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Research Update:

Germany-Based Real Estate Co. Summit Germany Ltd. Rated 'BB+'; Outlook Stable

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Research Update:

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Overview

- Summit Germany Ltd. owns and operates a portfolio of about €980 million, consisting mainly of office assets.
- We consider that the company's portfolio will generate stable operating cash flows, supported by its locations in and around German metropolitan areas and midsize cities.
- We are assigning our 'BB+' long-term corporate credit rating to Summit and a 'BBB-' issue rating to its proposed senior unsecured notes.
- The stable outlook reflects our view that Summit's portfolio, including ongoing asset rotation, should generate increasing recurring cash flows, thanks to a stable office leasing market in its main locations and favorable underlying market conditions in Germany.

Rating Action

On Jan. 15, 2018, S&P Global Ratings assigned its 'BB+' long-term corporate credit rating to the Germany-based real estate company Summit Germany Ltd. The outlook is stable.

At the same time, we assigned our 'BBB-' issue rating to Summit's proposed €250 million senior unsecured notes. The recovery rating on the notes is '2', indicating our expectation of substantial recovery (70%-90%; rounded estimate: 85%) in the event of a payment default.

Rationale

Summit is a real estate investment company focused on commercial properties in secondary locations in Germany. The company currently owns and manages 85 premises, valued at about €980 million as of Sept. 30, 2017. The majority of its assets are office properties (76% of portfolio value); the remainder are logistic assets (17%) and retail real estate (7%). We understand the company also has two residential development projects, but exposure to development is small (less than 5% of the total investment portfolio). The company's strategy is to expand its portfolio size to about €1.5 billion in the next few years, while enhancing its diversification.

Our rating takes into account the company's relatively small portfolio size and scale compared with higher-rated commercial real estate (CRE) companies that focus on offices in Europe, such as Alstria Office REIT-AG (BBB/Stable/--) or Beni Stabili SpA SIIQ (BBB-/Stable/--). The company is

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exposed solely to the German economy, which remains a highly fragmented real estate market across all segments. However, we understand that Summit's portfolio is well spread across the country, locations close to metropolitan areas and midsize cities with good infrastructure, near motorways, or international airports, such as Berlin, Cologne, or Stuttgart. We estimate that the macroeconomic fundamentals in the majority of Summit's locations are favorable, with positive demand trends for the CRE sector, relatively low unemployment rates, and GDP growth. We believe that about 20% of the portfolio is located in more rural areas or less dynamic cities, such as Eberswalde, Hof, or Obernkirchen, where the replacement of departing tenants may take longer compared with more central locations. Summit's tenant base is large, with about 680 tenants, mainly domestic companies. The company has some tenant concentration on Volkswagen AG (BBB+/Stable/A-2) generating about 7% of total rental income, and Deutsche Telekom AG (BBB+/Stable/A-2), which accounts for a further 6.7% of total annual rental income. Nevertheless, we understand the risk is partly mitigated across several lease agreements with both tenants.

We assess Summit's asset quality in terms of asset size and age as average and in line with rated German peers, such as Alstria Office REIT-AG or DEMIRE Deutsche Mittelstand Real Estate AG (BB/Stable/--). Most of the buildings are between 5,000 and 20,000 square meters, with limited need for capital expenditures (capex; estimated at €6 million to €8 million per year). The top-10 assets represent 40% of total market value, with the largest asset counting for 8.5%, an office building in Berlin with over 100 tenants. The company's average lease term of 4.4 years is slightly below other rated office players (five years or longer) but compares well with the German market lease length of approximately 3.6 years. Most of Summit's lease contracts are index-linked or subject to fixed annual increases, which should give the company some organic rental growth in the future.

On Sept. 30, 2017, total portfolio EPRA (European Public Real Estate Association) vacancy stood at about 9%, excluding vacant space for redevelopment. We expect the company to marginally decrease vacancy levels in the next 12 to 24 months, including newly acquired properties and some benefits from the disposal of noncore assets, representing about eight buildings and €20 million of portfolio value that has an average vacancy of above 50%.

Summit is a listed company on the Alternative Investment Market of the London Stock Exchange, and its main shareholder, Summit Real Estate Holdings (50%), is headquartered in Guernsey, U.K. Further minority shareholders are Invesco with about 29% and Fidelity with about 8%. The remaining 12% of shares are free float. Summit represents 90% of Summit Real Estate Holdings' cash generation and is consolidated under group accounts, constituting a significant proportion of the consolidated group. We therefore see Summit as playing an integral role in Summit Real Estate Holdings' identity and strategy. The two entities also share a name and brand, and the group's reputation and risk-management activities are closely linked. We believe that Summit Real Estate Holdings is likely to support Summit under any foreseeable circumstances, as the subsidiary is fundamental to its strategy and performance.

Summit's financial risk profile is underpinned by its moderate leverage, with S&P Global Ratings-adjusted ratio of debt to debt plus equity of approximately 45% and its solid EBITDA interest coverage close to 4x. The company's average debt maturity is 5.3 years, with 95% of debt fixed-rate or hedged. We understand that the company's strategy is to extend its maturity profile further, while keeping limited exposure to variable-rated liabilities.

In July 2017, Summit Real Estate Holding provided Summit a loan of €19.5 million at a coupon of 8%. We include the loan in our debt calculations. We understand the loan was issued as part of a transaction funding and will be repaid in the short term.

Under our base-case scenario, we expect Summit to maintain stable leverage ratios, including debt to debt plus equity of close to 45%, in line with the company's financial policy of a maximum loan-to-value ratio of 50%. We expect EBITDA interest coverage to remain well above 3x, thanks to the ongoing favorable low interest rate environment and the company's low exposure to variable-rate debt. We believe that the company will finance its growth plans with a balanced mix of debt and equity and that the portfolio will benefit from some positive asset revaluations.

In our base case, we assume:

- Low GDP growth for Germany of 1.7% in 2018 and 1.6% in 2019, with overall unemployment remaining below 5.0%.
- Approximately 2% like-for-like rental income growth for the next 12 to 24 months, mainly stemming from the company's existing contracts, of which roughly 50% are sliding-scale or index-linked rental contracts, as well as from new lettings and a gradually improving occupancy rate.
- Annual acquisitions of about €75 million-€100 million, in line with the company's growth strategy, while we assume asset disposals will be limited.
- Mid-to-high single-digit property revaluation for 2017 and mid-single-digit revaluation for 2018, reflecting the favorable underlying demand trends for its locations in and around midsize cities and metropolitan areas.
- Stable average cost of debt of close to 3%.

Based on these assumptions, we arrive at the following credit measures:

- EBITDA margin of about 80% for the next 12 to 24 months;
- S&P Global Ratings-adjusted EBITDA interest coverage of 3.5x-4.0x; and
- A ratio of debt to debt plus equity of close to 45%.

Liquidity

We assess Summit's liquidity as adequate. By our estimate, the company's liquidity sources will likely cover liquidity uses by well above 1.2x in the next 12 months. Summit has no large debt maturities in the next two to three years and limited committed capex.

As of Sept. 30, 2017, we forecast that Summit's liquidity sources over the next 12 months will include:

- Unrestricted cash balances of about €25 million; and
- Our forecast of cash funds from operations (FFO) of €40 million-€45 million.

This compares with our estimate of liquidity uses for the same period of:

- About €8 million debt maturities, including amortization;
- Total annual capex of €6 million, including tenant investments. However, we understand that most of the investments are not committed; and
- About €17 million of dividend payments, based on the company's policy to distribute 50% of free cash flow.

Summit has only 11% of its assets unencumbered. Most of the company's debt facilities relate to mortgaged bank debt and were granted for the purpose of financing real estate assets. Loan agreements are therefore mostly secured by land charges and assignments of rental payments and most of them include financial covenants, such as loan-to-value ratios or a debt service coverage ratio.

We expect Summit will maintain substantial (more than 10%) headroom under the financial maintenance covenants in its various debt agreements going forward.

Outlook

The stable outlook reflects our view that Summit's portfolio, including ongoing asset rotation, should generate increasing recurring cash flows, thanks to a stable office leasing market in its main locations and favorable underlying market conditions in Germany. We expect the company to generate like-for-like rental growth of around 2% over the next 12 months, mainly stemming from the positive fundamentals of the German real estate market and re-lettings. Most of Summit's properties in secondary locations, such as midsize cities or near metropolitan areas across Germany, benefit from favorable demand trends. We believe occupancy levels will remain broadly stable with a marginal decline of existing vacant space.

We forecast EBITDA interest coverage will remain well above 3x in the next 12 months, and debt to debt plus equity will be approximately 45%, in line with the company's financial policy.

Upside scenario

We could raise the rating if Summit enhanced the scale and scope of its portfolio, similar to rated CRE peers in the lower investment-grade category, with vacancy levels well below 10%, including newly acquired assets, locations with solid underlying macroeconomic fundamentals, and premises that have well-diversified tenant structures.

In addition, an upgrade would also depend on the company maintaining current credit metrics, with the ratio of debt to debt plus equity well below 50% and interest coverage remaining high, above 3x.

An upgrade would also hinge on our assessment of the controlling shareholder Summit Real Estate Holding and the alignment of the credit quality between the two entities.

Downside scenario

We could lower the rating if the company increased its leverage, with a debt-to-debt-plus-equity ratio of 50% or above or EBITDA interest coverage falling to 2.4x or below. This situation could materialize if Summit were to alter its current announced financial policy and undertook additional debt-financed acquisitions.

We could also lower the rating if the company disposed of a material share of its property portfolio, thereby reducing its scale and scope and increasing its concentration on single assets or tenants, resulting in a decline in the overall portfolio size to well below €1 billion, or investment in less favorable secondary locations away from metropolitan hubs.

Likewise, a weakening of our view of the controlling shareholder Summit Real Estate Holding would constrain the rating.

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: Fair (no impact)
- Comparable ratings analysis: Neutral (no impact)

Issue Ratings: Recovery Analysis

Key analytical factors

- The issue rating on Summit's proposed senior unsecured €250 million notes is 'BBB-', one notch above the corporate credit rating. The recovery rating is '2', reflecting the valuable asset base consisting of investment properties. However, our recovery prospects are constrained by the unsecured nature of the debt instrument and its contractual subordination to the current amount of secured debt (such as mortgage loans). For asset intensive companies, such as real estate companies, we cap our recovery rating on senior unsecured debt at '2'. We expect recoveries will be about 85%. We expect that the company will use the proceeds from the bond issuance to refinance mainly existing secured debt. We also take into account the company's strategy to add further unsecured debt to its capital structure.
- In our hypothetical default scenario, we envisage a severe macroeconomic downturn in Germany, resulting in market depression and exacerbated competitive pressures.
- We value the group as a going concern. Our stressed valuation figure comprises the stressed value of the company's property portfolio.
- Recovery prospects for the senior unsecured notes are very sensitive to a small change in the amount of senior secured debt or any other priority debt outstanding at default. Since there is no limitation on the incurrence of additional debt in the bond documentation, recoveries could be much lower if the amount of secured debt at default differs from our projections.

Simulated default assumptions

- Year of default: 2022
- Jurisdiction: Germany

Simplified waterfall

- Gross enterprise value at emergence: €658 million
- Net enterprise value (EV) at emergence after administrative costs: €625 million
- Estimated priority debt (mortgages and other secured debt): €202 million
- Net EV available to senior unsecured bondholders: €318 million
- Senior unsecured debt claims: €255 million
- Recovery expectation: 70%-90% (rounded estimate: 85%)

*All debt amounts include six months of prepetition interest.

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, Aug. 14, 2017
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 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 - Recovery: Methodology For Applying Recovery Ratings To National Scale Issue Ratings, Sept. 22, 2014
- Criteria - Corporates - General: Standard & Poor's Maalot (Israel) National Scale: Methodology For Nonfinancial Corporate Issue Ratings, Sept. 22, 2014
- Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 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

Ratings List

New Rating

Summit Germany Limited	
Corporate Credit Rating	BB+/Stable/--
Senior Unsecured	BBB-
Recovery Rating	2(85%)

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.capitaliq.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.

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