Deutsche Konsum REIT-AG
Germany, Real Estate

SCOPE BB STABLE

Corporate profile

Deutsche Konsum REIT-AG started operations in 2014 and received the REIT status ("real estate investment trust") in 2016 and is therefore exempted from the income-based tax. The objective of the company 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	2015/16	2016/17	2017/18E	2018/19E
EBITDA/interest cover (x)	4.6x	3.5x	3.5x	3.6x
SaD/EBITDA	3.9x	9.3x	9.5x	8.4x
Scope-adjusted FFO/SaD	20%	8%	7%	9%
Loan/value ratio (%)	30%	44%	50%	50%

Rating rationale

Scope assigns initial issuer rating of BB to Deutsche Konsum REIT-AG, 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 Germany-wide diversified portfolio, with stable occupancy and a weighted average unexpired lease term (WAULT) of over five years, leads to predictable and steady cash flows. Relatively high profitability as well as implicit caps on leverage and floors on revenue diversification lead to good debt protection measures as well as moderate leverage.

However, the rating is limited by DKR's absolute 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 43% of net rental income (NRI). Furthermore, we see higher 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. Scope's overall assessment of the financial risk profile is negatively affected by the company's dependence on external financing, with refinancing peaks in 2017/18 and 2019/20 as well as ambitious growth plans for the next few years.

Outlook

The Outlook for DKR is Stable and incorporates Scope's expectation that the company's asset base will grow as a consequence of EUR 100m in annual capex leading to recurring funds from operations of over EUR 20m by FY 2019/20. We anticipate that further expansion will be predominantly financed with debt levering the company up to a loan/value (LTV) ratio of 50% while debt protection, as measured by EBITDA interest cover, is expected to remain above 3x. The Outlook assumes that the two convertible bonds will not be converted into equity in January 2020 thus raising the company's external refinancing requirements.

A negative rating action is possible if the company leverages up to an LTV ratio of above 55% on a continuing basis, leading to a loss of its tax-exempt German real estate investment trust (G-REIT) status.

A positive rating action could be warranted if peaks in refinancing in FY 2017/18 and 2019/2020 are successfully addressed, with liquidity becoming adequate and credit metrics remaining at the levels described above.

Ratings & Outlook

Corporate rating	BB/Stable
Senior secured rating	BBB
Senior unsec. rating	BB+

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Related methodology

Corporate Rating Methodology, January 2018

Rating Methodology: European Real Estate Corporates January 2018

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Rating drivers

Positive rating drivers	Negative rating drivers
• Largest pure-play commercial property company 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 around 85% not expected to decrease 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 over 3x, expected to remain at this level going forward • LTV expected to remain below 50% as a consequence of implicit covenants in accordance with DKR's G-REIT status	• Limited size but expected to accelerate growth with asset base to rise to above EUR 0.5bn in the next three years. • Modest diversification across sales formats/exposure to hypermarkets with negative future prospects • Concentrated tenant portfolio with top three accounting for 44% of NRI, 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 as well as 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 • Weak liquidity is burdened by the ongoing high share of short-term debt and comparatively low FOCF

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Successful addressing of peaks in refinancing in FY2017/18 and 2019/2020 with liquidity becoming adequate and credit metrics of LTV below 50% and EBITDA interest expense of greater than 3x	• Leverage as measured by LTV above 55% on a continuing basis, leading to a loss of the tax-exempt REIT status

Financial overview

			Scope estimates	
Scope credit ratios	**2015/16**	**2016/17**	**2017/18E**	**2018/19E**
EBITDA/interest cover (x)	4.6x	3.5x	3.5x	3.6x
SaD/EBITDA (x)	3.9x	9.3x	9.5x	8.4x
Scope-adjusted FFO/SaD (%)	20%	8%	7%	9%
Loan/value ratio (%)	30%	44%	50%	50%
Scope-adjusted EBITDA in EUR m	**2015/16**	**2016/17**	**2017/18E**	**2018/19E**
EBITDA	12.5	13.4	20.1	28.7
Operating lease payment in respective year	0.0	0.0	0.0	0.0
Other	-0.1	0.0	0.0	0.0
Scope-adjusted EBITDA	12.5	13.4	20.1	28.7
Scope funds from operations in EUR m	**2015/16**	**2016/17**	**2017/18E**	**2018/19E**
Scope-adjusted EBITDA	12.5	13.4	20.1	28.7
less: (net) cash interest as per cash flow statement	-2.7	-3.9	-5.8	-7.9
less: cash tax paid as per cash flow statement	0.0	0.0	0.0	0.0
less: interest component operating leases	0.0	0.0	0.0	0.0
Change in provisions	-0.2	0.8	0.0	0.0
Other changes (e.g. non-cash staff costs)	0.0	0.0	0.0	0.0
Scope funds from operations	9.6	10.4	14.3	20.8
Scope-adjusted debt in EUR m	**2015/16**	**2016/17**	**2017/18E**	**2018/19E**
Reported gross financial debt	58.9	122.9	188.8	237.9
less: cash, cash equivalents	10.3	1.2	2.4	3.5
Cash not accessible	0.0	-0.1	-0.1	-0.1
add: pension adjustment	0.0	0.0	0.0	0.0
add: operating lease obligation	0.0	0.0	0.0	0.0
Scope-adjusted debt	48.5	124.0	191.1	241.4

Business risk profile

Industry risk: BB

While the real estate industry is often associated with cyclical features compared to industries with inelastic demand patterns, these vary considerably depending on the individual business model used. In general, commercial property companies especially face higher cyclicality due to their potential exposures to industries that are inherently vulnerable to changes in demand. Demand increases when the economy grows, and declines when it shrinks, as tenants may find themselves under severe financial pressure which leads to defaults. However, these companies generally benefit from long-term lease contracts, which partially mitigate the impacts of economic downturns. Also, companies operating across Europe with a strong focus on retail agglomerations (such as shopping centres and retail parks), or with large shares in 'high street' locations, benefit from highly diverse tenancies and more stable demand, even during economic downturns. Scope believes that the real estate industry tends to have low barriers to entry. Significant investment is needed to buy, maintain or develop properties. Thus, either: i) significant internal resources; or ii) good access to third-party capital is needed. We observe a high level of fragmentation within the real estate industry and good general access to credit due to collateral-eligible assets. Both are indicators that barriers to entry are relatively low. However, given diverse real estate regulations in Europe – especially in the residential sector – knowledge of local taxes and laws is important. Furthermore, technical know-how is essential for almost the whole value chain. This includes the performance of technical due diligence before buying a property or the implementation of refurbishment measures or ongoing maintenance. Consequently, property companies need to maintain in-house (or purchase external) know-how in order to remain up-to-date or to enter more markets. We therefore assess market entry barriers for commercial real estate corporates as medium. Substitution risk is judged to be medium for commercial property companies, because demand could decline as activities in physical locations (such as purchasing goods or working in an office building) might shift to e-commerce or virtual 'home' offices.

Figure 1: Industry risk assessment: European commercial real estate corporates

Cyclicality \ Barriers to entry	Low	Medium	High
High	CCC/B	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Source: Scope

Stable sector Outlook

Scope's 2018 Outlook for the real estate sector is Stable. Our view is based on still-lively investor and tenant demand which has a positive influence on business risk profiles. In addition, companies have been able to make use of the ECB's ongoing ultra-loose monetary policy (with an all-time high of capital market debt issuance at very low interest rates) to enhance their financial risk profiles. However, our assessment emphasises the further heightening of sensitivity to changes in politics, economic conditions and interest rates.

For more information please refer to Scope's 2018 Corporate Outlook (click here).

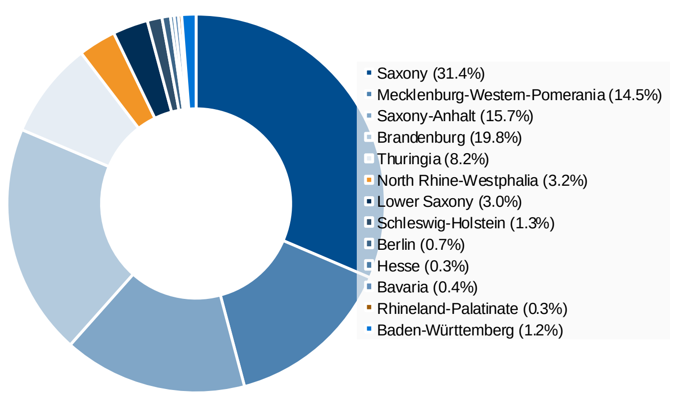
Commercial real estate corporate with limited size

DKR has achieved strong asset base growth since its foundation in 2014. However, the company is still limited in terms of size as demonstrated by total assets of EUR 316m at Q2 2018 and funds from operations of EUR 12.5m for the last twelve months to 31 Macrh 2018. Limited size burdens the company's access to capital markets especially in times of financial distress. However, with the anticipated further growth of DKR's asset base to over EUR 500m by YE 2019, we believe access should improve.

Largest pure-play commercial real estate company with focus on retail parks, DIY stores and local shopping centres

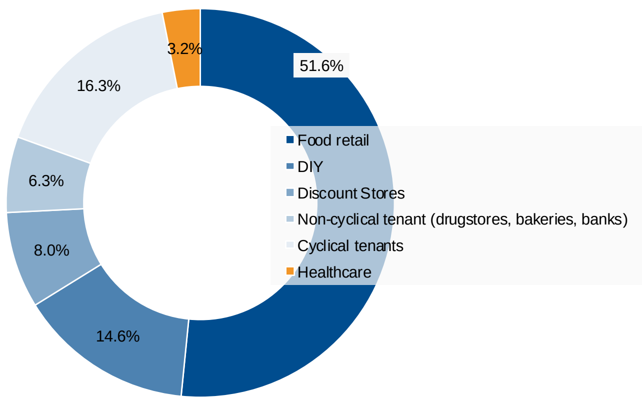
The company's size reflects the fragmented nature of the part of the German real estate market which is focussed on non-cyclical retail. DKR sees itself as consolidator in this segment. Since starting operations in 2014, DKR has become Germany's largest pure-play commercial real estate company, focussing on retail parks, DIY stores and local shopping centres, with a portfolio comprising 83 properties as at May 2018, followed by FCR Immobilien AG (37 properties[1]) and Deutsche Fachmarkt AG (21 properties[2]). DKR is also among the leading participants in this fragmented niche market in terms of portfolio size; here, its largest competitors are funds managed, for example, by redos real estate GmbH (44 properties), HAHN-Immobilien-Beteiligungs AG (161) or institutional investors with assets managed by Jones Lang LaSalle or MEC. As a consequence, we believe the company benefits from decent visibility with regard to tenants, potential investors and vendors. This visibility supports the re-letting of vacant space, tenant negotiations, property disposals as well as further portfolio growth with an estimated 25 properties to be acquired annually in the next few years.

Figure 2: Geographical diversification by GLA – May 2018



Source: DKR, Scope

Figure 3: Diversification (rent by tenant industry) – May 2018



Source: DKR, Scope

Portfolio diversified across Germany with a focus on the east

The geographical diversification of DKR's retail property portfolio across Germany is moderate (Figure 2) with a focus on the eastern federal states (90% of gross lease area, GLA). Scope believes that DKR's geographical diversification should mitigate cyclical swings to a certain extent as the federal states follow slightly different demand patterns, influenced by different industry exposures. However, DKR's diversification in terms of property type is judged to be modest. The company is predominantly exposed to retail parks (40.1% of NRI), local shopping centres (29.3%) and hypermarkets (15.6%). These three property types are closely linked to food retail which also explains the weak tenant industry diversification. Hypermarkets, in particular, are facing declining customer demand. Scope believes this will have a long-term negative impact on the company's cash flows with higher capex requirements as well as falling revenues from this segment.

Scope considers high exposure to non-cyclical tenant industries to be positive

Even if tenant industry diversification is judged to be weak, with 52% of NRI stemming from food retailers, Scope considers the importance of food, its recurring purchase and macro resilience to mitigate DKR's reliance on this sector. The company's overall exposure to non-cyclical industries, accounting for approx. 75% of NRI, is generally seen as positive (Figure 3).

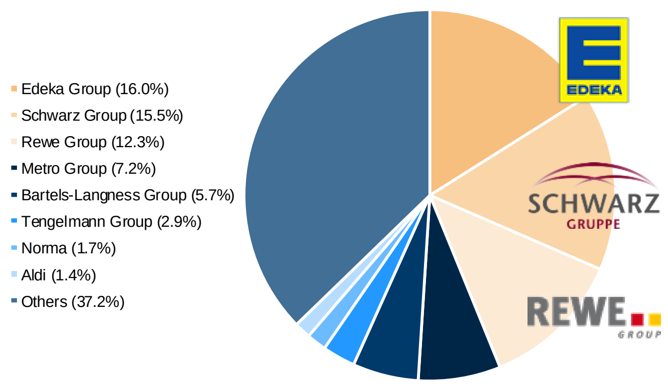
Weak tenant diversification with top three accounting for 43% of rental income

The nature of DKR's portfolio and tenant industry exposure (concentrated retail sectors such as food retail and DIY) is also reflected in its weak tenant diversification with the top

[1] As at 22 February 2018
[2] As at 30 September 2017

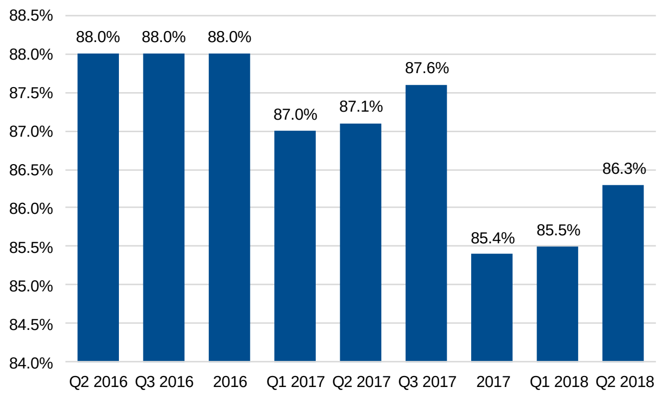
three tenants accounting for 43.8% and the top eight for 62.8% of the company's NRI as at end-March 2018 (Figure 4). This leaves the company very vulnerable to single tenant defaults or tenant restructuring efforts driven by the transformation of the German retail landscape. Weak tenant diversification is partially mitigated by the good credit quality of tenants representing 54% of NRI including the top three: Edeka Group, Schwarz Group and Rewe Group.

Figure 4: Rental income by tenants – May 2018



Source: DKR, Scope

Figure 5: Occupancy rate – Q2 2015/16 to Q2 2017/18



Source: DKR, Scope

Substantial haircuts on market values anticipated for distressed property disposals due to the limited liquidity of the markets DKR is exposed to

Even if the largest part of DKR's portfolio is assessed to be 'C' category, Scope believes this to apply only from an investor point of view. As such, the liquidity of these markets is judged to be weak – a situation which is exacerbated by small ticket sizes of approx. EUR 4m on average, attracting fewer investors than properties valued above EUR 20m. This could lead to substantial haircuts on market values in times of financial distress with the company being forced to sell properties. With regard to location, as perceived by existing and potential tenants, we consider 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.

Stable but modest occupancy of 85% as a result of acquisition strategy

DKR benefits from relatively stable occupancy of above 85% since starting operations in 2014 (Figure 5). The main driver of the company's relatively high vacancy rate (13.7% as at end-March 2018) is an acquisition strategy which focusses on properties with significant vacancies. We therefore do not expect any material reduction in vacancies going forward. Nevertheless, Scope believes that current occupancy levels are sufficient to ensure the future stability of rental income supported by a WAULT of 5.2 years as at end-March 2018. Further support stems from an even higher WAULT for DKR's food-retail anchor tenants of 6.4 years.

Stable and high profitability with EBITDA margin around 70%

The company has stable and relatively high profitability with EBITDA margins close to 70%. The comparatively high margins are mainly driven by economies of scale with small overheads justified by larger lot sizes compared to residential properties for example. DKR's profitability is burdened by its relatively high vacancy rates. A reduction to 10% from 13.7% (the current level) is expected to lift profitability into the range of much larger peers, benefitting the company's business risk profile. However, as Scope does not anticipate that this kind of reduction can be achieved within the next few years, profitability is expected to remain stable between 65% and 70%.

Financial risk profile

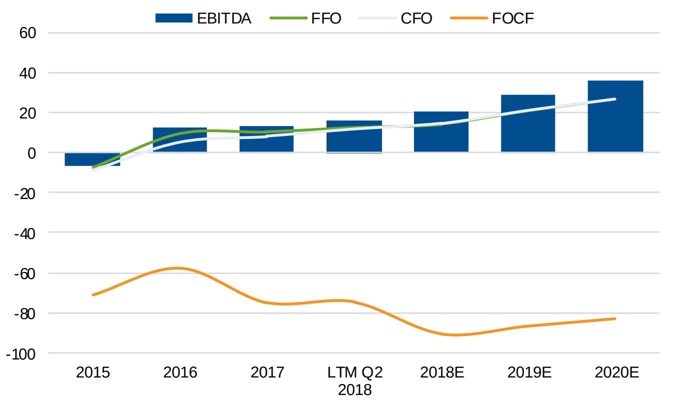
Scope's rating scenario assumes the following:

- like-for-like rental growth of 2.0% (2017/18) and (2018/19),
- additional increase of rents from new acquisitions reflecting a net initial yield (NIY) of 9.5%,
- operational expenses to increase by 2% per year,
- no conversion of convertible bonds in 2020,
- capital expenditure of EUR 100m per year,
- mandatory dividend distribution of 90% of German GAAP result.

Negative free operating cash flows driven by expansion capex demonstrating DKR's dependence on external financing

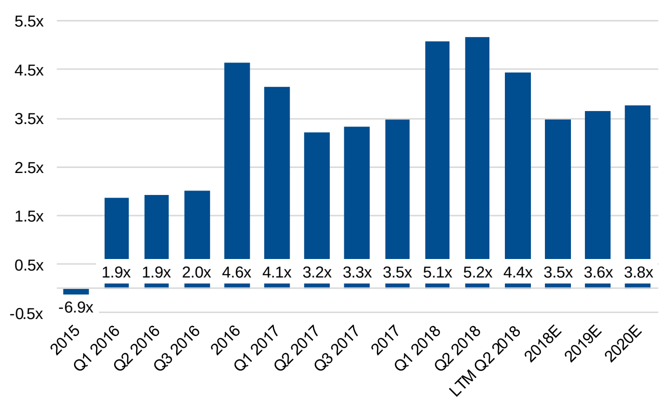
Since the company's foundation, DKR's operating cash flows including funds from operations (FFO) and cash flow from operations (CFO) have increased in line with asset base growth. The latter, however, has led to continuous negative free operating cash flows (FOCF) of between EUR 60m and EUR 80m (Figure 6) which have been financed externally with EUR 111m in capital increases and EUR 106m in debt issuances (net). In light of the company's objective of increasing its asset base further, we do not expect positive FOCF 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.

Figure 6: Cash flows



Source: DKR, Scope

Figure 7: Debt protection – EBITDA interest cover



Source: DKR, Scope

Strong debt protection with EBITDA interest cover above 3x

The company benefits from relatively high EBITDA interest expense cover of above 3x since the financial year ending 31 March 2016 (Figure 7). The main drivers of this sufficient level of debt protection are: i) the company's low indebtedness with Scope adjusted debt (SaD) of EUR 124m as at 31 March 2018; ii) the generally beneficial interest rate environment with the ECB's quantitative easing programme starting shortly after DKR launched operations in late 2014; 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 LTV ratio of 55% as well as minimum exposure to income-producing real estate properties with moderate occupancy with an industry average WAULT assuring stability of operating cash flows going forward.

Loan/value ratio expected to remain below 50%

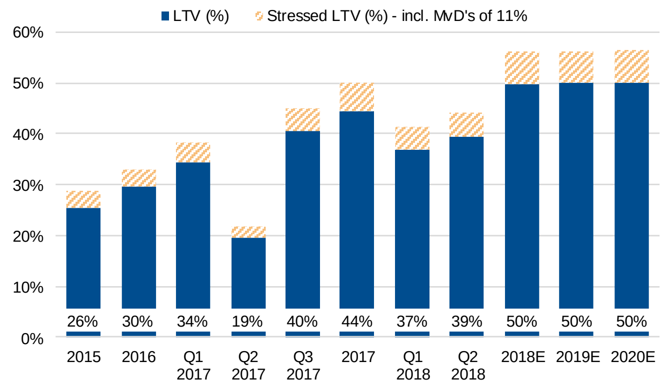
Leverage, as measured by the LTV ratio, is relatively strong and stood at 39% at 31 March 2018 (Figure 8). This is in line with the unweighted average of Scope's real estate peer group. The LTV ratio has, however, been volatile due to revaluations of DKR's investment properties contributing EUR 41m of 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, Scope judges gains in fair value to be at risk if the ECB ends quantitative easing and pricing for liquidity risk increases again. Nonetheless, with property values stressed by an 11% market value decline, the LTV ratio would still remain below 60% thus justifying a BB financial risk profile.

Implicit financial covenants of G-REIT status limit indebtedness

G-REIT regulations allow for a maximum leverage of only 55%. However, the company has disclosed its intention to leverage up to an LTV ratio of 50% backed by its financing pipeline of over EUR 100m to enable further property acquisitions.

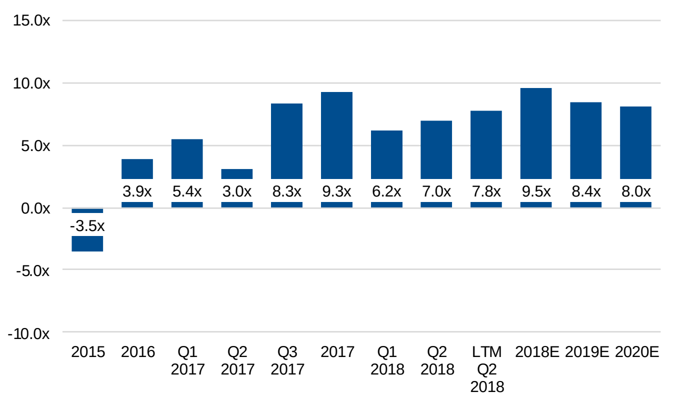
SaD/EBITDA has fluctuated around 8x in the past, reflecting DKR's low indebtedness with acquisitions financed with approx. 50% equity as well as high cash yields of over 10% for these acquisitions. We believe that SaD/EBITDA will be somewhat volatile in future, largely depending on the timing of acquisitions and the corresponding EBITDA contribution. Irrespective of timing we believe that SaD/EBITDA will remain at a level of around 8x going forward (Figure 9).

Figure 8: Leverage – loan/value ratio (%)



Source: DKR, Scope

Figure 9: Leverage – SaD/EBITDA



Source: DKR, Scope

Weak liquidity with peaks in refinancing in 2017/18 and 2019/20

We evaluate DKR's liquidity as weak based on our expectation that sources of liquidity will only cover uses by about 0.3x in the 12 months to end-March 2019 following consistently stretched liquidity in the past. In detail:

Position	FY 2016/17	Q2 2017/18
• Unrestricted cash	EUR 1m	EUR 1m
• Open committed credit lines	EUR 16m	EUR 16m
• Free operating cash flow (t+1)	EUR 10m	EUR -4m
• Short-term debt (t+1)	EUR 42m	EUR 41m

Liquidity is burdened by the ongoing high share of short-term debt on the one hand and negative free operating cash flow of EUR 4m forecasted for the next 12 months (excluding non-mandatory, non-executed expansion capex of EUR 83m) on the other. According to the company EUR 18m of short-term debt due within the next 12 months have been refinanced in May 2018 with a five years tenor.

Heavy, ongoing dependence on external financing

As a result, Scope has stressed the company's financial risk profile by two notches reflecting the company's heavy and ongoing dependence on external financing. However, Scope believes negative liquidity to be a manageable risk in the short to medium term with sufficient headroom provided by a high share of unencumbered assets (69%) and past extensions of short-term debt. Our assessment of the latter 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 100m at the end of February which is anticipated to make use of the company's unencumbered asset position. In addition, the company's G-REIT status requires adherence to financial covenants with regard to total leverage, thus limiting additional indebtedness for the company to a maximum LTV ratio of 55%.

Senior secured debt

Senior secured debt: BBB

DKR issued an EUR 40.0m bond in May 2018 with a six-year term (2018/24) and a coupon of 1.80% (ISIN: DE000A2G8WQ9). This bond will benefit from a first ranking mortgage on fifteen properties valued at EUR 67.2m as at May 2018. Scope believes that the structure benefits from adequate overcollateralisation, with an issue-specific loan-to-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), Scope expects an 'excellent' recovery thus allowing for a three-notch uplift on the company's issuer rating of BB.

Senior unsecured debt

Senior unsecured debt: BB+

Scope's recovery analysis signals 'above-average recovery' which translates into instrument ratings of BB+. Recovery is based on a hypothetical default scenario in FY 2019/20 with the company's liquidation value amounting to EUR 328m. This value is based on a 37% 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 as well as the unsecured EUR 37m in convertible bonds.

Outlook

Outlook: Stable

The Outlook for DKR is Stable and incorporates Scope's expectation that DKR's asset base will grow as a consequence of EUR 100m in annual capex leading to recurring funds from operations of above EUR 20m by FY 2019/20. We anticipate that further expansion will be predominantly financed with debt levering the company up to an LTV ratio of 50% while debt protection as measured by EBITDA interest cover is expected to remain above 3x. The Outlook assumes that the two convertible bonds will not be converted into equity in January 2020 thus raising the company's requirement for external refinancing.

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

A positive rating action could be warranted by successfully addressing peaks in refinancing in FY 2017/18 and 2019/2020 with liquidity becoming adequate and credit metrics remaining at the levels described above.

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