Rating Action Release 17 May 2018

Scope assigns initial issuer rating of B+ to FCR Immobilien AG, Outlook Stable

The issuer rating is predominately driven by the company's dependence on its trading business to secure sufficient coverage of both operational and financial expenses.

Rating action

Scope Ratings assigns an initial issuer rating of B+ to FCR Immobilien AG (FCR). Secured debt consisting of four bonds (ISINS: (i) DE000A12TW80; (ii) DE000A1YC5F0; (iii) DE000A2BPUC4; (iv) DE000A2G9G64) is rated BB-. The Outlook is Stable.

Rating rationale

Positive rating drivers include the company's moderate leverage with a loan/value ratio of around 50% as well as its geographically well diversified property portfolio within regions that are expected to have stable tenant demand leading to predictable recurring income.

The rating is constrained, however, by the company's small size which results in a lack of economies of scale. Furthermore, Scope has a negative view of both FCR's dependence on its trading activities to secure sufficient coverage of operational and financial expenses, and of its low quality assets which could lead to substantial price haircuts in a distressed sales scenario.

The bonds benefit from a pledge on investment properties at a value representing the bonds' outstanding nominal and the interest payable up to the bonds' maturity. This security improves credit risk for the bonds over that of the issuer.

Scope's rating scenario assumes the following:

- Like-for-like rental growth of 1.6% in 2018 and 2019
- Portfolio disposals in line with company expectations of EUR 42m in 2018 and EUR 60m in 2019
- Operational expenses to increase by 2% per year
- Capital expenditure of EUR 70m in 2018 and EUR 150m in 2019
- Portfolio acquisitions at a net initial yield 50bp below that of 2018 acquisitions
- IPO in 2018 with EUR 15m net proceeds
- Dividend distribution of 30% of German GAAP result

Rating drivers

Credit positive

- Good geographical diversification with assets spread across Germany.
- Asset portfolio predominately in illiquid 'D' locations, albeit with largely robust tenant demand leading to stable cash flows.
- FCR addresses operational risk with regard to asset acquisitions in advance supported by its existing relationships with major food retailers in Germany.
- Good credit quality and moderate tenant industry diversification with some cyclical exposure.
- Adequate occupancy rate of 87%
- Moderate leverage as measured by the company's LTV of around 50%, although this is likely to increase to finance aggressive growth plans.

- Good relationship with local banks (saving banks and Volksbanken) and relatively low senior LTV's of below 40% support availability of secured bank financing if markets weaken.

Credit negative

- Small company with limited access to capital markets, but ambitious growth plans in niche market with net expansion capex of EUR 500m up to 2020 helping to support visibility to tenants and investors.
- Concentrated tenant portfolio with top three accounting for 32% of rental income.
- Portfolio with high economic age of about 30 years resulting in relatively low attractivity to tenants and high capex needs and exposed to a rather short weighted average unexpired lease term of 3.6 years.
- Volatile and comparatively low EBITDA margin as a result of business model with high associated operating expenses and limited economies of scale.
- Persistently negative free operating cash flow as a consequence of aggressive growth leading to dependence on external financing.
- Volatile EBITDA interest cover heavily dependent on asset disposals as the company has a recurring EBITDA interest cover of around 1x.
- Key-person risk due to the contribution of the CEO and majority shareholder. The appointment of a second member of the Management Board envisaged for Q3 2018, according to the company, should reduce key-person risk.

Liquidity

FCR's liquidity is judged to be adequate, even if EUR 3.1m in debt due in the 12 months to YE 2018 is not covered by free operating cash flows. However, coverage is estimated at 4x, excluding discretionary expansion capex and including executed asset sales, namely in Dresden, Twistringen, Wismar and Schwedt as well as executed asset acquisitions in Magdeburg, Brandis, Gera and Altena for instance. In detail:

Position	YE 2017
• Unrestricted cash	EUR 4.9m
• Open committed credit lines	EUR 0.0m
• Free operating cash flow (t+1)[1]	EUR 0.5m
• Executed asset sales and acquisitions[2]	EUR 7.0m
• Short-term debt (t+1)	EUR 3.1m
Coverage	**4.0x**

With first maturities in 2019 (EUR 5.7m in bonds and EUR 2.1m in bank debt plus EUR 2.9m in scheduled amortisation) and the majority of debt coming due from 2021 onwards (83%), FCR benefits from a relatively backloaded maturity profile leaving sufficient time to address the refinancing of debt due at the property company level (special purpose vehicle). Scope has an adverse view of FCR's aggressive growth ambitions resulting in negative free operating cash flows, heightening dependence on external financing particularly for its holding level debt. This is particularly the case as: i) the servicing of related debt is solely dependent on disposal activity (as opposed to debt at special purpose vehicle level which mostly benefits from a direct pledge on rental income); and ii) the company has a relatively low unencumbered asset ratio of only 14% representing limited headroom for the refinancing of its senior unsecured debt.

Senior secured debt

As at March 2018 FCR had EUR 33m in secured bond debt outstanding. All bonds benefit from a first ranking pledge on investment properties at a value representing the bonds' outstanding nominal and interest payable up to the bonds' maturity. This would positively impact 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 'above-average recovery' thus allowing for a one-notch uplift on the company's issuer rating of B+.

Recovery is based on a hypothetical default scenario in FY 2019 with the company's liquidation value amounting to EUR 150m. This value is based on a 37% haircut applied to FCR'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 204m including EUR 33m in secured bonds.

Outlook

The Outlook for FCR is Stable and incorporates Scope's view of weakening leverage with loan/value reaching 70% by YE 2019 as a result of the company's aggressive growth plans for the next few years with negative free operating cash flows. Scope also incorporates persistent debt protection volatility, however, of around 1.7x supported by successful disposal activity and ongoing adequate liquidity.

[1] Excl. discretionary expansion capex of EUR 69.4m
[2] Executed asset sales EUR 8.9m // executed asset acquisitions (excl. debt financed portion) EUR 2.3m.

Rating-change drivers

A negative rating action would be possible if EBITDA interest expense were to fall below 1.7x on a sustainable basis or if access to external finance weakened.

A positive rating action could be warranted if EBITDA interest expense cover were to increase to above 1.7x on a sustainable basis predominately supported FCR's recurring EBITDA, while the company's leverage as measured by its loan/value ratio remained at around 50%.

Stress testing

No stress testing was performed.

Cash flow analysis

No cash flow analysis was performed. Scope performed its standard cash flow forecasting for the company.

Methodology

The methodologies used for this rating and rating outlook (Corporate Rating Methodology; Rating Methodology: European Real Estate Corporates are available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rated entity and/or its agents participated in the rating process.

The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity, third parties and Scope internal sources.

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Prior to the issuance of the rating or outlook action, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Regulatory Disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

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The ratings/outlooks were first released by Scope on 17.05.2018.

Potential conflicts

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