DEMIRE Deutsche Mittelstand Real Estate AG
Federal Republic of Germany, Real Estate

SCOPE B- POSITIVE

Key metrics

			Scope estimates	
Scope credit ratios	2022	2023	2024E	2025E
Scope-adjusted EBITDA interest cover	4.2x	3.9x	4.8x	2.6x
Scope-adjusted debt/EBITDA	15.6x	14.7x	13.9x	15.2x
Scope-adjusted loan/value ratio	54%	61%	54%	54%

Rating rationale

The company's business risk profile (BB-) benefits from a portfolio that is well diversified across Germany and property types, as well as moderate operating profitability. It is constrained by its limited size, tenant and property concentration, which could make cash flow more volatile, and generally weak asset quality due to a more secondary portfolio with underperforming assets.

The financial risk profile (B-) is supported by the recent bond restructuring, which provides time to continue with the divestment plan to reduce leverage and stabilise the capital structure. However, it is strongly constrained by the company's continued reliance on external financing or asset sales to meet upcoming debt maturities.

The rating is solely driven by the comparatively weaker financial risk profile, reflecting refinancing risk, particularly on the EUR 252m senior secured bond due end of 2027 which requires further deleveraging to enable refinancing. Without significant progress on asset sales, deleveraging appears impossible, leaving DEMIRE dependent on the willingness of its creditors to deal with this maturity wall.

Outlook and rating-change drivers

The Positive Outlook reflects the stabilisation of the issuer's capital structure through the recent bond restructuring, which provides some time to further deleverage without an immediate stress on liquidity, which remains under pressure. Deleveraging the balance sheet is expected through significant, planned asset sales, while the Scope-adjusted loan/value and Scope-adjusted debt/EBITDA are expected to remain between 50-55% and 13-15x, respectively, for the time being without additional property sales. In addition, the Outlook takes into account the continued refinancing of secured bank loans, albeit at a higher all-in cost, but still enabling DEMIRE to maintain a Scope-adjusted EBITDA interest cover above 2.2x going forward.

The upside scenario for the ratings and Outlook is: easing concerns about the company's liquidity profile, supported by a further reduction in senior secured bonds enabled by further asset sales.

The downside scenario for the ratings and Outlook is: growing concerns about liquidity and refinancing, triggered by a delay in asset sales relative to the issuer's plans.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
19 Dec 2024	New	B-/Positive

Ratings & Outlook

Issuer	B-/Positive
Senior secured bond (ISIN DE000A2YPAK1)	B

Analyst

Philipp Wass
+49 30 27891 253
p.wass@scoperatings.com

Related Methodologies/ Research

General Corporate Rating Methodology; October 2023

European Real Estate Rating Methodology; March 2024

ESG considerations for the credit ratings of real estate corporates; April 2021

Real Estate Outlook 2024, February 2024

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Geographically well-diversified portfolio with a focus on economically strong German regions • Diversified across property types … • Moderate and stable profitability with limited short-term upside • Recent bond restructuring buys time to continue with divestment plan to reduce leverage and stabilise capital structure • No incremental financing needs due to good operating cash generation • Good interest coverage thanks to payment-in-kind (PIK) toggle for shareholder loan • Track record of over EUR 200m of asset sales in the last two years	• Third tier German commercial property company with shrinking asset base and modest market share • ... but highest exposure to segments with structural shifts in demand • Limited exposure to ESG compliant assets (ESG factor: credit negative) • High tenant concentration • Weak operational performance of the more secondary portfolio with declining occupancy and WAULT as well as declining rental growth • Leverage remains elevated with upside contingent on successful execution of divestment plan • Inadequate liquidity (reflected by below par coverage of cash uses from cash sources) due to clustered refinancing needs in 2027 and 2028, while short-term refinancing needs are manageable

Positive rating-change drivers	Negative rating-change drivers
• Easing concerns about the company's liquidity profile, supported by a further reduction in senior secured bonds enabled by further asset sales.	• Growing concerns about liquidity and refinancing, triggered by a delay in asset sales relative to the issuer's plans.

Corporate profile

DEMIRE Deutsche Mittelstand Real Estate AG acquires and holds commercial real estate in medium-sized cities and up-and-coming regions adjacent to metropolitan areas throughout Germany. The issuer focuses on office properties, but is also diversified in retail, hotel and logistics properties.

As of 30 September 2024, DEMIRE manages 54 properties with a gross lettable area of 613,000 sqm and a total market value of approximately EUR 837m.

Financial overview

				Scope estimates		
Scope credit ratios	**2022**	**2023**	**Q3 2024[1]**	**2024E**	**2025E**	**2026E**
Scope-adjusted EBITDA interest cover	4.2x	3.9x	4.1x	4.8x	2.6x	4.6x
Scope-adjusted debt/EBITDA	15.6x	14.7x	13.5x	13.9x	15.2x	14.8x
Scope-adjusted LTV ratio	54%	61%	55%	54%	54%	55%
Scope-adjusted EBITDA in EUR m						
EBITDA	43.0	34.1	34.2	31.7	33.1	36.3
Other items[2]	8.3	15.0	6.6	7.0	2.2	0.0
Scope-adjusted EBITDA	**51.3**	**49.1**	**40.9**	**38.7**	**35.3**	**36.3**
Funds from operations in EUR m EUR m						
Scope-adjusted EBITDA	51.3	49.1	40.9	38.7	35.3	36.3
less: (net) cash interest paid	(12.2)	(12.6)	(9.9)	(8.1)	(13.5)	(7.8)
less: cash tax paid per cash flow statement	(2.6)	4.2	(3.8)	(4.5)	-	-
Change in provisions	(1.0)	(0.9)	0.2	0.4	-	-
Funds from operations	**35.6**	**39.8**	**27.4**	**26.4**	**21.8**	**28.5**
Net cash interest paid in EUR m EUR m						
Interest paid	17.0	14.8	14.6	13.8	17.1	17.7
Interest received	(4.9)	(2.2)	(4.7)	(5.7)	(3.5)	(9.9)
Net cash interest paid	**12.2**	**12.6**	**9.9**	**8.1**	**13.5**	**7.8**
Scope-adjusted total assets in EUR m						
Total assets	1,536.5	1,327.5	1,174.9	1,047.9	1,026.3	1,012.5
less: cash and equivalents	(57.4)	(149.5)	(164.5)	(51.5)	(28.5)	(34.1)
less: derivatives (assets)	0.0	0.0	-	0.0	0.0	0.0
Scope-adjusted total assets	**1,479.1**	**1,178.0**	**1,010.4**	**995.5**	**997.9**	**978.4**
Scope-adjusted debt in EUR m EUR m						
Reported gross financial debt	855.7	817.0	693.5	444.3	409.2	389.0
add: derivatives	-	24.1	24.1	24.1	24.1	24.1
add: shareholder loan	-	-	-	95.9	117.0	142.7
less: available cash and cash equivalents	(57.4)	(120.0)	(164.5)	(25.7)	(14.2)	(17.0)
add: pension adjustments	-	-	-	-	-	-
Scope-adjusted debt (SaD)	**798.2**	**721.1**	**553.0**	**538.5**	**536.0**	**538.7**

[1] 12 months ending September 2024 for cash flow-related metrics
[2] Includes non-recurring items, disposal gains/losses and dividends received

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Environmental, social and governance (ESG) profile[3]

Environment		Social		Governance	
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)		Labour management		Management and supervision (supervisory boards and key person risk)	
Efficiencies (e.g. in production)		Health and safety (e.g. staff and customers)		Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)	
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)		Clients and supply chain (geographical/product diversification)		Corporate structure (complexity)	
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	

Legend
Green leaf (ESG factor: credit positive)
Red leaf (ESG factor: credit negative)
Grey leaf (ESG factor: credit neutral)

Complex corporate structure

We highlight the rated entity's complex group structure. While the multi-layered structure allows the company to protect its liquidity in times of disruption within the property/sub-holding SPVs (see Limes default), it creates operational risk. However, the double LuxCo structure created as a result of the bond restructuring gives bondholders direct access to the shares of the companies under the second LuxCo layer (including DEMIRE and Fair Value REIT-AG) in the event of default. This is an advantage over the previous structure.

Core exposure to non-certified properties deemed credit-negative

DEMIRE's portfolio of non-certified properties is a competitive disadvantage which, combined with the more secondary locations in which the issuer operates, limits the rent levels achievable and requires relatively high capital expenditure to remain attractive to tenants, thereby avoiding the risk of stranded assets.

[3] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e. those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.

Business risk profile: BB-

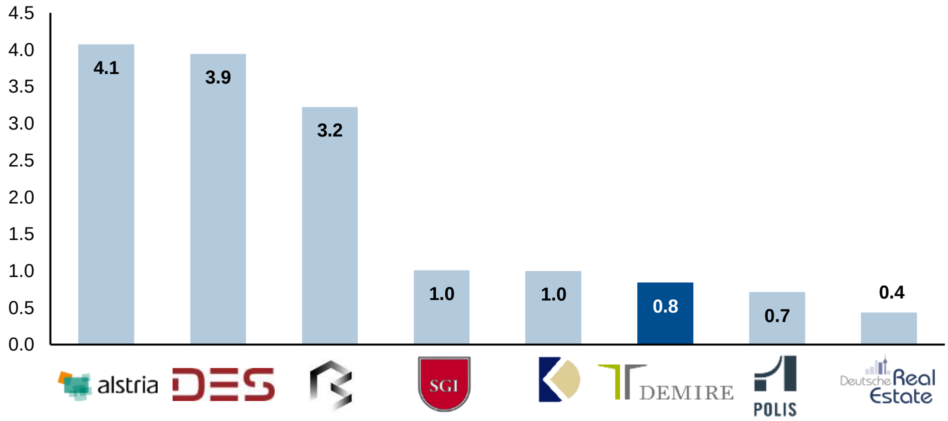
Industry risk profile: BB

DEMIRE is a buy-and-hold commercial real estate investor.

German commercial property company of limited size

DEMIRE is a German commercial real estate company of limited size. It has a portfolio of 54 properties with a gross lettable area of 613,000 sqm and Scope-adjusted total assets of EUR 1.0bn, all as at end-September 2024. The company's asset base has shrunk significantly since the end of 2021 (10 properties were either sold or deconsolidated; and Scope-adjusted total assets decreased by EUR 560m). These developments are the result of: i) executed disposals to meet funding needs; ii) an insolvency of the Limes portfolio[4]; and iii) significant fair value declines of 7% in 2022, 14% in 2023 and 3% in 2024 (all like-for-like). The declines were triggered by central banks' monetary tightening and the more secondary nature of DEMIRE's portfolio, which led to a sharp increase in capitalisation rates (rental yields up 1.6pp since end-2021) as investors became more cautious with regard to real estate in general and underlying property performance (see asset quality section, below) in particular. As a result, sales targeted by DEMIRE did not materialise at initially expected prices (e.g. LogPark Leipzig).

Figure 1: DEMIRE and peers, gross asset value (EUR bn) in Germany[5]



Sources: Public information, Scope

Given its limited size and focus on B and C cities, DEMIRE lacks the visibility and competitive advantage to attract high-profile, blue-chip tenants in an environment where tenants are more focused on strong locations and ESG-compliant properties (the company does not have the corresponding certifications; credit-negative ESG factor). DEMIRE's market position will continue to weaken, affecting its access to debt and equity markets, with further asset disposals planned to enable deleveraging. At the same time, we do not expect the next two to three years to see a reversal of the negative momentum that has unfolded since monetary tightening and has limited the company’s room for manoeuvre to meet refinancing needs in 2024.

Geographically well-diversified portfolio with focus on strong German regions

DEMIRE operates a well-diversified portfolio with properties spread across Germany, allowing it to benefit from different underlying market dynamics. Two-thirds (by annualised contracted rents) are located in the states with the highest GDP, i.e. North Rhine-Westphalia, Hesse, Bavaria and Baden-Württemberg.

4 A non-recourse loan of EUR 82m taken out by four subsidiaries of DEMIRE (property value EUR 137m) from DZ HYP AG was due to mature on 30 June 2024. It was not possible to reach an agreement on a standstill or an orderly repayment of the loan outside an insolvency of the property companies. As a result, the four property companies in the Limes portfolio have filed for insolvency and were deconsolidated in Q3 2024.

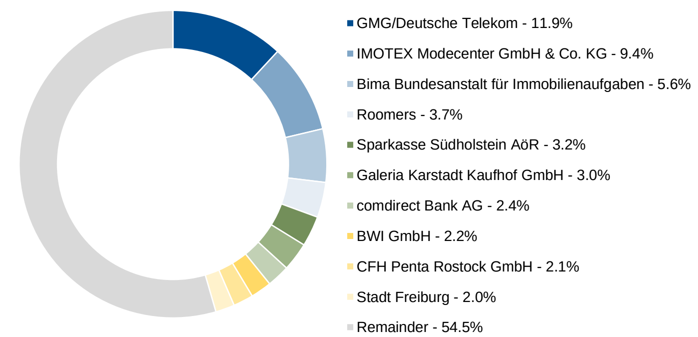
5 As at end-September 2024: Alstria Office REIT-AG, Deutsche Euroshop AG, Branicks AG, DEMIRE AG; as at end-June 2024: Deutsche Konsum REIT-AG, Deutsche Real Estate AG; As at end-March 2024: Sedlmayr Grund und Immobilien KgaA (at cost); as at end-2022: Polis Immobilien AG

However, we see some cluster risk, as the top 10 properties account for almost half of the contracted rental income, a share that is expected to increase further if targeted asset sales are successfully executed. This high concentration could lead to significant volatility, not only in the portfolio's key performance indicators such as rental growth or occupancy, but also in cash generation.

High tenant concentration

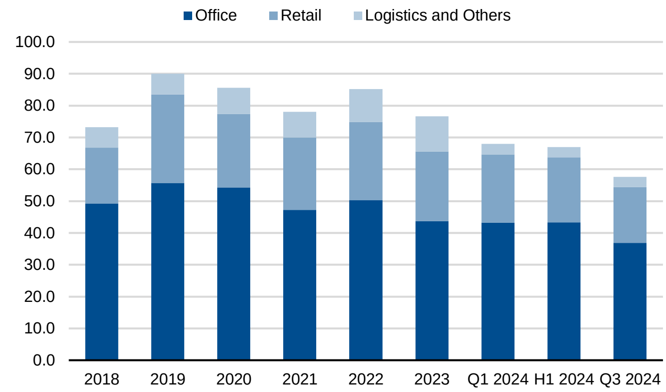
This risk is further amplified by the high concentration of the tenant portfolio, with the top three tenants accounting for 27% and the top 10 tenants accounting for 46% of rental income at the end of September 2024. Tenant concentration leads to high re-letting risk. This is compounded by the more secondary nature of DEMIRE's property locations, which could lead to more volatile cash generation due to longer re-letting periods and/or higher capital expenditure, as well as greater incentives to attract tenants. However, the risk of tenant default or the cessation of contractually agreed rental payments by a significant proportion of tenants is less likely given the considerable share of government, municipal (e.g. Bima, City of Freiburg) and blue-chip tenants. We still note an increasing bad debt ratio, reflecting the moderate to weak quality of the smaller tenants as well as the recent insolvencies of Mein Real (2023) and Galeria Karstadt Kaufhof (2024).

Figure 2: Top tenants by rental income as at end-September 2024



Sources: DEMIRE, Scope

Figure 3: Diversification of property types by contracted rent (EUR m)



Sources: DEMIRE, Scope

We believe that the tenant structure will continue to change, with larger tenants preferring inner-city locations in A and/or B cities. This will leave DEMIRE with a more granular tenant base (mainly SMEs or MicroCaps) albeit of weaker quality. We see this change as credit positive.

Diversified across property types, but highest exposure to segments with structural shifts in demand

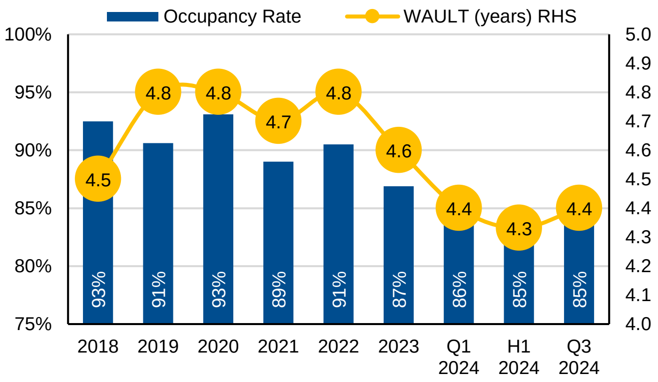
The strongest feature of DEMIRE's portfolio is its diversification across property types. Office properties accounted for 64% of annualised in-place rents at end-September 2024, retail for 30% and other (logistics, hotels, etc.) for 6%. However, DEMIRE's exposure to the weakest performing property types, retail and office, leaves cash flows vulnerable to the ongoing transformation of the European retail industry (see also Adapt or Disappear: E-commerce Transforms European Retail) as well as changes in employer behaviour, as the biggest ever experiment in remote working – triggered by the Covid-19 pandemic – proved largely successful. Companies are discovering the need for office space to allow staff to collaborate and increase productivity. However, the demand for space, especially in secondary locations, is expected to decline, as companies adjust their property requirements downwards in the medium term.

Vacancy in DEMIRE's office portfolio has increased by 2.8pp since 2022. This reflects lower space requirements in general, with many tenants switching to hybrid working and larger tenants not renewing their leases.

Weak operational performance of more secondary portfolio with declining occupancy and WAULT...

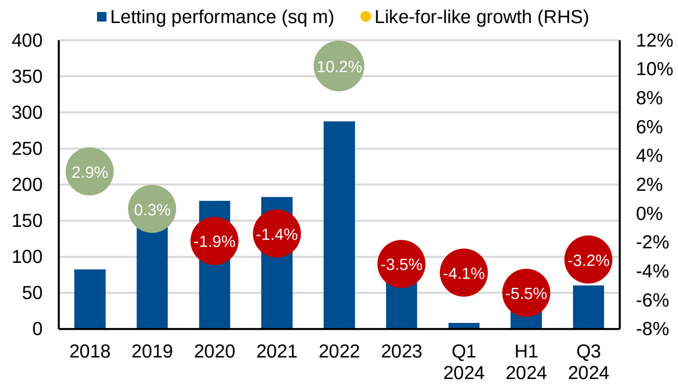
DEMIRE's asset quality is weak compared to the peers we cover. The occupancy rate has been on a continuous decline since 2019 and stood at 85% at end-September 2024. The WAULT has also fallen, reaching 4.4 years at the end of September 2024. The latter is partly driven by demand for higher flexibility in terms of space requirements from tenants in office (WAULT of 3.2 years, down 0.8 years since its peak in 2021), but also by asset specifics of some properties. WAULT decreased for retail properties to 4.8 years (down 1.7 years), mainly due to the insolvency of Galeria Karstadt-Kaufhof. This development has not been offset by stronger demand and longer leases for the rest of the portfolio (15.9 years). We expect WAULT to hover around four years or even to fall further, reflecting the portfolio's weaknesses with limited commitment from larger tenants with a greater focus on Central Business District (CBD) locations. The declining WAULT, coupled with weaker tenant quality on average, has reduced cash flow visibility, which is credit negative.

Figure 4: Occupancy and WAULT



Sources: DEMIRE, Scope

Figure 5: Letting performance ('000s) and rental growth



Sources: DEMIRE, Scope

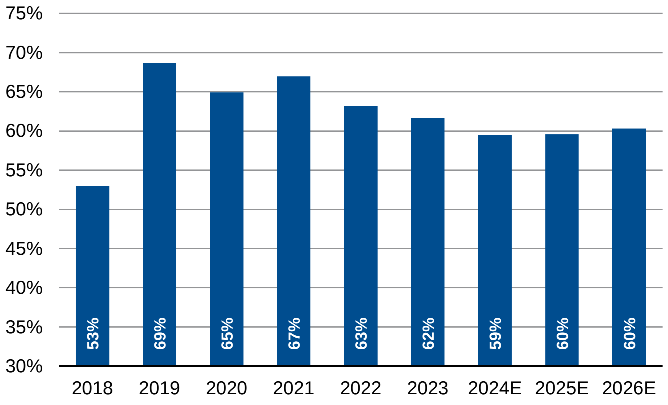
... as well as negative rental growth

The weak asset quality is also reflected in the recent negative like-for-like rental growth (2023: -3.5%, 2024 YTD: -3.2%). This indicates structural weaknesses in the property and/or the tenant portfolio with a number of insolvencies. We expect rents to grow slightly, driven by possible rent increases, as 75% of leases are index-linked, as well as some reversionary potential, offsetting a small but steady rise in vacancy. Stronger rental growth is possible if DEMIRE's increased investment bears fruit and parts of the portfolio are reconfigured to increase its attractiveness to tenants.

Moderate and stable profitability with limited short-term upside

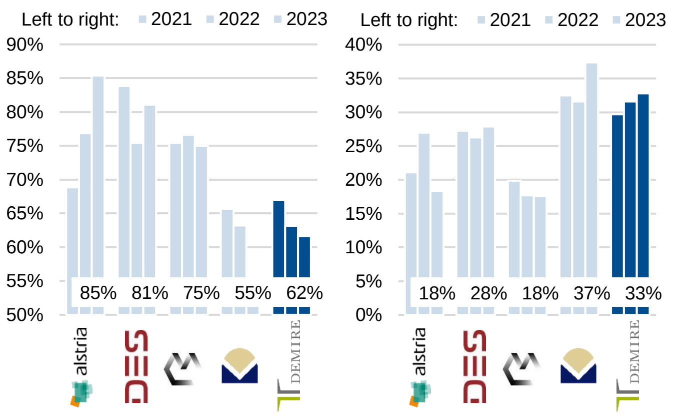
The moderate profitability of DEMIRE's buy-and-hold operations is the main support for the company's business risk profile. The Scope-adjusted EBITDA margin has been volatile but has stabilised above 60% on average (2023: 62%, last twelve months to end-September 2024: 59%). Going forward, we expect the margin to stabilise at around 60%, as rental growth will largely balance a higher proportion of non-recoverable operating expenses due to the rise in vacancies. We also expect slightly higher volatility going forward, mainly because SG&A expenses are only adjusted with a time lag after asset disposals.

Figure 6: Scope-adjusted EBITDA margin



Sources: DEMIRE, Scope estimates

Figure 7: Profitability (Scope-adjusted EBITDA margin – left – and EPRA cost ratio – right) compared to peers



Sources: DEMIRE, Scope

We do not expect the absolute level of profitability to improve significantly in the longer term. This is because the portfolio is generally of a more secondary nature and does not support premium rents but requires more management attention – reflected in relatively high EPRA cost ratios (Q2 2024: 42.5% EPRA cost ratio incl. vacancy and 33.1% excl. vacancy), also compared to peers.

Financial risk profile: B-

Recent bond restructuring buys time to continue with divestment plan to reduce leverage and stabilise capital structure

In November 2024, the company announced the successful completion of the restructuring of its EUR 600m bond (outstanding notional EUR 499m before restructuring), which was originally due in October 2024. Key elements of the restructuring included the extension of the remaining bond to end-December 2027 with a 5% cash coupon and a 3% PIK coupon in 2027. The restructuring reduced the notional amount of the bond by EUR 246m through a tender for EUR 50m at par and a tender for EUR 196m mainly at a price of 76.25%. The repayment was funded by cash on the balance sheet and a new EUR 93m shareholder loan. We do not provide an equity credit for the shareholder loan as it does not meet our criteria (the only criteria met are contractual subordination and coupon deferral, however, we do not regard the shareholder loan as permanent). In addition, the bond now benefits from a collateral package (see long-term debt rating).

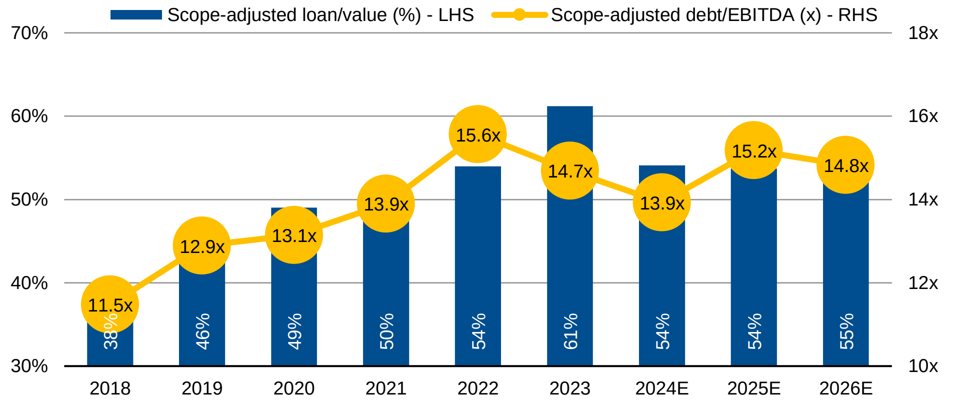
No incremental financing needs due to good operating cash generation

DEMIRE benefits from good operating cash generation from its buy-and-hold portfolio. This is despite some fundamental weaknesses given its more secondary nature of assets, which are being addressed by increased capital expenditure going forward. While it remains to be seen whether the measures will stabilise or improve cash generation going forward, the company benefits from some headroom to manage this expenditure given the PIK nature of the shareholder loan provided. Thus, the ability to generate cash will help to keep the debt level stable in the future. The successful completion of the DEMIRE divestment programme should help to further reduce the debt burden and alleviate ongoing refinancing concerns/stabilise the capital structure.

Leverage remains elevated with upside contingent on successful execution of divestment plan

Scope-adjusted loan/value will likely benefit from debt repayments made in 2024, decreasing to below 55% at end-2024 from 61% as at end-2023 (end-September 2024: 55%) and remaining between 50% and 55% going forward. Further improvements depend on the realisation of divestment proceeds. This could significantly boost not only Scope-adjusted loan/value but also Scope-adjusted debt/EBITDA, which we expect to remain between 13x and 15x in our rating scenario (last twelve months to end-September 2024: 13.5x). While we expect positive like-for-like rental growth, it will not be sufficient to substantially reduce Scope-adjusted debt/EBITDA over the next 12-24 months. This is mainly due to the smaller portfolio size following the deconsolidation of the Limes portfolio, which did not contribute to deleveraging because of its non-cash nature.

Figure 8: Leverage



Sources: DEMIRE, Scope estimates

Good interest coverage thanks to PIK toggle of shareholder loan

Scope-adjusted EBITDA interest cover remains adequate at over 2.2x (last twelve months to end-September 2024: 4.1x). This is despite the rise in the weighted average cost of debt to over 8% at end-2024 (end-September 2024: 1.9%), driven by the coupon increase to 5% from 1.875% on the EUR 600m bond extension in November and the 22% interest burden on the EUR 93m shareholder loan. However, the shareholder loan has a PIK toggle, which is expected to be used on each interest payment date to support the issuer's liquidity profile. In addition, the bond incentivises an early redemption of a minimum of EUR 50m in 2025 and 2026 to avoid PIK interest in the form of an extension fee (on top of the cash coupon) of 3% in 2026 and 2% in 2027.

However, Scope-adjusted interest cover falls to 1-2x after taking into account the interest expense related to the shareholder loan and the PIK component of the bond. This leaves minimal headroom to deal with a distortion in the portfolio's cash generation capability (due to weaker tenant quality or reduced tenant demand beyond our expectations) if this debt needs to be refinanced in 2027/2028 without the company having made significant progress in deleveraging.

Liquidity: inadequate

Liquidity is deemed inadequate. Cash sources (pro forma cash of approximately EUR 60m at end-September 2024 following the bond restructuring and expected free operating cash flow of EUR 40m until the end of 2026) are not sufficient to cover cash needs (EUR 109m of maturing bank debt between end-September 2024 and the end of 2026). However, we believe that the majority of maturing loans will be rolled over, refinanced with other banks or will not necessarily result in cash outflows for DEMIRE. This is because these loans are non-recourse.

This will not be the case for capital market debt. As such, the EUR 252m bond repayment in 2027 is dependent on either the successful execution of asset sales to free up the required capital or the extension and increase of secured financing. Significant progress on the divestment programme over the next 12-18 months could alleviate our liquidity profile concerns.

Inadequate liquidity is reflected by a negative 3 notch adjustment to the issuer's financial risk profile.

The financial covenants – set out in the terms and conditions of the EUR 600m 2019/2027 bond prospectus – are as follows:

- Net loan/value of max. 70% (Q3 2024: 52.3%)
- Interest coverage ratio of min. 1.50x (Q3 2024: 5.55x)

All of these covenants have been met with ample headroom and we expect DEMIRE to continue to do so. It would take a further fair value decline of over 20% or a fall in reported EBITDA of approximately 40% relative to our rating case for the company to fail to meet them, both of which are unlikely.

Balance in EUR m	2024E	2025E	2026E
Cash (t-1)	120.0	51.5	28.5
Restricted cash (t-1)[6]	(18.0)	(7.7)	(4.3)
Open committed credit lines (t-1)	0.0	0.0	0.0
Free operating cash flow (t)	13.7	0.0	25.9
Short-term debt (t-1)	670.7	35.0	70.2
Coverage	**17%**	**125%**	**71%**

The company is also subject to financial covenants at the loan level (loan/value, DSCR, debt yield, debt to rent), which have been met, mostly with good headroom, at the end of September 2024.

Supplementary rating drivers: +/- 0 notches

Financial policy: neutral

We assess financial policy as neutral. While DEMIRE does not have a specific financial policy, financial guidelines are determined by covenants that the company must comply with, which provides some comfort to creditors. We acknowledge the limited exposure to floating rate debt, also in the past, but see continued cluster risk related to the company's refinancing schedule. However, DEMIRE is addressing the latter with the flexibility provided by the adjustments made to the EUR 600m bond terms and conditions, which has been extended to end-2027 but allows for early repayments incentivised by an additional 3% PIK component due in 2027.

Long-term debt rating

Senior secured bond: B
ISIN DE000A2YPAK1

DEMIRE has EUR 252m in capital market debt (senior secured bond) outstanding as at end-November 2024.

Our recovery analysis suggests an excellent recovery, which would theoretically allow for a three-notch uplift on the issuer rating. The recovery is based on a hypothetical default scenario in FY 2026 with a distressed enterprise value of EUR 585m. This value is based on the liquidation value of the company and includes a discount of approximately 26% for DEMIRE's investment properties, consistent with a B category stress and reflecting the secondary nature of the portfolio, as well as 10% for insolvency costs. This compares to forecasted secured bank debt of EUR 137m, a secured bond of EUR 252m and EUR 143m in unsecured subordinated debt at the time of a potential default.

We have assigned a B rating to senior secured bond, one notch above the issuer rating. While we acknowledge the collateral provided (share and account pledges) for the senior secured bond, there is a significant amount of secured bank debt that ranks higher than the senior secured bond and benefits from a better collateral package (collateralised by real estate). We also note the potential volatility of the capital structure on the path to default, which could involve the introduction of additional secured bank debt, thus reducing recovery expectations for the holders of the senior secured bond. Both of these

[6] 15% haircut on sources of liquidity to reflect the risk that liquidity could quickly evaporate in times of severe negative rating migration/distress. The haircut is based on the relative strength of DEMIRE’s business and financial risk profiles.

factors could reduce the recovery expectations of the holders of the senior secured bond, which constrains the up-notching of the debt instrument rating for the senior secured bond to one notch.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

10 avenue de Messine
FR-75008 Paris

Phone +33 6 6289 3512

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
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