ADLER Real Estate AG
Germany, Real Estate

SCOPE BB POSITIVE

Corporate profile

ADLER Real Estate AG (ADLER) is one of Germany's largest property companies. In recent years, the company has grown rapidly by making acquisitions. ADLER owns almost 61,000 residential units. These are mostly located in northern and western Germany and offer affordable homes to tenants with low to medium incomes.

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**
EBITDA/interest cover (x)	1.6x	2.4x	2.4x	2.3x
Scope-adjusted debt (SaD)/EBITDA (x)	17.4x	22.6x	18.5x	18.3x
Scope-adjusted FFO/SaD (%)	2%	2%	2%	2%
Loan/value ratio (%)	62%	64%	58%	56%

Rating rationale

Scope affirms issuer rating on ADLER Real Estate AG at BB, Outlook Positive

ADLER's improved size, asset quality and profitability support the rating affirmation despite the temporary increase in leverage. We expect the company to reduce leverage via disposal activity, with proceeds used to pay down debt.

ADLER's BB issuer rating remains unchanged because it continues to benefit from a supportive business risk profile. This is based on the company's scale (achieved despite Germany's fragmented residential real estate industry, which entails low risk), its well-diversified portfolio in terms of geographies and tenants, its improving asset quality and its sufficiently high debt protection.

The rating is constrained by ADLER's exposure to the higher-risk development and commercial real estate segments as well as by its leverage, which is still comparatively high.

Outlook

The Outlook for ADLER is Positive and incorporates our expectation that the company's business risk profile will continue to improve, benefitting from the further upscaling of asset quality, measured by higher occupancy, like-for-like growth of rents above inflation rates and the addition of assets ('Wasserstadt Mitte') in strong locations. ADLER's business risk profile will also benefit from improving profitability, with EBITDA margins forecasted around 60%. The Outlook further reflects our expectation that ADLER's financial risk profile will improve. We anticipate that EBITDA interest cover will stay above 1.9x, and that leverage as measured by the company's loan/value will decline to around 55% within the next 12-18 months.

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

A positive rating action could be warranted by an improvement in ADLER's financial risk profile, i.e. if EBITDA interest cover were to remain above 1.9x and the loan/value ratio were to fall below 55%, both on a continuing basis.

Ratings & Outlook

Corporate ratings	BB/Positive
Senior unsecured rating	BB+

Analysts

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Related methodology

Corporate Rating Methodology, March 2019

Rating Methodology European Real Estate Corporates January 2019

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Rating drivers

Positive rating drivers	Negative rating drivers
• Medium-sized German residential real estate company with good access to debt and capital markets. • High granularity of residential tenant base with 61,000 residential units spread across the middle and northern parts of Germany. • Improving liquidity of property portfolio thanks to increasing exposure to 'A' and 'B' locations, at 29% of net rental income by end-December 2018 (34% after delivery of 'Wasserstadt Mitte' in 2019). • Improving stability of tenant demand going forward with exposure to markets with at least stable demand rising by another 1 pp up to 75% after delivery of 'Wasserstadt Mitte'. • Occupancy rates of 94%, up from 92% at end-December 2017 (excluding non-core portfolio). • Increasing profitability with EBITDA margin expected to remain around 60% (2018: 63%). • Debt protection, as measured by EBITDA interest cover, has improved to above 2.0x (2018: 2.4x) and is expected to stabilise above 2.0x going forward as a consequence of ADLER's stable income position and an anticipated further reduction in the weighted average cost of debt to an estimated 2.0% in 2019.	• Significant exposure to the higher-risk development segment (14% of gross asset value). However, we deem this risk manageable with one large-scale development to be delivered in 2019 and the majority of developments located in 'A'-cities ensuring liquidity and demand going forward. • Retail business (6.5% of gross asset value) exposes ADLER to the ongoing transformation of the German retail landscape. This is, however, largely mitigated by the portfolio's high occupancy rate of 97% and a weighted average unexpired lease term of around nine years. • Leverage is still comparatively high with the loan/value ratio at 64% as at end-December following the acquisition of BCP. However, disposals of the non-core portfolio and parts of the retail portfolio are expected to reduce loan/value to below 60%.

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• EBITDA interest expense remaining above 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	**2017**	**2018**	**2019E**	**2020E**
EBITDA/interest cover (x)	1.6x	2.4x	2.4x	2.3x
SaD/EBITDA (x)	17.4x	22.6x	18.5x	18.3x
Scope-adjusted FFO/SaD (%)	2%	2%	2%	2%
Loan/value ratio (%)	62%	64%	58%	56%
Scope-adjusted EBITDA in EUR m	**2017**	**2018**	**2019E**	**2020E**
EBITDA	77.3	119.3	164.6	169.4
Operating lease payment in respective year	5.7	6.1	6.1	6.1
less: disposal gains	-0.8	-8.1	-1.1	-2.6
Other	39.8	46.4	0.0	0.0
Scope-adjusted EBITDA	122.0	163.7	169.6	172.9
Scope funds from operations in EUR m	**2017**	**2018**	**2019E**	**2020E**
Scope-adjusted EBITDA	122.0	163.7	169.6	172.9
less: cash interest as per cashflow statement	-75.9	-67.8	-73.1	-74.9
less: pension interest	-0.1	-0.1	-0.1	-0.1
less: interest component of operating leases	-0.7	-1.5	-1.5	-1.5
less: cash tax paid as per cashflow statement	-8.5	-6.7	-20.2	-28.5
add: dividends received	0.2	0.5	0.0	0.0
Δ Provisions	-2.7	-1.5	0.0	0.0
Scope funds from operations	34.4	86.7	74.7	67.9
Scope-adjusted debt in EUR m	**2017**	**2018**	**2019E**	**2020E**
Reported gross financial debt	2,474.4	3,739.2	3,554.8	3,420.3
less: cash, cash equivalents (accessible)	-368.2	-77.7	-449.0	-287.0
add: operating lease obligations	14.9	33.2	33.2	33.2
add: pension adjustment	1.4	1.8	1.8	1.8
Scope-adjusted debt	2,122.5	3,696.5	3,140.8	3,168.3

Business risk profile (BBB-)

Industry risk: BBB+

The acquisition of Brack Capital Properties N.V. (BCP) in April 2018 exposes ADLER to commercial real estate (BB) and the development segment (B), weighing negatively on our overall assessment of weighted average industry risk.

Credit outlook stable for 2019: tighter monetary policy, slowing growth, political risks

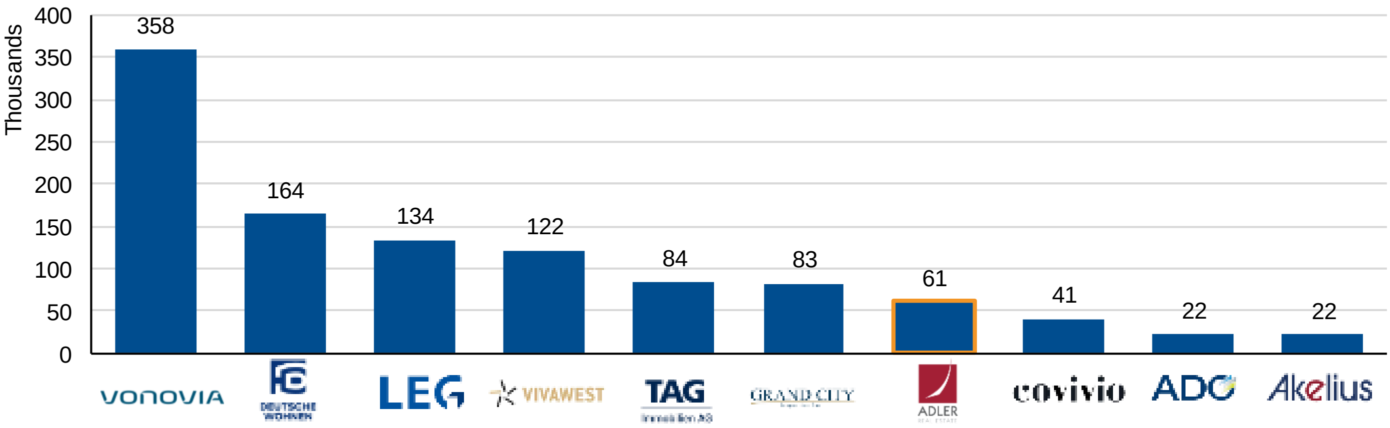
Real estate companies face an evenly balanced set of risks in 2019, resulting in a stable credit outlook. This outlook factors in less dramatic increases in property prices as a result of: i) slowly rising interest rates; ii) some easing of the supply-demand imbalance for most asset classes as development activity picks up; iii) slowing economic growth; iv) political uncertainty, notably surrounding Brexit, budget difficulties in Italy, and European Parliament elections in May 2019; and v) international trade relations.

For more information, refer to our corporate outlook for real estate (click here).

Medium sized German residential real estate company

ADLER is a medium sized property company in the fragmented European real estate market. It has assets with a consolidated market value of EUR 5.9bn and funds from operations of EUR 86m, both for FY 2018. Both of these figures benefitted from ADLER's acquisition of a majority share in BCP in April 2018, for a consideration of EUR 555m (net cash out of EUR 472m). This helped to boost ADLER's total assets by 40% and its number of apartments to approx. 61,000 from 49,000 at YE 2017. The size ADLER has achieved should support: i) access to external financing/capital markets; ii) visibility to tenants, investors and vendors; as well as iii) economies of scale.

Figure 1: ADLER Real Estate AG and competitors by no. of residential units in Germany



Sources: public information, Scope

While ADLER's market share is negligible for the German market (0.2%) it has a dominant market position in its core market of Wilhelmshaven (15.3% market share). The company has considerably lower market shares in the second and third largest markets (by size) of Duisburg (1.9%) and Leipzig (1.4%). We do not consider these limited market shares to be a negative driver due to the fragmented nature of the German real estate market. Conversely, we view relatively large market shares in core markets positively because they allow housing companies to influence price levels via the framework for guidance on local comparative rents (Mietspiegel).

Good geographic diversification across Germany

ADLER operates a reasonably diversified portfolio which is well distributed across Germany. It is chiefly focused on the middle and northern parts of Germany, with the top five markets in terms of cities representing 33% of its total portfolio (see Figure 2) and the top five markets in terms of federal states accounting for 85%. The acquisition of BCP in Q2 2018 added a complementary footprint in terms of asset diversification, and so has not altered our assessment of geographical diversification.

High tenant portfolio diversification, albeit of a rather weak credit quality

ADLER has a highly diversified tenant portfolio. This is thanks to strong portfolio growth and the company's focus on the residential segment. However, ADLER suffers from relatively high bad debt impairments, amounting to around 3% of gross rental income in 2018. We judge the credit quality of ADLER's tenant base to be weak, which is a natural result of its target customer profile of semi-skilled workers. However, ADLER's geographical and tenant diversification allows it to offset cash flow volatility arising from economic cycles, industry dynamics, regulatory changes or a loss of individual tenants.

Reasonably diversified development portfolio of EUR 1.7bn

In 2017, ADLER acquired a development scheme in Berlin ('Wasserstadt Mitte') as a develop-to-hold project. The acquisition of BCP in April 2018 added another development pipeline of an estimated EUR 1bn, comprising four development projects in Düsseldorf and one in Aachen. Together with new projects in Dresden and Berlin-Schönefeld, ADLER has a pipeline of approx. 5,100 residential units with a gross development volume of EUR 1.7bn, all of which will be added to the company's portfolio once delivered (with the exception of those projects that have been sold to third parties: approx. 900 units as at YE 2018). By 2020 an estimated 1,300 units will be completed and added to ADLER's portfolio. The delivery of the remainder is expected by 2027.

We believe that ADLER's development portfolio is reasonably well diversified. 'Wasserstadt Mitte' is due to be delivered in 2019 and the other projects are typically divided into sub-projects comprising around 100 units, in accordance with BCP's former development policy. This diversification reduces execution risk and allows ADLER to limit downside risk with regard to weakening customer demand for units that are either develop-to-sell or develop-to-hold, especially as we believe that the high supply-demand imbalance in cities such as Berlin, Dusseldorf and Dresden (representing more than 90% of gross development volume) is set to continue. Once delivered and added to the ADLER's buy-and-hold portfolio, we anticipate an enhancement of the company's property quality, helping to bypass regulatory rental limits and thus strengthen ADLER's recurring income stream.

Concentrated tenant structure in retail portfolio, but only marginal contribution to net rental income

The BCP acquisition also adds some exposure to retail parks, representing a 10% share of the company's gross asset value (as at end-December 2018). These retail parks consist of shopping centres and DIY stores spread across Germany. ADLER's retail park portfolio suffers from weak asset class-specific tenant diversification: the main tenants Obi, Kaufland and toom represent an estimated 50% of rental income. However, associated risk is partially mitigated by the relatively good credit quality of these main tenants and the small contribution they make to the group's net rental income (an estimated 5%).

Increasing exposure to cities with at least stable demand

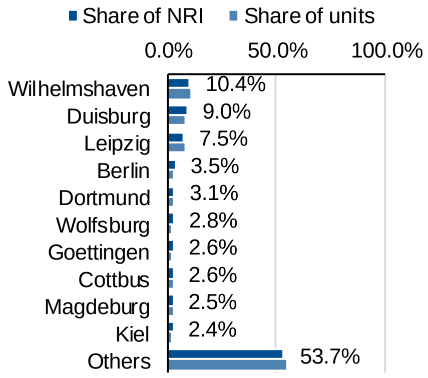
The acquisition of BCP has improved ADLER's residential portfolio locationwise, by adding exposure to 'B' and 'C' cities (+10 pp) or cities with stronger demographics including Leipzig (7.5% share of net rental income as at YE 2018 vs. 2.1% at YE 2017), Kiel (2.4% / 0.2%) and Hanover (2.3% / 0.0%). Over 90% of development projects are located in the 'A' cities of Berlin and Dusseldorf (the remainder are in Aachen and Dresden) protecting liquidity in the event of an economic downturn and limiting potential haircuts on this portion of the property portfolio. The finalisation of 'Wasserstadt Mitte will add EUR 15m in rental income in a city with strong demographics. This will lift the overall share of cities with at least stable demand to 75% of ADLER's portfolio, up from 74% as at YE 2018, and exposure to 'A' and 'B' cities to 34% from 29%.

High like-for-like rental growth in 2018 despite exposure to markets with limited scope for rent increases

The BCP acquisition reduced ADLER's exposure to markets with high price elasticity to 26% from 30% at YE 2017 (Figure 3). Markets with high price elasticity are forecasted to suffer from a decline in demand in the period to 2025.

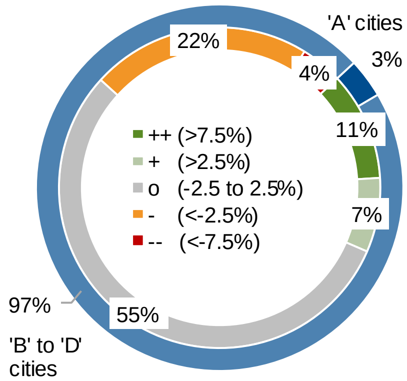
Despite its large exposure to markets with relatively weak fundamentals, and thus limited room for rent increases, ADLER has managed to raise rents. Like-for-like growth has caught up with peers, at 3.4% in FY 2018 (3.8% in 2017), even though bad debt impairments are still relatively high. However, the main contributor to relatively high like-for-like growth was BCP, which accounted for estimated growth of around 6.6% while ADLER only contributed 2.3%.

Figure 2: Geographical diversification by city



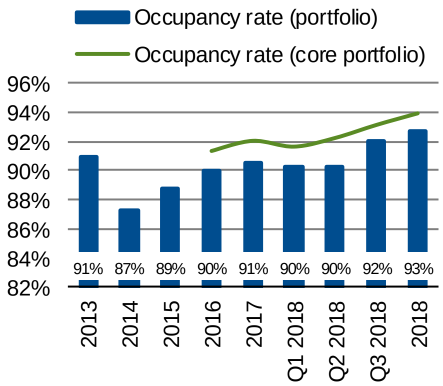
Sources: ADLER, Scope estimates

Figure 3: No. of units vs population forecast 2012 to 2015 // share of 'A' cities



Sources: ADLER, wegweiser-kommune.de, Scope

Figure 4: Occupancy levels



Sources: ADLER, Scope estimates

Potential downside risk for ADLER due to: i) the effects of declining demand or ii) rent caps should be somewhat mitigated by its average rent per square metre which is still low compared to market rents in those regions.

Adequate occupancy rate of 93% expected to improve going forward

ADLER's strategy (excluding BCP) of investing in affordable housing with the potential for value enhancement, predominantly located in high- and medium-level areas, has resulted in below-average occupancy. The strategy has also led to some capex requirements because the portfolio's average age is above 50 years. We therefore judge ADLER's comparatively low capital and maintenance expenditure of EUR 18 per sq m in 2018 (unchanged from 2017) to be inadequate for its portfolio structure. However, the anticipated increase in capex by an additional EUR 40m-EUR 50m should further enhance asset quality and support targeted occupancy growth from an adequate 93% at YE 2018 (YE 2017: 91%, YE 2014: 87%, see Figure 4).

The increase in occupancy and improvements in the like-for-like growth of rents are a result of ADLER's focus, initiated in 2016/17, on: i) the internalisation of property management; and ii) the better-quality property portfolio acquired with BCP. The disposal of an additional 3,700 non-core units with low occupancy and weak fundamentals in Q4 2018 (effective from Q1 2019) should keep occupancy comfortably above 90%. We consider occupancy rates of above 90% to be adequate for a business risk profile of BBB.

Well located retail portfolio benefitting from high occupancy and long WAULT

In contrast to competitors, ADLER's retail parks benefit from reasonably good asset quality. This is underpinned by an 8.5 year weighted average unexpired lease term, a 97% occupancy rate and a share of above 50% of gross asset value in primary and secondary cities. However, we believe that ADLER will dispose of its retail exposure in order to remain purely focused on residential real estate. As a consequence, we have not incorporated incremental positive elements into our assessment of the company's asset quality.

Improving profitability with an EBITDA margin of 63% for FY 2018, in line with industry peers

ADLER's EBITDA margin, excluding sales activity, stood at 63% for FY 2018, up from 43% in 2017. Economies of scale and rental growth during the year pushed it up to the level of ADLER's peers, which have margins of more than 60% excluding sales. Profitability clearly benefitted from the acquisition of BCP, which had an EBITDA margin excluding sales of above 70% – stronger than ADLER's standalone margin. Profitability should remain stable in the coming years, with adjusted EBITDA margin targets of around 60% representing a strong upward adjustment compared to the previous year's forecast. The anticipated rise in occupancy and economies of scale, including declared synergies of EUR 6m following the BCP acquisition, should partially mitigate the negative effect on profitability which the expected sale of the retail portfolio will have.

Financial risk profile (BB-)

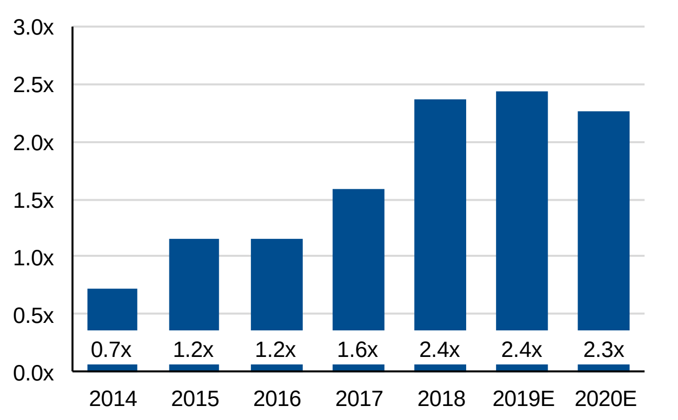
Our rating scenario assumes the following:

- Like-for-like growth at the upper end of a 2.5%-3.0% range per annum
- Occupancy to reach 95% by YE 2020
- Disposal of the remaining retail portfolio in 2019 for EUR 300m-EUR 325m
- Inflation of costs at 1.5% in 2019 and 2020
- Interest rate for newly issued debt to increase by 50 bp based on current weighted average cost of debt from 2020 on
- Repayment of all three BCP debentures and the 2015/20 EUR 300m bond in Q2 2019
- Growth rate of portfolio's fair values in line with rental growth
- No dividend payments with exception for minority shareholders

EBITDA interest expense cover expected to stabilise at around 2.0x

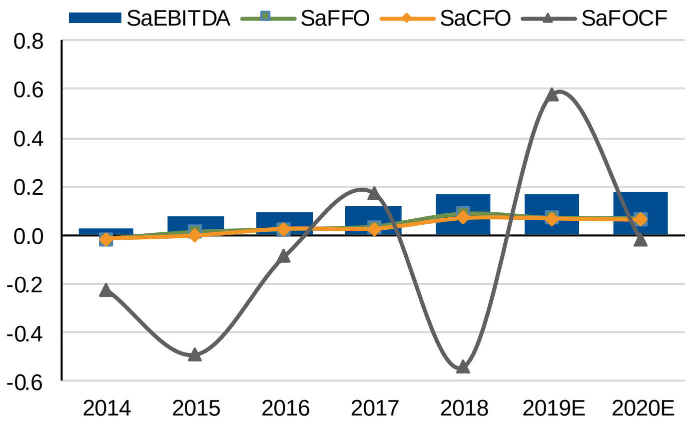
EBITDA interest expense improved further to 2.4x at YE 2018 from 1.6x at YE 2017. This was mainly due to the redemption of high-yielding liabilities (EUR 200m 4.75% 2015/20 bonds), financed by the issuance of EUR 800m in bonds in 2018 as well as the inclusion of BCP's comparatively lower yielding debt from Q2 2018 on. As a consequence, ADLER was able to further reduce its weighted average cost of debt to 2.2% at YE 2018 from 2.7% at YE 2017 (3.7% in YE 2016). Stable EBITDA anticipated for the next two years, a further reduction in the company's interest-bearing liabilities thanks to the disposal of the non-core portfolio in December 2018 and the weighted average maturity of around four years (YE 2018: 3.9 years) should help to keep EBITDA interest cover at around 2.0x for the next few years.

Figure 5: EBITDA interest cover (x)



Sources: ADLER, Scope estimates

Figure 6: Cash flows (EUR bn)



Sources: ADLER, Scope estimates

Free operating cash flows expected to turn positive in 2019 boosted by disposal proceeds

Scope-adjusted free operating cash flow (SaFOCF) turned negative in FY 2018 as a consequence of the cash-based acquisition of BCP. The acquisition also took its toll on the company's Scope-adjusted debt (SaD), which increased to EUR 3.7bn (+EUR 1.6bn YoY). ADLER disposed of its non-core portfolio in December 2018, with 1,400 units sold to an institutional investor (for EUR 62m) and 2,300 units to a joint venture with Benson & Elliot (EUR 118m). The sale will positively impact free operating cash flow in 2019, as all or part of the purchase price will be paid once ownership has been transferred. This positive effect, together with the sale of the retail portfolio planned for 2019, should return SaFOCF to positive territory in 2019. A 37% share of the retail portfolio (Rostock, Celle and Castrop-Rauxel) was sold in March 2019 via a share deal, with BCP holding a remainder of 10.1% at a premium of 7.6% to book value.

Leverage higher than expected, but anticipated to fall below 60% in 2019

The partially debt-financed acquisition of BCP in 2018 led to a steep increase in the company's indebtedness. At YE 2018, ADLER's loan/value ratio stood at 64% – 3 pp above our expectations as at April 2018 (61%). Nonetheless, we view positively management's commitment to reducing loan/value to a sustainable level of below 55%. This reduction will be underpinned by a further EUR 107m decrease in interest-bearing liabilities in the first three months of 2019 using exit proceeds from the sale of parts of the retail portfolio. Further deleveraging is expected to be supported by the disposal of the remaining retail portfolio (gross asset value of EUR 300m) in 2019 and stable operating performance. Deleveraging will not occur as fast as we expected in April 2018 which leaves the company exposed to unfavourable changes with regard to liquidity on capital markets and/or interest rates. However, we do not expect either of these possibilities to materialise in 2019.

SaD/EBITDA stood at 22.6x at YE 2018, representing a steep increase from FY 2017, but in line with our previous year's forecast. This high leverage, which is not affected by the relative pricing of properties, makes ADLER one of the highest levered companies in our peer group (which had typical leverage, as measured by SaD/EBITDA, of around 14x in FY 2018).

Adequate liquidity

ADLER's liquidity is judged to be adequate. In detail:

Position	YE 2018		YE 2019E	
Unrestricted cash	EUR	77.7m	EUR	449.0m
Open committed credit lines	EUR	0.0m	EUR	0.0m
Free operating cash flow (t+1)	EUR	587.5m	EUR	-21.2m
Short-term debt	EUR	184.4m	EUR	134.5m
Coverage		**3.6x**		**3.2x**

We expect that ADLER will be able to comfortably cover debt due in 2019 with internal liquidity. The company has EUR 310m of secured cash inflows from disposals of its non-core portfolio and parts of its retail portfolio. Furthermore, ADLER largely addressed its refinancing in 2020 (EUR 435m) with a bond issuance of EUR 400m in April 2019. Scope believes that ADLER has good access to capital markets, given the company's current leverage with a loan/value ratio of 60% (including debt reduction from asset sales in December 2018 and March 2019), its strong, well-established relationships with banks and the recurring income producing nature of its operations. Scope further believes that the refinancing of the EUR 1.2bn of debt maturing in 2021 should be a manageable risk, because ADLER benefits from an unencumbered asset position of approx. EUR 1.3bn, providing headroom of around EUR 0.9bn under financial covenants to source secured funding.

Senior unsecured debt: BB+

Our recovery analysis signals an 'above average recovery' which translates into instrument ratings of BB+. Recovery is based on a hypothetical default scenario in FY 2020 with the company's liquidation value amounting to EUR 3.2bn. This value is based on a 34% haircut applied to ADLER's assets, reflecting a market value decline of one standard deviation of the German property price index as well as liquidation costs of approx. 26% for assets and 10% for insolvency proceedings. This compares to secured financing of a forecasted EUR 1.7bn as well as an unsecured EUR 2.1bn in bonds.

We do not rate the debentures issued by BCP (EUR 116m) because they are not irrevocably guaranteed by ADLER. The company has announced that it will use those proceeds of the EUR 400m bond issuance in April 2019 which are in excess of the EUR 300m needed to repay the 2015/2020 bond (XS1211417362), to repay BCP's debentures. We therefore believe that these debt instruments will be repaid in Q2 2019. Change of Control covenants for BCP's debentures have been waived after the acquisition by ADLER in April 2018.

Outlook

Outlook: Positive

The Outlook for ADLER is Positive and incorporates our expectation that the company's business risk profile will continue to improve, benefitting from the further upscaling of asset quality, measured by higher occupancy, like-for-like growth of rents above inflation rates and the addition of assets ('Wasserstadt Mitte') in strong locations. ADLER's business risk profile will also benefit from improving profitability, with EBITDA margins forecasted around 60%. The Outlook further reflects our expectation that ADLER's financial risk profile will improve. We anticipate that EBITDA interest cover will stay above 1.9x, and that leverage as measured by the company's loan/value will decline to around 55% within the next 12-18 months.

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