Vonovia S.E.
Federal Republic of Germany, Real Estate

SCOPE A- NEGATIVE

Key metrics

			Scope estimates	
Scope credit ratios	**2021**	**2022**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	4.4x	4.8x	3.6x	3.6x
Scope-adjusted loan/value ratio	45%	45%	45%	46%
Scope-adjusted debt/EBITDA	25.4x	18.7x	18.3x	16.5x

Rating rationale

Vonovia's strong business risk profile is the key driver of 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, and high tenant diversification that supports stable rental cash flow. 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 diversified debt structure and a 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 loan/value and Scope-adjusted debt/EBITDA, which makes the company vulnerable to adverse market movements and is not commensurate with the current rating. The rating is also held back by Vonovia's ongoing focus on the German market, with its associated regulatory risk.

Outlook and rating-change drivers

We have revised Vonovia's Outlook to Negative from Stable due to the risk that the Scope-adjusted loan/avlue ratio might remain above 45%, despite Vonovia's ability to reduce its debt burden over the next 18 months by selling assets and raising fresh capital by selling minority stakes in certain portfolios. The Outlook includes investments of EUR 0.9bn per year with the goal of creating a carbon-neutral portfolio by 2045, minimising ESG-related risks for real estate assets. Strong cash generation, benefiting from stable occupancy and like-for-like rental growth of 3%-5%, as well as the relatively slow transition of higher interest rates into Vonovia's liability structure ensure that Scope-adjusted EBITDA interest coverage is maintained above 3x.

A downgrade would occur if the Scope-adjusted LTV ratio were persistently above 45%. This could be triggered by a further decline in portfolio value, which we expect due to a potential weakening of residential property values that may not be offset by a reduction in debt. A negative rating action could also be triggered if the share of non-domestic net rental income failed to rise above 15% in the medium term, likely driven by a limited success in disposing of German assets.

A positive rating action, i.e. a return of the Outlook to Stable, could be justified by a return of the Scope-adjusted loan/value ratio to below 45%. This could be supported by a successful capital release through the disposal of non-core assets and fair value declines below our expectations.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
29 Jun 2023	Outlook change	A-/Negative
8 Jul 2022	Affirmation	A-/Stable
9 Dec 2021	Affirmation	A-/Stable

Ratings & Outlook

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

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Related Methodologies/ Research

General Corporate Rating Methodology; July 2022

European Real Estate Rating Methodology; January 2023

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

German housing bubble unlikely to burst; June 2022

European residential real estate firms face up to 10% fall on average in fair values by end-2024; April 2023

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Bloomberg: RESP SCOP

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 flats in Germany, Austria and Sweden • Well-diversified portfolio spread across German, Austrian and Swedish metropolitan areas with strong 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 and high and stable occupancy • Strong debt protection with Scope-adjusted EBITDA/interest cover of more than 3x, backed by organic EBITDA growth • Excellent access to external financing, benefiting from highly diversified debt structure and financial headroom with an unencumbered asset ratio of 157% at end-2022	• Exposed to regulatory risk due to predominant focus on Germany (86% of net rental income as at end-March 2023), but anticipated further European roll-out likely to reduce this exposure • High leverage (Scope-adjusted LTV ratio of 46% at end-March 2023; Scope-adjusted debt/EBITDA of 18.6x in 12 months ending March 2023) that is subject to constant pressure with limited visibility on Vonovia's ability to reduce its debt burden over the next 18 months given the state of both capital and investment markets • Negative discretionary cash flow since FY 2017 anticipated to become break-even because of lower expansion capex to comply with Vonovia's intention to stop incremental debt issuances

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted loan/value ratio of below 45%	• 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 93bn (end-March 2023). Vonovia also manages around 72,000 third-party flats.

Financial overview

				Scope estimates		
Scope credit ratios	**2021**	**2022**	**Q1 2023[1]**	**2023E**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	4.4x	4.8x	4.5x	3.6x	3.6x	3.3x
Scope-adjusted loan/value ratio	45%	45%	46%	45%	46%	47%
Scope-adjusted debt/EBITDA	25.4x	18.7x	18.6x	18.3x	16.5x	15.1x
Scope-adjusted EBITDA in EUR m						
EBITDA	2,037	2,479	2,391	2,381	2,532	2,667
Other items[2]	-178	-70	13	-33	0	0
Scope-adjusted EBITDA	**1,858**	**2,409**	**2,404**	**2,348**	**2,532**	**2,667**
Funds from operations in EUR m						
Scope-adjusted EBITDA	1,858	2,409	2,404	2,348	2,532	2,667
less: (net) cash interest paid	-422	-502	-534	-652	-709	-815
less: cash tax paid per cash flow statement	-93	-188	-173	-176	-227	-232
Change in provisions	437	-216	-136	-12	0	0
Funds from operations	**1,779**	**1,503**	**1,561**	**1,510**	**1,595**	**1,620**
Net cash interest paid in EUR m						
Net cash interest per cash flow statement	-431	-508	-541	-644	-703	-809
Change in other items[3]	8	6	7	-8	-7	-6
Net cash interest paid	**-422**	**-502**	**-534**	**-652**	**-709**	**-815**
Scope-adjusted total assets in EUR m						
Total assets	106,320	101,390	97,739	97,327	92,989	87,281
less: cash and equivalents	-1,315	-1,198	-1,192	-1,304	-1,058	-822
less: derivatives (assets)	0	0	0	0	0	0
Scope-adjusted total assets	**105,005**	**100,191**	**96,547**	**96,023**	**91,930**	**86,459**
Scope-adjusted debt in EUR m						
Reported gross financial debt	47,909	45,742	45,410	43,630	42,350	40,455
add: derivatives	332	272	261	261	261	261
less: cash	-1,433	-1,302	-1,297	-1,409	-1,163	-926
add: restricted cash	118	104	104	104	104	104
add: pension adjustments	304	324	298	324	324	324
Scope-adjusted debt	**47,230**	**45,140**	**44,777**	**42,911**	**41,877**	**40,218**

[1] 12 months ending March 2023 for cash flow-related metrics
[2] Includes non-recurring items and disposal gains on fixed assets
[3] Pension interest

Table of Content

Key metrics 1
Rating rationale 1
Outlook and rating-change drivers 1
Rating history 1
Corporate profile 2
Financial overview................................. 3
Environmental, social and governance (ESG) profile 4
Business risk profile: A 5
Financial risk profile: BBB-...................... 9
Supplementary rating drivers: +/- 0 notches 13
Long-term and short-term debt ratings.. 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 housing stock by 2045

Vonovia is committed to addressing climate issues and to ensuring the viability of its business in the long run. The company has a clear target of making its housing stock carbon neutral by 2045, in line with the German government's goal, and plans to focus on new sustainable construction, refurbishments and innovations in the energy mix. As part of its transition, Vonovia is aiming for a carbon intensity of less than 25 kg CO2/sq m by 2030 (2022: 33.0 kg CO2/sqm). The company is also investing to improve the energy efficiency of its current portfolio, as evidenced by a refurbishment rate of 1.9% in 2022 in Germany (2021: 2.3%; 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 the German regulatory framework). To reduce the financial impact of these measures on its customers, Vonovia limits rent increases to EUR 2 per sq m 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

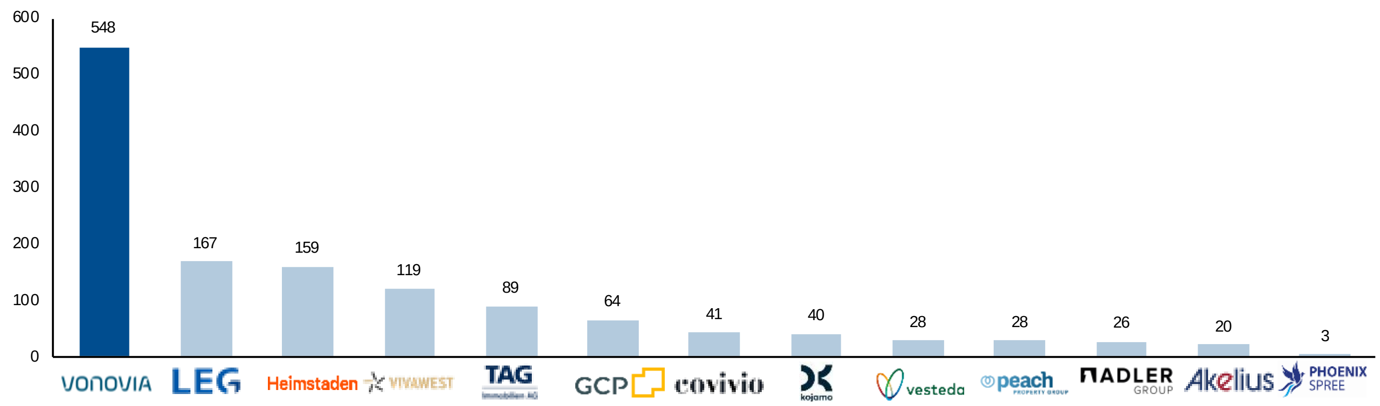
Vonovia is a housing company with a buy-and-hold strategy. It generates 83% of its EBITDA by leasing out flats or community service properties (industry risk of A). It also has some exposure to i) healthcare services (rated A) via its nursery home operators Katharinenhof, Hamburger Senioren Domizile and Pflege & Wohnen; and ii) real estate development (home building 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 (70% of the development pipeline has no price risk).

Tier 1 real estate corporate: largest residential landlord in Europe

At end-March 2023, Vonovia was by far Europe's largest residential landlord commanding a portfolio of around 550,000 residential units (stable YoY). The portfolio is likely to shrink as Vonovia is expected to become a net seller in 2023 with inorganic growth put on hold to preserve cash. This is due to the current capital market environment, with a higher cost of capital from rising interest rates and falling share prices[5]. Vonovia has identified around 40,000 units that could be opportunistically sold as they show either i) above-average capex needs to achieve climate neutrality; ii) high restrictions on rent increases; or iii) low-yielding assets outside urban quarters.

Figure 1: Vonovia and European competitors by number of residential units ('000s) as at end-March 2023[6]



Sources: public information, Scope

The strong market positioning supports Vonovia's access to investment markets as demonstrated by its recent disposals (1,350 flats to CBRE Investment Management for EUR 0.6bn) and the successful participation of minority shareholders in certain portfolios (sale of 30 % of the preferred shares in the Südewo portfolio to an investment vehicle managed by Apollo for EUR 1.0bn). These large capital releases are unmatched by peers, underpinning Vonovia's standing in the markets. Vonovia aims to dispose of further assets, including portfolios to municipalities, the healthcare division of Deutsche Wohnen and minority interests in its Swedish operations.

We expect the company to retain its strong position as a major stakeholder in the German residential real estate market (87% of net rental income as at end-March 2023), Sweden (10%) and Austria (3%).

[5] Down by around 20% YTD; 40% YoY
[6] As at end-2022: Covivio, Vivawest, Vesteda, Peach Property, Phoenix Spree

Cash flow stability is supported by the company's absolute size, with Scope-adjusted total assets of EUR 97bn at end-March 2023 (down 6% YoY) and Scope-adjusted funds from operations of EUR 1.6bn for the 12 months ending March 2023 (down 17% YoY), bolstered by good diversification and economies of scale. Scope-adjusted total assets are about to shrink driven by constant pressure on the fair value of properties (EUR 5.2bn in fair value decline YoY) and expected disposal activity. Still, Vonovia's absolute size and cash generation capacity will keep it ahead of peers, affording it excellent access to capital markets to source financing. This was evidenced by Vonovia's ability to tap into capital markets in times of stress (early 2020 and Q4 2022).

Further growth anticipated to happen outside the domestic market, but only in the medium term

Vonovia holds only 1.2% of Germany's fragmented residential real estate market, which allows it to grow in the country without risking intervention by the competition authority. However, growth in Germany is limited by i) around 91% of German flats 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 growth to focus on outside markets, namely Sweden, Austria, France and the Netherlands. Vonovia's growth ambitions are on hold for now given the changed capital market environment.

High possible penetration of residential market given relatively low rents on average

Vonovia' portfolio mainly focuses on low-to-mid income tenants as indicated by the average rent of 7.54 EUR/sq m and month as at end-March 2023 (7.23 EUR/sq m for Germany when excluding Deutsche Wohnen), thus, attracting households with a monthly income of at least EUR 1,807[7] on or 20%[8] of the German households.

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 mid-sized cities. The top 10 regions account for 81% of net rental income (NRI) as at end-March 2023. However, we believe portfolio concentration is negligible because the major German metropolitan areas consist of multiple large cities, such as the southern Ruhr area (about 7% of NRI), the Rhine Main area (8%), Rhineland (7%) and the northern Ruhr area (4%). The wide distribution of flats across Dresden (7%) and Hamburg (4%) partially mitigates the dominant exposure to these cities.

The addition of Deutsche Wohnen's portfolio significantly increased Vonovia's exposure to Berlin and its regulatory framework (about 25% for the combined portfolio's net rental income). This cluster risk remains despite the disposal of 15,000 residential units to the City of Berlin. Vonovia is making efforts to mitigate this risk by seeking to appease stakeholders by i) limiting rent increases[9] and ii) not fully passing refurbishment costs onto tenants. Vonovia's commitment in 2021 to developing about 13,000 units in the city by 2026 seems unachievable following the halt on new construction activity announced in 2022.

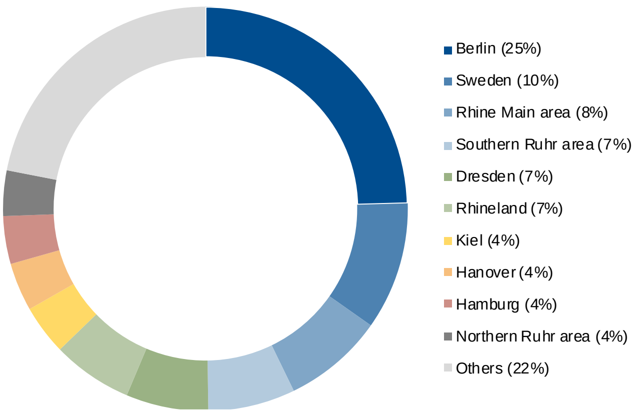
Deutsche Wohnen transaction increased dependence on German regulatory framework

Vonovia expanded its geographical outreach following acquisitions of Austria's Conwert Immobilien Invest SE (2017) and BUWOG AG (2018), Sweden's Viktoria Park AB (2018) and Hembla AB (2019), shareholdings in France's ICF Novedis (2018) and Dutch residential fund Vesteda (2020). The 2018 European roll-out followed by portfolio additions in Sweden in 2019 supports the company's business risk profile and its medium-to-long-term goal of becoming a European leader. This expansion has also helped to tackle the largest risk to its business risk profile – the dominant exposure to the German regulatory framework for residential landlords. Even though regulatory risk in

[7] (Average rent in Germany + 2.50 EUR/sq m in service charge) x average flat size (60 sq m) / one-third (living cost → industry standard)
[8] Distribution of monthly income per household 2021. Source: statista.de
[9] Maximum of one per cent per year up until 2024 and in the following two years no more than the rate of inflation.

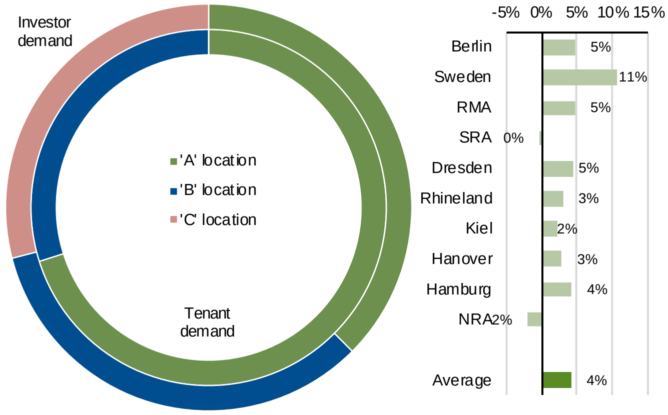
other European countries is as high as in Germany, we do not expect it to move in the same direction simultaneously. Thus, an internationally diversified portfolio should partially de-link cash flow predictability and stability from regulatory changes in a single country.

Figure 2: Geographical diversification by rental income as at end-March 2023



Sources: Vonovia, Scope

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



RMA: Rhine Main area
SRA: Southern Ruhr area
Sources: Vonovia, Worldbank, Statistik Nord, IT.NRW, Scope and others
Note: Location ratings as defined by Scope

The successful acquisition of Deutsche Wohnen SE led to a decrease in the share of non-domestic exposure that represents around 11% of residential units (down 4pp compared to pre-acquisition) and 13% of net rental income (down 6pp) as at end-March 2023. We expect Vonovia to pursue further European expansion, increasing the share of non-domestic rental income to above 15%, a level commensurate with the assigned business risk profile but only in the medium term. This is because of the current capital market environment, as higher cost of capital from rising interest rates and the stark reduction in Vonovia's share price meet unchanged market fundamentals, thus making accretive acquisitions scarce. We note that Vonovia's healthcare business mitigates the comparatively lower contribution of non-domestic income for now, as it benefits from market fundamentals and regulation that are different to those in the residential business. In addition, we emphasise that the targeted divestments of up to 40,000 flats in Germany can positively influence the geographic distribution of rental income.

Highly diversified tenant portfolio with average credit quality

Vonovia's tenant diversification is very high thanks to its absolute size (around 550,000 units as at end-March 2023) 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 GRI in recent years (2022: 0.5%). Tenant credit quality is good to moderate, 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 demand for residential real estate as well as healthy underlying macroeconomic fundamentals. This is evidenced by: i) the entire portfolio being in cities or regions in which demand is expected to be at least stable until 2030, with an increasing share of regions to benefit from a forecasted population increase of at least 2.5% thanks to the acquisition of Deutsche Wohnen (68% as at end-March 2023/unchanged YoY); and ii) around half of flats being located in 'A' locations, namely Berlin (26% as at end-March 2023/down 1pp YoY), Stockholm (5%/unchanged), Hamburg (4%/unchanged), Stuttgart (2%/unchanged), Vienna (2%/unchanged) and Munich (2%/unchanged) – all of which determine investor and tenant demand. We expect strong tenant demand to continue, supporting high and stable occupancy as well as like-for-like rental growth. Furthermore, we believe the portfolio will continue to benefit from some liquidity, 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 continuous increases in capex, including for maintenance, modernisation and new developments, reaching EUR 2.3bn in FY 2022 (estimated at EUR 64.8 per sq m) from EUR 0.2bn in 2013 (EUR 20.0 per sq m). Based on company information, we expect spending of around EUR 1.8bn this year. 2023 investment volume is substantially below that of previous years following revised capital allocation as a consequence of higher cost of capital. An increase in spending in 2024 and therafter is subject to achieving leverage targets by releasing capital. Spending should 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 the Bürgerliches Gesetzbuch (BGB), Germany's civil code (modernisation). Rental growth from the application of market rents (new developments) will be muted as it is subject to a shift in the company's development pipeline to develop-to-sell as increased capital costs reduce the proportion of assets that meet Vonovia's return expectations, with the required rents being unaffordable for most tenants. Vonovia remains the largest home builder in Germany. New developments should support rental growth in the coming years, with a project pipeline of around 60,000 units as at end-March 2023, around two-thirds of which should be added to the company's investment property portfolio in the medium term as only 9% are either related to projects under construction or projects from the short-term pipeline.

Stable portfolio key performance indicators

The key performance indicators of the portfolio remained stable, with occupancy at 97.8% as at end-March 2023 (up 20bp YoY), a sticky tenant portfolio (13 years of average lease length) and increasing rental income (3.9% like-for-like rental growth for the 12 months ending March 2023). We see some risk for the German portfolio's performance as the supply-demand imbalance in urban areas remains a key political issue. However, we believe Vonovia mitigates this risk well as it considers the needs of all stakeholders[10].

A good example is the company's 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 of reaching net-zero emissions by 2050 (ESG factor: credit-positive) and reducing 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 around 3.5% without attracting more regulatory scrutiny, helped by an exposure to markets with pronounced housing shortages. Greener properties attract tenants, which supports high occupancy and ensures stable and predictable cash flow. In turn, this facilitates further organic growth with rental uplifts in line with cities' qualified rent indices that are expected to see pronounced increases in 2023 and 2024. We expect a dip in rental growth for non-energy efficient flats in markets with declining demand such as Bottrop, while acknowledging that Vonovia's exposure to these markets is very limited.

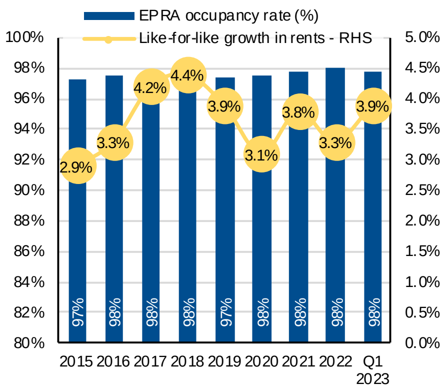
Profitability subject to inflationary pressure on cost base

Vonovia's profitability as measured by the Scope-adjusted EBITDA margin stood at 75% for the 12 months ending March 2022 (up 210bp YoY). We expect profitability to further improve and eventually outperform that of 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; and ii) synergies from the Deutsche Wohnen acquisition (EUR 105m run rate by 2024; 80% by YE 2023). These factors should help to ease i) inflationary pressure on the company's cost base that is expected to grow faster than the company's top line in 2023;

[10] 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

ii) the transformational shift of the development portfolio towards develop-to-sell from develop-to-hold with achievable margins below that of buy-and-hold activities; and iii) a significant decline in EBITDA contribution from value-added services due to a cut back in investment ('optimize apartments') that drove utilization of 4,000 full-time equivalents[11] in the past. We expect profitability to remain stable at around 75%[12] in the medium term.

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



EPRA: European Public Real Estate Association
Sources: Vonovia, Scope

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

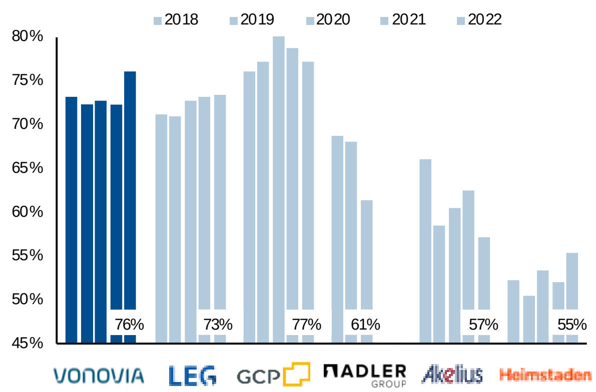
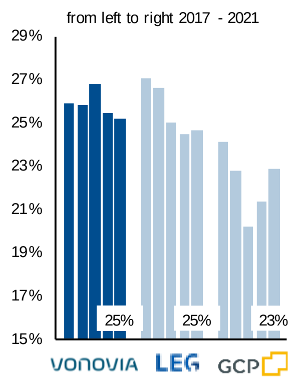


Figure 6: EPRA cost ratio (including vacancy) versus peers



Sources: Vonovia, public information, Scope

Financial risk profile: BBB-

Cash flow driven by capex, boosting top-line growth

Vonovia's operating cash flow, including Scope-adjusted EBITDA and funds from operations, has increased since its IPO in 2013, in line with the growth and improvement in its asset base 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 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, have led to volatile and negative cash flow, which had to be financed with EUR 9.6bn of net capital increases wand EUR 15.4bn of debt issuances (net) between 2015 and end-March 2023. However, we acknowledge the company's regular use of scrip dividends to strengthen equity (2023: acceptance rate of 45%).

Both free operating cash flow and discretionary cash flow will benefit from i) Vonovia's adjusted inorganic growth policy – no major acquisitions for the time being; and ii) substantially reduced capital expenditure as guided by the company (down to EUR 0.9bn in 2023, from EUR 1.4bn in 2022). Thus, cash flow including discretionary items such as dividends and bolt-on acquisitions will remain break-even on average, leading to a limited need for incremental debt issuances.

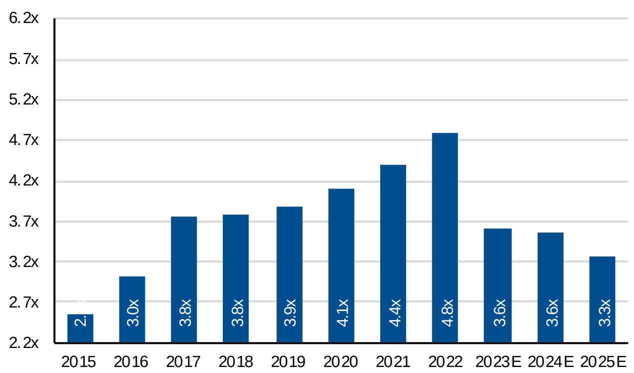
We consider around 60% of Vonovia's capex as discretionary, meaning the company could cease related building activities within three months if access to external financing weakened or either cost of capital or regulatory changes impacted the profitability of these measures.

[11] Reduction of workforce through fluctuation, not because of a cost-cutting strategy
[12] An important share of rental income (11% as at end-March 2023) does not allow for separation between service charge prepayments and gross rents, thus distorting Scope-adjusted EBITDA margin by 3-5pp

Given the company's track record of disposing assets, we have factored in successful sales in addition to signed deals (Apollo and CBRE) once the markets reopen, which we expect in late 2023.

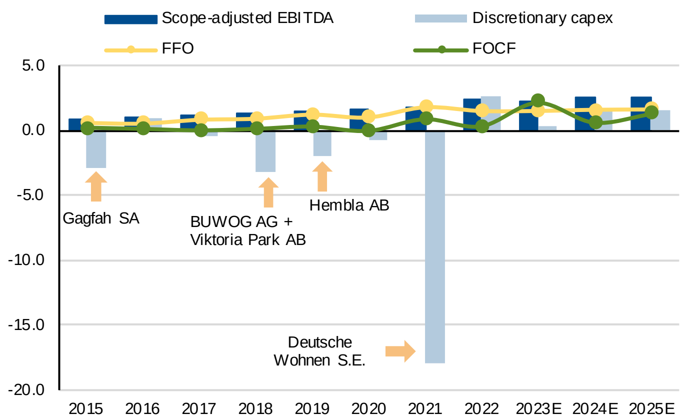
Our rating case does not include a potential disposal of the healthcare services division and related properties (gross asset value of EUR 1.1bn) or the potential sale of a minority stake in the Swedish operations (estimated value close to EUR 7bn) but would release capital and substantially reduce leverage.

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



Sources: Vonovia, Scope estimates

Figure 8: Cash flows (EUR bn)



FFO: funds from operations
FOCF: free operating cash flow
Sources: Vonovia, Scope estimates

Strong debt protection backed by economies of scale and debt reduction going forward

Vonovia's debt protection (Scope-adjusted EBITDA interest cover) stood at a strong 4.5x for the 12 months ending March 2023, unchanged YoY. Debt protection has increased in recent years, reflecting i) strong growth in Scope-adjusted EBITDA, leveraging scaling effects via large acquisitions and a high degree of standardisation; and ii) the beneficial interest rate environment owing to the ECB's quantitative easing since early 2015. The latter helped to reduce the weighted average cost of debt to 1.5% as at end-March 2023 from 2.6% at end-2015. These two effects have largely offset the EUR 32bn increase in Scope-adjusted debt between end-2015 and end-March 2023.

We expect interest cover to decrease to 3-4x, factoring in the drastically changed interest rate environment that significantly increases financing costs in the medium term. The increase in funding costs is partially mitigated by i) Scope-adjusted EBITDA forecasted to grow by more than 3% annually; ii) a substantial reduction in interest-bearing debt through asset sales and limited capital expenditure (down to EUR 0.9bn in 2023, from EUR 1.4bn in 2022); iii) a focus on secured lending, which has been subject to only limited margin increases (20-50bp) to keep borrowing costs under control; and iii) high hedging (96% as at end-March 2023) and a long average maturity (7.2 years).

Low Scope-adjusted LTV resilient to market value declines

Historically, Vonovia has strongly benefited from the economic and interest rate environment. The value of its portfolio appreciated by EUR 31.3bn between 1 January 2013 and end-June 2022, of which two-fifths are estimated to be performance-driven (rental growth) and the remainder due to strong yield compression during the same period.

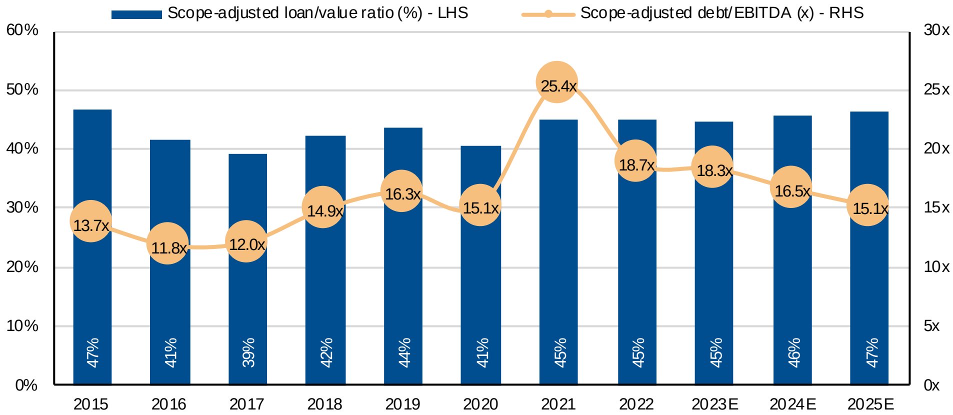
Lower house prices have become an issue given the decline in fair values visible since H2 2022 (around 4%). We expect fair values to drop by another 10% by end-2024 driven by further yield widenings, especially as most central bank rates[13] are either equal to or close to Vonovia's portfolio yield (end-2022: 3.5%) and we do not expect a near-term halt or reversion of interest rate increases by the Fed or the ECB. Like-for-like rental growth in the next couple of years will not make up for this, leaving the fair value of investment properties subject to constant pressure. The downside potential for property fair values in excess of our expectations is largely mitigated by the remaining difference between reinstatement costs for residential real estate (at least EUR 3,500 per sq m) and the company's current valuation, which is significantly lower.

We expect the Scope-adjusted loan/value ratio to remain around 45-50% in the next 12-18 months (end-March 2023: 46%) supported by inorganic growth being put on hold to preserve cash, dispose of properties and raise fresh capital by selling minority stakes in dedicated portfolios that will reduce debt by around EUR 2bn until end-2023. Our expectation regarding the achievability of debt reduction is supported by Vonovia's proven access to capital and investment markets. Having said that, a Scope-adjusted LTV of above 45% is not commensurate with the current issuer rating. We note that Vonovia could support deleveraging by selling its healthcare division or a minority stake in its Swedish operations[14].

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

Residential real estate cash flows tend to be resilient to changes in general demand. Therefore, Scope's financial risk assessment puts less emphasis on leverage, as measured by Scope-adjusted debt/EBITDA. Nonetheless, Vonovia needs to reduce Scope-adjusted debt/EBITDA – which recently exceeded a sustainable level of 15x (12 months ending March 2023: 18.6x). This is necessary to partially offset the pressure on leverage from expected market value declines and to enable the offsetting of higher interest costs while keeping the financial risk profile at a level that supports a good investment grade rating.

Figure 9: Leverage



Sources: Vonovia, Scope estimates

[13] Fed: 5.25%; Bank of Canada 4.5%; Bank of England: 4.5%; ECB: 3.25%
[14] Neither scenario is incorporated in our base case scenario. The positive effect on Scope-adjusted LTV I is estimated at 2.5-3.0pp

Adequate liquidity

Vonovia's liquidity is adequate based on our expectation that sources of liquidity will cover uses by about 1.8x in the 12 months to end-2023. In detail:

Balance in EUR m	2023E	2024E
Unrestricted cash (t-1)	1,198	1,305
Open committed credit lines (t-1)	3,000	3,000
Free operating cash flow[15]	2,749	1,130
Short-term debt (t-1)	3,790	3,180
Coverage	**183%**	**171%**

Please note that we exclude discretionary expansion capex from our calculation of liquidity, as these investments will only be made if external financing is available.

We view positively the company's revised objective of meeting refinancing needs well in advance (within 12-18 months) given the challenging refinancing environment. We recognise the company's successful strategy of diversifying its equity sources by inviting investors to take minority stakes in certain portfolios, as well as its ability to sell properties close to market value in the current environment to ensure the repayment of unsecured bonds from available cash while prolonging secured financing or securing higher funding, e.g. signing a EUR 600m European Investment bank loan (undrawn to date) or a EUR 550m loan with Berlin Hyp.

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 and good relationships with diverse banks.

Unencumbered assets

Vonovia's unencumbered asset position was 157% at end-2022, which grants it access to secured loans from traditional banks. This comfortable asset position is due to the company's policy of keeping 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.

LTV ratio as defined by Vonovia stood at 46.6% at end-March 2023 compared to 46.4% as calculated by us.

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) and during the beginning of the steep rise in interest rates (EUR 1.5bn in November 2022). Management aims to use all available financing sources to maintain and secure financing needs in the long term.

[15] 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 2023. This assumes that 40% of capital expenditure on average was committed in FY 2022 or is already at the construction stage.

Supplementary rating drivers: +/- 0 notches

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

	Policy	Q1 2023[16]
Loan/value ratio	40 to 45%	47%
Unencumbered asset ratio	equal or larger 125%	157%
Stability of rating	A-	A-

Based on the communicated financial policy and our view that the issuer is committed to adhering to it, as 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 2023, Vonovia had partially utilised a EUR 40bn Euro Medium Term Note programme. Senior unsecured debt, rated A-, benefits from an unencumbered asset ratio of 157%, as disclosed by the issuer, which provides a pool of collateral to debt holders.

Short-term debt rating: S-1

The S-1 short-term debt rating is supported by better-than-adequate internal liquidity, good banking relationships, strong access to diverse funding sources and to undrawn committed credit lines, which allows the company to address short-term refinancing needs. Vonovia had a non-utilised EUR 3bn commercial paper programme as at end-May 2023.

[16] 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	31.03.2023	31.12.2022	31.12.2022	31.12.2022
Business risk profile				
Scope-adjusted total assets (EUR m)	96,547	20,999	10,641	6,283
Portfolio yield (net initial yield)	2.7%**	3.6%	3.2%	4.2%
Gross lettable area ('000 sq m)	34,800	10,858	na	1,234
Number of residential units	548,368	167,400	64,281	19,545
Countries active in	3	1	2	4
Top three 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 (%)	97.8%	97.1%	95.8%	91.9%
WAULT (years)	13.0	11.2	9.0	8.4
Tenant sales growth (%)	N/A	N/A	N/A	N/A
Like-for-like growth rents (%)	3.9%	3.1%	2.9%	11.9%
Occupancy cost ratio (%)	N/A	N/A	N/A	N/A
Scope-adjusted EBITDA margin	75%	73%	77%	57%
EPRA cost ratio (incl. vacancy)	25.2%**	24.7%	22.9%	na
EPRA cost ratio (excl. vacancy)	24.2%**	23.0%	20.9%	na
Financial risk profile				
Scope-adjusted EBITDA/interest cover	4.5x	5.1x	5.1x	16.0x
Scope-adjusted loan/value ratio	46%	44%	39%	21%
Scope-adjusted debt/EBITDA	18.6x	15.7x	13.5x	10.3x
Weighted average cost of debt (%)	1.5%	1.3%	1.3%	1.2%
Unencumbered asset ratio (%)	157%	218%	229%	204%
Weighted average maturity (years)	7.2	6.5	5.9	4.0

* Subscription ratings available on ScopeOne
** As at end-2022

Sources: Public information, Scope

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