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Research Update:

Aroundtown Outlook Revised To Negative On Tightening Leverage Headroom And Market Uncertainty; Affirmed At 'BBB+'

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Rating Action Overview

- Aroundtown's (AT's) first-quarter results show S&P Global Ratings-adjusted debt to debt plus equity ratio of 49.3%. Although some of this deterioration is due to the reclassification of hybrids with first call dates in January 2023 that previously had intermediate equity content, we see these as still having a qualitative benefit for the financial risk profile and hence our underlying view of AT's leverage.
- Under our updated base case, incorporating more challenging property market conditions and our expectation of further increasing capitalization rates, we anticipate a property devaluation of about 10% in the next 12 months that would put additional pressure on debt to debt plus equity ratio, and we expect the ratio will temporarily exceed 50%, our rating downside threshold, over the same period.
- Although AT's operational performance remains solid with like-for-like rental income growth at 3.5% in first-quarter 2023, the group's hotel segment has yet to completely bounce back from the pandemic, and office vacancy has risen to 11.5% from 10.8% a year earlier. AT continues to have strong liquidity, in our view, with more than €3 billion of cash and signed disposals that together cover debt maturities until end-2025.
- We therefore revised our outlook on AT to negative from stable and affirmed our 'BBB+/A-2' long- and short-term issuer credit ratings. We also affirmed our 'BBB+' rating on the company's senior unsecured debt and our 'BBB-' ratings on its subordinated debt.
- The negative outlook reflects a one-in-three likelihood that we could downgrade AT over the next 12-24 months if our underlying view of the company's credit metrics (taking account of the qualitative benefits of the hybrids that no longer receive equity content) deteriorated beyond our updated base case, with debt to debt plus equity increasing to 50% or higher and EBITDA interest coverage falling toward 2.4x or below on a prolonged basis.

Rating Action Rationale

We expect AT's ratio of debt to debt plus equity to temporarily exceed our 50% rating downside threshold in 2023, following our revised base-case assumptions. According to AT's first-quarter results, published on May 30, the company posted a ratio of debt to debt plus equity of 49.3% as adjusted by S&P Global Ratings. This is close to our rating downside threshold of 50%. We understand the company did not perform a valuation process in the first quarter but will include an updated valuation result in its second-quarter results. Considering that the ECB raised interest rates by another 25 basis points on June 15 and the still-limited amount of real estate transactions on the market, we think property yields will expand and asset devaluation might be stronger than previously anticipated. As such, we forecast AT's property valuation will decline by 7%-8% in 2023 and another 2%-3% in 2024, intensifying pressure on the already tight headroom of its debt to debt plus equity ratio. We forecast that the ratio will marginally exceed 50% in 2023, then return to below 50% in 2024. The negative outlook captures the increased risk that the company is not able to maintain its ratio of debt to debt plus equity below 50% for a prolonged period, for instance, due to higher devaluations beyond our base case. Despite higher funding costs for the sector, we continue to forecast that AT's EBITDA interest coverage will stand at about 2.9x in 2023 and at 2.6x-2.8x in 2024 (versus 3.4x for the rolling 12 months to first-quarter 2023). This reflects the company's long-dated debt profile of 4.8 years with limited refinancing needs until end-2024, its high exposure to hedged or fixed interest rates at 90%, and solid annual like-for-like rental income growth of at least 2% over our forecast horizon. That said, the hedge ratio could decrease to 83% by end-2023 if expiring hedges are not renewed, and along with higher expected funding costs on its subordinated notes could tighten the headroom under its EBITDA interest coverage ratio closer to 2.4x, also a rating downside threshold. The company has indicated a commitment to its financial policy and has taken steps to address the challenges in the current market environment, including the suspension of dividends in 2023, a buyback of about €1.1 billion of senior bonds year to date at a discount averaging about 20% and proceeds from asset disposals for a total of €700 million so far this year.

Although AT's operating performance remains stable, it is not immune to market challenges. AT posted a solid 3.5% like-for-like increase in its rental income in its first-quarter results, supported mainly by the inflation-linked nature of part of its office segment, which had a like-for-like rental income contribution of 5.4%. The company's lease length in the office segment stood at 4.2 years and is in line with industry average. As of March 31, 2023, only 5% of leases will mature in 2023 and about 12% annually in the following two years. However, the recovery of its hotel segment still lags pre-pandemic levels, with expected rent collection for 2023 of only 85%-90% versus 69% for 2022, which is weaker than peers'. Although we expect occupancy levels to remain broadly stable at 92.0%-93.0% (versus 92.3% as of first-quarter 2023), benefiting in particular from solid demand for its residential assets, we believe the office segment could experience a 1% or 2% drop in occupancy rates due to macroeconomic uncertainties and the reduction in office space by tenants for cost-saving measures.

AT's announcement to not exercise its call option of its nominal US$700 million perpetual notes at the first optional call date in July does not affect its credit quality. In line with our criteria, we will remove the equity content (50%) on the hybrid bond at its first call dates in July because their residual maturity falls below 20 years. Together with the two hybrids not called in January this year, the company's hybrid stock with no equity treatment will increase to about €1.1 billion

compared with its total hybrid stock of €4.7 billion, including full consolidation of Grand City Properties. The decision not to call the three hybrid bonds year to date affects AT's ratio of debt to debt plus equity by about 2%, although we recognize that the hybrids can still play an equity-like role. The group indicated that its decision reflects the current market conditions, and we believe that the coupon on a newly-issued hybrid instrument to replace the existing notes would significantly exceed the reset rates applicable under the terms and conditions of those hybrid bonds, which would put greater pressure on the company's funding costs. We think the hybrid bonds continue to qualitatively benefit the group's credit quality. The instrument remains subordinated, and relatively long-dated elements of the balance sheet and the group could still use the bonds to conserve cash, for instance, by potentially deferring coupon payments if ever needed. In our view, the decision not to call demonstrates the group's willingness to keep the hybrids to conserve cash and manage the timing of any refinancing. We fully factor this in when assessing the overall creditworthiness of the group, even if its core financial metrics deteriorate slightly. For our base case, we assume the group's other hybrid bonds with first call dates later in 2023 and in 2024 will be replaced at materially higher coupons than the current pricing.

AT maintains strong liquidity. The company benefits from a high unrestricted cash position on the balance sheet of about €3.0 billion as of March 31, 2023, and additional €390 million of disposal proceeds to be received (excluding vendor loans) post reporting date. Those sources will sufficiently cover upcoming debt maturities until end-2025. Furthermore, the company recently bought back senior unsecured bonds of about €960 million at an average discount of 21%, addressing its debt maturities beyond the time horizon for our strong liquidity assessment. We understand that AT had a solid covenant headroom of well above 15% under all of its financial covenants.

Outlook

The negative outlook reflects a one-in-three likelihood of a downgrade in the next 12-24 months if AT's credit metrics deteriorated beyond our base-case assumptions, with debt to debt plus equity increasing to 50% or higher, or EBITDA interest coverage falling toward 2.4x or below on a prolonged basis. This could happen due to a stronger-than-currently anticipated devaluation of its properties, a weakening operational performance with vacancies increasing strongly, and the recovery of its hotel assets is further delayed.

Downside scenario

We would downgrade the company if, over a prolonged period:

- Debt to debt plus equity increased to 50% or higher;
- Debt to EBITDA deviated materially from our forecast;
- EBITDA interest coverage fell toward 2.4x or below; or
- The operating environment deteriorated significantly, leading to a strong increase in vacancy rates in its commercial property portfolio or a stronger devaluation of its asset base than we currently anticipate.

Upside scenario

We would revise the outlook to stable if we have more visibility that, on a prolonged basis:

- Debt to debt plus equity remained below 50%;
- EBITDA interest coverage stayed above 2.4x;
- Debt to EBITDA remained in line with our forecast; and
- The operating environment remained solid with stable occupancy levels, positive like-for-like rental income growth, and a higher visibility of future property values.

Company Description

AT is the largest listed Germany-based commercial real estate company, and it focuses on investing in rental-income-generating properties, mainly in Germany. AT carries out its residential investments through its 60% holding in Grand City Properties.

AT is incorporated in Luxembourg and listed at the Prime Standard on the Frankfurt Stock Exchange. As of end-March 2023, the largest shareholder was AT's founder Mr. Yakir Gabay, who held a 15% stake through Avisco Group PLC and Vergepoint. The company owns 29% of its own shares (including 12% through TLG Immobilien AG) and the remaining 56% is free float.

Our Base-Case Scenario

Assumptions

- Nearly flat real GDP growth in Germany in 2023, then picking up to almost 1.0% in 2024; we forecast a consumer price index in Germany of 6.7% in 2023 and 3.0% in 2024.
- Real GDP in the U.K. to decline by 0.5% in 2023 and increase to 1.5% in 2024; we forecast a consumer price index in the U.K. of 6.0% in 2023 and 1.5% in 2024.
- Annual like-for-like rental income growth of 2.5%-3.0% in 2023 and 2.0%-2.5% in 2024, factoring in benefits from the company's commercial indexation-linked rental contract, solid tenant demand across all of its asset segments, and additional recovery in the hotel assets.
- Overall occupancy levels to stay broadly stable at 92%-93% in the coming 12-24 months. That said, we believe occupancy levels in the commercial real estate segment may contract slightly by 1%-2% over the next 12-18 months.
- Property portfolio devaluation of 7%-8% for 2023 and a further drop of 2%-3% in 2024.
- Total annual capital expenditure of about €500 million over the next couple of years, mainly linked to repositioning activities and modernization of existing assets.
- We expect asset disposals to amount to €800 million-€900 million in 2023 and another €400 million-€500 million in 2024.
- No further significant increases in vendor loans provided to the buyers of its disposal exposure and conservatively forecast outstanding vendor loan to be received 50% in 2024 and 50% in 2025 although we understand that company expect it to be received by end-2024.

- Limited new debt issuances, excluding hybrids and no share buybacks.
- Noncall of its hybrid with first optional call date in July 2023 and replacement of its hybrids that have first call dates in October 2023 and in 2024 with an equivalent instrument that would be treated as being at least 50% equity.
- No shareholders dividend for 2023 as announced by the company and from 2024 onwards a payout of 75% of reported funds from operations (FFO) as per its current dividend policy.
- Average cost of debt to remain below 2% (excluding hybrid coupon payments), at least until end-2024, thanks to limited refinancing needs and a high portion of fixed or hedged debt.

Key metrics

Aroundtown S.A.--Key Metrics

	2021a	2022a	2023e	2024f	2025f
Debt to EBITDA (x)	17.7	16.1	~15.5	14.0-15.0	13.5-14.5
EBITDA interest coverage (x)	3.5	3.5	~2.9	2.6-2.8	2.5-2.7
Debt to debt plus equity(%)	47.0	48.9	50.0-51.0	49.0-50.0	48.0-49.0

a--Actual. e--Estimate. f--Forecast.

Ratings Score Snapshot

Issuer Credit Rating	BBB+/Negative/A-2
Business risk:	Strong
Country risk	Very Low
Industry risk	Low
Competitive position	Strong
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	bbb+
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Strong (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bbb+

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

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- 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
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

- Tear Sheet: Aroundtown S.A., April 4, 2023

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Aroundtown S.A.		
Issuer Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2
Ratings Affirmed		
Aroundtown S.A.		
Senior Unsecured	BBB+	
Subordinated	BBB-	
AT Securities B.V.		
Subordinated	BBB-	

ATF Netherlands B.V.

Subordinated	BBB-

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

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