Deutsche Konsum REIT-AG
Germany, Real Estate

SCOPE BB+ STABLE

Corporate profile

Deutsche Konsum REIT-AG started operations in 2014 and attained REIT ('real estate investment trust') status in 2016, exempting it from income-based tax. The company's objective is to acquire and manage a retail portfolio focused on regional areas and medium sized cities across Germany.

Key metrics

			Scope estimates	
Scope credit ratios	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
EBITDA/interest cover (x)	3.5x	5.2x	5.5x	5.3x
Scope-adjusted debt (SaD)/EBITDA	9.1x	12.1x	9.8x	9.4x
Scope-adjusted FFO/SaD	9%	7%	8%	9%
Loan/value ratio (%)	44%	54%	52%	50%

Rating rationale

Scope upgrades issuer rating of Deutsche Konsum REIT-AG to BB+, Outlook Stable

The issuer rating of BB+ for Deutsche Konsum REIT-AG (DKR) is supported by the size the company has achieved in the niche market of commercial real estate with a focus on non-cyclical retail. Its portfolio is diversified across Germany, with stable occupancy and a weighted average unexpired lease term (WAULT) of over five years, leading to predictable and steady cash flows. Relatively high profitability, implicit caps on leverage and floors on revenue diversification afford good debt protection measures and moderate leverage.

However, the rating is limited by DKR's size which is expected to burden the company's access to capital markets in times of economic turmoil. DKR's focus on a niche market leads to a heavy reliance on single tenants and weak tenant diversification, with the top three accounting for 42% of gross rental income. Furthermore, we see high downside volatility for the company's property portfolio as a consequence of relatively small ticket sizes and rather weak macro locations, both resulting in limited fungibility. Our overall assessment of DKR's financial risk profile is negatively affected by the company's ambitious growth plans for the next few years.

Outlook

The Outlook for DKR is Stable and incorporates our expectation that DKR's asset base will grow as a consequence of EUR 100m in annual capex leading to recurring funds from operations of around EUR 25m by FY 2018/19. We anticipate that further expansion will be equally financed with debt and equity to keep the loan/value ratio at around 50% while debt protection, as measured by EBITDA interest cover, is expected to remain above 5x.

A negative rating action is possible if the company leverages up to a loan/value ratio of above 55% on a continuing basis, leading to a loss of its tax-exempt REIT status.

A positive action would require the company to grow significantly in size, as measured by its total assets, leading to greater diversification with regard to geographies and tenants. This possibility is judged to be remote at present.

Ratings & Outlook

Corporate ratings	BB+/Stable
Senior secured rating	BBB
Senior unsecured rating	BBB-

Analysts

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Related methodology

Corporate Rating Methodology, January 2018

Rating Methodology: European Real Estate Corporates, January 2019

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Rating drivers

Positive rating drivers	Negative rating drivers
• Largest pure-play commercial property company in Germany with a focus on non-cyclical retail, supporting visibility with regard to tenants, potential investors and vendors • Moderate geographical diversification with property portfolio spread across Germany • Stable occupancy of above 85% not expected to fall materially as a result of DKR's acquisition strategy • Profitability in line with larger peers, benefitting from economies of scale • Sufficiently high EBITDA interest cover of greater than 5x, expected to remain at this level going forward • Loan/value expected to remain below 55% as a consequence of implicit covenants in accordance with DKR's REIT status	• Limited size but expected to further accelerate growth with asset base to rise to above EUR 0.5bn in FY 2018/19. • Modest diversification across sales formats/exposure to hypermarkets with negative future prospects • Concentrated tenant portfolio with top three accounting for 42% of gross rental income, albeit partially mitigated by the majority's good credit quality • Properties' macro locations expected to lead to higher downside volatility for fair values, but micro locations and limited competition support tenant demand and thus stable cash flows • Negative free operating cash flows (FOCF) as a consequence of portfolio expansion and mandatory dividend payments

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Remote at present	• Leverage, as measured by loan/value, of greater than 55% on a continuing basis, leading to a loss of tax-exempt REIT status

Financial overview

			Scope estimates	
Scope credit ratios	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
EBITDA/interest cover (x)	3.5x	5.2x	5.5x	5.3x
SaD/EBITDA	9.1x	12.1x	9.8x	9.4x
Scope-adjusted FFO/SaD	9%	7%	8%	9%
Loan/value ratio (%)	44%	54%	52%	50%
Scope-adjusted EBITDA in EUR m	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
EBITDA	13.4	19.8	29.0	35.1
Operating lease payment in respective year	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	13.4	19.8	29.0	35.1
Scope funds from operations in EUR m	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
Scope-adjusted EBITDA	13.4	19.8	29.0	35.1
less: cash interest as per cashflow statement	-3.9	-3.8	-5.3	-6.7
less: cash tax paid as per cashflow statement	0.0	0.1	0.0	0.0
Δ Provisions	0.8	0.4	0.0	0.7
Scope funds from operations	10.4	16.5	23.7	29.9
Scope-adjusted debt in EUR m	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
Interest-bearing debt	118.7	231.6	277.3	322.8
Finance lease	4.2	7.9	7.9	7.9
Cash	-1.2	-0.1	-0.9	-0.7
Restricted cash	0.1	0.3	0.3	0.3
Scope-adjusted debt	121.8	239.7	284.6	330.3

Business risk profile

Industry risk: BB

Industry risk for DKR is modest, as the company is exposed to the highly cyclical real estate industry, with its main segments comprising leasing, management and the development of commercial real estate buildings.

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. The 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.

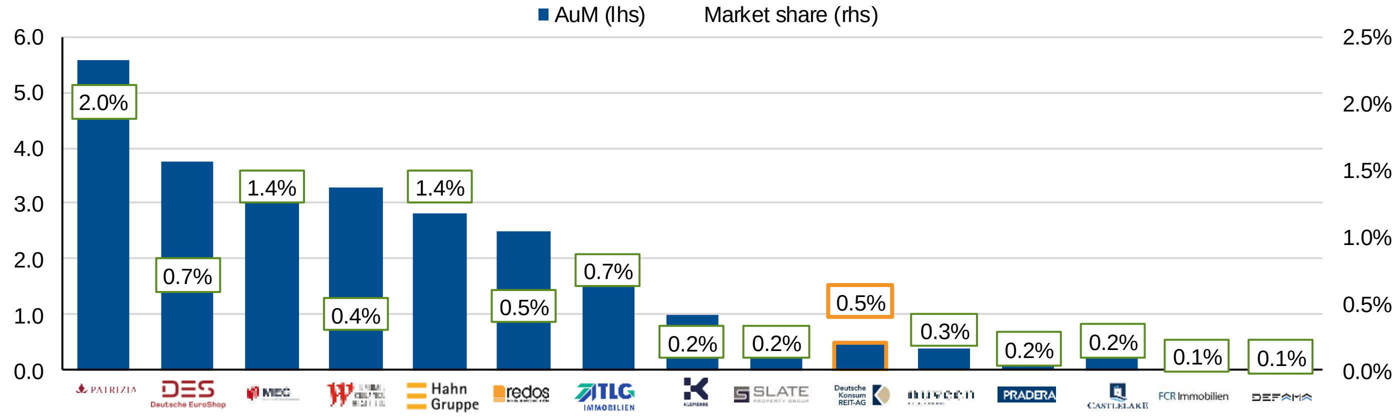
For more information, refer to the corporate outlook for real estate (click here).

Company of limited size, however, expected to accelerate growth

DKR has achieved strong growth of its asset base since its inception in 2014. However, the company is still of limited size as evidenced by total assets of EUR 453m at end-September 2018 and funds from operations of EUR 16.5m for the FY 2017/18. Nevertheless, the pace of expansion with high double-digit growth rates of its gross lease area (GLA), gross rental income (GRI) and number of properties since end-September 2017 demonstrates DKR's improving access to and visibility on investment markets.

However, DKR's continued small size burdens the company's access to capital markets as evidenced by: i) limited capital market debt exposure of only EUR 77m (32% of debt as at end-September 2018) in bonds; ii) only one tier 2 (Carmignac Gestion – 0.43% of DKR's shares) investor and a heavy dependence on its main shareholder Obotritia Kapital KGaA (Scope: BB-/Stable) providing 31% (direct and in indirect holdings) in equity as well as a revolving credit facility of EUR 25m.

Figure 1: Deutsche Konsum REIT-AG and competitors by AuM[1] (EUR bn) and estimated market share in Germany[2]



Sources: public information, Scope

However, with further growth anticipated, DKR should be able to improve its access to capital markets, thus enabling a further diversification of funding sources in the next few years as well as lifting its funds from operations to above EUR 25m.

Largest pure-play commercial property company in Germany with a focus on non-cyclical retail

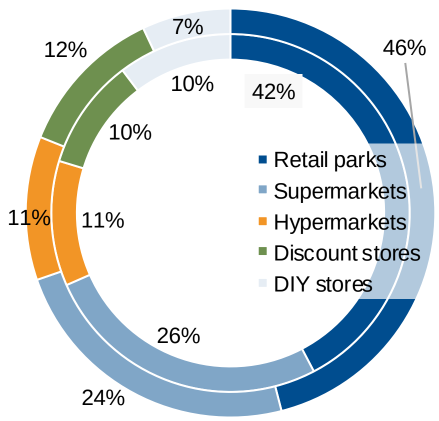
DKR's market share in German retail space is negligible at an estimated 0.5%. However, we observe that the German market for retail space is rather fragmented with the largest market participants barely reaching a share of above 1%. Our analysis therefore focuses on the retail sub-segment of retail parks that is relevant for DKR.

[1] AuM = Assets under management
[2] Based on each company's share in German retail GLA

DKR is the largest German pure-play commercial real estate company to focus on retail parks, DIY stores and supermarkets (‘Nahversorgungszentren’) with a portfolio consisting of 108 properties (estimated market share of 5%3, followed by FCR Immobilien AG [38 properties4] and Deutsche Fachmarkt AG [30 properties5]). In terms of its portfolio size, DKR is also among the leading market participants in a fragmented niche market with its largest competitors being funds managed by, for instance, redos real estate GmbH (72 properties), HAHN-Immobilien-Beteiligungs AG (160) or institutional investors with assets managed by Jones Lang LaSalle (54) and MEC (55).

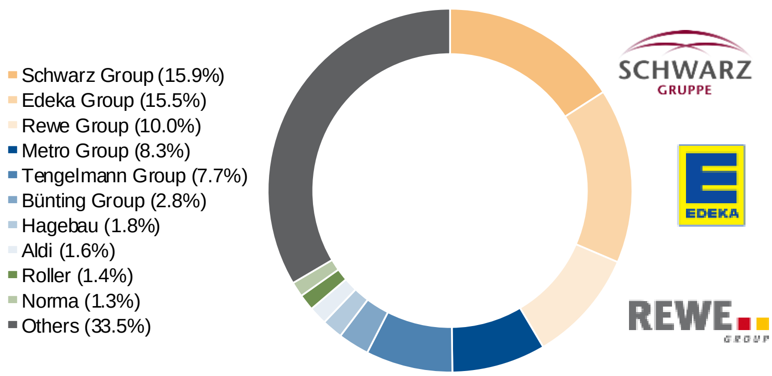
We therefore believe the company benefits from decent visibility to its tenants, potential investors and vendors (evidenced by a deal pipeline of above EUR 1bn in 2018). This supports the reletting of vacant space, property disposals and the further growth of the portfolio with an estimated 25 properties to be acquired in FY 2018/19 (EUR 100m investments).

Figure 2: Property type by GLA (inner ribbon) and GRI (outer ribbon)



Sources: DKR, Scope

Figure 3: Tenant diversification by GRI as at end-September 2018



Sources: DKR, Scope

Moderate geographical diversification with property portfolio spread across Germany

The geographical diversification of DKR’s retail property portfolio across Germany is moderate with a focus on the eastern federal states (90% of GLA). We believe DKR’s geographical diversification should mitigate cyclical swings somewhat as the federal states have slightly different demand patterns, influenced by different industry exposures.

As a result of the economic recovery of the former East Germany, negative population migration stopped in 2011 and has achieved positive growth since. This development should enhance the prospects of the majority of DKR’s tenants thus supporting GRI and occupancy rates in the next few years.

Modest diversification across sales formats

DKR’s diversification of property types can be summarised as modest. The company is predominantly exposed to retail parks (46.0% of GRI), supermarkets (23.7%) and hypermarkets (11.4%). These three property types are closely linked to food retail which also explains the weak tenant industry diversification (food retail: 52% of GRI at end-September 2018). Hypermarkets are facing declining demand from customers, with two out of three of the largest German hypermarket chains (Real and Marktkauf) experiencing declining sales. We anticipate that this will have a long-term negative impact on the company’s cash flows with higher capex needs and declining revenues from this segment. We therefore view positively the decreasing share of hypermarkets in DKR’s

[3] Based on 393 retail parks in Germany with a GLA of above 10,000 sqm (Bulwien Gesa 2015) // DKR has 19 properties with a GLA of over 10,000 sqm as at end-January 2019
[4] As at 30.06.2018
[5] As at 30.09.2018

portfolio (GRI contribution minus 4.2 pp YoY) and the increasing share of the more resilient DIY segment.

Weak tenant industry diversification

Although we judge tenant industry diversification to be weak, with 52% of GRI stemming from food-retailers, the importance of food, its recurring purchase and macro resilience mitigates DKR's reliance on this sector. DKR's overall exposure to non-cyclical industries, to which circa 74% of GRI is related, is generally seen as positive (non-cyclical industries include food retail, DIY, chemists, bakeries and healthcare).

Concentrated tenant portfolio with top three accounting for 42% of GRI

The nature of DKR's portfolio and tenant industry exposure (concentrated retail sectors like food retail and DIY) is also reflected in its weak tenant diversification, with the top three tenants accounting for 41.5% and the top 10 for 66.5% of the company's GRI at end-September 2018. This leaves the company very vulnerable to single tenant defaults and/or restructuring driven by the transformation of the German retail landscape. Weak tenant diversification is partially mitigated by the investment grade character of tenants representing 57.5% of GRI including the top three: Edeka Group, Schwarz Group and Rewe Group.

However, the recent default of AWG in January 2019 (fashion retailer I EUR 0.4m in rental income representing 1.2% of DKR's GRI) illustrates the vulnerability of DKR's tenant portfolio, especially for those that are part of the 26% share of cyclical tenants, discounters or small, local players.

Properties' macro locations expected to lead to higher downside volatility of fair values

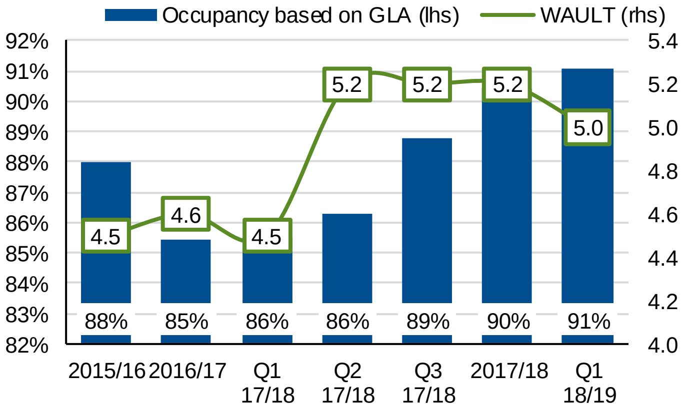
Although the largest part of DKR's portfolio is assessed to be of a 'D' nature, we believe this is only the case from an investor point of view. The liquidity of these markets is judged to be weak. This is amplified by the low ticket sizes, averaging approx. EUR 4.5m, that attract fewer investors than properties valued at above EUR 20m (five in total as at end-September 2018).

With regard to locations as perceived by existing and potential tenants, we judge DKR's portfolio to be fairly strong, especially as retail parks and local shopping centres benefit from limited competition with strict rules for zoning and planning. This ensures that existing food retail locations remain viable.

Improving occupancy of around 90% as at YE 2018 not expected to decrease materially as a result of DKR's acquisition strategy

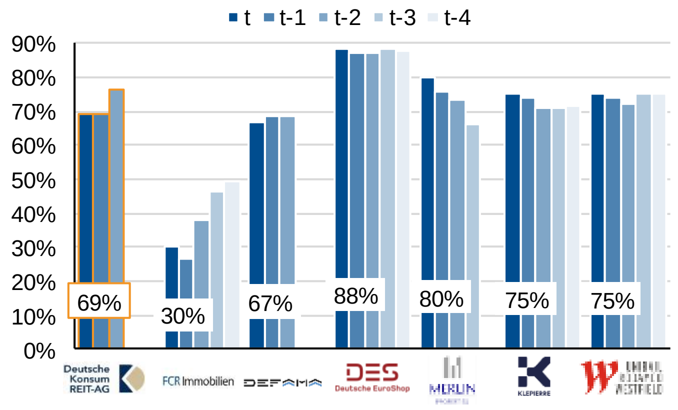
DKR has benefitted from relatively stable occupancy of above 85% since its inception in 2014. It has improved considerably since end-June 2018 to above 90% as at YE 2018 because of the delivery of refurbished retail space with significantly increased occupancy as well as more stable (higher occupancy levels) portfolio additions since. The main driver of the company's vacancy rate is its acquisition strategy which focusses on properties with significant vacancies. Consequently, we do not expect any material reduction in the vacancy rate. Instead, we expect occupancy to remain between 85% to 90% going forward, with vacancies being reduced by new leases thanks to successful refurbishments and new area concepts, counterbalanced by new vacancies from acquisitions until DKR changes its aggressive growth strategy. Nevertheless, we believe that current occupancy is sufficient to ensure the future stability of rental income supported by the improving WAULT of above five years as at YE 2018. Further support is provided by the food-retail anchor tenants' even higher WAULT of 5.7 years.

Figure 4: Occupancy and WAULT



Sources: DKR, Scope

Figure 5: EBITDA margin vs. peers



Sources: DKR, Scope estimates

Profitability in line with larger peers, benefitting from economies of scale

The company has stable and relatively high profitability with EBITDA margins close to 70%. These comparatively high margins are mainly driven by economies of scale with small overheads thanks to larger lot sizes, compared to residential properties for instance.

The company's profitability is burdened by its relatively high vacancy rate (circa 12% through FY 2017/18). A reduction to 10% would lift profitability into the 'A' category range. However, as we do not anticipate this kind of sustainable reduction within the next few years, profitability is expected to remain stable at between 65% and 70%.

DKR's return on assets tends to hover around 5% reflecting the industry average for commercial property companies.

Financial risk profile

Our rating scenario assumes the following:

- like-for-like rental growth reflecting CPI linkage (80%)
- increase in operational expenses in line with inflation rate forecasts for Germany as published in the European Commission's Autumn Forecast (11/2018) – 2019: 1.9%, 2020: 1.6%
- fair value adjustments reflecting growth in like-for-like rents with no further occupancy increases assumed
- new borrowings at interest rates increasing by 50 bp per annum
- exclusion of EUR 7.5m invested in short-term loans via Creditshelf from calculation of credit metrics
- capital expenditure of EUR 100m per year
- additional increase of rents from new acquisitions reflecting a net initial yield of below 9.5%
- mandatory dividend distribution of 90% of German GAAP result
- no tax applicable due to the company's REIT status
- capital issuance (equity and debt) in line to keep loan/value ratio at around 50%

Strong debt protection with EBITDA interest cover above 5x, expected to remain at this level going forward

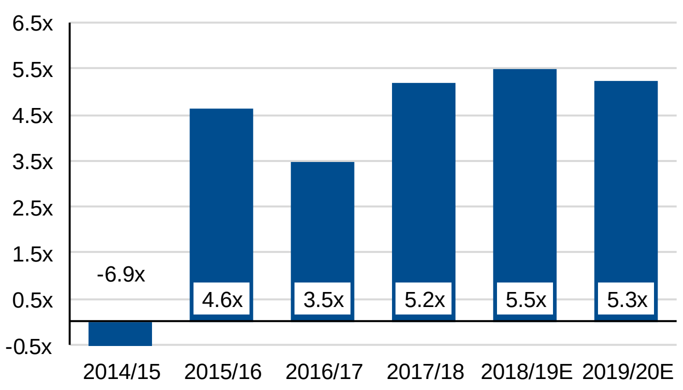
The company benefits from relatively high EBITDA interest expense cover of above 3x since the financial year ending 30 September 2016. The main drivers of this sufficient level of debt protection are: i) the company's low indebtedness with Scope-adjusted debt (SaD) of EUR 240m as at end-September 2018; ii) the generally beneficial interest rate environment with the ECB's quantitative easing programme starting shortly after DKR launched operations in late 2014 – subsequently leading to a relatively low weighted average cost of debt of 1.9% as at end-December 2018; and iii) the company's acquisition strategy aimed at properties producing cash yields of above 10% from day one. We do not believe that EBITDA interest cover will weaken to below 3x going forward despite the anticipated increase in indebtedness required to expand the company's asset base. Our view is predominately supported by regulation-driven caps for leverage which the company intends to adhere to, with a maximum loan/value ratio of 55%, as well as minimum exposure to income-producing real estate properties with moderate occupancy, and an industry average WAULT assuring stable operating cash flows going forward.

Negative FOCF driven by expansion capex demonstrating DKR's dependence on external financing

Since it was founded, DKR's operating cash flows, including Scope-adjusted funds from operations (SaFFO) and Scope-adjusted cash flow from operations (SaCFO), have increased in line with asset base growth. The latter, however, has led to continuous negative Scope-adjusted free operating cash flows (SaFOCF) of between EUR 60m and EUR 140m which have been financed externally with EUR 111m in capital increases and EUR 229m in debt issuances (net). In light of the company's objective of increasing its asset base further, we do not expect positive SaFOCF within the next couple of years, with capital expenditure of around EUR 100m per year according to the company's guidance. However, around 95% of expansion capex is of a discretionary nature. As a result, the company could stop acquisition activity immediately if access to external financing were to weaken, resulting in positive FOCFs.

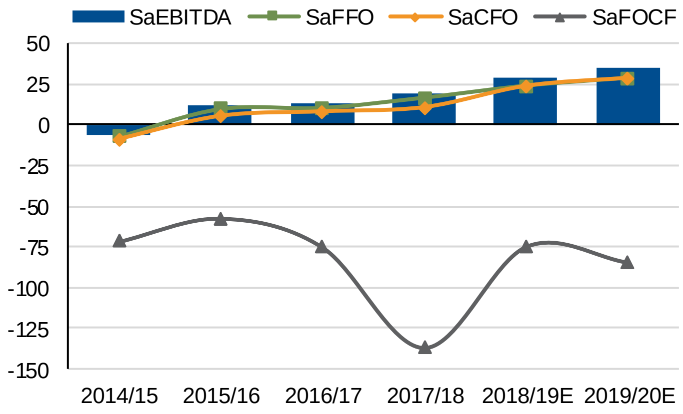
The company's REIT status affords tax exemption at the cost of dividend payments that reflect 90% of the German GAAP results. Consequently, dividends are not of a discretionary nature and are incorporated into DKR's FOCF.

Figure 6: EBITDA interest cover (x)



Sources: DKR, Scope estimates

Figure 7: Cash flows (EUR bn)



Sources: DKR, Scope estimates; all figures are adjusted by Scope

Loan/value expected to remain below 55% / Implicit financial REIT status covenants limit indebtedness

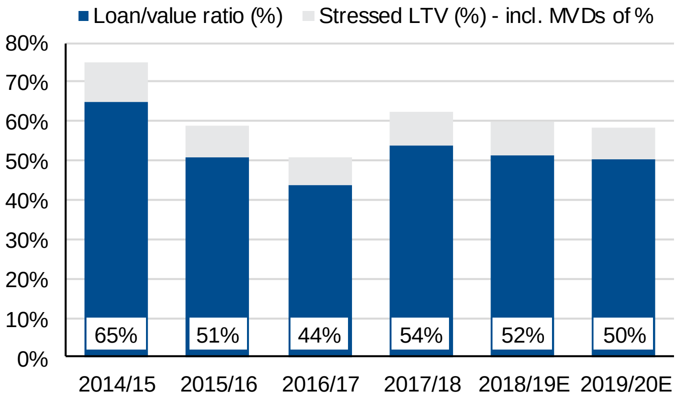
Leverage, as measured by the loan/value ratio, weakened over the course of FY 2018/19 in line with our expectations and stood at 54% at end-September 2018. The loan/value ratio has, however, been volatile due to revaluations of DKR's investment properties contributing EUR 57m of fair value gains/implicit equity since 2015. As these value adjustments have been predominately driven by yield compression rather than like-for-like rental growth, we judge gains in fair value to be at risk if the ECB ends quantitative easing and pricing for liquidity risk increases once more. This is further illustrated if we stress property values with a 14% market value decline which results in a loan/value ratio of above 55%, thus placing the company's issuer rating at risk if not properly addressed with swift deleveraging.

German REIT regulations allow for a maximum leverage of only 55%. We do not expect deleveraging going forward as the company has disclosed its intention to keep leverage around 50%, backed by its financing pipeline of over EUR 40m, to allow further property acquisitions in 2018/19.

SaD/EBITDA fluctuating around 9x supported by high net initial yield of over 10% for the company's portfolio

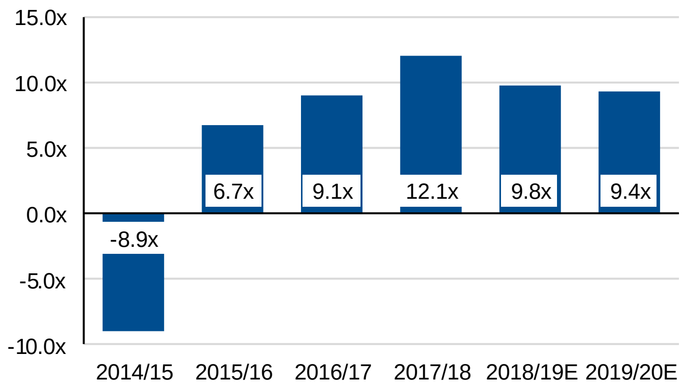
SaD/EBITDA has fluctuated around 9x in the past (2017/18: 12.1x), reflecting DKR's low indebtedness with acquisitions financed with approx. 50% equity as well as high cash yields of over 10% for these acquisitions. We believe that SaD/EBITDA will be somewhat volatile in future, largely depending on the timing of acquisitions and the corresponding EBITDA contribution. Irrespective of timing, we believe that SaD/EBITDA will remain at around 9x going forward.

Figure 8: Loan/value ratio



Sources: DKR, Scope estimates

Figure 9: SaD/EBITDA



Sources: DKR, Scope estimates

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

Position	YE 2017/18		Q1 2018/19		YE 2018/19E	
Unrestricted cash	EUR	-0.2m	EUR	0.0m	EUR	0.6m
Open committed credit lines	EUR	0.0m	EUR	0.0m	EUR	0.0m
Free operating cash flow (t+1)	EUR	12.6m	EUR	13.6m	EUR	10.0m
Short-term debt (t+1)	EUR	8.6m	EUR	8.6m	EUR	8.7m
Coverage		**1.4x**		**1.6x**		**1.2x**

In the past, liquidity was burdened by an ongoing high share of short-term debt. However, DKR has managed to restructure its liabilities by extending its convertibles by five years and introducing long-term financing to replace some short-term debt and flatten the maturity schedule. In addition, DKR managed to improve its FOCF beyond our previous expectations to EUR 12.6m for 2018/19 (excluding non-mandatory, non-executed expansion capex of EUR 92.5m and a net rental contribution of EUR 5.3m), thanks to massive portfolio investments lifting net rental income to EUR 35.5m (annualised). As a result, we judge liquidity to be adequate, relieving the company of a two-notch stress on its financial risk profile that reflected its former heavy and ongoing dependence on external financing.

In general, we believe liquidity to be a manageable risk for DKR in the short to medium term with sufficient headroom provided by a reasonably high share of unencumbered assets (EUR 60m / 12% of total assets as at end-December 2018). This liquidity assessment is also supported by our view that the company has good, well-established relationships with banks as demonstrated by a financing pipeline of over EUR 40m at the end of December 2018. DKR is anticipated to make use of its unencumbered asset position if it draws upon this pipeline. In addition, the company's REIT status requires adherence to financial covenants with regard to total leverage, thus limiting additional indebtedness to a maximum loan/value ratio of 55%.

Senior secured debt: BBB

DKR issued a EUR 40.0m bond in May 2018 with a six-year term (2018/24) and a coupon of 1.80% (ISIN: DE000A2G8WQ9). This bond benefits from a first ranking mortgage on fifteen properties valued at EUR 67.2m as at May 2018. We believe that the structure benefits from adequate overcollateralisation, with an issue-specific loan/value ratio of 60%. This positively influences recovery rates in a default scenario. According to our methodology and reasonable discounts on the company's asset base (as described below), we expect a 'superior' recovery6 in a default scenario, thus allowing for a two-notch uplift on the company's issuer rating of BB+.

Senior unsecured debt: BBB-

Our recovery analysis signals an 'above-average' recovery which translates into instrument ratings of BBB-. Recovery is based on a hypothetical default scenario in FY 2019/20 with the company's liquidation value amounting to EUR 363m. This value is based on a 36% haircut applied to DKR'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 286m, a fully drawn, unsecured credit line of EUR 25m and the unsecured EUR 37m in convertible bonds. Recovery is sensitive to the advance rate used and DKR's portfolio is judged to be rather illiquid. We therefore limit our up-notching on the issuer rating.

Outlook

The Outlook for DKR is Stable and incorporates our expectation that DKR's asset base will grow as a consequence of EUR 100m in annual capex leading to recurring funds from operations of around EUR 25m by FY 2018/19. We anticipate that further expansion will be equally financed with debt and equity to keep DKR's loan/value ratio at around 50% while debt protection, as measured by EBITDA interest cover, is expected to remain above 5x.

A negative rating action is possible if the company leverages up to a loan/value ratio of above 55% on a continuing basis, leading to a loss of its tax-exempt REIT status.

A positive action would require the company to grow significantly in size, as measured by its total assets, leading to greater diversification with regard to geographies and tenants. This possibility is judged to be remote at present.

[6] Recovery is sensitive to the advance rate used and DKR's portfolio is judged to be rather illiquid. We therefore limit the up-notching of the issuer rating.

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