

Diok RealEstate AG

September 20, 2018

Financial Analysis / Corporate Bond

Analysts

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Office Real Estate Structurer with a clear time horizon

Diok RealEstate AG is an active portfolio holder that commenced its business in 2017 with the aim of structuring an office property portfolio tailored to institutional investors in the medium term and selling its assets or the whole company in a block trade after a holding period of three to five years. In order to achieve this operational goal, the company benefits from its management's broad experience in building commercial real estate portfolios.

The company focuses its business activities on identifying and acquiring office properties in attractive secondary locations in Germany, which are characterised by consistently higher rental yields. There are no plans to participate in risky and capital-intensive real estate development. The individual transactions range between EUR 5 million and EUR 25 million. The Diok management expects the gross asset value of the office property portfolio to be at least EUR 803 million by the end of 2020.

It is planned to finance the purchase price with 65% Loan to Cost via banks. According to the Company's business plan, the financing structure of the mortgage loans will translate over time into an initial LTV of 54% in 2018 and 48% in 2020. Taking interest and amortisation into account, the risk buffer for the operating business will average 1.33%. If administrative expenses and transaction costs are taken into account, this is reduced to an average of 1.07%.

Two variants of a risk analysis were carried out to quantify the risks. The first variant considers the probability of default at the end of the bond's term in 2023, with default probabilities ranging between 7.99% and 9.22%. The second variant of the risk analysis evaluates the *annual* probabilities of default. Here, we simulate under stricter conditions, in which we do not allow capital injections in order to avoid over-indebtedness in the balance sheet. The default probabilities range between 13.00% and 21.08%.

The company's current equity is mainly composed of the appreciation of the real estate as well as the goodwill of Diok Asset GmbH, contributed in kind via an increase in capital. In the event of a distressed situation, we regard this equity as not secured for the purpose of a liability buffer.

Based on our risk analysis, we would consider the bond of Diok RealEstate AG as comparable to a Standard & Poor's rating of BBB to BB.

Liquidity Ratios

	2018e	2019e	2020e
EBIT/Interest Expense	0,0	1,0	1,3
ICR	0,8	1,3	1,6
DSCR	0,8	1,0	1,2
Net Debt / EBITDA	87	19	15
NOI in Mio.	2,3	21,2	42,9
FFO in Mio.	-1,9	0,3	4,4
Hebel (Kaufpreise)	8,5	18,6	18,5
Hebel (Marktwerte*)	5,9	5,4	4,9

Source: BankM-Research * = incl. value uplift after purchase by 20%.

Industry	Real Estate
Financial Reporting	IFRS
Business year	December 31
Management Board	Daniel Grosch Markus Drews
Supervisory Board	Florian Funken (Chairman) Arndt Krienen Stefan Lutz
Issuer	Diok RealEstate AG
Subscription period	24.09.2018 - 26.09.2018
Issuing volume	up to EUR 250 mln
nominal value per bond	€ 1,000
Minimum Subscription	€ 100,000
Maturity	5 years
Coupon	6% p.a.
Issue price	100%
Rating	no rating
ISIN	DE000A2NBY22
Listing	Open Market Frankfurt

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Business Model

Diok RealEstate AG focuses its business activities on the identification and acquisition of office properties in attractive secondary German locations. The aim of its operating activities is to build up an office property portfolio in good to very good micro locations. Only portfolio properties that are cash flow positive from the outset and have low vacancy rates are acquired. Due to the investment focus in secondary locations the objects are expected to return an extra yield of 200bps compared to primary locations. There are no plans to participate in risky and capital-intensive property development. The individual transactions range between EUR 5 million and EUR 25 million.

In order to achieve this operational goal, the Diok management draws on its broad experience in the development of commercial real estate portfolios. Over the past four years, Mr Drews has played a leading role in the acquisition of commercial real estate in secondary locations worth EUR 1.2 billion. In addition, the network of real estate agents that has grown over the years secures access to office properties that are not sold via traditional bidding procedures. This gives the management the prospect of value appreciation potential, some of which is realised immediately upon purchase. At the same time, the management gains access to high-yield, cash flow-positive properties that are almost fully let or have further optimisation potential. The medium-term goal here is to build up an investor-friendly commercial property portfolio that differs from office properties in prime locations in terms of a more stable and higher rental yield and a lower vacancy rate.

Diok has potential acquisition properties with a current volume of EUR 618 million (EUR 506 million in May 2018) available for the planned portfolio expansion. In addition to an average purchase price factor of 12.86, an occupancy rate of around 93% and an average square metre purchase price of 1,276 EUR/m², the acquisition pipeline had an average weighted rental period (WALT) of 5.84 years in May 2018. Based on a consistently increasing pipeline the company believes that the acquisition targets will be met.

While the valuation and selection of suitable commercial properties is carried out by the management itself, personnel-intensive activities such as property management and optimisation are outsourced to an external property manager. On the one hand, this keeps the company's fixed costs low. On the other hand, the Diok management can continue to concentrate on building up the real estate portfolio. Core asset management tasks such as reporting, controlling, budgeting and strategy remain with the company.

The Diok management intends to structure the commercial property portfolio in such a way that core properties with a stable value and long-term leases account for 75% of the portfolio. Another 25% are opportunistically acquired commercial properties with potential for re-letting or development (value add properties). The core properties are characterised by a low vacancy rate of less than 5%, a longer WALT (weighted average letting terms) and relatively low administrative expenses. With corporate customers with strong credit ratings as tenants, the core properties rented on a long-term basis generate stable rental returns with a comparatively low risk of loss of rent. Both categories are required to generate positive cash flows from the first day on.

Value add properties, on the other hand, have vacancy rates of more than 5% and a shorter WALT. By implementing an active property management approach, vacancy rates can be reduced and additional revenue streams realised. This allows rental yields to be achieved that are significantly higher than those of properties that have already been fully let. Substituting tenants in combination

Portfolio management of office properties in secondary locations

Experienced management

Pipeline: EUR 506.6 million

Property management outsourced

Opportunistic share of 25%

with rent increases through customer-specific further development of rented office space also represents a complementary measure to further exploit the rental potential. Substitution also offers the possibility of extending the term of existing rental agreements (WALT). This active property management approach not only allows rental yields on value-added properties to be increased, but also improves the risk/return profile through optimised leases, which ultimately should have a positive impact on the market value of the acquired and further developed value-added properties.

Key Data of the Issue

Issue Volume	up to EUR 250.000.000, targeted minimum amount of EUR 100,000,000
Issue Price	100%
Subscription Period	24.09.2018-26.09.2018
Maturity	01.10.2023
Coupon	6%
Covenants	on reporting dates (31 December, starting on 31.12.2019): consolidated LTV shall be $\leq 85\%$ and unencumbered assets $\geq 10\%$ no dividend payment if $LTV \geq 75\%$; dividend payment of up to 50% of net profit if $65\% < \text{Net LTV} < 75\%$ publication of annual financial statements and half-year portfolio reports use of proceeds only for acquisitions and business development and general business purposes
Call by Issuer	y3 @104%, y4@102%, y5 @100%, Change of Control at any time
Global Lead Manager	BankM - Repräsentanz der FinTech Group Bank AG
Selling Agents	Jyske Bank A/S, GFI Securities Ltd.
Arranger	Swiss Merchant Group AG
Backstop Commitment	arranger has agreed to acquire up to EUR 10,000,000
Admission to Trading	no admission at a regulated market expected, application for inclusion in the Open Market at Frankfurt Stock Exchange

Source: Diok RealEstate AG (Private Placement Memorandum)

Financing & Operating Margins

NOI at least 6.5%

Diok RealEstate founds property companies (PropCos) at whose level the acquisition and portfolio management of the individual properties is carried out. This is financed by secured bank loans and subordinated loans of the AG from borrowed funds.

Irrespective of whether the acquired properties are core or value add properties, the management aims for an initial return on the annual net income of the property (NOI%), which corresponds to the ratio of annual net income of the property to gross investment, of between 6% and 7.5%. At portfolio level, the NOI% should be at least 6.5%.

When calculating the NOI%, additional operating costs and expenses (deducted from the annual net rent) are included in addition to the ancillary purchase costs (notary and land register costs, possibly brokerage fees are added to the purchase price). These include non-apportionable operating costs (including maintenance reserves, provisions for repairs and vacancy periods as well as administrative costs). As a result, the majority of the operating costs associated with property management are already included in the calculation of NOI%.

The net operating income (NOI) generated by the individual office properties flows into the income statement as revenue and is ultimately available to cover the operating costs of Diok RealEstate AG. While administration costs of the Group and the property companies and the transaction costs associated with the planned capital measures reduce NOI% by an average of around 5%. The remaining 95% are available for interest payments and amortisation, taxes and necessary investments in the portfolio properties.

Cash flow of Diok RealEstate AG is primarily generated by the interest spread between NOI% and the financing costs plus repayment of the borrowed funds. As described above, a target value of 6.5% is targeted for the return on property investments (NOI%). The investments at the level of the property companies are financed by the inflow of funds from the bond and senior secured loans. While the bond carries an interest rate of 6%, the Diok management anticipates an average borrowing rate of 2.5% p.a. for the bank loans with an average duration of 10 years protecting against risks associated with changes in interest rates. On average, this implies cost of debt of 3.91% in 2019 and 2020. An annual repayment of 2.5% is assumed for the repayment of the real estate loans. The reduction in debt through regular repayments is an important component of the company's risk provisioning, as we will show below in our risk analysis.

The financing structure stipulates that on average 35% of the office property purchase price is paid with funds from the bond and the rest is covered by senior bank loans with a long-term fixed-interest period (10 years). The bond funds are therefore as economically liable as equity although equity is liable in the first place. This has a positive effect on the financing conditions (in particular the amount of the borrowing rate), as only 65% of the purchase price plus ancillary costs are provided by bank loans and the risks for the financing banks decrease significantly. The assumption of immediate value up-lifts of 20% after purchase as well as appreciation of 2.5% p.a. entails an LTV (in 2020, when the bond proceeds will be fully invested) of approx. 80%, 48% of which are attributable to bank loans and 31% to bond funds.

When calculating the average financing costs, the coupon of the bond is weighted at 35% and the interest of the bank loans plus the repayment rate at 65%. This results in weighted financing costs (interest + amortisation), which rise from 5.11% to 5.23% between 2019 and 2020. Taking NOI% into account, the average risk buffer is 1.33%. If the administrative costs of the Group and the property companies mentioned above as well as the transaction costs associated with the planned capital measures are also included in the calculation, the average risk buffer is reduced to 1.07%.

In order to react quickly to promising office property offers, acquisitions are initially fully pre-financed with funds from the bond and later refinanced via bank loans. This can lead to a reduction in the risk buffer if refinancing is made more difficult due to changed market conditions. The risk buffer is also adversely affected by delays in building up the commercial real estate portfolio, as the interest on the bond funds borrowed inevitably has to be paid on comparatively few properties ("cost of carry" problem). This applies in particular to the purchase phase. Rising interest rates or repayment rates also have a negative impact on the risk buffer. In addition, rent losses and/or rent decreases reduce the NOI%, which can also lead to a compression of the risk buffer.

Investments and indebtedness

The company currently holds office properties worth EUR 53 million in its portfolio (Supernova portfolio with commercial properties in Neuss, Bochum, Freiberg, Ulm and Hattingen). For 2018, the management expects an NOI of EUR 1.43 million (for six months) from the Supernova portfolio, which corresponds to a NOI% of 6.7% based on the gross investment (purchase price + ancillary purchase costs = EUR 42.5 million).

In addition to the almost completed acquisitions mentioned above, Diok's management has set itself the goal of investing a further EUR 43.4 million in office properties in the current 2018 financial year. In a first step, this purchase

Financing through bond funds as economic equity and bank loans

Current stock

Investments in 2018

would be financed entirely with funds from the bond in order to anticipate delays in bank audit processes and to be able to react opportunistically to attractive commercial property offers. The company's goal is to build up a property portfolio of around EUR 149 million by the end of 2018.

Investments in 2019

For the coming financial year, the business plan envisages further investments of EUR 261 million, so that the market value of the commercial real estate portfolio could reach EUR 466 million at the end of 2019. Taking into account the pre-financed acquisitions in 2018 described above, the total use of funds from the bond at the end of 2019 amounts to around EUR 141 million.

Planning from 2020

The remaining EUR 103 million from the net proceeds of the issue (after deduction of EUR 6 million in issuing costs) are earmarked for the purchase of further office properties with a volume of EUR 272 million in 2020. Taking into account the anticipated increases in value planned in the business plan for the purchase of the properties and an annual increase in the market value of the properties held in the portfolio, the expected gross asset value at the end of 2020 is EUR 803 million.

After 2020, there will be no further acquisitions in the baseline scenario, as the bond will be fully invested at this point in time. Together with the secured real estate loans taken out with banks, the total debt of the Diok reaches its peak in 2020 at around EUR 642 million. On the other hand, the expected market value of the commercial real estate portfolio is EUR 803 million at the end of 2020.

Liquidity and ability to service debt

Diok's business plan provides for an average amortization rate of 2.5% p.a. and interest cost of 2.5% on its senior bank borrowings. In addition, the Company's liquidity will be utilized by the coupon payments of the bullet bond as well as general administrative expenses, taxes and capital expenditures.

At the end of 2018, management expects a net loss for the year of EUR 1.9 million, while the result for 2019 is expected to be positive at EUR 0.5 million. The negative result in 2018 is partly due to the fact that the annual net income of the individual commercial properties as well as the financing costs are only included in the income statement on a pro rata basis. While a negative free cash flow of EUR 0.58 million is anticipated in the 2018 financial year according to this calculation, the internal financing power of the company will lead to a steady increase in cash on hand from 2019 onwards. Important key figures such as the interest coverage ratio (ICR) or debt service coverage ratio (DSCR) are also continuously improved in the business plan scenario. While the ICR will rise from 0.78 in 2018 to 1.62 in 2020, the DSCR is expected to increase from 0.76 to 1.22 over the same period.

Cost-of-Carry

It should be noted here that in the business plan coupon payments are only taken into account for the bond funds actually invested; each non-invested euro generates holding costs (cost of carry). Management will therefore endeavour to invest all borrowed funds as quickly as possible.

Market Environment

With the aim of becoming one of the leading office real estate companies in Germany, Diok RealEstate AG concentrates its operating activities on secondary locations. Its business is therefore dominated by market forces at secondary locations outside major German cities.

Diok RealEstate AG

September 20, 2018

Market Environment - 7/23 -

The German office real estate market is characterised by a polycentric structure defined by the "Top 7 Cities" Berlin, Cologne, Düsseldorf, Frankfurt, Hamburg, Munich and Stuttgart. The demand for office space in the "top 7 cities" has always been the focus of international companies. On the other hand, outside the "top 7 cities", which are classified as secondary locations, demand for office properties is dominated by locally rooted, location-loyal tenants. In addition, regional investors tend to have a long-term investment horizon (Source: Bulwiengesa, "Secondary Cities: Investment Opportunities on the German Office Property Market", June 2017). This means that secondary locations have a more stable rental yield than the "Top 7 Cities".

Due to Diok RealEstate AG's focus on secondary locations, the company is exposed not only to the development of macroeconomic factors such as population, gross domestic product ("GDP") and employment in Germany, but also to the development of real estate markets such as letting activity, rent levels and vacancy rates in German secondary locations.

Compared to the "top 7 cities", secondary locations represent a significant growth market in the office sector. With less volatile vacancy rates, stable rental growth and higher yields, secondary locations are also characterised by lower investment risks compared with the "top 7 cities".

In the years 2008 - 2017, the secondary locations outperformed the "top 7 cities" due to constantly higher risk-adjusted rental yields (source: Bulwiengesa, "Büroimmobilienmarkt: Investmentchancen an Sekundäraustellen", April 2018).

The German office real estate market at a glance

High investment volume in office properties

The German office real estate investment market is currently experiencing a high transaction volume. In 2017, the transaction volume amounted to 56.8 billion euros and exceeded the peak value of two years previously by 1.7 billion euros (source: press portal). In 2015 and 2017, market participants experienced the two most vivid financial years since the 2008 financial crisis (source: JLL).

The office real estate market accounted for 55% of the total investment volume in commercial real estate in 2017 (Source: Bulwiengesa, "Office real estate market: investment opportunities in secondary locations", April 2018). Over the past five years, the office real estate market has had a stable share of the overall real estate market, with continued strong demand for office space. The reasons for the strong demand for office space are the robust overall economic development and the continuing favourable conditions on the German labour market, which are reflected in a steady increase in the number of employees.

Strong macroeconomic conditions in Germany

With around 82.7 million inhabitants and a nominal GDP of 3.263 billion euros in 2017, Germany is the most populous country in the EU. Germany has the fourth highest nominal GDP in the world and in 2017 accounted for 29% of the total GDP of the euro zone (19 countries) (source: Federal Statistical Office).

After a sharp decline in real GDP in 2008 and early 2009 as a result of the global financial crisis and the associated economic downturn, the German economy recovered and continued to grow at an average annual growth rate of 2.1% between 2010 and 2017 (source: Federal Statistical Office). In 2017, the German economy continued its upward trend with real GDP growth of 1.37%, well above the Eurozone average of 1.19% (source: Eurostat).

Market structure

Advantages of secondary locations

GDP growth

Employment dynamics

The steady economic growth in Germany was driven by a strong employment dynamic characterized by a persistently low unemployment rate and moderately rising wages. Over the past ten years, the number of employees in Germany has risen steadily from 40.3 million in 2007 to 44.4 million in 2017 (source: Federal Statistical Office). In 2017, 1.5 million people were unemployed in Germany, corresponding to an unemployment rate of 3.5%, unchanged from the previous year (source: Federal Statistical Office). Parallel to this, nominal wages rose by an average of 3.21% per year between 2010 and 2017, which further increased the purchasing power of German consumers (source: Federal Statistical Office).

Office property investments in secondary locations

Increasing proportion of transactions at secondary locations

Transaction volumes

In the first half of 2018, the volume of office property transactions fell by 1% to €25.6 billion (source: JLL). Secondary locations, defined as the area outside the "top 7 cities", accounted for around 37% (€ 9.57 billion) of the total transaction volume (source: PMA, JLL). Secondary locations represent an important, liquid and growing market. They accounted for around 33% of the trading volume in 2017 (Source: Bulwiengesa, "Office Property Market: Investment Opportunities in Secondary Locations", April 2018). In addition, the transaction volume at secondary locations between 2008 and 2017 showed average annual growth of around 9% (source: Bulwiengesa, "Office real estate market: investment opportunities at secondary locations", April 2018).

Rent yield differences

The observed increase in transaction volumes was primarily due to rental yield differences between the "top 7 cities" and secondary locations. Although demand for office real estate led to a decline in rental yields, secondary locations still offer an average rental yield of 200 basis points above the yield investors receive for their investments in the "top 7 cities".

German office real estate market in secondary locations

Stable demand

In contrast to Germany's "top 7 cities", secondary locations have developed in a very stable manner in recent years, both in terms of average rental growth and vacancy rates. Demand for secondary locations is driven above all by small and medium-sized enterprises, which are characterised above all by strong loyalty to the location and a high degree of stability. Office employment, the most important indicator of demand on the office market, has developed positively across all market sectors in recent years. The upward trend in office employment should continue in the coming years and have a positive effect on the office market (Source: Bulwiengesa, "Secondary Cities: Investment Opportunities on the German Office Property Market", June 2017).

Low cyclicity

Several factors can explain the lower cyclicity of secondary locations. First, prime yields were higher in the secondary locations than in the "top 7 cities", while rents rose similarly strongly. Second, the volatility of investor returns was significantly higher in the "top 7 cities" than in the secondary locations. Finally, construction activity in the secondary locations was mainly demand driven and probably less speculative, reducing the risk profile of the secondary locations and the potential for local price bubbles. In addition, demand in many secondary locations is following a stable upward trend (source: PMA, Fidelity, BNP Paribas, Bulwiengesa).

Results of Operations, Financial Position and Net

Assets

In order to estimate the future development of Diok RealEstate AG, we refer to the financial figures expected by management for the future, which are derived from the business plan. We take these key figures as given and have not subjected them to any further review.

This planning is based on the following assumptions defined by the company: The bank loans at the level of the property company bear interest at 2.5% and comprise 65% of the purchase price plus ancillary purchase costs. In addition, the properties are acquired at attractive conditions according to company assumptions and can therefore be acquired at approx. 20% below the market value (value uplift). The value of the property increases by 2.5% p.a. while it is held in the portfolio. The costs of each property company are fixed at EUR 10,000 p.a., while asset management is outsourced at costs of 1.5% and property management at 2.39% of the annual net rent. The rent default risk is estimated at 3%.

Assumptions

Profit and loss account

	<i>mln EUR</i>	2018e	2019e	2020e
NOI		2,3	21,2	42,9
Administrative Expenses				
Group + other operating expenses		-0,4	-0,8	-1,0
PropCos		-0,2	-0,2	-0,3
Transaction Costs		-0,3	0,0	-0,3
+/- Change in fair value		25,6	55,9	65,9
EBITDA		27,0	76,0	107,3
Depreciation		-1,5	-4,6	-7,9
EBIT		25,5	71,4	99,4
Financial Result (cash)		-1,8	-15,0	-25,5
Earnings before tax and minorities		23,7	56,4	74,0
Corporate Tax		0,0	-0,1	-1,2
Net Profit		23,7	56,3	72,8

Source: Diok RealEstate AG

Cash Flow Statement

	<i>mln EUR</i>	2018e	2019e	2020e
Net Profit		23,7	56,3	72,8
Earnings Before Taxes (EBT)		23,7	56,3	71,6
+/- Change in fair value of investment property		-25,6	-55,9	-65,9
FFO I before Taxes		-1,9	0,4	5,6
' +/- current tax		0,0	-0,1	-1,2
FFO I before Taxes		-1,9	0,3	4,4

Source: Diok RealEstate AG

Balance Sheet

	<i>mln EUR</i>	2018e	2019e	2020e
Assets				
Starting Investment properties		79,8	148,9	465,5
Sale / Purchase		43,4	260,6	271,5
Valuation gain market value increase		25,6	55,9	65,9
Valuation gain CAPEX & TIs		0,1	0,1	0,1
Ending Investment properties		148,9	465,5	803,1
Assets held for sale		0,0	0,0	0,0
Gross Asset Value		148,9	465,5	803,1
Cash		0,0	0,0	5,7
TOTAL ASSETS		148,3	465,3	808,8
Liabilities				
Starting attributable equity		0,0	25,2	86,1
Valuation gain from market value increase		25,6	55,9	65,9
Retained Profit		-0,4	5,1	14,7
Ending attributable equity		25,2	86,1	166,8
Bank liabilities (nominal capital)		123,7	379,4	642,1
TOTAL EQUITY AND LIABILITIES		148,3	465,3	808,8

Source: Diok RealEstate AG

Leverage Analysis

We regard leverage as an important indicator of market risk because it is a factor that intensifies price fluctuations in the real estate market.

In the table below, we have simulated the development of Diok RealEstate AG's equity capital with (one-off) fluctuations on the real estate market. Here we assume, as an exception, that there is no value uplift at the time of purchase and that the value remains constant during holding in the portfolio. To do this, we change the gross asset value (GAV) directly by the specified percentage. By way of example, it can be seen that without value uplifts, equity increases by a factor of 5 from EUR 16.5 million in 2018 to EUR 36.3 million in 2020. With a one-off increase in market prices of 6%, equity rose to EUR 121.6 million and thus more than sevenfold. If the market value were to decline by 5.4% in 2019, the company would become over-indebted.

		2018e	2019e	2020e
GAV		140	401	673 <i>acc. to Business plan</i>
Equity		16	22	36 <i>acc. to Business plan</i>
Equity in mln resulting from fluctuations of real estate prices by	9%	29,1	57,7	96,8
	6%	24,9	45,7	76,6
	3%	20,7	33,6	56,5
	0%	16,5	21,6	36,3 <i>acc. to Business plan</i>
	-3%	12,3	9,6	16,1
	-6%	8,1	-2,5	-4,1
	-9%	3,9	-14,5	-24,3

Source: BankM Research, Diok RealEstate AG

Diok RealEstate AG

September 20, 2018

Peer Group Comparison - 11/23 -

Peer Group Comparison

We determined a peer group for the Diok Real Estate AG bond by selecting comparable unsecured euro bonds with an issue volume of between EUR 100 million and EUR 300 million and a coupon of between 2% and 9%. As a result, we were able to identify 24 bonds from 22 companies.

Peer Group Table

Issuer	coupon	matu- rity	Rating	cur. yield	amount issued € Mio.	coun- try	Leverage	EBITDA / Interest Expense	type
DIC Asset AG	3.25	2022	-	3.19	180	DE	3.00	2.46	call.
VGP NV	3.9	2023	-	3.74	225	BE	2.22	5.09	mat.
ADLER Real Estate AG	2.125	2024	-	2.16	300	DE	4.00	1.97	call.
Summit Germany Ltd	2	2025	BB+	2.10	300	GG	2.00	12.11	call.
Warehouses De Pauw CVA	3.375	2021	-	3.21	125	BE	2.14	7.71	mat.
Immob. Grande Distrib. SIIQ SpA	2.5	2021	-	2.46	300	IT	2.08	5.71	call.
Accentro Real Estate AG	3.75	2021	-	3.64	100	DE	2.26	3.97	mat.
Consus Real Estate AG	4.75	2024	-	4.75	150	DE	3.97	0.77	mat.
CA Immobilien Anlagen AG	2.75	2023	-	2.57	150	AT	1.97	6.16	mat.
Cie Immobiliere de Belgique SA	3	2022	-	2.91	100	BE	2.47	1.42	mat.
ARGAN SA	3.25	2023	-	3.18	130	FR	3.86	4.96	mat.
Summit Germany Ltd	2	2025	BB+	2.11	300	GG	2.00	12.11	call.
Klepierre SA	2.125	2025	-	2.01	255	FR	2.41	7.49	mat.
Gecina SA	2.875	2023	BBB+	2.62	300	FR	1.68	19.93	mat.
ICADE	3.375	2023	-	2.97	300	FR	3.14	5.80	mat.
Altearea SCA	3	2021	-	2.89	230	FR	4.45	7.53	mat.
Nexity SA	3.522	2021	-	3.33	146	FR	3.44	10.25	mat.
Nexity SA	2.6	2025	-	2.60	121	FR	3.44	10.25	mat.
Fonciere des Murs SCA	2.218	2023	-	2.10	200	FR	1.97	13.48	call.
Beni Stabili SpA SIIQ	2.125	2022	-	2.05	125	IT	2.38	3.52	mat.
Fonciere de Paris SIIC SAS	3	2023	-	2.88	100	FR	1.68	19.93	mat.
Societe de la Tour Eiffel	3.3	2025	-	2.99	200	FR	2.26	5.64	mat.
Eurosic	3.051	2023	-	2.84	125	FR	1.68	19.93	call.
Cibus Nordic Real Estate AB	4.181	2021	-	4.10	135	SE	2.39	-	call.

Source: Bloomberg, BankM Research, data of 10.09.2018, 10am

In this peer group, the Diok bond offers both the highest coupon and the clearly highest current yield. Based on the company's business plan, we initially expect a leverage of over 5.9 in 2018, which will fall to 4.9 by 2020 (based on the fair value of the properties assumed in the company's business plan) Based on the purchase price of the properties, the leverage moves from 8.5 in 2018 to 18.6 in 2019 to 18.5 in 2020. The average leverage of the peer group is 2.72. This means that the higher return is reflected by a much higher leverage compared to the peer group.

Based on the company's business plan, with EBITDA of EUR 20 million in 2019 and interest costs of EUR 140 million for bond liabilities, the interest coverage ratio is 2.38, which is below the peer group average (6.63).

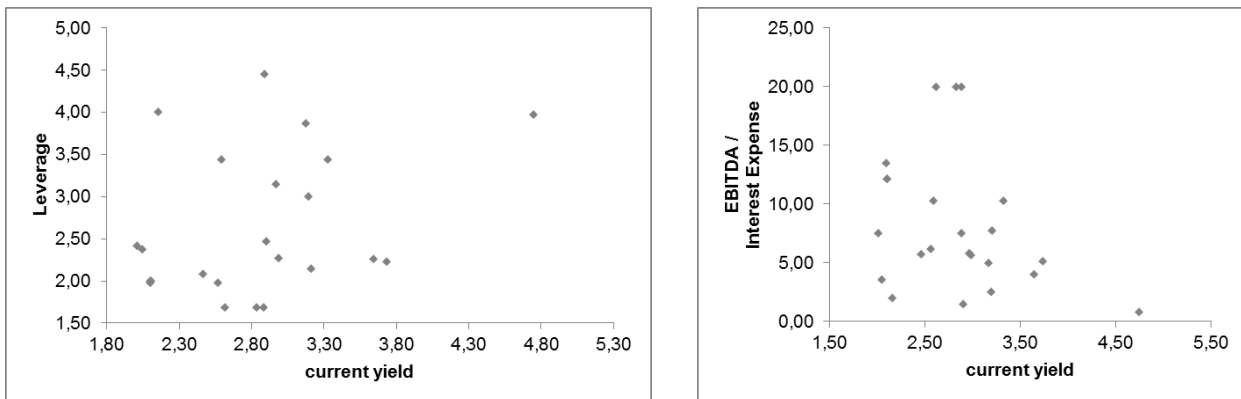
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We want to align the Diok bond quantitatively with comparable bonds and therefore consider the relationship between the current yield and the valuation-relevant parameters (i) leverage and (ii) EBITDA / interest expense.

With regard to (i), the trend of rising yields with increasing leverage is discernible. Parameter (ii) shows that higher interest coverage ratios are more likely to be found in the range of lower yields.

With regard to both parameters, however, there is no statistically significant correlation.

Relationship between leverage or interest coverage ratio and current yield



Source: Bloomberg, BankM Research, data of 10.09.2018, 10am

Risk Analysis

Influencing Factors

The financial resources provided by bond investors are subject to risks that are influenced by many different variables over which Diok management has no influence. These include in particular interest rate risks and market price fluctuations for commercial real estate. Interest rate risks are generated by developments on the Pfandbrief markets, on which lending banks make their lending policies and conditions dependent. At the same time, a wide variety of economic supply and demand effects influence the observable market price fluctuations of commercial real estate, which in turn can in part be attributed to developments on the Pfandbrief markets.

Random variables

It is almost impossible to shed light on all relevant uncertainty factors in a risk analysis. For this reason, we limit ourselves to three indicators which are used to quantify interest rate risks (first random variable) and market price fluctuations for office properties (second random variable). The indicator for interest rate risks primarily simulates uncertainty about the financing costs of real estate loans taken out with banks (risk: borrowing rate). In our risk analysis, interest rate risks are approximated by monthly data for mortgage Pfandbriefe and public Pfandbriefe with a term of 10 years. The data range from January 2000 to July 2018 and are published on the Deutsche Bundesbank homepage.

In addition, two indicators combined in a random variable simulate the market price fluctuations of commercial real estate. This quantifies the risks of price fluctuations for the properties held in the portfolio and the direct increases in value anticipated by Diok management for the purchase of office properties (value uplift for the portfolio and purchase). Here we rely on annual data from the Bulwiengesa analysis house, which was made available to us for the period from

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1975 to 2017. While one indicator captures the development of office rents in German cities, the second indicator shows the price development of commercial properties. Both indicators show a very high and statistically significant coefficient of determination for the price development of commercial real estate. The reason for this is the fact that office rents represent an important valuation parameter (IAS 40 in combination with IFRS 13) in the valuation of office properties. In addition, price developments for commercial properties influence the market prices of commercial real estate, as these are an integral part of the properties.

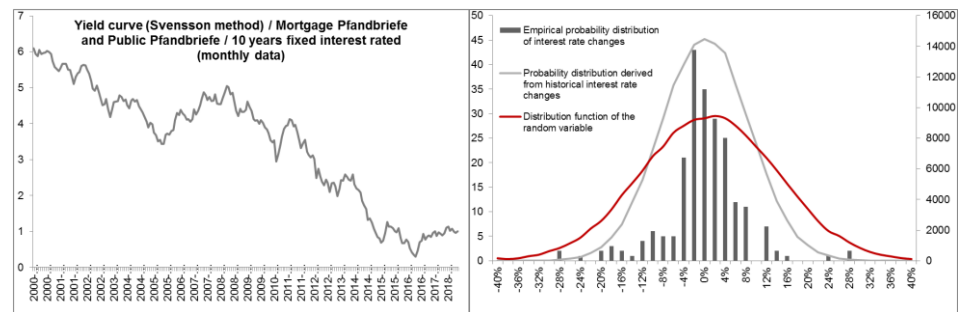
The following section derives the distribution functions of the two random variables, which are integrated into the business plan and form the basis for our scenario analysis. We have deliberately opted for a symmetrical distribution function for both random variables, although the empirical data show a right-skew distribution function for interest rate changes (skewness=0.94 & kurtosis=7.33) and a left-skew distribution function for the price development of commercial real estate (office rents: skewness=-0.62 & kurtosis=0.22; land prices: skewness=-0.30 & kurtosis=1.5). A symmetrical distribution function makes interest rate increases more probable in the simulation, whereas price declines for commercial real estate are more significant. The aim of the simulation is to show how the default probability of the bond changes with the expected investment returns and interest costs.

Procedure

Derivation of random variables - interest rate risks

For the simulation of annual interest rate risks, the empirical frequency distribution of the monthly logarithmic rates of change of the interest rates for German mortgage Pfandbriefe and public Pfandbriefe was first derived. As can be seen from the diagram on the right, monthly rates of change in Pfandbrief interest rates between -28% and +28% could be observed between January 2000 and July 2018.

In order to define a random variable for the simulation, the first two moments of the empirical distribution function were simulated with a normal distribution (grey bell curve). As can easily be seen, the generated distribution function does not cover all values (fat tails). To capture the extreme values of the change rates, a synthetic distribution function was generated in a second step, which assigns a higher probability to more extreme realizations with the same mean value (red bell curve). After converting the monthly data to annual values, a random variable results which generates the expected annual interest rate changes with an expected value of -5% and a standard deviation of 45.6% (pure form).



Source: Deutsche Bundesbank

At first glance, a standard deviation of 45.6% appears to be quite high, since the range around the mean value, within which 95.44% of all entries are found, includes a value range of -96.2% and 86.2%. However, an analysis of the rates of change shows that these values did occur during the period under review. The Pfandbrief interest rate dropped from 2.58% to 0.97% between December 2013 and December 2014, which corresponds to a logarithmic rate of change of -97.8%.

The first random variable in the business plan was linked to the interest calculation in 2019 and 2020. For 2018, however, the simulation continues to assume an interest rate of 2.5%, which reflects the expectations of the Diok management. It should be noted that the random variable simulates the rates of change, so that in 2019 the simulation is based on an interest rate of 2.5%, which changes from simulation to simulation according to the simulated rate of change. In 2020, the interest rate is then based on the interest rate realised in the previous year before a new rate of change is simulated which leads to a new realisation of the interest rate.

Derivation of random variable - market price fluctuations

In constructing the distribution function of the second random variable, which reflects market price fluctuations for commercial real estate, the annual

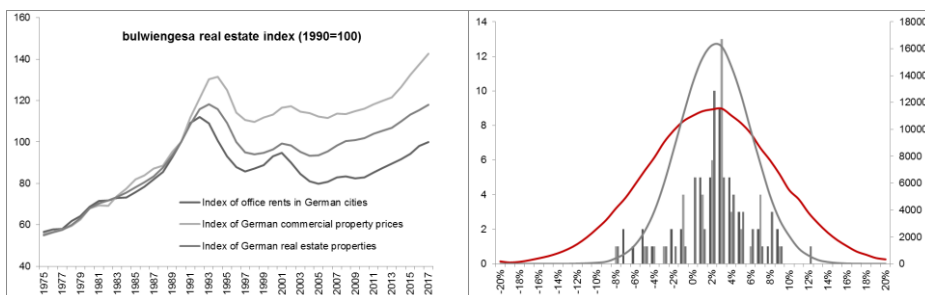
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logarithmic rates of change of office rents and commercial land prices were used. As can be seen in the graph on the left below, the two indicators are highly correlated both with each other and with the index for commercial property prices.

The first step was to derive the frequency distributions of the logarithmic rates of change for all three time series. We then combined the first two moments of the empirical distribution functions and simulated a normal distribution (grey bell curve). As can easily be seen, the distribution function generated in this way does not cover all the expressions (fat tails). In order to capture the extreme manifestations of the combined rates of change, in a further step we generated a synthetic distribution function that assigns a higher probability to more extreme realizations with the same mean value (red bell curve). From this, we derive a random variable that generates the expected annual market price fluctuations of office properties with an expected value of 1.35% and a standard deviation of 6.79% (pure form).



Source: Bulwiengesa, BankM Research

As can be seen from the graph on the right, the synthetic distribution function includes all extreme values and thus ensures that all price changes for office real estate observed over the past 42 years are reflected in the simulation. However, the distribution function also simulates much more extreme characteristics than observed in reality. This poses no problem insofar as it is an almost symmetrical distribution function in which the number of excessively negative realisations corresponds approximately to the number of excessively positive realisations.

In the business plan, the management anticipates an annual increase of 2.5% in value of commercial properties held in the portfolio. We transfer this fixed value to the second random variable. Furthermore, the management expects a direct increase in value of 20% in the acquisition of the commercial properties. This assumption will also be transferred to the second random variable. The reason for this is the fact that properties acquired below value which experience a fundamental increase in value through appropriate measures (reduction of vacancy rates, increase in rents, etc.) cannot necessarily be sold on the market at "fair value" at any time. Economic and psychological effects could lead to a decoupling of price formation from fundamental factors, which would have a negative impact on the feasibility of implemented value enhancement measures for office real estate.

Simulation - probability of default after 5 years

In the first part of our risk analysis, we have calculated 21 parameter constellations in order to make statements about the probability of default in five years. Here we have assumed that negative balance sheet equity values caused by market price fluctuations before maturity of the bond are offset by external capital sources, which are not discussed in detail in our analysis. For each parameter constellation, 30,000 simulations are performed. In each individual simulation, the equity value calculated at the end of the bond term in 2023 is calculated.

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Settings and results

The equity value is calculated from the expected market value of the commercial real estate portfolio to be sold plus cash on hand and less the borrowed funds, which comprise the bank loans taken out and the EUR 250 million for the bond. If the equity value is negative at the end of the period under review, a default occurs. The probability of default is then calculated on the basis of the sum of all events leading to the default. It should be noted here that this default is not accompanied by a default of the bank loans as long as the company meets its credit obligations, as the fixed interest rates of the loans taken out with banks amount to 10 years.

In setting 1, we have replaced the constant (2.5% p.a.) for the annual write-up of the portfolio properties with random variable 2, which remains in pure form in all the following parameter constellations (expected value of 1.35%; standard deviation 6.79%). All other assumptions of the Diok business plan remain unchanged. The risk of default is 0.45%.

Setting 2 is based on setting 1. However, we also introduce random variable 2 for the increase in purchase value (expected value 20%; standard deviation 6.79%). The probability of default rises slightly to 0.67%.

Setting 3 corresponds to setting 1 with the difference that 10% is assumed for the appreciation in value on purchase. The risk of default is 2.81%. If the parameter for the increase in value also fluctuates during the purchase, the default risk in setting 4 increases to 3.36%.

In setting 5, we eliminate the increase in value upon purchase and use random variable 2 only to simulate the annual change in the properties held in the portfolio. All other assumptions of the business plan remain valid. The probability of default increases significantly to 11.80%.

In setting 6, random variable 2 in its pure form is used for the simulation. Random variable 2 now influences the value of the properties held in the portfolio as well as the anticipated increases in value upon purchase. The probability of default is slightly reduced to 10.10% due to the positive expected value of random variable 2.

Setting 7 is based on setting 6. However, we lower the expected value of random variable 2 for the increase in value at purchase to 0%. We leave the standard deviation at 6.79%. The probability of default rises to 13.25%.

Setting 8 is based on setting 5 and additionally includes random variable 1 in pure form (expected value -5%; standard deviation 45.6%) for interest rate risks in the simulation. The calculation of the probability of default yields 12.10%.

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	Value uplift on the acquisition of commercial real estate	Yearly changes of office estates held as investment property	Interest rate	Redemption	Default rate	Number of Simulations
1	20%	Random variable 2	2.50%	2.50%	0.45%	30000
2	Random variable 2 (E(r)=20%)	Random variable 2	2.50%	2.50%	0.67%	30000
3	10%	Random variable 2	2.50%	2.50%	2.81%	30000
4	Random variable 2 (E(r)=10%)	Random variable 2	2.50%	2.50%	3.36%	30000
5	0%	Random variable 2	2.50%	2.50%	11.80%	30000
6	Random variable 2	Random variable 2	2.50%	2.50%	10.10%	30000
7	Random variable 2 (E(r)=0)	Random variable 2	2.50%	2.50%	13.25%	30000
8	0%	Random variable 2	Random variable 1 (Initial interest rate=2.5%, E=-5%;Std=45%)	2.50%	12.10%	30000
9	0%	Random variable 2	Random variable 1 (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	12.44%	30000
10	0%	Random variable 2	3.00%	2.50%	13.51%	30000
11	0%	Random variable 2	3.50%	2.50%	15.43%	30000
12	0%	Random variable 2	4.00%	2.50%	15.43%	30000
13	0%	Random variable 2	4.50%	2.50%	17.50%	30000
14	Random variable 2 (E(r)=0)	Random variable 2	Random variable 1 (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	13.68%	30000
15	Random variable 2 (E(r)=5%)	Random variable 2	Random variable 1 (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	7.08%	30000
16	Random variable 2 (E(r)=5%)	Random variable 2	Random variable 1 (Initial interest rate=2.5%, E=-5%;Std=45%)	2.50%	6.64%	30000
17	Random variable 2 (E(r)=10%)	Random variable 2	Random variable 1 (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	3.58%	30000
18	0%	Random variable 2	2.50%	2.50%	13.57%	30000
19	Random variable 2	Random variable 2	Random variable 1 (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	14.15%	30000
20	Random variable 2 (E(r)=5%)	Random variable 2	Random variable 1 (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	9.61%	30000
21	Random variable 2 (E(r)=5%)	Random variable 2	Random variable 1 (Initial interest rate=2.5%, E=-5%;Std=45%)	2.50%	8.64%	30000

Source: BankM Research

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Setting 9 is based on setting 8 with the difference that for the expected value of random variable 1 the expected value is reduced to 0% (standard deviation remains at 45.6%). The probability of failure increases slightly to 12.44%.

Settings 10 to 13 examine how the default probability changes if the value increases are completely disregarded in the purchase and the interest costs rise from 3% to 4.5%. The key message is that rising interest rates in an environment in which office properties with little or no potential for appreciation can be acquired have devastating effects on the company. The default probabilities range between 13.51% and 17.50%.

Settings 14 to 17 combine both random variables and calculate the probabilities of default on the basis of different expected values. If random variables 1 and 2 fluctuate by 0% for given standard deviations, a default occurs in 13.68% of all cases. If the expected value of random variable 2 for the increase in value at purchase increases to 5% and everything else remains the same, the probability of default is significantly reduced to 7.08%. The default probability decreases further if the expected value of random variable 2 for the increase in value at purchase is increased from 5% to 10%.

Settings 18 to 21 examine how default probabilities change when holding costs are taken into account in the business plan. The calculations show that the consideration of holding costs (bond money borrowed but not invested) increases the default probabilities on average by 2% (comparison: setting 5 & 18, setting 15 & 20, setting 16 & 21).

Conclusion: 5-year period observation

For the parameter constellations examined, random variable 2 for the annual change in the portfolio properties was consistently included in pure form in the calculations. In order to illustrate the effects of the parameter "value appreciation on purchase" on risk, we have calculated various values between 0 and 20%. Since we do believe that the experienced Diok management is capable of value increases, we consider all parameter constellations with an expected value of at least 5% to be realistic. Setting 15, 16, 20 and 21 thus result in an average probability of default of 8%. If we did not trust the management to increase the value and apply random variable 2 in its pure form, the average probability of default would rise to 9.22%.

Simulation - Annual Probabilities of Default

In the second part of our risk analysis, we no longer assume that negative balance sheet equity values will be offset by additions of equity. If at any point in time (during the period 2019-2023) all liabilities exceed the assets of Diok, we now assume that a continuation of the company is predominantly unlikely and that a default will occur. Furthermore, we now assume that the increase in value of the purchase in 2018 will not fluctuate, but will be fixed at different levels. Contrary to this, when calculating the five-year probability of default, we have allowed the value of the properties, acquired in 2018 or to be acquired in 2018, to fluctuate. As it turns out, the confirmation of the anticipated increases in value upon purchase in 2018 is an important event for the probable continuation of the company.

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	Value uplift on the acquisition of commercial real estate	Yearly changes of office estates held as investment property	Interest rate	Redemption	Default rate	Number of Simulations
1	Random variable 2 (value uplift on the acquired assets (2018=20%; E(r)=5% ab 2019)	Random variable 2	Random variable 1 = variable (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	13.00%	200000
2	Random variable 2 (value uplift on the acquired assets (2018=15%; E(r)=5% ab 2019)	Random variable 2	Random variable 1 = variable (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	16.37%	200000
3	Random variable 2 (value uplift on the acquired assets (2018=10%; E(r)=5% ab 2019)	Random variable 2	Random variable 1 = variable (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	21.08%	200000
4	Random variable 2 (value uplift on the acquired assets (2018=5%; E(r)=5% ab 2019)	Random variable 2	Random variable 1 = variable (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	27.42%	200000
5	Random variable 2 (value uplift on the acquired assets E(r)=5%)	Random variable 2	Random variable 1 = variable (Initial interest rate=2.5%, E=0%;Std=45%)	2.50%	28.31%	200000

Source: BankM Research

When calculating the annual default rates, we assume that the expected increase in value at purchase is at least 5%. Setting 1 shows that a default occurs with a probability of 13.00%, although the acquisitions in 2018 actually led to an increase in assets on the balance sheet. If holding costs are also taken into account, the probability of default increases to 18.55 %.

Setting 2 is based on setting 1 and illustrates how the default rate changes if the book profits of the acquired properties are 5% lower in the first year. The default rate rises to 16.37%.

In Setting 3, we further reduce the book profits of the acquired properties in 2018 by 5%-age pts. to 10% and calculate a default rate of 21.08%. If the increase in value at purchase in 2018 were only 5%, the probability of default would be 27.42% (setting 4).

For comparison, in setting 5 the increase in value at purchase in 2018 is not fixed, but fluctuates around the expected value of 5%. A default occurs with a probability of 28.31%.

The annual default rates for the bond are shown in the table below. The table shows that the default rates tend to increase in the individual years as the value of the properties acquired in 2018 declines. This effect is particularly pronounced in 2019. It also shows that the probabilities of default tend to decline over time as the value of the properties acquired in 2018 increases. The matrix also shows that the probability of default rises disproportionately strongly in 2019 if management is unable to achieve a value increase of at least 10% in the properties acquired in 2018.

	2019e	2020e	2021e	2022e	2023e	Accumulated
1 (20%)	1,52%	2,25%	4,42%	2,92%	1,89%	13,00%
2 (15%)	3,17%	2,97%	4,97%	3,23%	2,03%	16,37%
3 (10%)	5,85%	3,82%	5,63%	3,56%	2,22%	21,08%
4 (5%)	10,29%	4,72%	6,31%	3,82%	2,28%	27,42%
5 (E(5%))	11,19%	4,72%	6,26%	3,83%	2,30%	28,31%

Source: BankM Research

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Conclusion: yearly consideration

Both in deriving the probability of default after 5 years and in calculating the annual default rates, the capabilities of the Diok management have a decisive influence on the default rates. However, the matrix of annual default rates makes clear that the value increases of the acquired properties in 2018 are of crucial importance for the probable continuation of the company. Since we are convinced by the management, a crash on the property market is unlikely in the short term and Diok has access to a pipeline with an average vacancy rate of 7%, we expect a one-off increase in the value of the properties acquired in 2018 of at least 10%. If the annual fluctuation of the properties held in the portfolio (random variable 2 in pure form) occurs in subsequent years, a default rate of between 13.00% and 21.08% is calculated based on our calculations (expected value uplift at purchase of 5% p.a. with a given standard deviation of 6.79%).

Summary of the risk analysis

We have carried out two variants of a risk analysis. The first considers the probability of default at the end of the term of the bond in 2023. The probabilities of default here are between 7.99% and 9.22%. This assessment assumes that in the event of a default at AG level that has occurred in the meantime, equity will be added in order to avoid over-indebtedness in the balance sheet. We cannot assess the extent to which this will occur.

The second variant of the risk analysis examines the annual probabilities of default. Here, we simulate under stricter conditions, under which we do not allow capital injections to avoid over-indebtedness in the balance sheet. The default probabilities range between 13.00% and 21.08%.

On the basis of an S&P study (S&P Default, Transition, and Recovery: 2017 Annual Global Corporate Default Study and Rating Transitions), we would consider Diok RealEstate AG's bond to be comparable to a Standard & Poor's rating of BBB to BB. S&P defines bonds with a BBB rating as rather good on average and not particularly safe. Even minor deteriorations in the economy can lead to problems. BB implies that it is a speculative investment; problems in the economy would most likely lead to defaults.

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3. Date of first publication of this document:

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