Vonovia S.E.
Germany, Real Estate

A- STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	4.1x	4.5x	4.7x	5.0x
Scope-adjusted debt/EBITDA	15.1x	25.4x	16.6x	15.6x
Scope-adjusted loan/value ratio	41%	45%	41%	39%

Rating rationale

Vonovia's strong business risk profile is the key driver for the rating. Vonovia is Europe's largest residential real estate corporate, with excellent access to capital and investment markets, a well-diversified portfolio spread across German, Austrian and Swedish metropolitan areas, as well as high tenant diversification that supports stable rental cash flows. Furthermore, economies of scale and high occupancy across the company's portfolio support high and stable profitability. Vonovia's financial risk profile benefits from a low Scope-adjusted loan/value (LTV) ratio, diversified debt structure, and high unencumbered asset position, allowing the company to weather changes in the lending environment.

The rating is constrained by high leverage as measured by Scope-adjusted debt/EBITDA, which makes the company vulnerable to adverse market movements. The rating is also held back by Vonovia's ongoing, but weakening, focus on the German market, with its associated regulatory risk, and negative discretionary cash flows, though anticipated to become break-even to facilitate the target of no incremental debt issuance going forward.

Outlook and rating-change drivers

The Outlook for Vonovia remains Stable and reflects improving credit metrics in the medium term, driven by reduced expansion capex following the issuer's 'no incremental debt' target, with the Scope-adjusted LTV anticipated to decline to around 40% and Scope-adjusted debt/EBITDA forecasted to reach around 15x in the next 12 to 18 months. The Outlook includes investments of EUR 2.0bn-2.8bn yearly during the forecasted period (including bolt-on acquisitions) targeting a carbon-neutral portfolio by 2045.

A negative rating action is possible if Scope-adjusted LTV rose above 45% on a sustained basis. This could be triggered by i) a change in financial policy; or ii) a significant drop in portfolio value following an adverse change in German regulations or weaker market sentiment regarding residential real estate valuations, a remote scenario at present. A negative rating action could also be triggered if the share of non-domestic net rental income cannot return above 15% in the medium term, likely triggered by growth focused on German peers.

A positive rating action is unlikely in the short term but could be warranted if the Scope-adjusted LTV dropped below 40% and Scope-adjusted debt/EBITDA fell to around 8x, both on a sustained basis. This could result from a change in capital allocation or a reduction in both expansion capex and shareholder remuneration. It is more likely that a positive rating action would be a consequence of an advanced business risk profile driven by a continued improvement of profitability.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
8 Jul 2022	Affirmation	A-/Stable
9 Dec 2021	Affirmation	A-/Stable
26 May 2021	Affirmation	A-/Stable

Ratings & Outlook

Issuer	A-/Stable
Short-term debt	S-1
Senior unsecured debt	A-

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Related Methodologies/ Research

Corporate Rating Methodology; July 2021

European Real Estate Methodology; January 2022

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

German housing bubble unlikely to burst; June 2022

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Vonovia S.E.

Germany, Real Estate

Positive rating drivers	Negative rating drivers
• Exposed to low-risk, regulated residential real estate industry, which decouples rental growth from GDP development • Tier 1 real estate corporate (largest residential landlord in Europe), with around 550,000 apartments in Germany, Austria and Sweden • Well-diversified portfolio spread across German, Austrian and Swedish metropolitan areas with positive demographics; highly diversified tenant portfolio with average credit quality • Good portfolio locations and improving property condition (ESG factor), which support high like-for-like rental growth as well as high and stable occupancy • Strong debt protection with Scope-adjusted EBITDA/interest cover of more than 4x, backed by organic EBITDA growth • Low Scope-adjusted LTV of 44% at end-March 2022, expected to improve to around 40% due to target of no more incremental debt • Excellent access to external financing, benefiting from highly diversified debt structure and financial headroom with unencumbered asset ratio of 163% at end-March 2022	• Exposed to regulatory risk due to predominant focus on Germany (86% of net rental income as at end-March 2022), but anticipated further European roll-out likely to reduce this exposure • Weak Scope-adjusted debt/EBITDA: expected to have peaked in 2021 (25x) but return to around 15x in the next few years • Negative discretionary cash flow since FY 2017 anticipated to become break-even because of lower expansion capex due to target of no more incremental debt issuances

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted loan/value ratio of below 40% and Scope-adjusted debt/EBITDA of around 8x • Improved business risk profile	• Scope-adjusted loan/value ratio of above 45% on a sustained basis • Non-domestic net rental income contribution of below 15% for a sustained period

Corporate profile

Vonovia S.E. is Germany's largest residential real estate company. Vonovia owns and manages around 550,000 residential units in Germany, Austria and Sweden valued at around EUR 96bn (end-March 2022). Vonovia also manages around 72,000 third-party apartments.

Financial overview

				Scope estimates		
Scope credit ratios	**2020**	**2021**	**Q1 2022[1]**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	4.1x	4.4x	4.5x	4.7x	5.0x	4.9x
Scope-adjusted debt/EBITDA	41%	45%	44%	41%	39%	38%
Scope-adjusted loan/value ratio	15.1x	25.4x	22.1x	16.6x	15.6x	14.9x
Scope-adjusted EBITDA in EUR m						
EBITDA	1,768	2,037	2,263	3,144	2,954	3,065
Other items[2]	-104	-178	-232	-448	-87	-38
Scope-adjusted EBITDA	**1,664**	**1,858**	**2,031**	**2,696**	**2,868**	**3,027**
Funds from operations in EUR m						
Scope-adjusted EBITDA	1,664	1,858	2,031	2,696	2,868	3,027
less: (net) cash interest paid	-406	-422	-456	-571	-568	-622
less: cash tax paid per cash flow statement	-78	-93	-74	-381	-181	-169
Change in provisions	-150	437	376	-91	0	0
Funds from operations (FFO)	**1,030**	**1,779**	**1,878**	**1,653**	**2,118**	**2,236**
Net cash interest paid in EUR m						
Net cash interest per cash flow statement	-428	-431	-464	-566	-564	-617
Change in other items[3]	22	8	8	-5	-5	-5
Net cash interest paid	**-406**	**-422**	**-456**	**-571**	**-568**	**-622**
Scope-adjusted total assets in EUR m						
Total assets	62,417	106,320	105,805	111,232	115,496	120,350
less: cash and equivalents	-453	-1,315	-3,406	-980	-898	-910
less: derivatives (assets)	0	0	0	0	0	0
Scope-adjusted total assets	**61,804**	**104,888**	**102,282**	**110,134**	**114,480**	**119,322**
Scope-adjusted debt in EUR m						
Reported gross financial debt	25,581	47,909	47,728	45,144	45,003	45,538
less: equity credit (hybrid)	-501	0	0	0	0	0
add: derivatives	299	332	293	293	293	293
less: cash	-613	-1,433	-3,523	-1,097	-1,016	-1,027
add: restricted cash	160	118	118	118	118	118
add: pension adjustments	254	281	281	281	281	281
Scope-adjusted debt	**25,180**	**47,207**	**44,897**	**44,739**	**44,679**	**45,203**

[1] 12 months ending March 2022 for cash flow-related metrics
[2] Includes non-recurring items and disposal gains on fixed assets
[3] Equity credit for interest on hybrid debt and pension interest

Table of Content

Environmental, social and governance (ESG) profile 4
Business risk profile: A 5
Financial risk profile: BBB....................... 9
Supplementary rating drivers: +/- 0 notches 12
Long-term and short-term debt ratings.. 12
Appendix: Peer comparison.................. 13

Environmental, social and governance (ESG) profile[4]

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)

Target: carbon neutral by 2045

Vonovia's strategy is committed to addressing climate issues, aimed at ensuring the viability of its business in the long run. The company has a clear target to make its housing stock carbon-neutral by 2045, in line with the German government's goal, and plans to capitalise on new sustainable construction, refurbishments and innovations in the energy mix. In the interim, Vonovia is aiming for a carbon intensity of less than 25 kg CO_2/sqm by 2030 (2021: 38.4 kg CO_2/sqm). The company also investing to improving the energy-efficiency of its current portfolio, evidenced by a refurbishment rate of 2.3% in 2021 in Germany (2020: 2.9%; 2022 target: 2.0%-2.5%). These investments – mostly accompanied by general modernisation – help to keep its portfolio in high demand and boost organic rental growth (in line with German regulatory framework). To reduce the financial impact of these measures on its customers, Vonovia limits rent increases to EUR 2 per sq m after invest being one third below the maximum allowed by law.

[4] 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: A

Industry risk profile: A

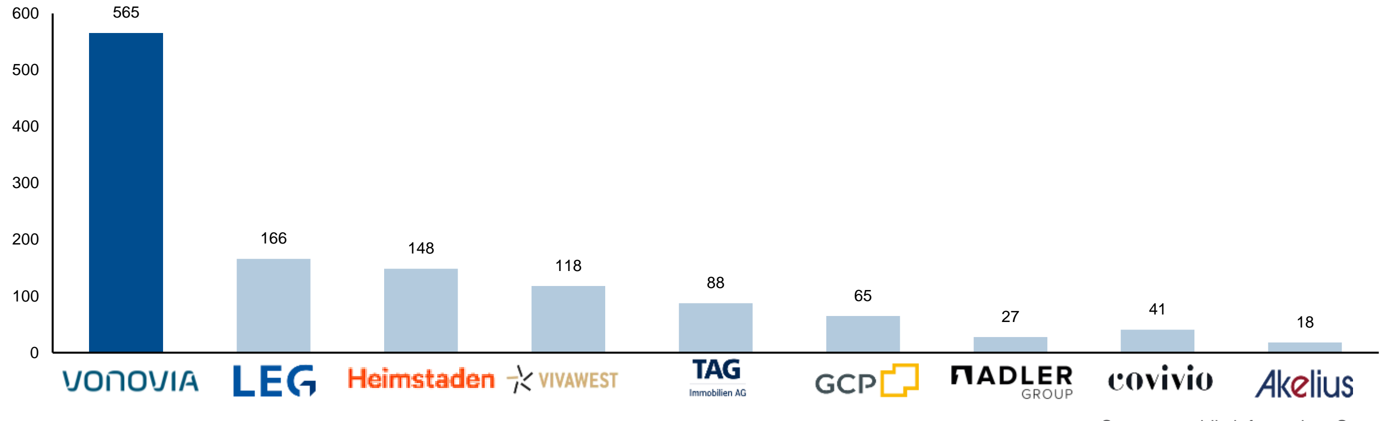
Vonovia is a residential buy-and-hold company that generates most of its EBITDA (83%) through leasing out apartments or community service properties (industry risk of 'A'). It also has some exposure to i) healthcare services ('A') via its nursery home operators Katharinenhof, Hamburger Senioren Domizile and Pflege & Wohnen; and ii) real estate development (homebuilding rated 'BB') via its integrated development platform (BUWOG AG).

We expect development activities to continue to contribute around 5% of reported EBITDA. This sub-segment comes with high cyclicality and many non-controllable factors that make cash flows volatile. Development risk generally falls on Vonovia's counterparties, medium to large contractors such as Porr and Strabag by contractual agreement (70% of the development pipeline has no price risk).

Tier 1 real estate corporate – largest residential landlord in Europe

Vonovia's portfolio grew to around 550,000 residential units as at end-March 2022 (up 33% YoY) after it acquired 87.6% of the voting rights of Deutsche Wohnen S.E. as at end-October 2021, offset partly by the disposal of around 15,000 residential units to the City of Berlin (Q1 2022). This number is expected to remain broadly stable, with smaller bolt-on acquisitions and the development of rental apartments to balance out recurring sales (2022 target: 3,300 units). Vonovia is looking to sell i) its healthcare services division and related properties; ii) portfolios that do not strategically match; and iii) some portfolios to joint venture structures, aimed at broadening the investor base while maintaining its majority stake. This does not form part of our rating case but would release capital to substantially reduce leverage. Even so, Vonovia will retain its position as a major stakeholder in the residential real estate markets of Germany (86% of net rental income as at end-March 2022), Sweden (11%) and Austria (3%).

Figure 1: Vonovia and European competitors by number of residential units ('000s) as at end-December 2021[5]



Sources: public information, Scope

Cash flow stability is helped by the company's absolute size, supported by good diversification and economies of scale, with Scope-adjusted total assets of EUR 102bn at end-March 2022 and Scope-adjusted funds from operations of EUR 1.9bn for the 12 months ending March 2022.

Vonovia is Europe's largest real estate corporate. Including Deutsche Wohnen, Vonovia's market capitalisation is around EUR 40bn as at mid-June 2022, affording excellent access to capital markets to source financing.

[5] As at YE 2021: Vonovia S.E., LEG Immobilien S.E., Akelius Residential Property AB, Heimstaden Bostad AB, ADLER Group S.A., Grand City Properties S.A.; as at YE 2020: Covivio S.A. and Vivawest GmbH

Further growth anticipated outside of domestic market of Germany

We estimate Vonovia to hold only 1.2% of Germany's fragmented residential real estate market. Such a small share allows it to grow without risking intervention by the local competition authority. Even so, growth in Germany is limited due to i) around 91% of German apartments being off-market (45% are owner-occupied, 36% have private landlords and 10% are owned by government-related entities or cooperatives); and ii) the increasing pressure to tighten housing regulation. We therefore expect future growth to focus on non-German markets, namely Sweden, Austria, France and the Netherlands.

Vonovia is refraining from acquiring the majority in Adler Group S.A. - which is possible given its 20.49% shareholding[6] and purchase option for another 13.3% - because of increased cost of capital. Generally, an acquisition of a majority stake would weaken Vonovia's credit quality as it would increase i) cluster risk associated with the German exposure (specifically Berlin); and ii) the share of the higher-risk development exposure through the addition of around 6,000 units to be developed with a gross asset value of EUR 0.9bn.

High penetration of residential market possible given low average rent

Vonovia's portfolio focuses on low- to medium-income tenants, as indicated by the average rent of 7.40 EUR/sqm and month as at end-March 2022 (7.23 EUR/sqm for Germany excluding Deutsche Wohnen). Thus, attracting households with a monthly income of at least EUR 1,616[7] – around 80%[8] of the German market.

Well-diversified portfolio spread across German, Austrian and Swedish metropolitan areas

Vonovia has a well-diversified investment portfolio, mainly in and around German, Austrian and Swedish metropolitan areas and midsize cities. Top 10 regions account for 79% of net rental income (NRI) as at end-March 2022. However, portfolio concentration is negligible because major German metropolitan areas consist of multiple large cities, such as the southern Ruhr area (around 7% of NRI), the Rhine Main area (around 8%), the Rhineland (around 6%) and the northern Ruhr area (around 4%). We also believe that the wide distribution of apartments in Dresden (around 6%) and Hamburg (around 4%) partially mitigates the dominant exposure to these cities.

However, the addition of Deutsche Wohnen's portfolio significantly increased Vonovia's exposure to Berlin and its regulatory framework (around 27% for the combined portfolio's NRI). This cluster risk remains despite around 15,000 residential units being sold to the City of Berlin as Vonovia committed to develop around 13,000 units in the city by 2026. Nonetheless, Vonovia is seeking to mitigate this risk by i) limiting rent increases[9]; ii) actively contributing to government-led initiatives[10]; and iii) not passing costs of refurbishing the housing stock to save energy to tenants in full.

European roll-out: 2017 to 2020

Vonovia expanded its geographical outreach after acquiring Austria's conwert Immobilien Invest SE (2017) and BUWOG AG (2018), Sweden's Viktoria Park AB (2018) and Hembla AB (2019), and shareholdings in France's ICF Novedis (2018) and Dutch residential fund Vesteda (2020). We believe that the European roll-out, supports the company's business risk profile and its goal of becoming a European market leader. This expansion has also helped to tackle the largest risk regarding its business risk profile – the dominant exposure to German regulation on residential landlords. Even if regulatory risk in other European countries is not as high as in Germany, we do not expect it to move in the same direction simultaneously. Thus, an internationally diversified portfolio

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[6] Vonovia exercised into the collateral provided by Aggregate Holdings Invest S.A. - full stake that Aggregate holds in Adler Group S.A. (26.6%) - for the granted EUR 250m Lombard loan to Aggregate Holdings Invest S.A. because of a covenant breach

[7] (Average rent Germany plus 2 EUR/sq m in service charge) multiplied by average apartment size (60 sqm) and divided by one-third (living cost equates to industry standard)

[8] Distribution of monthly income per household 2019. Source: statista.de

[9] Maximum of one percent per year until 2024; in the following two years, no more than the rate of inflation.

[10] https://investoren.vonovia.de/news/vonovia-se-vonovia-unterschreibt-berliner-wohnungsbu-ndnis/7b39dbd2-b1ce-494a-acb9-c6c8d0242900/

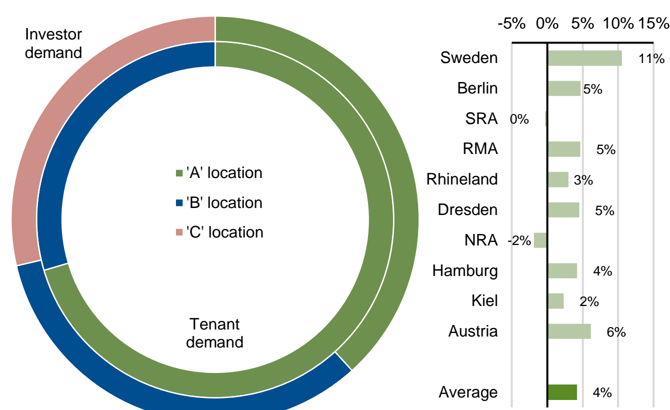
should partially de-link cash flow predictability and stability from regulatory changes in a single country.

Figure 2: Geographical diversification by rental income as at end-March 2022

Berlin (27%)
Sweden (11%)
Rhine Main area (8%)
Southern Ruhr area (7%)
Dresden (6%)
Rhineland (6%)
Hanover (4%)
Kiel (4%)
Hamburg (4%)
Northern Ruhr area (4%)
Others (21%)

Sources: Vonovia, Scope

Figure 3: Categorisation of location by investor (outer circle), tenant demand (inner circle) and population growth, 2020 to 2030



Sources: Vonovia, Worldbank, Statistik Nord, IT.NRW, Scope and others
Note: Location ratings as defined by Scope

Deutsche Wohnen transaction increased dependence on German regulatory framework

However, the addition of Deutsche Wohnen's portfolio significantly increased the German exposure to 89% of residential units (up 4pp YoY) and 86% of NRI (up 5pp) as at end-March 2022, especially to Berlin (around 27% of net rental income). Meanwhile, ambitions to expand beyond Germany came to a halt: the combination of a higher cost of capital, due to the rising interest rates and the strong reduction in Vonovia's share price, and unchanged market fundamentals has made accretive acquisitions both scarcer and less accessible. Hence, an increase of non-domestic rental income to above 15%, which would be commensurate with the assigned business risk profile, would only materialise over the medium term.

Highly diversified tenant portfolio with average credit quality

Tenant diversification is very high thanks to Vonovia's absolute size (around 550,000 units as at end-March 2022) and residential focus. This limits the cash flow impact of a single tenant's default or delayed rental payment – illustrated by debt impairments representing around 1% of NRI in recent years (2021: 1.5%). We judge tenants' credit quality to border between moderate and modest, similar to the weighted average credit quality of German households (Vonovia's target customer).

Property locations with positive demographics and liquidity

Vonovia's properties are distributed across locations with favourable tenant demand and healthy macroeconomic fundamentals. Demand in the portfolio's regions is expected to be at least stable until 2030, with an increasing share of the portfolio to benefit from a forecasted population increase of at least 2.5% following the acquisition of Deutsche Wohnen S.E. (68% as at end-March 2022, up 7pp YoY). In addition, around half of apartments are in 'A' cities, i.e. those most in demand among both investors and tenants: Berlin (27% as at end-March 2022, up 16pp), Stockholm (5%, down 1pp), Hamburg (4%, down 1pp), Stuttgart (2%, down 1pp), Vienna (2%, down 1pp) and Munich (2%, unchanged). We foresee the strong tenant demand to continue, supporting high and stable occupancy as well as like-for-like rental growth. Furthermore, the portfolio will continue to be somewhat liquid, even in times of economic turmoil. Such strengths limit potential haircuts on current property values.

Improving property condition backed by substantial increase in capex since 2013

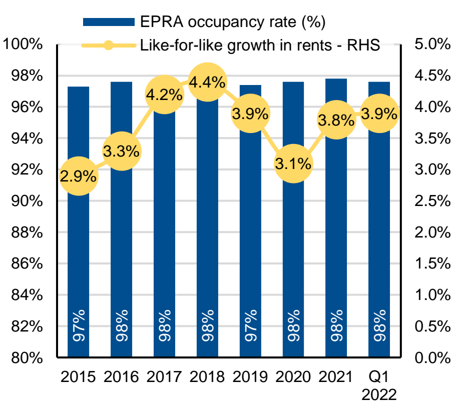
Portfolio property conditions have improved with the continuous increases in capex, including for maintenance, modernisation and new developments, reaching EUR 2.2bn in FY 2021 (estimated at EUR 76.1 per sq m) from EUR 0.2bn in 2013 (EUR 20.0 per sq m). Based on company information and despite the enlarged portfolio, we expect spending of

around EUR 1.7bn this year (including Deutsche Wohnen). This should help to support like-for-like rental growth over the next few years, with an increasing share of spending set aside for rental adjustments according to section 559 of Germany's civil code for residential modernisation (Bürgerliches Gesetzbuch) and the application of market rents (new developments). However, the latter is subject to the shift of the company's development pipeline to a develop-to-sell strategy, as the higher cost of capital has reduced the amount of potential projects that can meet Vonovia's yield expectations. Even so, Vonovia remains the largest homebuilder in Germany with 3,000-4,000 completions targeted yearly (2022: 3,600). New developments should help support rental growth, with a project pipeline of more than 60,000 units (incl. Deutsche Wohnen) as at end-March 2022, around one third of which is estimated to be added to the company's investment property portfolio.

Stable key portfolio performance indicators

Key portfolio performance indicators have remained stable, with occupancy at 97.6% as at end-March 2022 (up 40bp YoY), a sticky tenant portfolio (12.8-year average lease) and increasing rental income (3.9% like-for-like growth for the 12 months ending March 2022). However, the German portfolio's performance could come under pressure from tighter regulation, with the supply-demand imbalance in urban areas remaining a key political issue. However, we believe Vonovia mitigates this risk well as it considers the needs of all stakeholders[11]. A good example is its high run-rate for energy efficiency (at least 3% of the portfolio yearly), making it one of the few frontrunners supporting the EU's goal to reach net-zero emissions by 2050 (ESG factor: credit-positive) and reducing the cash flow impact from carbon taxes (introduced in 2021 with a fixed step-up). This focus also supports strong like-for-like rental growth of at least 3.3% without attracting more regulatory scrutiny, helped by an exposure to markets with pronounced housing shortages. Such portfolios also attract tenants, which helps to keep occupancy high and ensures stable and predictable cash flow that facilitates further organic growth.

Figure 4: Occupancy levels & like-for-like rental growth



Sources: Vonovia, Scope

Figure 5: Profitability vs peers (Scope-adjusted EBITDA margin)

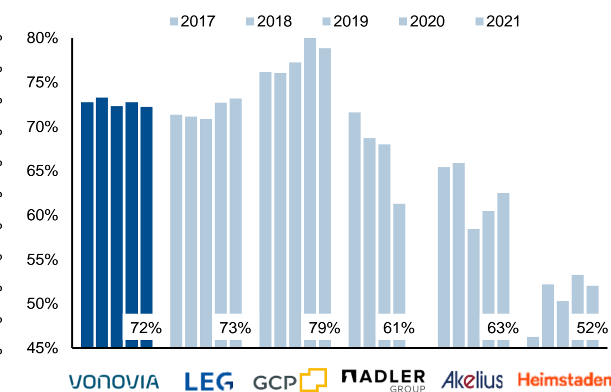
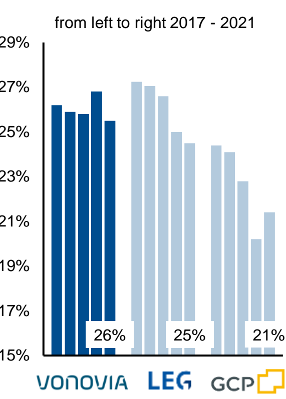


Figure 6: EPRA cost ratio (incl. vacancy) vs peers*



Sources: Vonovia, public information, Scope

Future profitability subject to increased focus on develop-to-sell and higher utility costs

Vonovia's profitability as measured by the Scope-adjusted EBITDA margin stood at 73% for the 12 months ending March 2022 (up 20bp YoY). We believe profitability will further improve and eventually outperform top peers' within the next couple of years. The more stable and higher like-for-like growth of Scope-adjusted EBITDA will be driven by i) high investments into the in-place portfolio (highest among peers), boosting organic rental growth; ii) a further roll-out of the value-added business, though subject to scarcity of

[11] Tenants could raise social hardship objections; people aged over 70 have special vested rights; 3% run-rate on energy efficient modernisation with a self-imposed cap on rent increases; no claw-back of rent not collected during Berlin 'rent freeze' period

labour; and iii) synergies gained through the Deutsche Wohnen acquisition (EUR 105m run-rate by 2024). All should help to ease inflationary pressure on the company's cost base, which will keep profitability stable at around 75%[12] in the medium term.

Profitability will, however, face some pressure from:

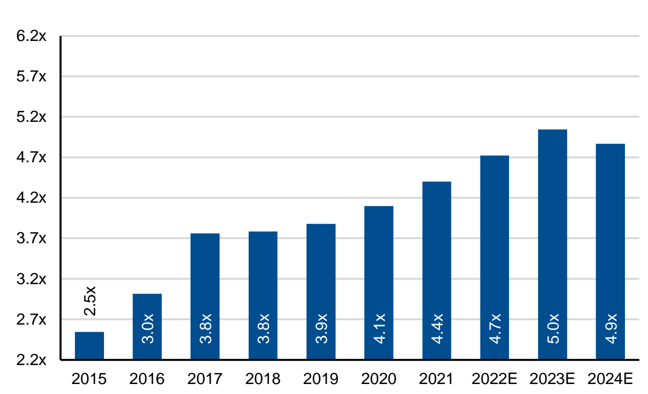
1. The shift in focus of the development portfolio from develop-to-hold to develop-to-sell, (estimated to reach two-thirds as at end-March 2022 from less than a third as at end-December 2021) as develop-to-sell comes with lower margins. The significant overall pipeline, estimated EUR 18bn[13], will make this effect more pronounced.
2. The higher risk of rent impairments as not all tenants will be able to cover the rising utility costs, mostly energy-related.

Financial risk profile: BBB

Cash flow driven by high capex, boosting top-line growth

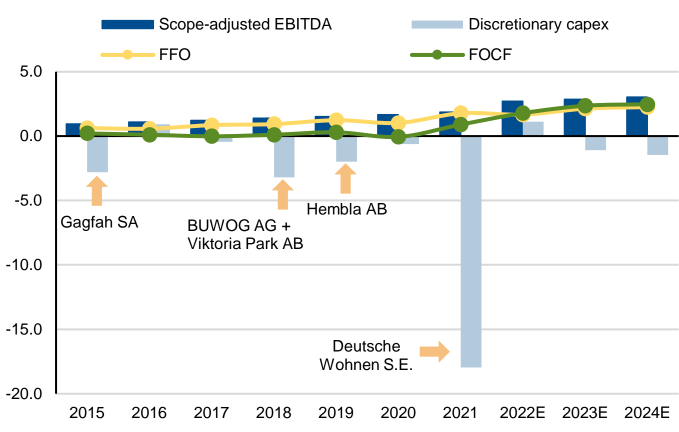
Operating cash flows, including Scope-adjusted EBITDA and FFO, have increased since Vonovia's IPO in 2013, in line with the improved size and quality of its assets via developments, modernisations and refurbishments. We view positively the company's ability to finance investment in its existing portfolio using operating cash flow, with free operating cash flow (FOCF) kept at around break-even in the last few years. However, aggressive growth via acquisitions (Conwert S.E., BUWOG AG, Viktoria Park AB, Hembla AB and recently Deutsche Wohnen S.E.) along with high dividend payouts has led to volatile and negative cash flow, which has had to be financed with EUR 10.3bn of capital increases (net) and EUR 17.5bn of debt issuances (net) between 2015 and end-March 2022. However, we acknowledge the regular use of scrip dividends to strengthen equity.

Figure 7: Scope-adjusted EBITDA/interest cover (x)



Sources: Vonovia, Scope estimates

Figure 8: Cash flows (EUR bn)



Sources: Vonovia, Scope estimates; 'Sa' = Scope-adjusted

Portfolio investment is targeted between EUR 1.3bn-1.5bn in 2022[14], around EUR 0.6bn lower than our expectation as at December 2021. Thus, cash flow after discretionary spending will remain at break-even on average, benefiting from lower acquisition volume and expansion capex for develop-to-hold projects and leading to a limited need for incremental debt issuances. Furthermore, we consider around 60% of the capex to be discretionary, meaning the company could cease related building activities within three months if needed, for example, if access to external financing weakened or these activities became less profitable due to a higher cost of capital or regulatory changes. Still, we expect Vonovia to continue making opportunistic acquisitions, which may lead to

[12] A large share of rental income (11% as at end-March 2022) does not allow for separation of service charge prepayments from gross rents, thus distorting Scope-adjusted EBITDA margin by 3-5pp

[13] EUR 12bn for Vonovia based on disclosure by the issuer for Q1 2022 (49,000 units multiplied by average size of 70 sq m and average costs of 3,500 EUR/sq m – all midpoint) and EUR 6bn for Deutsche Wohnen based on disclosure by the issuer as at YE 2021

[14] Including capex on space creation (develop-to-hold), upgrade buildings and TIs

higher-than-anticipated capital expenditure (EUR 2.0bn including bolt-on acquisitions for 2022). Nonetheless, given Vonovia's financial policy, we believe large acquisitions would be financed in part by equity, thus not impairing leverage.

Disposals of the healthcare services division and related properties (GAV of EUR 1.2bn) that is currently under evaluation, units that do not strategically match, or portfolios to joint venture structures (while maintaining a majority stake) are not part of our rating case but would release capital to substantially reduce leverage.

Strong debt protection backed by economies of scale and no incremental debt issuance going forward

Vonovia's debt protection (Scope-adjusted EBITDA/interest cover) was a strong 4.5x in the 12 months ending March 2022 and was up 0.3x YoY. The increase in recent years reflects i) strong growth in Scope-adjusted EBITDA, due to economies of scale gained from large acquisitions and high standardisation; and ii) the beneficial interest rate environment owing to the ECB's quantitative easing since early 2015, which has helped to reduce the weighted average cost of debt to 1.2% as at end-March 2022 from 2.6% at YE 2015. These two effects have largely offset the EUR 32bn increase in Scope-adjusted debt between YE 2015 and end-March 2022.

We expect Scope-adjusted EBITDA/interest cover to remain above 4x in the next few years. This will be driven by i) growing Scope-adjusted EBITDA on the back of high like-for-like rental growth; ii) the shift in the expansion strategy targeting no incremental debt issuance for the time being, thus keeping gross indebtedness stable; and iii) the almost full hedging of interest rates (96% as at end-March 2022) and the long average maturity (7.7 years), which will protect debt rates (1.2%) from rising interest rates (due to central banks attempting to stem inflation).

Low Scope-adjusted LTV resilient against significant market value declines

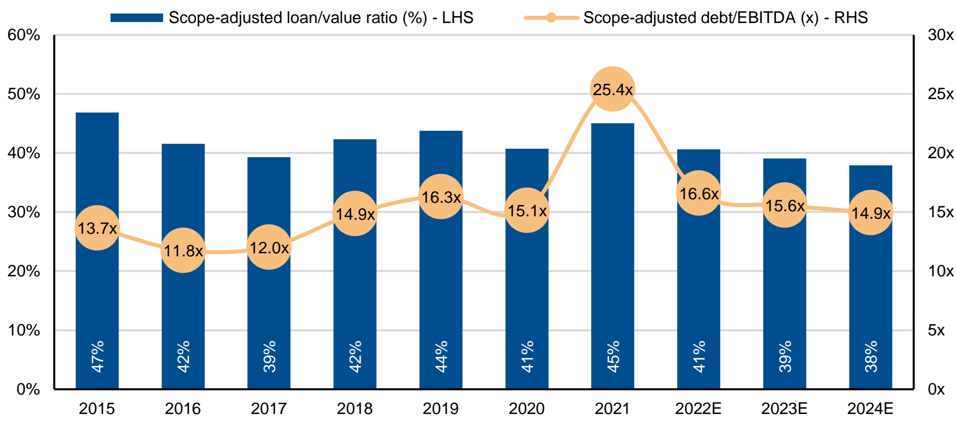
Vonovia has strongly benefited from the current economic environment. Portfolio value appreciated by EUR 28.6bn between 1 January 2013 and end-March 2022, of which two-fifths are estimated to be performance-driven (rental growth) and the remainder due to strong yield compression.

This higher portfolio value has led to a reduction of Scope-adjusted LTV to 40%-45% since 2016 (end-March 2022: 44%) from 55% at YE 2013, further supported by the EUR 11.6bn of net capital increases. Both fair value appreciation and substantial equity issuances benefited the company's financial risk profile and financial headroom, keeping leverage under control following the cash-financed acquisition of 87.6% of voting rights in Deutsche Wohnen S.E. (October 2021). The good headroom will continue, supported by at least stable asset values backed by increasing rental income as well as no incremental debt issuance. Furthermore, Vonovia can support deleveraging by disposing of its non-strategical portfolio[15].

Thus, we forecast Scope-adjusted LTV to decline to around 40% in the coming years, backed by the regular use of scrip dividends (47.8% acceptance rate for dividends to be paid in 2022). Furthermore, given the good fundamentals of the German residential real estate market, performance-driven fair value appreciation remains possible, even in the absence of yield compression. The potential for fair value declines is largely mitigated by the remaining difference between reinstatement costs for residential real estate, of at least EUR 3,500 per sq m, and the company's current valuation, which is significantly lower.

[15] Includes units that do not strategically match, selected development projects as well as healthcare services division and related properties currently under review by Vonovia (both not incorporated in our base case scenario; positive effect on Scope-adjusted LTV estimated at 1.5-2.0pp)

Figure 9: Leverage



Sources: Vonovia, Scope estimates

Leverage peaked in 2021, with a steady reduction to around 15x expected in the next few years

Cash flows from residential real estate are generally resilient to changes in general demand. Therefore, our financial risk assessment in this segment puts less emphasis on leverage, as measured by Scope-adjusted debt/EBITDA. Nonetheless, Scope-adjusted debt/EBITDA provides good visibility on leverage independent of market value changes driven by the capitalisation rate. For FY 2022, we forecast Scope-adjusted debt/EBITDA to fall from its 2021 peak (25x, up 10x YoY mainly driven by the increase in indebtedness to finance the Deutsche Wohnen S.E. takeover in October 2021 with limited EBITDA contribution for 2021) and return to pre-acquisition levels of around 15x. Main drivers are the anticipated growth in EBITDA while indebtedness remains stable.

Adequate liquidity

Vonovia's liquidity as adequate based on our expectations that sources of liquidity will cover uses by about 1.0x in the 12 months to YE 2022.

Balance in EUR m	2022E	2023E
Unrestricted cash (t-1)	1,315	980
Open committed credit lines (t-1)	3,000	3,000
Free operating cash flow[16]	2,551	3,137
Short-term debt (t-1)	7,058	4,391
Coverage	**97%**	**162%**

As at YE 2021 liquidity was exposed to a high amount of short-term debt (EUR 7.1bn) maturing in 2021. However, most was repaid in Q1 2022, including EUR 3.5bn in short-term debt that related to the takeover of Deutsche Wohnen. Thus, debt due in 2022 reduced to EUR 2.7bn as at end-March 2022, which should be easily covered by free operating cash flow (EUR 2.6bn forecast), available cash (EUR 3.5bn as at end-March 2022) and undrawn committed credit lines (EUR 3.1bn).

Generally, liquidity risk is manageable in the short to medium term, with headroom provided by i) a high share of unencumbered assets in combination with Vonovia's financial policy; and ii) excellent access to capital markets (EUR 2.6bn in bond issuances YTD) and good relationships with a diverse set of banks.

[16] Discretionary expansion capex is excluded from the liquidity calculation as these investments are made only if external financing is available. Thus, free operating cash flow for the purpose of liquidity only incorporates mandatory capital expenditure of EUR 0.5bn for modernisation, refurbishment and new developments in FY 2022. This assumes around 40% of capital expenditure on average was committed in the year before or is already under construction.

Unencumbered assets

Vonovia's unencumbered asset position is 163% as at end-March 2022, which enables access to secured loans from traditional banks to supplement capital markets financing. This is due to the company's policy to keep unencumbered assets above 50% and LTV below 45%. This policy provides comfort that traditional bank lenders will step in because secured financing is eligible for covered bond refinancing.

Excellent access to capital markets and good banking relationships

Vonovia benefits from excellent access to capital markets and traditional lenders, evidenced by its variety of funding sources and strong issuance activity in the last few years, including a successful bond issuance at the peak of the Covid-19 crisis (EUR 1bn in April 2020). Management aims to use all available financing sources to maintain and secure financing needs into the long term.

Supplementary rating drivers: +/- 0 notches

Vonovia's financial policy focuses on securing access to external financing and includes:

	Policy	Q1 2022[17]
Loan/value ratio	40 to 45%	44%
Unencumbered asset ratio	equal or larger 125%	163%
Stability of rating	A-	A-

Based on the communicated financial policy and our view that the issuer is committed to adhering to it, evidenced by the recent acquisition, we expect the company's financial risk profile to remain investment grade, reducing the downside volatility of the rating.

Long-term and short-term debt ratings

Senior unsecured debt rating: A-

As at end-May 2022, Vonovia had partially utilised a EUR 40bn EMTN programme. Senior unsecured debt, rated A-, benefits from an unencumbered asset ratio of 163%, as disclosed by the issuer, which provides a pool of collateral to debt holders.

Subordinated (hybrid) debt rating: withdrawn

Vonovia has repaid its EUR 1bn hybrid bond in 2021 and does not intend to issue similar debt instruments for the time being. Therefore, we have withdrawn the subordinated (hybrid) debt rating.

Short-term debt rating: S-1

The S-1 short-term rating is supported by better-than-adequate internal liquidity, good banking relationships, strong access to diverse funding sources and access to undrawn, committed credit lines, which Scope believes allow the company to address short-term refinancing needs. Vonovia had a non-utilised EUR 3bn commercial paper programme as at end-May 2022.

[17] According to calculation of the issuer

Appendix: Peer comparison

	Vonovia S.E.	LEG Immobilien S.E.	Grand City Properties S.A.	Akelius Residential Property AB
	A-/Stable	--/--*	--/--*	--/--*
Last reporting date	31.03.2022	31.03.2022	31.03.2022	31.12.2021
Business risk profile				
Scope-adjusted total assets (EUR m)	102,282	20,411	10,430	6,199
Portfolio yield (NIY)	2.6%	3.2%	4.1%	4.0%
Gross lettable area ('000 sq m)	34,900	10,500	N/A	1,115
Number of residential units	550,496	166,342	65,894	17,770
Countries active in	3	1	2	4
Top 3 tenants (%)	<1%	<1%	<1%	<1%
Top 10 tenants (%)	<1%	<1%	<1%	<1%
Office (share net rental income)	N/A	N/A	N/A	N/A
Retail (share NRI)	N/A	N/A	N/A	N/A
Residential (share NRI)	96%	98%	N/A	98%
Hotel (share NRI)	N/A	N/A	N/A	N/A
Logistics (share NRI)	N/A	N/A	N/A	N/A
Others (share NRI)	4%	2%	N/A	2%
Property location	'A' to 'B'	'B'	'A' to 'B'	'A'
EPRA occupancy rate (%)	97.6%	97.6%	94.9%	87.5%
WAULT (years)	12.7	11.2	9.0	8.4
Tenant sales growth (%)	N/A	N/A	N/A	N/A
Like-for-like growth rents (%)	3.9%	3.2%	2.8%	1.5%
Occupancy cost ratio (%)	N/A	N/A	N/A	N/A
Scope-adjusted EBITDA margin	73%	73%	79%	63%
EPRA cost ratio (incl. vacancy)	25.5%	24.5%	21.4%	na
EPRA cost ratio (excl. vacancy)	24.4%	22.8%	19.5%	na
Financial risk profile				
Scope-adjusted EBITDA/interest cover	4.5x	5.4x	4.6x	3.0x
Scope-adjusted loan/value ratio	44%	43%	38%	Net cash
Scope-adjusted debt/EBITDA	22.1x	16.7x	13.3x	Net cash
Weighted average cost of debt (%)	1.2%	1.2%	1.1%	1.5%
Unencumbered asset ratio (%)	163%	Around 200%	230%	296%
Weighted average maturity (years)	7.7	7.3	6.6	4.5

* Subscription ratings available on ScopeOne
Sources: Public information, Scope

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