Credit Rating Announcement

30 November 2023

Scope downgrades Deutsche Konsum's issuer rating to B under review for a developing outcome

The rating downgrade reflects DKR's recent announcement of significant write-downs on property values and shareholder loans, impairing both credit metrics and upcoming refinancings.

The latest information on the rating, including rating reports and related methodologies, is available on this LINK.

Rating action

Scope Ratings GmbH (Scope) has today downgraded the issuer rating of German commercial real estate company Deutsche Konsum REIT-AG (DKR) to B from BB+/Stable. Scope has also downgraded DKR's EUR 40m bond (ISIN: DE000A2G8WQ9) to BB from BBB and the senior unsecured debt rating to BB- from BBB-. Simultaneously all ratings were placed under review for a developing Outcome.

Rating rationale

The downgrade follows the recent announcement of significant impairments amongst others, which leads to: i) a stark increase in LTV to above 60% with a lapse of binding financial policy to keep it under control; ii) an increase in leverage as measured by Scope-adjusted debt/EBITDA; iii) a deterioration in Scope-adjusted EBITDA interest cover with limited visibility and uncertainties about future refinancing conditions; and iv) liquidity concerns with upcoming maturities that are not yet addressed.

DKR released on 24 November 2023 its preliminary full-year results for FY 2022/23 ahead of schedule (19 December 2023) and announced significant write-downs. The company received external valuations on its property which showed a decline of 9% (like-for-like). Thus, the company has written down asset values for its full-year results by EUR 125m, taking investment properties down to EUR 989m from EUR 1,104m reported at Q3 2022/23. In addition, DKR has impaired its shareholder loan to Obotritia Capital KGaA by 55% as a precautionary measure (full outstanding amount is EUR 65.7m). DKR still expects the shareholder loan to be repaid in full and is in negotiations with Obotritia and it is Scope's understanding that Obotritia has already provided collateral of around EUR 60m.

Furthermore, DKR has decided to derecognise the previously recorded tax receivables and instead started to recognise deferred taxes for the first time, reflecting the unclear time perspective and unclear outcome of the legal dispute with tax authorities in regard to its G-REIT status. As such tax expenses of EUR 72.5m are reflected in the year-end financial statements, of which EUR 62.2m consists of non-cash deferred tax liabilities. Due to the above-mentioned factors, a EUR 203m loss under IFRS was recorded for FY 2022/23, also resulting in a loss under German GAAP and thus no dividends are proposed for FY 2022/23.

The significant write-downs in assets impact Scope's credit metrics strongly. Leverage as measured by Scope-adjusted LTV increases to 62% as of FYE 2022/23, up from 51% at Q3 2022/23. As such it increases substantially above Scope's previous rating downgrade trigger and Scope does not foresee a considerable deleveraging in the short-to-medium term with an LTV around 60% in its base case. While Scope understands the company is working on a potential equity raise and intends to sell unencumbered assets to reduce debt, such measures cannot be included in the rating base case until contractually agreed upon. Scope also views DKR's derecognition of tax receivables built up under G-REIT premises and the corresponding build-up of deferred tax liabilities as an implied change in the company's strategy with negative credit implications. While Scope until now has expected the company to uphold and defend its German REIT status, which acts as a legally binding financial policy to keep LTV below 55% over time, that commitment seems to be significantly weakened given the recent announcement.

Scope-adjusted debt/EBITDA increases to 14.7x as of FYE 2022/23, up from 11.6x, based on a reduced EBITDA. Scope understands the limitations of the preliminary communicated financial numbers and with it the agency's EBITDA calculation, with value adjustments impacting administrative expenses, which potentially could lead to an improved EBITDA assessment once the full annual disclosure is available.

Scope-adjusted EBITDA interest expenses are impacted alike by the aforementioned reduction in EBITDA for FY 2022/23, taking the interest cover metric down to 2.4x from 3.7x last year. Scope expects interest costs to increase in the next two years despite a reduction in debt, as DKR's refinancing will likely be more costly in its current position. Refinancing unsecured upcoming maturities with secured financing might somewhat dampen the increase. Given CPI-adjusted rent developments aiding EBITDA going forward, Scope expects a relatively stable development of EBITDA interest cover for the next two years in its base case.

Liquidity has historically been burdened by the high share of short-term debt as flagged by Scope, and continues to be burdened. Sources of liquidity (unrestricted cash of EUR 4.9m as at FYE 2022/23 and Scope-adjusted free operating cash flow forecasted at EUR 26m) do not cover short-term debt of EUR 152m as at FYE 2022/23. Scope has historically viewed such shortfalls as manageable in light of a high portion of truly unencumbered assets that could be pledged/refinanced against and the perceived liquid shareholder loan to Obotritia. A timely repayment of that outstanding shareholder loan in full (EUR 65.9m) would have a significant positive impact on DKR's liquidity and its refinancing needs, especially the senior unsecured maturity of EUR 70m in April 2024. Given the announced cautionary impairment of the shareholder loan and the lack of visibility on its repayment, Scope removes it as a mitigant in its liquidity assessment which renders DKR's liquidity inadequate. Given the size of upcoming maturities within the next 12 months, which Scope understands DKR is currently proactively addressing, the agency deducts two notches in its liquidity assessment.

With that, DKR's financial risk profile assessment is lowered to B from BBB- based on the above detailed: i) stark increase in LTV to above 60% with a lapse of binding financial policy to keep it under control; ii) the increase in leverage as measured by Scope-adjusted debt/EBITDA; iii) the deterioration in Scope-adjusted EBITDA interest cover with limited visibility and uncertainties about future refinancing conditions; and iv) the liquidity concerns with upcoming maturities that are not yet addressed.

The company's business risk profile is assessed unchanged at BB+, supported by the company being one of the largest landlords in Germany investing in food-anchored retail, moderately spread across Germany. Tenant diversification is more concentrated, though this is somewhat mitigated by the perceived investment grade quality of the top three tenants, which are all active in non-cyclical food retail. The company's food retail locations remain supportive to the portfolio, with a high financial occupancy of around 94% (EPRA measured) and a WAULT of 5.0 years at FYE 2022/23. Profitability as measured by the EBITDA margin has been stable between 60-65% for the first three quarters of 2022/23 and is expected to be so in the future, while FY 2022/23 is burdened by the aforementioned accounting effects.

DKR does not yet have a dedicated ESG strategy. Most ESG requirements relate to the ESG strategies of tenants.

Lastly, Scope highlights the negative governance issues (ESG factor: credit-negative) that have resulted in a negative one-notch adjustment of DKR's standalone rating. These stem from the perceived conflict of interest situation that arose through the shareholder loan being provided by DKR to Obotritia, with one of its main shareholders, previous CEO and thereafter Chairman of the Board, Rolf Elgeti, also being General Partner of Obotritia. Scope appreciates that Rolf Elgeti recently stepped down as Chairman of the Supervisory board but sees the conflict of interest not remedied as he remained in the Supervisory board.

One or more key drivers of the credit rating action are considered ESG factors.

Under review for a developing outcome

Scope will closely monitor the developments of DKR regarding the refinancing of its upcoming unsecured bond (April 2024) and secured bond (May 2024). Scope will also closely monitor any potential upcoming asset sales or capital raises by the company and follow closely developments regarding the repayment of the shareholder loan and upcoming refinancing proposals by DKR for its upcoming maturities. Scope will resolve the under-review status once there is sufficient clarity on the refinancing of DKR's upcoming maturities.

A prerequisite for an upgrade is the orderly refinancing of its upcoming maturities that removes Scope's liquidity concerns. As such Scope foresees a materialisation of potential asset sales, capital raises, a contractually agreed repayment schedule for its shareholder loan with Obotritia and/or a potential secured financing of its currently unencumbered asset portfolio as preconditions. Furthermore, any plan should not involve a restructuring of liabilities that leads to losses for DKR's creditors.

A downgrade could be triggered by a deterioration of DKR's liquidity or insufficient progress on the ongoing refinancing of the upcoming maturities. The latter poses ultimately an implied default risk for DKR at the bonds' maturity, though Scope considers this unlikely and has not reflected this scenario in its base case.

Long-term debt ratings

DKR issued a EUR 40.0m bond in May 2018 (EUR 35.9m outstanding) with a six-year term (2018-24) and a coupon of 1.80% (ISIN: DE000A2G8WQ9). This bond benefits from a first-ranking mortgage on 13 properties valued at EUR 96m as at September 2022 (the most recent valuations are not yet available). The structure's over-collateralisation is adequate, with an issue-specific loan/value ratio estimated of 41%. This positively influences recovery rates in a default scenario. According to Scope's methodology and based on discounts on assets (as described below), a 'excellent' recovery is expected in a default scenario, thus allowing for a three-notch uplift to BB on the issuer rating of B.

Scope's recovery analysis for senior unsecured debt signals an 'excellent' recovery. This is based on a hypothetical default scenario in FY 2023/24 with a company liquidation value of EUR 677m, including a haircut applied to assets, reflecting a BB category stress according to Scope's methodology, and liquidation costs of 10% for insolvency proceedings. This compares to a forecasted EUR 371m of secured financing, EUR 37m in unsecured convertible bonds, EUR 140m in senior unsecured bonds and EUR 68m in Schuldschein loans. DKR's Scope-adjusted unencumbered asset ratio amounted to 1.9x at end-December

2022, allowing for an uplift of the debt class rating to the BB category according to Scope's methodology. The senior unsecured debt is thereby rated at BB-, two notches above the issuer rating of B.

Stress testing & cash flow analysis

No stress testing was performed. Scope Ratings performed its standard cash flow forecasting for the company.

Methodology

The methodologies used for these Credit Ratings and/or Outlook, (General Corporate Rating Methodology, 16 October 2023; European Real Estate Rating Methodology, 25 January 2023), are available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. Also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The Rated Entity and/or its Related Third Parties participated in the Credit Rating process.

The following substantially material sources of information were used to prepare the Credit Ratings: public domain, the Rated Entity and Scope Ratings' internal sources.

Scope Ratings considers the quality of information available to Scope Ratings on the Rated Entity or instrument to be satisfactory. The information and data supporting the Credit Ratings originate from sources Scope Ratings considers to be reliable and accurate. Scope Ratings does not, however, independently verify the reliability and accuracy of the information and data.

Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and/or Outlook and the principal grounds on which the Credit Ratings and/or Outlook are based. Following that review, the Credit Ratings and/or Outlook were not amended before being issued.

Regulatory disclosures

These Credit Ratings and/or Outlook are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and/or Outlook are UK-endorsed.

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The Credit Ratings/Outlook were first released by Scope Ratings on 31 May 2018. The Credit Ratings/Outlook were last updated on 27 March 2023.

Potential conflicts

See www.scoperatings.com under Governance & Policies/Regulatory for a list of potential conflicts of interest disclosures related to the issuance of Credit Ratings.

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With more than 250 employees operating from offices in Berlin, Frankfurt, Hamburg, London, Madrid, Milan, Oslo and Paris, Scope Group is the leading European provider of independent credit ratings, ESG and fund analysis. Based on forward-looking and innovative methodologies, Scope offers a European perspective that contributes to greater diversity of opinion for institutional investors worldwide. **Scope Ratings** is the largest European credit rating agency, registered in accordance with EU and UK rating agency regulation, offering opinion-driven and non-mechanistic credit risk analysis. **Scope ESG Analysis** provides tools for analysing and reporting on ESG impact and risk, as well as second-party opinions on green, social and sustainable bonds. **Scope Fund Analysis** rates more than 10,000 funds and asset managers across all major asset classes. The shareholders of Scope Group include CEO and founder Florian Schoeller and anchor shareholder Stefan Quandt, numerous senior personalities in European finance and industry as well as institutional investors from several European countries. More on www.scopegroup.com

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