S&P Global Ratings

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Research Update:

German Real Estate Landlord DIC Asset AG Outlook Revised To Negative On Delayed Deleveraging; 'BB+' Ratings Affirmed

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Rating Action Overview

- DIC Asset AG's (DIC's) leverage has increased in the first half of 2022 after it took over VIB Vermögen, with an S&P Global Ratings-adjusted ratio of debt to debt plus equity reaching 58.9% (beyond our 55% rating downside threshold) and EBITDA interest coverage decreasing to 2.7x (closer to our 2.4x downside threshold).
- Changing market conditions, including rising interest rates and suffering equity and debt markets, are a challenge to DIC's plan to reduce leverage to previous levels by year-end 2022 and we have therefore updated our previous base case and now assume debt to debt plus equity will fall below 55% only in 2023.
- DIC has about €580 million of debt maturities coming due in the first half of 2024, and so DIC's liquidity could become a constraint for our rating if it cannot refinance those maturities well in advance.
- Therefore, we revised our outlook on DIC to negative from stable and affirmed our 'BB+' long-term issuer credit rating
- We also affirmed the 'BB+' issue rating on DIC's senior unsecured bond, and kept the recovery rating at '3', which indicates our estimate of 60% recovery in a default.
- The negative outlook reflects our view that the company may not be able to restore its credit metrics in line with the current rating level within the next 12 months, with debt to debt plus equity remaining above 55%, and address its funding needs in 2024 in a timely manner.

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Rating Action Rationale

Tougher market conditions will likely delay DIC's deleveraging progress following its takeover of VIB Vermögen AG (VIB). At the beginning of 2022, DIC took over logistic real estate player VIB Vermögen AG and currently holds about 61% of VIB, fully consolidated into DIC's financial statements as of June 30, 2022. The transaction was funded by a bridge loan of €500 million and available cash of about €281 million. We anticipated leverage would temporarily increase beyond our rating thresholds for a short period, but we expected DIC to perform a 10% equity increase and dispose of assets to stabilize its credit metrics by year-end 2022, in line with its strategy. As of June 30, 2022, S&P Global Ratings-adjusted ratio of debt to debt plus equity stood at 58.9% (versus 52.2% at year-end 2021) and its rolling-12-months EBITDA interest coverage at 2.7x (versus 3.3x at year-end 2021). Debt to EBITDA spiked to 20.1x, strongly distorted by the take-over of VIB, with only three months of EBITDA contribution. Given the current difficult market environment, we have revised our base case and expect our adjusted ratio of debt to debt plus equity to exceed our downside threshold of 55% in 2022 and that DIC will deleverage to below this level most likely only within the following year. While we now assume equity issuances will remain challenging for the next few months, our base case still includes that the company should be able to dispose of sufficient assets over the next six to nine months to reduce leverage in line with its financial policy, with a medium-term loan-to-value target of below 45% (if including only the owned yielding commercial portfolio it translates into S&P Global Ratings-adjusted debt to debt plus equity of about 50%). Including the recent interest rate hike by the European Central Bank, which will increase future funding costs for corporations, we forecast that the company's capacity to cover its interest expenses will remain comfortably above 2.4x and that debt to annualized EBITDA will stabilize around 13.0x-14.0x by year-end 2023. That said, DIC's credit metrics would have little headroom within the current rating level, and we believe there is a one-in-three chance that the company will fail to achieve those ratios in a timely manner.

DIC's funding and liquidity profile remains adequate for the next 12 months, but large refinancing needs emerge in 2024. As of June 30, 2022, DIC had unrestricted cash available of about €453 million. This should comfortably cover its upcoming limited short-term debt maturities of about €294 million for the next 12 months. In July 2022, the company issued €100 million of promissory notes at 3.56% and with an average debt maturity of 3.6 years. It used the proceeds to pay down its outstanding bridge loan due in the first quarter of 2024 to €400 million from €500 million. Average cost of debt stood at only 1.8% at the end of July 2022. Our base case assumes the cost of debt will gradually increase and new funding will range between 3.5% and 4.5% by the end of 2023. The company's weighted average debt maturity is currently about 4.2 years. That said, the company has a total of approximately €800 million of debt maturities in 2024, which we expect it to address in a timely manner, so that the average debt maturity remains above our three-year requirement and sufficient liquidity sources are available to cover upcoming financial obligations for a 12-month period. We understand that the company had adequate headroom under its financial covenants as of June 30, 2022, and we expect them to maintain solid headroom. That said, DIC's bond covenants for loan-to-value are set at 60%, and headroom has tightened since the takeover of VIB (we understand, the lowest headroom is 13% as of June 30, 2022). That said, we expect the headroom to widen again and remain well above 10% with the expected reduction in leverage.

Despite DIC's enhanced scale and scope, and increased portfolio diversification, the commercial real estate sector faces headwinds amid economic challenges. The acquisition of VIB has benefited the company's scale and scope, as well as its portfolio diversification. As of June 30, 2022, the fair value of its commercial portfolio, which includes only owned yielding assets, stood at €4.5 billion, comprising 208 properties. The company's total assets under management increased to €14.2 billion from 11.9 billion at year-end 2021. The share of logistics properties increased to 39% from 2% in the commercial portfolio with the share of office properties diluting to 34% from 68% and enhancing its segment diversification. The European Real Estate

Association (EPRA) vacancy stood at only 4.2% for the combined entities. DIC managed a solid like-for-like rental growth of 3.7% in the first half of 2022, mostly benefiting from lease indexations. The growing inflationary environment, forecast at 8.4% growth in Germany in 2022 and 7% for 2023, is expected to benefit DIC's rental income, as the majority of its rental contracts are linked to the consumer price index (CPI). However, a potential economic recession, combined with cost-saving initiatives and potential reduction of required office space, represents a high threat for further operational growth for the office real estate landlords, and slowing demand could impact occupancy levels and rental income over the next two to three years. REITs might also invest less in further acquisitions, partially driven by increasing construction raw materials and energy supply prices, leading to lower asset rotations and flat-to-negative property portfolio valuation trend.

Outlook

The negative outlook reflects our view that DIC may not restore its credit metrics in line with the current rating level amid uncertain market conditions within the next 12 months. This could result if the company is not able to take sufficient steps to reduce leverage in a timely manner, such as further delays to perform a 10% equity increase and dispose of assets to stabilize its credit metrics.

Downside scenario

We could lower the rating if:

- DIC fails to improve debt to debt plus equity to below 55%;
- Debt to annualized EBITDA deviates strongly from our forecast; or
- Its EBITDA interest coverage declines to below 2.4x.

We could also lower our rating on DIC if the company's liquidity deteriorates, in particular if the company does not address its upcoming bulk of maturities in 2024 well in advance.

Upside scenario

We could revise our outlook back to stable if DIC continues to generate stable and predictable cash flows, including maintaining occupancy levels high and takes steps to delever in line with its strategy, so that:

- Debt to debt plus equity falls below 55%;
- Debt to EBITDA decreases in line with our base case; and
- The interest coverage ratio remains above 2.4x.

Company Description

DIC is a listed German real estate holding company, which invests directly and indirectly in commercial real estate assets in Germany.

The company operates through two business segments:

- Commercial Portfolio, composed of 208 properties with a market value of €4.49 billion (as of June 2022), generating around 80% of EBTIDA in the first half of 2022.
- Institutional Business, composed of 149 properties with a market value of €9.7 billion, where DIC acts as an asset manager, generating about 20% of EBITDA.

Our Base-Case Scenario

Assumptions

- Our expectations of real GDP growth rate in Germany at 1.5% in 2022 and -0.3% in 2023. We estimate CPI growth in Germany to be about 8.4% in 2022 and 7% in 2023.
- Like-for-like rental income growth of about 3.5%-4.0% in 2022 and 2.0%-3.0% in 2023, benefiting from the company's inflation-linked lease agreements, and partially offset by our expectations of flat to slightly lower occupancy levels in the office segment.
- We assume an overall flat portfolio valuation in 2022, while slightly declining in 2023 and 2024.
- Property disposals of up to €600 million within the upcoming 12 months.
- Average cost of debt to remain favorable at around 2% over the next 12 months, including our expectations of higher interest costs on future debt issuances at 3.5%-4.5%.
- Annual cash dividends of about €40 million-€50 million.
- We do not include any equity raising in our base case.
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Key metrics

- A debt-to-debt plus equity ratio of about 57% in 2022 and improving to just below 55% in 2023.
- Adjusted debt to annualized EBITDA at about 13x by the end of 2023.
- Adjusted EBITDA interest coverage ratio of about 3x over the same period.

Issue Ratings--Recovery Analysis

Key analytical factors

- DIC's €400 million senior unsecured notes are rated 'BB+', in line with the issuer credit rating.
- The recovery rating is unchanged at '3', indicating our expectation of 50%-70% recovery (rounded estimate 60%) in the event of a payment default. The recovery rating reflects the valuable asset base mostly consisting of stabilized income-producing investment properties.
- Our recovery prospects are constrained by the unsecured nature of the debt instrument and its contractual subordination to the current amount of secured debt.
- In our hypothetical default scenario, we envisage a severe macroeconomic downturn in Germany, resulting in market depression and exacerbated competitive pressures.

- For VIB, in our recovery analysis we give value to only the 61% stake that DIC owns.
- We value the group as a going concern. We use a combined approach on the basis of discrete asset value and EBITDA multiple to take into consideration the stressed value of DIC's owned yielding properties (commercial portfolio) and the EBITDA contribution derived from its fee income business (institutional business).
- Recovery prospects for the proposed senior unsecured notes are very sensitive to a small change in the amount of senior secured debt or any other priority debt outstanding at default. Since there is no limitation on the incurrence of additional debt in the bond documentation, recoveries could be much lower if the amount of secured debt at default differs from our projections.

Simulated default assumptions

- Year of default: 2027
- Jurisdiction: Germany

Simplified waterfall

- Consolidated net enterprise value at emergence (after 5% administrative costs): €3.027 billion
- First-lien secured debt (at the DIC holding level): €1.031 billion
- Value available for senior unsecured claims, after deducting minority stake claims at VIB Vermögen AG: €968 million
- Senior unsecured debt claims (at the DIC holding level): €1.536 billion
- Recovery Rating: 3
- Recovery expectation: 50%-70% (rounded estimate: 60%)

*All debt amounts include six months of prepetition interest

Ratings Score Snapshot

Issuer Credit Rating	BB+/Negative/--
Business risk:	Fair
Country risk	Very Low Risk
Industry risk	Low Risk
Competitive position	Fair
Financial risk:	Significant
Cash flow/leverage	Significant
Anchor	bb
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)

Issuer Credit Rating	BB+/Negative/--
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Positive (+1 notch)
Stand-alone credit profile:	bb+

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- DIC Asset AG 'BB+' Ratings Affirmed After Announced Partial Takeover Offer On VIB; Outlook Stable, Feb. 3, 2022

Ratings List

Outlook Action; Ratings Affirmed

	To	From
DIC Asset AG		
Issuer Credit Rating	BB+/Negative/--	BB+/Stable/--

Senior Unsecured	BB+	**BB+**
Recovery Rating	3(60%)	3(60%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914