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**Research Update:**

## Austrian Commercial Real Estate Company Immofinanz AG Assigned Preliminary 'BBB-' Rating; Outlook Stable

**Primary Credit Analyst:**

Nicole Reinhardt, Frankfurt + 49 693 399 9303; nicole.reinhardt@spglobal.com

**Secondary Contact:**

Franck Delage, Paris (33) 1-4420-6778; franck.delage@spglobal.com

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## Research Update:

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## Rating Action Overview

- Immofinanz AG owns and manages a property portfolio valued at about €4.3 billion as of Sept. 30, 2018, consisting of 223 office and retail assets across Central and Eastern Europe.
- We expect rental income growth for Immofinanz's portfolio to remain positive over the next 12-24 months, thanks to stable demand trends in the company's operating environment, stable occupancy levels, and rental growth from new lettings and upcoming project completions.
- We are assigning our preliminary 'BBB-' long-term issuer credit rating to Immofinanz and preliminary 'BBB-' issue rating to its proposed senior unsecured notes.
- The stable outlook reflects our view that strong demand for Immofinanz's office assets in several European capital cities should enable the group to generate resilient cash flows over the next 12-24 months.

## Rating Action Rationale

Our preliminary rating on Immofinanz reflects our view of the company's portfolio valued at about €4.3 billion, including approximately €360 million of properties under construction and €192.5 million of pipeline projects. Its standing portfolio of about €3.7 billion consists mainly of office properties (62% as of Sept. 30, 2018) and retail assets (38%) across Central and Eastern Europe (CEE), and we consider it has relatively good scale and size. The company's standing portfolio is spread across seven core countries, including Austria (about 22% as of Sept. 30, 2018), Poland (20%), Romania (17%), Germany (8%), Hungary (13%), the Czech Republic (9%), and Slovakia (8%), with the remaining 3% in noncore countries. The company's strategy is to focus on office and retail real estate in the CEE while ensuring exposure to development projects is less than 10% of gross asset value. Immofinanz is listed on the Vienna and Warsaw stock exchange and has a free float of about 78%. Its largest shareholder is S Immo AG, which has a 12% shareholding.

Although the market is very fragmented, the company has a good market position as one of the largest commercial property owners in the CEE. We consider the company's office buildings to be good quality and they are mainly in the capital cities, such as Vienna, Prague, or Bucharest, which have good infrastructure and accessibility. The office portfolio benefits from a

national as well as international tenant base, such as trivago N.V., O2, or KPMG LLP. The CEE office market should remain resilient for office landlords like Immofinanz as the region--in particular, Poland and Romania (together about 37% of total portfolio value)--is a major outsourcing hub for multinationals and financial institutions, due to lower labor costs and a qualified workforce.

In our view, Immofinanz's retail portfolio focuses more on secondary and tertiary cities, which have less favorable dynamics than larger metropolitan areas. We consider that the company's retail assets are generally less stable and recession-proof than other segments, such as residential. The sector is also facing increasing pressure from e-commerce in mature markets, particularly in the fashion industry, which accounts for 32% of Immofinanz's tenant mix in its retail portfolio. We still consider that the retail markets where Immofinanz operates currently benefit from positive economic trends, such as positive real GDP growth, stable unemployment rates, and improving consumer spending, and that these should continue to support the company's cash flow generation over the next 12 to 24 months.

ImmoFinanz's commercial portfolio is spread across 223 properties, with the top-10 assets representing 29% of the total portfolio and no single asset accounting for more than 5%. In addition, the company's tenant base is very diversified, with no tenant representing more than 4% of total annual rental income. Immofinanz's rental contracts are linked to indexation, and its average lease term of about four years is somewhat lower than that of other rated commercial real estate peers in Europe, but in line with peers' in the CEE, such as Atrium European Real Estate or NEPI Rockcastle PLC.

That said, we view the company's occupancy--94.5% as of Sept. 30, 2018--as relatively low. Although occupancy levels at its retail assets are high at 97.7%, its office portfolio shows occupancy rates of 91.8%, which is below that of other rated peers in the investment-grade category. We recognize the company's recent track record of increasing occupancy levels for its office assets and anticipate that the current level will remain stable or even improve.

The company has current development projects across seven properties with a carrying value of €263 million or 6% of total portfolio value, whereas 88% belongs to two office projects in Germany. We view development risk at limited as we understand that those projects are almost fully pre-let and that the company does not plan to increase development activities, relative to its portfolio size.

Overall, we consider that exposure to CEE countries, such as Poland, Romania, or Hungary, poses higher country risk than exposure to more mature markets, like France or Germany. We see that office supply is picking up in capitals like Vienna and Warsaw, which could put pressure on occupancy levels or rents in future.

Our assessment of Immofinanz's financial risk profile is underpinned by its

relatively weak EBITDA interest coverage of just 1.8x for the 12 months to Sept. 30, 2018. We expect this ratio will gradually improve close to 2x by the end of 2018 and toward 2.4x by the end of 2019, thanks to Immofinanz's recent refinancing activities and also assuming further successful refinancing of upcoming secured debt maturities with the proposed senior unsecured bond in benchmark size. We expect that upcoming debt issuances will be used to redeem short-term debt with higher average cost of debt than the company currently reports. We view as supportive the company's moderate leverage ratio; it had an adjusted ratio of debt to debt plus equity of approximately 38% as of Sept. 30, 2018 and its financial policy includes a net loan-to-value target ratio of around 45%.

Following planned refinancing activities, the company's average debt maturity should improve to close to five years from 3.5 years as of Sept. 30, 2018.

Our preliminary rating on Immofinanz incorporates one notch of uplift from the anchor, based on our comparable ratings analysis. In our view, Immofinanz's EBITDA interest coverage will move to 2.4x in the next 12 months, and its hedging exposure will increase to 85% from 75%. We anticipate that this will bring the company's credit metrics in line with other investment-grade companies in the region. Our assessment also reflects Immofinanz's sizable portfolio and its limited dependency on single assets or tenants, compared with rated peers in that have speculative-grade ratings.

The final rating will depend on our receipt and satisfactory review of all final transaction documentation of the company's proposed senior unsecured long-term debt issuances of benchmark size. Accordingly, the preliminary rating should not be construed as evidence of the final rating. If we do not receive final documentation within a reasonable timeframe, or if final documentation departs from materials reviewed, we reserve the right to withdraw or revise our rating. Potential changes include, but are not limited to, utilization of funding proceeds, maturity, size, and conditions of the funding, financial and other covenants, and security and ranking of the funding.

## **Outlook**

The stable outlook on Immofinanz reflects our view that the company's income-generating property portfolio should continue to generate stable cash flows in the next 12 to 24 months. We base our view in particular on solid demand from corporations for Immofinanz's office assets, which are located mainly in European capital cities. We also believe that occupancy levels will remain at the current level or higher in both core segments, office and retail, supporting further like-for-like rental income growth.

On this basis, we anticipate that Immofinanz will be able to maintain a debt-to-debt plus equity ratio of well below 50%, with EBITDA interest coverage improving to well above 2x in the next 12 months.

### Downside scenario

We could consider lowering the ratings if our ratio of debt to debt plus equity increased to 50% or above, or if the company failed to improve EBITDA interest coverage to more than 2x. Such a scenario could be the result of challenging refinancing conditions, significant negative revaluation or write-downs of assets, debt-financed acquisitions, or a deterioration in the CEE markets, leading to declining occupancy levels or lower rental income.

### Upside scenario

We could raise the ratings if the company strengthens its business risk profile on the back of an increase in scale and diversification toward stable markets where demand and supply trends are favorable for its commercial segments, while keeping like-for-like rental income growth positive and occupancy levels high.

We could also raise the ratings if the company improved its credit profile, with its ratio of debt to debt plus equity moving to 40% or below and EBITDA interest coverage rising substantially to 3.5x or above, on a sustainable basis. This may result from a more conservative financial policy, sizable equity contribution for any new possible acquisitions, or significantly higher-than-expected revaluation gains on its properties.

## Company Description

Immofinanz AG was founded in 1990 and is one of the largest listed commercial real estate companies in Austria and the CEE market. The company operates in the commercial property segment, mainly offices and retail. As of Sept. 30, 2018, the company's total portfolio comprised 223 properties valued at about €4.3 billion including approximately €360 million of properties under construction.

Immofinanz AG is listed on the Vienna Stock Exchange and the Warsaw Stock Exchange. Largest shareholder is S Immo with 12% holding, with free float of 78%.

## Our Base-Case Scenario

Our base case assumes:

- Like-for-like rental income growth of 1%-2% for the next 12 to 24 months, assuming stable occupancy levels and flat overall indexation with some benefits from new or re-letting activities.
- For its core country exposures, we assume real GDP growth of 2% in Austria and 3.5% in Poland and Romania for 2019, consumer price index (CPI) of about 2.1% in Austria, 2.5% in Poland, and 3.5% in Romania, as

well as stable unemployment rates in all of its operating countries.

- Overall flat revaluation result across all real estate segments.
- Limited asset rotation in 2019 and 2020, with annual development expenditure of about €200 million-€250 million in the next 12 to 24 months.
- An average cost of debt of about 1.8%-2.0%, including the planned refinancing in benchmark size.

Based on these assumptions, we arrive at the following credit measures for Immofinanz for the next 12 to 24 months:

- Gross EBITDA margin increasing to 55%-60% on the back of current cost reduction efforts and stabilization of its portfolio, and S&P Global Ratings-adjusted ratio of debt to debt plus equity of 45%-47%;
- EBITDA interest coverage ratio of closer to 2.5x; and
- Debt to EBITDA of around 15x.

## Liquidity

We assess Immofinanz's liquidity at adequate. We anticipate that liquidity sources will likely cover liquidity uses by about 1.4x for the next 12 months. Our analysis is pro forma the refinancing of secured debt.

We forecast Immofinanz's liquidity sources as of Sept. 30, 2018 are:

- Unrestricted cash balances of about €699 million, including net proceeds received from the sale of the stake in CA Immobilien;
- Our forecast of cash FFO of about €50 million-€60 million for next 12 months; and
- About €85 million of contracted assets disposals.

For the same period, we forecast that Immofinanz's liquidity uses are:

- Short-term debt maturities of around €200 million, including amortization;
- Around €125 million of committed capital expenditure for next 12 months;
- About €81 million of anticipated dividend payments;
- About €90 million of committed acquisitions of retail parks in Slovenia, Serbia and Croatia; and
- About €100 million-€130 million of planned share repurchases in next 12 months.

## Covenants

Most of the company's currently outstanding financial covenants are on its secured mortgage debt. We notice that some outstanding loans have a covenant

headroom of less than 10%, but understand that the amount is below 5% of total outstanding debt and that those covenants are mainly related to recent refinancing, where the covenant level is set close to the current ratio level.

We expect that, pro forma the proposed senior unsecured bond, the company will maintain adequate headroom (greater than 10%) under all remaining covenants and new covenants documented in the future funding sources.

## Issue Ratings - Subordination Risk Analysis

### Capital structure

As of Sept. 30, 2018, Immofinanz's capital structure comprised mainly of secured bank facilities of about €2.1 billion and a convertible bonds of €281 million. Weighted average cost of debt stood at 2.17%, including hedging costs.

We understand that the company plans to use the proceeds of the proposed senior unsecured bond in benchmark size to refinance mainly secured debt of shorter debt maturities and higher cost of debt.

### Analytical conclusions

We assume, that the capital structure post transaction and refinancing will have a secured debt to total asset ratio below our threshold of 40%. Therefore, we align our preliminary issue rating on the unsecured bonds with our preliminary issuer credit rating.

## Ratings Score Snapshot

Issuer Credit Rating: BBB-(prelim)/Stable/--

Business risk: Satisfactory

- Country risk: Intermediate risk
- Industry risk: Low risk
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)

- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

## Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

New Rating

Immofinanz AG

Issuer Credit Rating

BBB-(prelim)/Stable/--

Senior Unsecured

BBB-(prelim)

### Additional Contact:

Industrial Ratings Europe; Corporate\_Admin\_London@spglobal.com

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