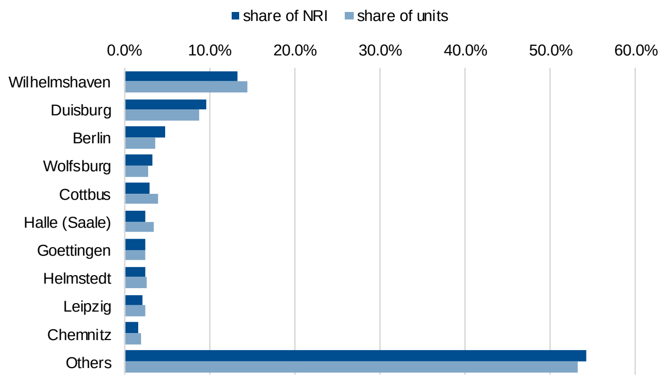
Good asset and tenant diversification

Adler operates a reasonably diversified portfolio which is well distributed across Germany, with the top five markets representing 34%/86% (by city / by federal state) of its total portfolio.

Thanks to the strong growth of the portfolio and Adler's focus on the residential segment, Adler shows a very high diversification of its tenant portfolio. Adler suffers from comparably high bad debt impairments of EUR7.5m (3% of gross rental income) in 2016. Scope judges credit quality of Adler's tenant base to be weak going hand in hand with its targeted customer profile of semi-skilled workers.

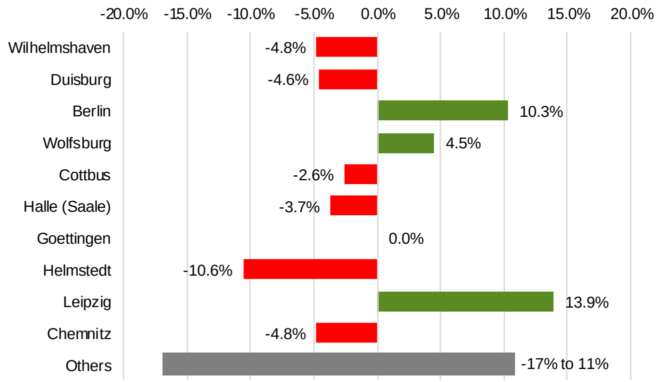
Scope believes that Adler's diversification regarding both geography and tenants demonstrates its ability to offset cash flow volatility arising from economic cycles, industry dynamics, regulatory changes and a loss of individual tenants.

Figure 2: Top 10 locations by NRI and # of units - 2016



Source: Adler, Scope

Figure 3: Top 10 cities // population forecast 2030



Source: wegweiser commune.de, Scope estimates

Assets are mainly situated in less liquid 'B' and 'C' locations and display some CAPEX requirements

Adler's current property portfolio mostly reflects the company's strategy of investing in affordable housing property with potential for value enhancement as well as being predominantly located within high and medium-level centres (Ober- and Mittelzentren) with a strong macroeconomic environment. As a result, Adler's assets are mainly located in 'B' and 'C' locations, such as Wilhelmshaven and Duisburg, which tend to be less liquid than properties in 'A' locations. This increases the risk of potential price haircuts in a distressed sales scenario.

Exposed to markets with declining demand/limited scope for rent increases

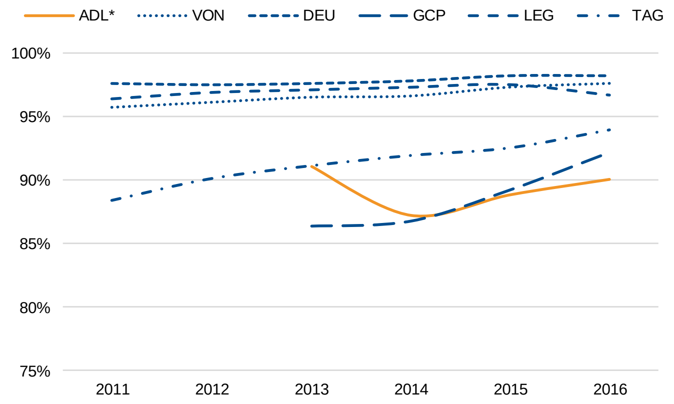
Adler is exposed to markets with high price elasticity regarding customers as most of the company's core markets – with the exception of Berlin, Wolfsburg and Leipzig – are expected to suffer from a strong decline in demand in the next decade. Adler has stated that its portfolio is tailored towards a target group of (semi) skilled workers with an average gross income of EUR 22-24k p.a. who require two-bedroom (60m²) apartments. Due to low prices, Adler could offer such apartments for about EUR 4,000 p.a. representing 23% of relevant income per household (housing cost ratio). This is slightly above Germany's housing cost ratio of 20%, thus underpinning the limited capacity for rent increases in these markets. According to Adler, one third of its tenants rely on governmental subsidies to enable rental payments. Whilst this boosts the stability of rental income, it further limits scope for rent increases.

Potential downside risk for Adler due to i) effects of declining demand or ii) rental break in force should be somewhat mitigated by its average rent per square metre which is low compared to market rents in the relevant regions.

Adequate occupancy rate of 90% expected to improve further going forward

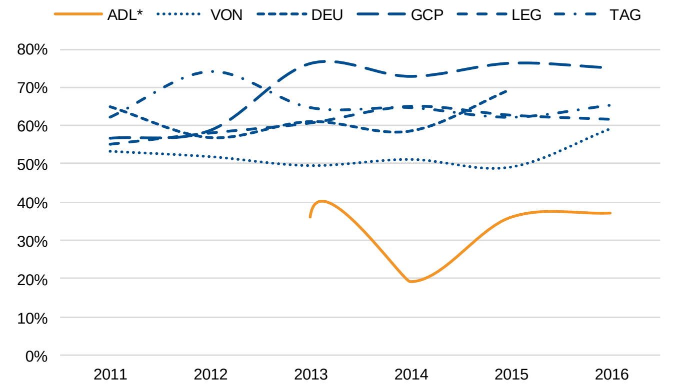
Adler's strategy also results in below-average occupancy in the acquired properties as well as some CAPEX requirements as the portfolio's average age is above 50 years. We therefore judge Adler's capital and maintenance expenditure of EUR 14.7 per m² in 2015 and 2016 to be inadequate as it is comparably low. However, Adler almost finalized its EUR15m Capex and modernisation program concerning 1,500 vacant residential units. A 2nd tranche of the modernization program has been resolved. Scope believes this supports the company's targeted growth as regards occupancy from an adequate 90% at end September 2017 (YE2016: 90%, YE2014: 87%) to above 90% by YE2018. This assumption is further supported by Adler's 2016/17 focus on (i) the internalisation of property management and the deconsolidation of ACCENTRO as at YE2017. The latter owns 1,956 apartments for privatization which typically show lower occupancy rates (occupancy rate of 85% at end September 2017). The disposal of additional 3,300 non-core units with a low occupancy of 76% targeted for 2018 should further bolster the company's occupancy rate at above 90%. Scope considers occupancy rates of above 90% to be adequate for a business risk profile (BRP) of BBB.

Figure 4: Occupancy rate Adler and peers[1]



Source: Adler, public information of peers, Scope

Figure 5: EBITDA margin Adler and peers[1]



Source: Adler, public information of peers, Scope

Improving profitability with an EBITDA margin of 37% for the last twelve months to 30th September, 2017, still slightly below industry peers

EBITDA margin, excluding sales activity, stood at 37% for the last twelve months to 30th of September 2017, up from 20% in 2014. Though driven by some economies of scale and rental growth during the year, it is still slightly weaker than that of Adler's peers, which have margins of more than 50% excluding sales. However, even with reduced portfolio growth rates, the overall trend of increasing profitability should remain stable in the coming years, with adjusted EBITDA margin targeted of between 45% and 50% going forward. The increase in profitability should benefit from:

- an expected rise in occupancy to above 90% by YE2018 and
- increasing economies of scale as a result of the internalization of key operational functions incl. property-, facility- and energy-management as well as the centralization of the IT-infrastructure and the introduction of shared services.

Both reduces operational expenses that cannot be passed on to tenants

Financial risk profile

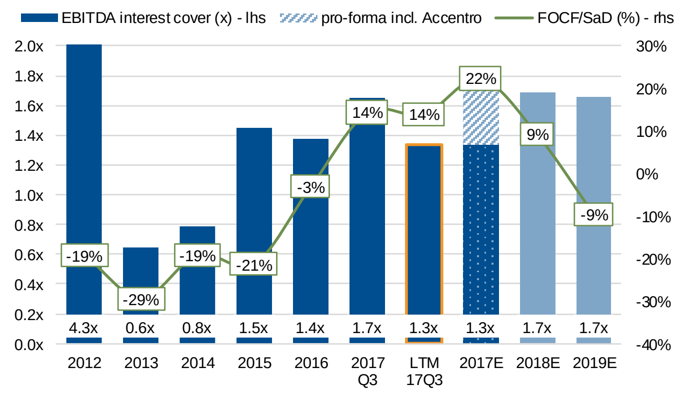
EBITDA interest expense cover expected to stabilize at a moderate level above 1.7x

EBITDA interest expense improved to a moderate 1.7x at end-September 2017 from 1.4x at YE 2016. This was due mainly to the redemption of high-yielding liabilities, financed by a portion of the EUR 422m generated by the Conwert disposal in January 2017. Adler reduced its weighted average cost of debt to 2.7% (3.5% in Q3 2017) by repaying EUR 605m of promissory notes at end-November, covered by a EUR 800m bond issuance. The liability restructuring is estimated to increase funds from operations by EUR 11m and reduce annual amortisation by EUR 1m from 2018 on. Scope expects Adler to repay high-yielding liabilities quickly, which would reduce interest expense further. The

[1] VON = Vonovia S.E. I DEU = Deutsche Wohnen AG I LEG = LEG Immobilien AG I TAG = TAG Immobilien AG I GCP = Grand City Properties S.E.
* publicly rated by Scope Ratings

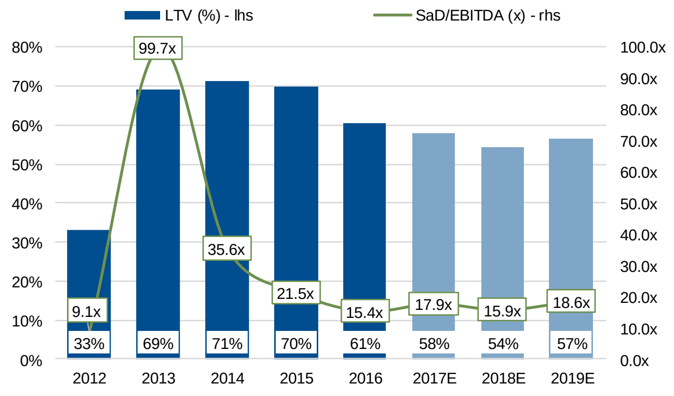
repayment of promissory notes and high-yielding debt should, in Scope's view, maintain debt protection above an EBITDA interest cover of 1.7x.

Figure 6: EBITDA interest cover and FOCF/SaD



Source: Adler, Scope estimates

Figure 7: loan/value ratio and SaD/EBITDA



Source: Adler, Scope estimates

Strong improvement of leverage driven by reduction of indebtedness and fair value adjustments

The loan/value ratio reduced to nearly 60% as at YE 2016 for the first time since Adler changed strategy in 2012, thanks to EUR 199m of fair-value adjustments and a reduction of Scope-adjusted debt (SaD) by EUR 118m in 2016. This is well ahead of Scope's expectations as of last year; on the other hand, the agency judges the German market to be overpriced (see Corporate Outlook 2018), and loan/value is increasingly sensitive against the changes expected for interest rates. Nonetheless, Scope views positively management's commitment to reduce loan/value to a sustainable level of below 55%, underpinned by a further EUR 148m reduction of interest-bearing liabilities in the first nine months of 2017. As a result, Scope expects loan/value to decrease below 60% at YE 2017. In addition, should the non-core portfolio be disposed of in 2018, the resulting reduction of SaD by over EUR 150m would likely maintain the loan/value levels going forward.

SaD/EBITDA was 15.4x at YE 2016, experiencing a further sharp decline from 21x in 2015. Due to Scope's expectation of a more subdued investment policy and a slightly improving EBITDA, the agency forecasts leverage (measured by SaD/EBITDA) to remain stable for the coming years at around 15x (excluding one-off effects).

Adequate liquidity, supported by flat repayment schedule and stable free operating cash flows

We assess Adler's liquidity as adequate based on our expectation that sources of liquidity will exceed uses by about 6x in the 12 months to YE2018. This follows improved liquidity from 2016 as a result of the change in the company's strategy that now focus more on organic instead of dynamic growth. The latter led to negative free operating cash flows in the past. In detail:

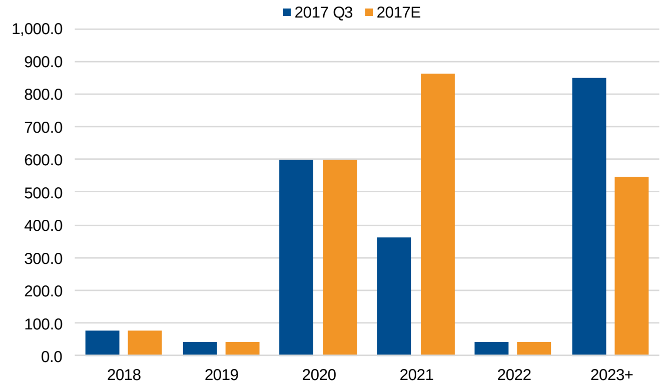
Position	Q1 2017	Q3 2017	Q4 2017F
• Unrestricted cash[2]	EUR 125m	EUR 117m	EUR 292m
• Open committed credit lines	EUR 77m	EUR 70m	EUR 70m
• Free operating cash flow (t+1)	EUR 31m	EUR 125m	EUR 148m
• Short-term debt (t+1)	EUR 81m	EUR 77m	EUR 77m

Scope's view is also supported by the company's strong relationships with banks. The refinancing of the EUR 500m bond maturing in 2020 should be eased with the company's

[2] Only including cash at the parent and subsidiary level but excl. marketable securities (Q1: EUR89m; Q3: EUR99m)

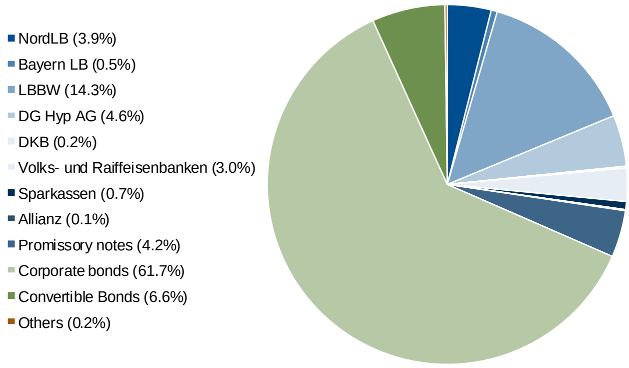
unencumbered asset position of over EUR1bn, with headroom under financial covenants to source secured funding of up to EUR540m[3].

Figure 8: Debt maturity profile (EUR m) – Q3 2017



Source: Adler, Scope

Figure 9: Lender structure – December 2017



Source: Adler, Scope

BB+ senior unsecured rating

As at YE 2017 Adler has EUR 1.65bn of capital market debt (of which EUR 1.5bn are outstanding) incl. four straight bonds and three convertibles (see table below). Recovery for all senior unsecured issuances is estimated to be in between 51% and 70% allowing for a one-notch uplift on the issuer rating of BB.

Figure 10: Capital market debt

	tenor	ISIN	Issuance volume (EURm)	Spread/ Coupon	Maturity	Issuer
Bond	5 years	DE000A1R1A42	35.0	8.750%	03.04.2018	ADLER Real Estate AG
Mandatory convertible bond	3 years	DE000A161ZA7	175.0	0.500%	17.08.2018	ADLER Real Estate AG
Convertible bond	5 years	DE000A1YCMH2	11.3	6.000%	27.12.2018	ADLER Real Estate AG
Bond	5 years	XS1211417362	500.0	4.750%	08.04.2020	ADLER Real Estate AG
Convertible bond	5 years	DE000A161XW6	137.0	2.500%	29.06.2021	ADLER Real Estate AG
Bond	4 years	XS1731858392	500.0	1.500%	06.12.2021	ADLER Real Estate AG
Bond	6 years	XS1731858715	300.0	2.125%	06.02.2024	ADLER Real Estate AG

Source: Adler, Scope

Outlook

The Outlook for Adler is Stable and incorporates Scope's expectation of gradually increasing rental income for the core portfolio, driven by a rise in occupancy to above 93% by YE 2018 and like-for-like rental growth in line with inflation forecasts of between 1.5% to 2.0%. This is further backed by:

- improving profitability (EBITDA margins of more than 45% according to Scope's methodology) and
- balanced cash flow from investment, including a continuation from FY 2016 of subdued capex spending as well as the disposal of the non-core portfolio.

[3] Calculated based on forecasted numbers for FY2017 using financial covenants of EUR 800m bond issuance in November 2017 (Secured indebtedness / total assets max. 40% and total indebtedness/total assets max 60%) and incorporating the EUR 500m bond repayment.

Scope expects credit metrics to be more stable going forward, with an EBITDA interest cover of around 1.7x and loan/value ratio of below 60%.

A negative rating action is possible if debt protection as measured by EBITDA interest cover decreased below 1.5x or if the company's access to external financing weakened.

A positive rating action is tied to a further improvement in the financial risk profile, i.e. if EBITDA interest cover increased above 1.9x and loan/value ratio reduced below 55%, both on a continuing basis.

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.

The rating analysis has been prepared by Philipp Wass, Director. Responsible for approving the rating: Olaf Tölke, Managing Director

The rating was first assigned by Scope on 25.07.2016. / The rating was last updated on 11.01.2018.

Methodology

The methodologies used for this rating and/or rating outlooks are Rating Methodology Corporate Ratings and Rating Methodology: European Real Estate Corporates both 2017 Jan. Available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope 's public credit rating methodologies on www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Stress testing & cash flow analysis

No stress testing was performed. Scope performed its standard cash flow forecasting for the company under review.

Solicitation, key sources and quality of information

The rated entity and/or its agents participated in the rating process.

The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties and Scope internal sources. Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Potential conflicts

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