

Research Update:

# Germany-Based Diok Real Estate AG Assigned 'B' Rating; Outlook Stable

May 8, 2020

## Rating Action Overview

- Diok Real Estate AG owns and manages an office property portfolio valued at about €205 million as of year-end 2019 (€257 million including acquisitions to be closed in second-quarter 2020).
- We consider that the company's portfolio can generate sustainable EBITDA and cash flow over the next 12 months, supported by its focus on midsize cities in secondary locations in Germany.
- We are assigning our 'B' long-term issuer credit rating to Diok and our 'B-' issue rating to its senior unsecured bond due 2023.
- The stable outlook reflects our view that the underlying macroeconomic fundamentals and positive demand trends in Diok's main locations remain solid, supporting occupancy improvement and rental income growth.

## Rating Action Rationale

**Diok's small size, limited asset and tenant diversity, and short operational track record are key business risk factors.** Pro forma committed acquisitions so far this year, Diok owns and manages 17 office assets valued at about €257 million, spread across Germany's secondary locations. Diok's property portfolio is smaller than those of other rated peers in Germany's commercial real estate segment. We note some asset concentration, with the top-two assets in the Rhineland region and Munich accounting for about 32% of the total pro forma portfolio value. The company's average asset value is lower than that of other rated peers, at €20 million-€25 million per asset. We expect asset diversity will further improve while the portfolio expands. Diok's tenant base is small, with only about 40. The top 10 tenants account for about 65% of total annualized rental income, and about half of the company's assets are single-tenant properties, which could temporarily pose cash flow risk for the respective building once a tenant moves. We also take into account Diok's relatively short operational track record, given its recent incorporation in 2018 and its rapidly expanding portfolio.

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**Market fundamentals are expected to remain favorable for Diok's office assets, although we believe secondary locations are less dynamic than metropolitan cities.** Diok's strategy focuses on office properties in small-to-midsize secondary locations in Germany that border metropolitan cities. We view market dynamics, such as rental growth potential and demand-supply trends in the office market across Germany as favorable. However, we believe secondary locations such as Ulm, Aachen, or Neuss are less dynamic than metropolitan cities such as Berlin or Frankfurt, and it might take longer to find replacements if a tenant moves out once the lease contract expires. 59% of Diok's portfolio is in North Rhine-Westphalia, 23% in Bavaria, 11% in Baden-Wuerttemberg, 5% in Hessen, and the remainder in Saxony-Anhalt. Nevertheless, we believe most of its portfolio to be located in cities with good infrastructure and favorable macroeconomic fundamentals, including unemployment and real GDP growth in line with the German average.

**Diok's solid tenant base and moderate asset quality support stable long-term rental income, with no development exposure.** Overall, we view Diok's tenant base as solid, consisting predominantly of well-established German midsize companies and long-term public sector tenants. Tenants are typically responsible for certain property expenses (double net lease), and the lease contracts are linked to indexation, in line with the industry standard. Diok's two largest tenants are the software company SAP and pharmaceutical company Nuvisan, each contributing about 10% of its annualized gross rental income. We believe Diok's tenant base is exposed mainly to resilient industries such as IT, pharma, and health care as well as public institutions that should be relatively resilient during the current COVID-19 pandemic and expected economic slowdown in Germany. We view Diok's overall portfolio quality as average and in line with that of rated peers with a focus on secondary locations, such as DEMIRE Mittelstand Real Estate AG. The company has no large capital expenditure (capex) needs due to its tenant mix, its overall small portfolio size, and solid weighted average lease length of more than five years. The current occupancy rate of 93% is low compared with the German market rate, but in line with that of German office peers such as Alstria Office-REIT AG (92% as of end 2019). We view positively that the company is not involved in any development activities.

**The rating incorporates a one-notch upward adjustment for our positive view of Diok under our comparable rating analysis.** We believe Diok's business model as a real estate holding company--with stable rental income, limited asset rotation, and a supportive economic environment--compares favorably with that of some rated peers with similar business risk profiles and comparably high leverage, such as developers or small consumer product-focused companies, which tend to show more volatile performance and credit metrics. Although the company's cash-flow base remains small and limited, its long-term lease contracts with domestic tenants and, in particular, the share of public-sector tenants, provide near-term cash flow visibility and stability.

**We forecast S&P Global Ratings-adjusted debt-to-debt plus equity will remain higher than 75% and EBITDA interest coverage below 1.5x for the next 12 months.** We consider Diok's debt leverage to be high compared with industry standards, and believe it will remain so over the next few years, with the ratio of debt to debt plus equity well above 65% and debt to EBITDA higher than 20x. We believe Diok's interest coverage will improve in the next 12-18 months thanks to the full EBITDA contribution in 2020 from recent acquisitions. The company anticipates an equity buildup in the next few years, based mainly on revaluation gains on properties purchased, in line with its strategy of buying properties at a 10%-15% discount, while funding the acquisition with debt. The company's debt matures in 3.4 years on average, which is somewhat shorter than for rated commercial real estate peers with all debt at fixed interest rates. Diok has placed two

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tranches of its senior unsecured bond due 2023, totaling €45 million (€25 million issued in October 2018 and €20 million issued in July 2019), since the bond was set up in 2018. The drawn amount as of Dec. 31, 2019, was €33.7 million. The bond allows for issuance of up to €250 million with a fixed coupon rate of 6%. Most of the bonds' proceeds has funded the company's growth strategy. We understand that the company will finance its growth plans mostly with a mix of secured bank debt and taps of the unsecured bond.

### Outlook

The stable outlook reflects our view that Diok's asset portfolio can generate increasing EBITDA and cash flows over the next 12 months, mainly supported by the rental contribution from recent acquisitions. We believe the dynamics of the office property market in Germany's secondary locations remain favorable, with solid demand and rising occupancy rates. We forecast EBITDA interest coverage will improve to 1.2x-1.5x in the next 12-18 months, while debt to debt plus equity remains high, at 75%-80%.

### Downside scenario

We could lower the ratings if the company suffers from key tenant losses or operational deterioration, such as higher vacancies, which could significantly affect its rental income and EBITDA generation; or invests in less-favorable secondary locations away from metropolitan hubs.

We could also lower the ratings if the company's liquidity deteriorates, with covenant headroom becoming tighter.

### Upside scenario

We would raise the ratings if Diok increases its portfolio's scale and scope significantly, in locations with favorable demand trends for German office properties and increasing occupancy levels, while enhancing its tenant and asset diversity to a level comparable with that of other higher-rated peers.

An upgrade would be contingent on a strong reduction of leverage, with debt-to-debt plus equity falling below 65% on a sustainable basis, with EBITDA interest coverage increasing to above 2x. This could occur, for example, due to unexpected significant debt repayment or equity-financed acquisitions.

### Company Description

Diok is a German real estate company, focusing on office assets in secondary locations of Germany. The company launched operations in 2018 and its portfolio had a gross asset value of about €205 million at year-end 2019, consisting of 15 assets (pro forma committed acquisitions of 17 assets worth €257 million). Diok aims to attain a gross asset value of €2 billion by 2023 through acquisitions with an average asset value of about €25 million.

The company is privately owned, with five main shareholders, two of which are on the management board, Daniel Grosch (35%) and Markus Drews (20%). Other shareholders include Swiss Merchant Group AG (20%), Marc Leffin (20%), and Timo Herbrand (5%).

## Our Base-Case Scenario

### Assumptions

- About 0.5%-1.5% like-for-like rental growth for the overall portfolio in 2020. We forecast a GDP decline of 6% in Germany in light of COVID-19. Nevertheless, we believe the company may benefit somewhat from new rental agreements, before rental growth recovers to approximately 1.5% in 2021
- Occupancy levels at 93%-94%, supported by long-term leases and solid demand across Germany's office market.
- Acquisitions of €100 million-€150 million in 2020, of which about €50 million have already been committed.
- No assets disposal, since we understand the company would like to integrate recently acquired assets.
- Flat like-for-like portfolio revaluations for current properties, excluding revaluation gains achieved through acquiring assets at a discount, reflecting the company's focus on midsize properties in secondary locations where real estate prices are rising less quickly than in large metropolitan areas.
- Average cost of debt at 3%-4%.

### Key metrics

- EBITDA interest coverage improving to 1.2x-1.5x in the next 12-18 months.
- Debt to debt plus equity staying high at 75%-80%.

### Liquidity

We assess Diok's liquidity as less than adequate. We estimate that the company's liquidity sources will cover liquidity uses by about 1.1x for the next 12 months.

We forecast Diok's principal liquidity sources as of Dec. 31, 2019, as:

- Unrestricted cash balances of about €3.5 million;
- Our forecast of cash funds from operations of about €1.5 million; and
- About €65 million of committed debt financing in the form of the senior unsecured bond and senior secured debt.

We forecast the company's principal liquidity uses as of the same date as:

- About €24 million of short-term debt maturities and amortization;
- About €40 million of committed acquisitions; and
- €0.5 million-€1 million of committed capex.

## Covenants

Diok has financial covenants under one of its secured bank loans, related to its loan-to-value (LTV) ratio and the issuer credit rating. We understand that the company has adequate headroom (more than 10%) under the covenants. The senior unsecured bond due 2023 has financial covenants stipulating a maximum net total LTV ratio of 85% and a minimum unencumbered assets ratio of 10%. We understand that the company will keep sufficient headroom (greater than 10%) under all of its covenants.

## Issue Ratings--Recovery Analysis

### Key analytical factors

- The issue rating on Diok's €250 million 2018/2023 senior unsecured nominal notes with an outstanding amount of €33.7 million at year-end 2019 is 'B-', one notch below the issuer credit rating.
- The recovery rating is '5', reflecting the valuable asset base consisting of investment properties. However, recovery prospects are constrained by the unsecured nature of the debt and its contractual subordination to the current amount of secured debt (such as mortgage loans).
- We expect average (10%-30%; rounded estimate 20%) recovery prospects in a default scenario.
- The company has used most of the proceeds from the bond issuance to finance acquisitions.
- In our hypothetical default scenario, we envisage a severe macroeconomic downturn in Germany resulting in market depression and exacerbated competitive pressures.
- We value the group as a going concern. Our stressed valuation figure comprises the stressed value of the company's property portfolio.
- Recovery prospects for the 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: 2023
- Jurisdiction: Germany

### Simplified waterfall

- Gross enterprise value at emergence: €144 million
- Net enterprise value at emergence after administrative costs: €137 million
- Estimated priority debt (mortgage loans and other secured debt): €131 million

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- Net enterprise value available to senior unsecured bondholders: €6 million
- Senior unsecured debt claims: €35 million
- Recovery expectation: 10%-30% (rounded estimate 20%)

\*All debt amounts include six months of prepetition interest.

## Ratings Score Snapshot

Issuer Credit Rating: B/Stable/--

Business risk: Weak

- Country risk: Very low
- Industry risk: Low
- Competitive position: Weak

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b-

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

## Related Criteria

- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate

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Entities, Nov. 13, 2012

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

### New Rating

#### Diok Real Estate AG

Issuer Credit Rating	B/Stable/--
Senior Unsecured	B-
Recovery Rating	5(20%)

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](http://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](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](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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