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Research Update:

Germany-Based Grand City Properties Upgraded To 'BB+' On Stronger Capital Structure; Outlook Stable

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Overview

- The equity base of German residential property company Grand City Properties S.A. (GCP) has risen thanks to a €175 million capital increase in December 2013. We now project that GCP's credit metrics will be commensurate with an "intermediate" financial risk profile in 2014-2015.
- We understand that GCP's management is committed to maintaining stable credit metrics and financing its acquisitions conservatively.
- We are therefore raising our long-term corporate credit rating on GCP to 'BB+' from 'BB' to reflect the company's improved financial risk profile.
- We are also assigning our 'BB+' issue rating and recovery rating of '3' to GCP's proposed convertible bonds maturing in 2019.
- The stable outlook reflects our view that steady tenant demand in GCP's main locations should continue to support rental income growth in 2014.

Rating Action

On Feb. 14, 2014, 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 assigned a 'BB+' issue rating to GCP's proposed convertible bonds of at least €100 million due 2019. The recovery rating on these bonds is '3', indicating our expectation of "meaningful" (50%-70%) recovery in the event of a payment default.

In addition, we are raising our issue rating on GCP's €200 million bonds due 2020 to 'BB+' from 'BB'. The recovery rating on these bonds is unchanged at '3'.

Rationale

The upgrade reflects our view that GCP's €175 million capital increase in December 2013 will improve the company's credit metrics in 2014-2015. In addition, we understand that management is committed to maintaining debt leverage at current levels. We are therefore revising our assessment of GCP's financial risk profile upward to "intermediate" from "significant."

After the recent equity raise, the capital structure appears well-capitalized, with an equity ratio of about 50% and a reported loan-to-value (LTV) ratio of less than 50%. We also note that the unencumbered asset base has increased to more than 30% of the total portfolio, and we project it will increase further in 2014.

We understand that management is committed to maintaining a large, stable, recurring cash flow base from the rental income stream and limited asset disposals. We also understand that management is committed to maintaining debt leverage at about 50% LTV through the combined use of equity and debt to finance new acquisitions.

Overall, we believe that GCP's credit metrics will become commensurate with an "intermediate" financial risk profile in 2014, and stabilize at that level thereafter. In view of the currently favorable equity and debt capital markets, we believe that management has the means to undertake acquisitions without releveraging the capital structure. Should market conditions weaken, we also understand that the company will focus solely on improving its internal cash flow.

We have revised upward our financial projections for 2014-2015 taking into account GCP's equity base, recent acquisitions, and a lower average cost of debt.

Our base-case scenario for GCP in 2014 assumes:

- Gross rental income of about €200 million, based on recent acquisitions and positive like-for-like rental income growth of 6%, mainly from rent increases and a stable occupancy rate.
- An EBITDA margin of 48%, supported by economies of scale realized on a larger property portfolio.
- A stable average cost of debt of about 4%, thanks to current favorable financing conditions.

Based on these assumptions, we arrive at the following credit measures for GCP in 2014:

- EBITDA of about €100 million;
- Total debt of about €1.0 billion;
- A fixed-charge-coverage ratio of 2.2x and an interest coverage ratio of 2.7x; and
- Debt to debt plus equity of about 50%.

We continue to assess GCP's business risk profile as "fair." This reflects our view that country risk in Germany is "low" and that the residential property segment is less cyclical than the commercial property segment. Our assessment also reflects positive supply-and-demand trends in large urban areas, with solid economic growth prospects. At the same time, the supply of new property developments is rising, but remains below the current level of demand.

We assess GCP's competitive position as "fair," notably reflecting the size of the company's property portfolio (30,000 units) and related asset and tenant diversity. The asset quality of most apartments in GCP's portfolio is average to low, and most of the assets are located in the North-Rhein-Westphalen region and in Berlin. In 2014-2015, we forecast that average rents will increase, and that the average vacancy rate (14%) and average stay of tenants (10 years) will remain stable.

We continue to assess GCP's management and governance as "fair."

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%. GCP's liquidity position is mostly supported by substantial cash balances and positive funds from operations (FFO). GCP has limited capital expenditures (capex) 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, we calculate GCP's liquidity sources as mostly consisting of:

- €126 million of unrestricted cash, which we believe the company will use mostly for acquisitions; and
- Our forecast of €50 million in FFO in 2014 under our base-case scenario.

This compares with potential liquidity uses of:

- €8 million of debt amortization;
- Our forecast of €5 million of capex; and
- No dividend payments.

We understand that GCP has significant headroom under the debt covenants for most of its assets. Some of the newly acquired assets have tight (5%-15%) headroom under their LTV covenants. However, these covenants were set at the inception of the asset financing. We project increased occupancy in the assets, which should increase rental values and therefore headroom under the covenants.

Outlook

The stable outlook reflects our opinion that GCP's recurring cash flow and debt leverage should remain steady in 2014. Under our base-case scenario for 2014, we forecast positive like-for-like rental income growth of about 6%, based on an increase in average rents and a stable occupancy rate. Higher rents should occur mainly thanks to solid demand for GCP's apartments in most locations. Rating stability depends on the company maintaining a fixed-charge coverage ratio of more than 2.1x and a debt-to-capital ratio of up to 50%.

Upside scenario

We believe that an upgrade is contingent on GCP's property portfolio maturing, with lower vacancy rates and more predictable rent growth. An upgrade is also contingent on our upward revision of GCP's management and governance score to "satisfactory" from "fair," as the company increases the number of managers and thereby reduces its dependence on key executives.

In terms of financial metrics, an upgrade depends on GCP's ability to maintain a fixed-charge coverage ratio of more than 2.1x and debt to debt plus equity of about 50% at all times. We will monitor the financing of future acquisitions and the company's ability to access equity and debt capital markets.

Downside scenario

We would lower the rating if GCP alters its current policy to accommodate higher leverage through large debt-financed acquisitions, or if it increases its asset rotation, which would reduce the stability of cash flows. We could also lower the rating if GCP's fixed-charge coverage ratio decreases to less than 2x and its debt-to-capital ratio increases to more than 50% on a sustained basis. This would most likely occur if the company started acquiring large portfolios of properties that required more extensive renovation than the assets it has acquired in the past.

Ratings Score Snapshot

Corporate credit rating: BB+/Stable/--

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

Financial risk: Intermediate
- Cash flow/leverage: Intermediate

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: Neutral (no impact)
- Comparable rating analysis: Neutral (no impact)

Recovery Analysis

Key analytical factors

- The issue ratings on the proposed senior secured convertible bonds of at least €100 million, due in 2019, and the existing €200 million senior secured bonds due in 2020 are 'BB+'. The recovery ratings on these bonds are '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. The ratings are constrained by the subordination of the bonds to a high level of bank debt, and our view of the weak security package.
- We consider that the proposed convertible bonds will rank pari passu with the existing senior secured bonds, as the proposed bonds will benefit from the same security package and similar documentation as the existing senior secured bonds.
- Our hypothetical default scenario assumes a default in 2019, most likely triggered by deterioration in real estate market values and a decline in the quality of the properties. This leads to lower occupancy rates and rental incomes and the company's subsequent inability to refinance its debt maturities.
- 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 numerical recovery coverage exceeds the threshold for a '3' recovery rating, we cap the rating at '3' to reflect our view of the weak security package and the significant amount of structurally senior secured bank debt.

Simulated default assumptions

- Year of default: 2019
- Jurisdiction: Germany

Simplified waterfall

- Gross enterprise value at default: €920 million
- Administrative costs: €46 million
- Net value available to creditors: €874 million
- First-lien debt claims: €500 million*
- Unsecured debt claims: €308 million*
- --Recovery expectation: 50%-70%

*All debt amounts include six months' prepetition interest.

Related Criteria And Research

Related Criteria

- 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	

New Rating

Grand City Properties S.A.		
Senior Secured	BB+	
Recovery Rating	3	

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