Research Update:

German Residential Property Company Vonovia SE 'BBB+' Rating Affirmed On Deutsche Wohnen Takeover Offer; Outlook Stable

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Rating Action Overview

- Germany's largest residential property owner, Vonovia SE, is likely to strengthen its competitive position in Berlin, following its takeover bid on peer Deutsche Wohnen SE.
- The acquisition's funding will temporarily weaken Vonovia's credit metrics, but we expect these to remain commensurate with the rating level.
- We therefore affirmed our 'BBB+' long-term issuer credit rating on Vonovia and our ratings on its senior unsecured and subordinated hybrid debt instruments.
- The stable outlook reflects our view that the company will likely integrate Deutsche Wohnen and dispose a significant number of assets in the near term, with maintaining EBITDA interest coverage well above 2.4x and debt to debt plus equity at less than 60%.

Rating Action Rationale

Vonovia's bid on Deutsche Wohnen would enlarge the company's leading market position in Germany, in particular Berlin. The affirmation follows Vonovia's announcement of a €16.5 billion cash offer (based on €52 per share or €53.03 including Deutsche Wohnen's 2020 dividends) to acquire 89.9% of the share capital of Berlin-headquartered Deutsche Wohnen, Germany's second-largest listed residential landlord (below the 90% threshold requiring a co-investment agreement and making it subject to the German real estate transfer tax). If completed, the transaction would enhance Vonovia's market position in Germany and particularly Berlin, where the majority of Deutsche Wohnen's portfolio is located. We estimate market share in Berlin would increase to about 8% from about 2% currently. We understand Vonovia aims to gain control of Deutsche Wohnen and fully integrate it as a core division that would be part of the group's identity and strategy. We estimate that the combined group's gross asset value, excluding planned disposals, will reach about €89 billion (up from Vonovia's €59 billion currently), and it would generate more than €1.8 billion annualized EBITDA, based on about 569,000 flats (compared with

415,000 currently). We expect the company to capitalize on resulting economies of scale, driving higher margins. Vonovia has demonstrated its capacity to integrate acquired portfolios to expand its business by keeping operating capabilities internally and developing an integration platform that accelerate integration. We continue to view the company's business risk profile as excellent.

Deutsche Wohnen's asset profile fits well with Vonovia's portfolio, while concentration in Germany will increase to 90%. We view Deutsche Wohnen's portfolio as complementing Vonovia's existing asset base, with similar rent levels and high occupancy rates, supported by persisting structural supply and demand imbalance for affordable housing. Still, and despite the large portfolio base, Vonovia will remain concentrated in a single country, with around 90% of the resulting portfolio in Germany (compared with 85% currently). While the nature of the regulated German market supports cash flow stability and predictability, underpinning Vonovia's creditworthiness, the high concentration brings some regulatory and reputational uncertainty compared with globally more diversified residential real estate peers in the same business risk category. We understand that the company will provide a purchase option to the City of Berlin to acquire about 20,000 apartments and it will likely dispose further assets over the short-to-near-term.

We expect Vonovia to maintain its credit metrics within our rating thresholds. Although the proposed transaction will result in a temporary deterioration of credit metrics, we view the company as having some buffer under its downside triggers at 60% debt to debt plus equity to factor in any setbacks or delays related to the transaction. The estimated €29.7 billion acquisition costs comprise gross proceeds of €16.8 million equity price offer (assuming an 89.9% take-up), which will be fully funded by new equity issuance (assumed to be about €8 billion), significant disposal proceeds, existing rolled-over debt, and newly issued debt. We understand that the company has a committed acquisition bridge facility of €22 billion. Under our base-case scenario, we believe Vonovia will deliver on the proposed terms and maintain leverage metrics in line with current ones over the next 12-18 months. We anticipate the company's debt-to-debt plus equity ratio will remain at 54%-55% by year-end 2021 (versus 51.6% as of March 31, 2021). This is still below our 60% threshold for a possible downgrade. We also anticipate EBITDA interest coverage to remain above 3x over the same period, supported by our view of limited changes in its funding costs, which stood at 1.4% as of March 31. Similarly, we recognize Vonovia's track record of previous portfolio acquisitions and its commitment to maintaining leverage levels in line with the company's 40%-45% loan-to-value (LTV) target.

We expect the low-yielding market environment to continue weighing on Vonovia's debt to EBITDA negatively. The transaction will likely cause a spike in adjusted debt to EBITDA to above 21x in 2021, before stabilizing near 17x for the remainder of our forecast period. This compares negatively with residential real estate holding companies that have similar LTV but operate in more volatile, higher-yielding markets such as the U.S. The divergence between Vonovia's leading ratio based on valuations (LTV) and cash flow-based metrics such as debt to EBITDA illustrates the company's vulnerability to a change in prevailing yields, which, although not our base-case scenario for the German residential asset class, could result in metrics persistently deviating from its target 40%-45% LTV. This is because the relatively small cash earnings base would not mitigate the increase in debt leverage from a material change in market yields. Its acquisitive nature also results in higher debt-to-EBITDA metrics. These factors lead us to characterize the company's growth strategy as aggressive, which we incorporate into our rating.

Outlook

The stable outlook reflects our view that the combined entity's portfolio will continue generating robust and stable cash flow, supported by strong market fundamentals in Germany for ongoing demand for affordable housing, and to a lesser degree in Austria and Sweden. This should enable the company's EBITDA interest coverage to remain well above 2.4x for at least the next two years. We also expect Vonovia to integrate the transaction, in line with its track record, while ensuring a sufficient liquidity cushion and complying with its publicly stated financial policy (with a reported LTV of 40%-45%, comparable to S&P Global Ratings-adjusted debt to debt plus equity of 50%-55%) through a significant number of asset disposals and a €8.0 billion rights issue. We expect management will maintain prudent financial discipline to manage its extensive capital expenditure's renovation pipeline without increasing its leverage.

Downside scenario

We could consider a negative rating action if:

- Vonovia deviates from its stated financial policy if it could not deliver on its planned disposals or equity issuance;
- Debt to debt plus equity increases to 60% or above, because of unexpected debt-funded acquisitions or a deterioration of market conditions from changes in the regulatory and legal environment; or
- The liquidity cushion decreases, for example, because of a decreasing free operating cash flow base or additional cash-funded transactions or late refinancing of upcoming maturities.

Upside scenario

We could raise our rating on Vonovia by one notch if:

- The company's financial policy becomes more conservative, demonstrated by a lower appetite for leverage and signs that debt to debt plus equity would sustainably stay below 50% while maintaining EBITDA interest coverage at 3x or above;
- Vonovia increases the amount of income available for paying down debt, so that its debt-to-EBITDA ratio falls well below its historical average of 15x-17x sustainably; and
- The company further diversifies into markets with strong fundamentals and favorable demand trends, decreasing its concentration on the German economy and mitigating the potential further tightening of domestic regulation, leading to stronger free cash flow.

Company Description

Vonovia is the leading listed residential real estate holding company in Germany, and largest listed real estate landlord by portfolio size in Europe. Its portfolio was worth about €56.7 billion as of March 31, 2021, and comprised about 414,715 owned residential units in Germany, Austria, and Sweden. The company manages an additional 74,000 units for third parties.

Vonovia's strategy focuses on affordable apartments, leased at €7.18 per square meter on average (as of March 31, 2021). The company is listed on the German stock index (DAX) with an average market cap of about €29 billion as of May 2021. The largest shareholders are BlackRock (7.3%), followed by Norges Bank (6.3%). Free float is 93.7%.

Liquidity

Post-transaction, we would expect the enlarged group's liquidity to remain adequate. Excluding one-time transaction outflows backed up by the same amount of equity and a €22 billion bridge loan (already committed), our estimates of the group's pro forma liquidity sources would still exceed its uses by more than 1.2x for the next 12 months following the deal's closing. We also think, Vonovia will continue enjoying a strong credit standing and easy access to capital markets while maintaining a prudent liquidity strategy.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/A-2

Business risk: Excellent

- Country risk: Very low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Significant

- Cash flow/leverage: Significant

Anchor: a-

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Vonovia SE, March 30, 2021

Ratings List

Ratings Affirmed	
Vonovia SE	
Issuer Credit Rating	BBB+/Stable/A-2
Vonovia SE	
Senior Unsecured	BBB+
Subordinated	BBB-
Vonovia Finance B.V.	
Senior Unsecured	BBB+
Subordinated	BBB-

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on 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.