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Research Update:

Germany-Based Grand City Properties Rating Raised To 'BB' On Stronger Cash Flow Metrics And Lower Debt Leverage

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Overview

- German residential property company Grand City Properties has increased its equity base after conversion of convertible bonds into shares. Credit metrics are above our base-case scenario for 2013.
- We are therefore upgrading the corporate credit rating to 'BB' from 'BB-' to reflect the improved financial risk profile.
- The stable outlook reflects our view that solid tenant demand overall should continue to support rental income growth in the property portfolio in 2014.

Rating Action

On Nov. 27, 2013, Standard & Poor's Ratings Services raised to 'BB' from 'BB-' its long-term corporate credit rating on German residential property company Grand City Properties S.A. (GCP). The outlook is stable.

At the same time, we are raising our issue rating on GCP's bonds due 2020 to 'BB' and are affirming the recovery ratings on these bonds at '3', indicating our expectation of "meaningful" (50%-70%) recovery in the event of a payment default.

Rationale

The rating action reflects our view that GCP's cash flow and leverage ratios are likely to improve by more than we previously expected in 2013 and remain stable in 2014.

In addition, we understand that the company's financial policy is to maintain a large, stable, recurring cash flow base with limited asset disposals, and a loan-to-value (LTV) ratio below 55%. In our view, our projected credit metrics for 2014, combined with the company's public financial policy, indicate that its financial risk profile should be assessed as "significant."

We expect GCP's key financial ratios, like fixed-charge coverage and debt to debt plus equity, to remain in the ranges defined in our criteria for a real estate company with a "significant" financial risk profile.

For 2013, we estimate fixed-charge coverage (which includes bank debt amortization) will reach 1.9x while EBITDA interest coverage should be well over 2.0x, based on a like-for-like rental income growth of 8% and a slightly lower average cost of debt. The full conversion into equity of the €100 million convertible bond, announced in October 2013, has reduced debt leverage. The debt to debt plus equity ratio decreased to 55% (compared with 61% in 2012). In addition, GCP has accessed capital markets several times in the past 12 months and demonstrated good access to bank funding for refinancing loans and making new acquisitions.

Our base-case scenario for 2014 assumes:
- Gross rental income to rise to €150 million;
- Like-for-like rental income growth of more than 6%, stemming from higher average occupancy and rent increases;
- €250 million of acquisitions;
- €70 million of disposals; and
- Stable average cost of debt of around 4%.

Based on these assumptions, we arrive at the following credit measures for 2014:
- EBITDA of €70 million;
- Debt levels of around €750 million;
- A fixed-charge coverage ratio of around 1.9x; and
- A debt-to-debt+equity ratio of around 55%. This is chiefly based on our expectation that the company will fund acquisitions with a balanced mix of debt and equity and should retain access to bank financing.

GCP's business risk profile remains "fair," as defined in our criteria. This reflects our view of the low country risk of Germany and solid demand from urban households in Germany. The supply of new developments remains limited, although it is growing, due to high construction costs and limited available financing.

The fair business risk profile also reflects our assessment of GCP's competitive position as "fair," based on the size and scope of its residential property portfolio. GCP has doubled the size of its portfolio in the past 12 months, improving its asset and tenant diversity. The portfolio comprises 22,000 units that generate €150 million of annualized gross rental income. However, it is still smaller than that of peers such as Deutsche Annington, limiting economies of scale.

The portfolio includes affordable multifamily buildings spread across Germany, with some concentrations in strong markets such as Berlin, Cologne, or Nuernberg. It also has concentrations in some weak locations in Nord-Rhein-Westphalen. It is exposed to limited development risk, mostly through the renovation of existing assets. On average, tenants stay for around 10 years, which we consider a long time. Although the average vacancy rate remains high, it has decreased to 12%, and the portfolio remains mostly underrented, which confers some downside protection should demand weaken.

Liquidity

We assess GCP's liquidity position as "adequate" under our criteria for real estate companies. Our analysis includes a stress scenario under which EBITDA declines by 10%. The liquidity position is mostly supported by substantial cash balances and positive funds from operations. GCP has limited capital expenditures and no large debt maturities in the next two years. We anticipate that liquidity sources will likely cover financing requirements for 2014 by 1.2x.

As of Sept. 30, 2013, liquidity sources should mostly consist of:
- €126 million of unrestricted cash, which we expect to be mostly used for acquisitions; and
- A forecast €50 million in funds from operations during 2014, under our base-case scenario.

This compares with potential liquidity uses of:
- €10 million of debt amortization;
- Our forecast of €10 million of capital expenditures; and
- No dividend payments.

On June 30, 2013, GCP had significant headroom under its debt covenants for most of its assets. Some of the newly acquired assets have tight (5%-15%) headroom under their LTV covenants. However, these were set with the lender at the inception of the asset financing. With expected increased occupancy, rental values--and thus headroom under the covenant--should grow gradually.

Outlook

The stable outlook reflects our opinion that GCP should generate stable recurring cash flow and maintain stable debt leverage in 2014. Under our base-case scenario for 2014, we forecast like-for-like rental income growth of more than 6% based on lower average vacancy rates and an increase in average rent levels. In our view, tenant demand should remain solid in most of the company's property locations. Rating stability will depend on the company maintaining a fixed-charge coverage ratio of more than 1.7x and a debt-to-capital ratio of less than 60%.

Upside scenario

We could raise the rating if demand/supply trends in the German residential market remain positive and we see a continued increase in the size and scope of GCP's residential property portfolio in the country's most dynamic regions. We would also view positively a longer track record in terms of commitment to financial policy and a sustained improvement in credit metrics, with a fixed-charge coverage ratio rising above 2.1x and a debt-to-capital ratio below 50%.

Downside scenario

Conversely, we would lower the rating if we expect GCP to increase leverage in its capital structure through large debt-financed acquisitions, or if it were to increase its asset rotation, which would decrease the stability of its cash flows. We would view this as contradicting the company's stated financial policy. We would also downgrade the rating if the fixed-charge coverage ratio is likely to decrease to below 1.7x and the debt-to-capital ratio to increase to above 60%. This would most likely occur if the company shifted toward acquiring large portfolios of properties that required more-extensive renovation works compared with the assets it has historically acquired.

Ratings Score Snapshot

Corporate Credit Rating: BB/Stable

Business risk: Fair
- Country risk: Very Low
- Industry risk: Low
- Competitive position: Fair

Financial risk:
- Cash flow/Leverage: Significant

Anchor: BB

Modifiers
- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Liquidity: Adequate
- Financial policy: Neutral
- Management and governance: Neutral
- Comparable rating analysis: Neutral

Recovery Analysis

Key analytical factors

- The issue rating on the €200 million senior secured bonds due in 2020 is 'BB' and the recovery rating on these bonds is '3', indicating our expectation of meaningful (50%-70%) recovery in the event of a payment default.
- The issue and recovery ratings are supported by the company's substantial asset base in the growing German real estate market. That said, our recovery ratings are constrained by the subordination of the bonds to a high level of bank debt, and our view of the weak security package.
- Our hypothetical default scenario projects deterioration in real estate market values and a decline the quality of the properties, which would lead to lower occupancy rates and rental incomes. This would result in

the company's inability to refinance its maturing debt, leading to a default in 2018.
- We believe that most of GCP's value lies in its significant real estate asset base. We therefore value the company primarily using a discrete asset valuation approach.
- Although the numerical coverage exceeds the threshold for '3' recovery rating, we cap the ratings at '3' given our view of the weak security package and the significant amount of structurally senior secured bank debt.

Simulated default assumptions

- Year of default: 2018
- Jurisdiction: Germany

Simplified waterfall

- Net enterprise value (after 5% administration costs): €630 million
- First-lien debt claims: €435 million*
- Second-lien debt claims: €206 million*
- --Recovery expectation: 50%-70%

*All debt amounts include six months of prepetition interest.

Related Criteria And Research

- Corporate Methodology, Nov. 19, 2013
- Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009

Ratings List

Upgraded

	To	From
Grand City Properties S.A.		
Corporate Credit Rating	BB/Stable/--	BB-/Stable/--
Senior Secured	BB	BB-
Recovery Rating	3	3

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