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Research Update:

Germany-Based Grand City Properties Upgraded To 'BBB+' On Vacancy Reduction And Lower Leverage; Outlook Stable

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Overview

- Grand City Properties (GCP) has further matured its property portfolio by increasing the proportion of income-producing assets on the back of its revised acquisition policy earlier this year and materially lower vacancy rates.
- Furthermore, GCP has amended its financial policy, limiting its ratio of debt to debt-plus-equity to 45%.
- We are therefore raising our long-term rating on GCP to 'BBB+' from 'BBB' and our issue ratings on GCP's senior unsecured and subordinated hybrid debt instruments by one notch.
- The stable outlook reflects our opinion that steady tenant demand in GCP's main locations should continue to support rental income growth over the next 12-24 months, and that the company's leverage should remain in line with the company's recently updated financial policy.

Rating Action

On Nov. 23, 2016, S&P Global Ratings raised its long-term corporate credit rating on Germany-based Grand City Properties S.A. (GCP) to 'BBB+' from 'BBB'. The outlook is stable.

We also raised our issue ratings on GCP's senior unsecured debt to 'BBB+' from 'BBB' and on its subordinated hybrid debt 'BBB-' from 'BB+'.

Rationale

The upgrade reflects GCP's increased proportion of income-producing properties, reflecting a reduction of vacancy rates to well below 10%, which supports a more stable and higher recurring cash-flow base. As of Sept. 30, 2016, GCP's property portfolio represented about €4.6 billion. The company benefits from a broad geographic spread across densely populated regions with good growth prospects in Germany. Its focus on mainly metropolitan areas with favorable macroeconomic fundamentals enabled the company to markedly reduce vacancy to 8.1% in October 2016 from 12.5% at the same time a year earlier. In our opinion, this improvement brings GCP closer to rated peers with the same business risk assessment in the German residential market. These peers include Vonovia and Deutsche Wohnen, for example, which enjoy higher and more stable occupancy ratios compared with GCP.

The upgrade also reflects GCP's recently revised financial policy that limits its target ratio of debt to debt-plus-equity to 45% (versus 50% before). The company reduced its S&P Global Ratings-adjusted ratio of debt to debt-plus-equity to 45% at end-September 2016 from 49% at year-end 2015. We believe this has strengthened the company's debt leverage metrics, comparable with companies we assess at the same rating level.

We believe that the company's portfolio of mainly well-performing properties and its more conservative financial policy support its overall credit risk, which led to the one-notch upgrade.

We understand that management is committed to maintaining a large, stable, recurring cash-flow base from its rental income stream, and limiting asset disposals. GCP's geographic presence is well-balanced between growing regions with healthy rental growth prospects, such as Berlin (18% of portfolio value), Dresden/Leipzig/Halle (19%), and North Rhine-Westphalia (33%)-—the latter region includes cities such as Cologne, Duisburg, and Dortmund, with solid demographic trends. Demand continues to outpace supply of new property developments in GCP's core regions, further facilitating improvements in occupancy rates.

GCP's property portfolio has expanded to 84,000 owned units over the past few months (from 76,000 at year-end 2015), and, like its residential property peers, it has very good asset and tenant diversity. The company adjusted its acquisition strategy at the beginning of 2016, shifting its focus to primarily higher occupied premises (vacancy less than 10%), resulting in higher portfolio occupancy rates and further stability to rental income generation.

We view the asset quality of most apartments in GCP's portfolio as average, reflecting that the company still has some exposure to lower quality premises, which points to GCP's previous acquisition strategy. Vacancy levels have declined to 8.1% (at end-October 2016) since end-December 2015 (12.5%) but remain high compared with other residential real estate companies rated by S&P Global Ratings.

In 2016-2017, we forecast that GCP's average rents will continue to increase thanks to 90% of the company's in-place rents being below market, but improvement will be slow because tenant turnover remains below 10% per year and rents are subject to regulation in Germany.

Our assessment of GCP's financial risk profile is based on our forecast of an adjusted ratio of debt to debt–plus-equity of approximately 44% in the next 12-24 months and a sound EBITDA interest-rate-coverage ratio of well above 4x. In view of the favorable equity and debt capital markets, we consider that management has the means to undertake moderately sized acquisitions without increasing leverage in its capital structure. We view the company's recently updated financial policy with a ratio of debt to debt plus equity of maximum 45% as credit positive and an important component for remaining at the same rating level going forward. We assume that the percentage of net operating income generated from unencumbered assets will remain above 50% in the near term.

Taking into account GCP's recent acquisitions and refinancing activities, our base-case assumptions include:

- Gross rental income of about €420 million-€440 million for 2016 and up to €500 million for 2017, including some recently completed acquisitions and some further forecasted portfolio growth, and positive like-for-like rental income growth of about 5% for 2016 and about 3.0%-3.5% for 2017. We believe this will result mainly from the solid vacancy reduction from at least 200-300 basis points year on year for 2016, and to a smaller degree the following year, some increase in rental levels of existing as well as new leases, low consumer price index inflation of about 0.5% for 2016 and 1.6% in 2017, and real GDP growth of approximately 1.7% and 1.5%, respectively.
- Asset valuation growth of 6%-9% for the next 12-24 months due to the good fundamentals of the German residential market and its favorable demand trends in GCP's key regions, such as Berlin, Cologne, and Dresden, where supply from new property developments remains limited.
- Stable EBITDA margin of about 53% for 2016 and 2017, excluding gains on revaluation and asset disposals.

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

- Debt to debt-plus-equity of approximately 44%;
- EBITDA interest coverage of close to 5x; and
- Debt to EBITDA of approximately 9x-10x.

Based on our business and financial risk profile assessments, we have a choice between 'bbb+' or 'a-' as an initial analytical outcome, or anchor. We choose the lower of these, as we view GCP's business risk positioned below those of peers in the same category, such as Vonovia or Deutsche Wohnen, due to the much-smaller scale and scope of the company's portfolio, as well as substantially lower portfolio occupancy rates.

In addition, we positively reassessed GCP's management and governance to reflect the very good track record of GCP's management in executing successfully its strategy, and the strong expertise and experience within its operating market and industry.

GCP is 32%-owned by Aroundtown Property Holdings PLC. (BBB/Stable/--), which has a weaker credit profile than its subsidiary, while the majority of its shareholder structure remains free float (about 57%). Aroundtown decreased its shareholding in GCP in 2014 to 32% from 38% the previous year, and it has since deconsolidated GCP from its financial accounts--there are no cross-default provisions between the two companies. As a result, we do not align our ratings on GCP with those on Aroundtown, nor cap it at the same level. We acknowledge that GCP has established a track record of operating as an independent listed company. We may reassess the relationship between the two companies if Aroundtown gained majority control in GCP.

Liquidity

We assess GCP's liquidity as strong, including if EBITDA declined by 10%.

We forecast that GCP's liquidity sources will exceed its funding needs by well above 1.5x over the next 12-24 months. The company's liquidity position is supported by a substantial cash balance and the absence of large debt maturities in the next few years. In addition, GCP's liquidity is supported by undrawn committed credit lines, maturing in more than 12 months.

As of Sept. 30, 2016, we calculate GCP's liquidity sources as mostly comprising:

- About €644 million of cash and liquid investments, including the €200 million issued subordinated notes in September 2016 and about €145 million of market securities;
- €245 million of undrawn committed credit lines, maturing in more than 12 months; and
- Our forecast of €170 million-€180 million of cash funds from operations (FFO) for the next 12 months.

This compares with potential liquidity uses of:

- About €50 million of short-term debt, including debt amortization;
- Our forecast of approximately €60 million-€70 million of capital expenditures, although we understand that most of it is not committed; and
- Dividends of about €70 million-€80 million, including dividend distribution to both common shareholders and hybrid investors.

We expect GCP to maintain significant headroom under the financial maintenance covenants in its various debt agreements.

Outlook

The stable outlook reflects our opinion that steady tenant demand in GCP's main locations should continue to support rental income growth over the next 12-24 months and that leverage should remain in accordance with the company's recently adjusted financial policy.

Under our base-case scenario for 2017, we forecast positive like-for-like rental income growth of about 3%, based on an increase in average rents and some further improvement in occupancy rates. Rating stability also depends on the company maintaining debt to debt-plus-equity below 45% and an EBITDA interest coverage ratio of at least 3.5x.

Downside scenario

We could lower the rating if the company fails to maintain its adjusted financial policy or if debt to debt-plus-equity increases again to 45% or more as a result of large debt-financed acquisitions and an easing financial policy. We could also revise our rating downwards if the company was to substantially increase its acquisitions of turnaround properties, resulting in less stable cash flows and back to increasing vacancy levels closer to 10% or above.

We could also lower the rating if GCP continues to issue hybrid instruments, leading it to exceed our threshold of 15% capitalization on a forward-looking basis. This would lead us to view its hybrid notes as having minimal equity.

Upside scenario

We could raise the ratings if GCP's portfolio shows a strong progress in reducing vacancy rates further to below 5%, with a portfolio size getting closer to that of other residential companies that we rate at a higher level. An upgrade would also depend on the company continuing to reduce its leverage with the ratio of debt to debt-plus-equity close to 35%, and maintained that level as part of a more conservative financial policy while keeping a strong EBITDA interest coverage of above 3.5x.

Ratings Score Snapshot

Corporate credit rating: BBB+/Stable/--

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)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 01, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014

- Criteria - Corporates - General: Standard & Poor's Maalot (Israel) National Scale: Methodology For Nonfinancial Corporate Issue Ratings, Sept. 22, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- General Criteria: Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings, Oct. 24, 2013
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Upgraded

	To	From
Grand City Properties S.A.		
Corporate Credit Rating	BBB+/Stable/--	BBB/Positive/--
Senior Unsecured	BBB+	BBB
Subordinated	BBB-	BB+

Additional Contact:
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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. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the 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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.