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# Rising Rents, Stable Leverage, And Dividend Cut Support Vonovia's Credit Profile

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This report does not constitute a rating action.


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PARIS (S&P Global Ratings) March 21, 2023--Despite the current inflationary pressures weighing on German households' purchasing power, real estate holding company Vonovia SE (BBB+/Stable/A-2) was able to raise rents steadily and maintain high collection and occupancy rates of 99.8% and 98%, respectively, in 2022. The company's financial performance for the year was in line with S&P Global Ratings' expectations, including steady rental income growth, contained asset valuation decline, and an announced dividend cut.

**Vonovia's rental income growth is in line with our assumptions.** The company posted a 3.3% like-for-like increase in rental income for the full year after 3.4% in first-half 2022, which is within the 3.0%-3.5% range we forecast in November (see "Outlooks On Vonovia And Deutsche Wohnen Revised To Stable On Tougher Market Conditions; 'BBB+' Ratings Affirmed," published Nov. 11, 2022). This compares with 3.2% in 2021 and 3.1% in 2020, and includes Deutsche Wohnen, which Vonovia acquired in November 2021. We now forecast 2.5%-3.5% organic growth of rental income in 2023-2024. This is because strong demand for housing and a progressive rise in rent indexation due to inflation should offset the lower potential for growth from Vonovia's downsized renovation program, which generally allows it to raise its rents. Moreover, elevated construction costs would likely limit new housing supply in the market in 2023-2024, further exacerbating the shortage of housing in Germany (see "German Residential REITs Face A Mixed Outlook In 2023," published Feb. 20, 2023).

**Higher operating costs weighed on the value-added segment, while property development and recurring sales fared well.** EBITDA from the value-added segment (technical services, mostly craftsmen) declined by 17.6%, since the revenue increase was offset by lower investments and materially higher operating costs due to labor shortages, pushing the company to spend more on outsourcing. We expect cost pressures to progressively ease in 2023 although business volumes could remain subdued. EBITDA from the recurring sales segment remained positive (up 19.3%) thanks to higher pricing. As demand slowed during the year, the company boosted volumes in the fourth quarter by lowering its fair value minimum step-up to 28% from 39%, as expected. For 2023, we think the company's plans to maintain or slightly decrease its fair value minimum step-up should continue to offset potential volume declines. EBITDA from developments remained relatively stable, down only 1.2%. We believe the ongoing shift to build-to-sell property from build-to-hold will continue to support revenue in the next two years.

**Valuation declines in the second half of 2022 were limited, and we believe Vonovia's balance sheet has sufficient buffers for 2023.** Vonovia reported 0.5% like-for-like growth of property valuations for the full year of 2022, including a decline of 3.9% in the second half. This is a sharp slowdown from 2021, when growth was 14.3%, but still well within our assumption of a 10% contraction for the period June 30, 2022, to Dec. 31, 2023. While demand from institutions declined sharply in 2022 due to weaker funding conditions, we understand demand from households remains somewhat more resilient and less sensitive to rising mortgage interest rates.

**We continue to assume higher funding costs and limited noncore asset disposals.** We assume a 4.5% refinancing coupon on all upcoming debt maturities, based on management's track record of raising debt cheaper than unsecured bond trading. In addition, we assume significantly lower capital expenditure in 2023 at about €850 million (excluding capitalized maintenance) or 0.9% of the gross asset value (GAV) than in 2022 (€1,445 million or 1.5% GAV). In our base-case scenario, we don't assume the sale of Deutsche Wohnen's nursing homes or of the large joint venture portfolio, which the company is contemplating. Under these conservative assumptions, Vonovia's EBITDA-to-interest ratio should weaken in the 2.8x-3.5x range in 2023-2024, although it declined to only 3.7x as of Dec. 31, 2022, from 3.8x on Dec. 31, 2021.

**The company's liquidity situation remains adequate.** Vonovia's overall debt maturities are manageable, given their long average remaining term of 7.4 years as of Dec. 31, 2022, and staggered nature. No more than 10%-11% of debt (about €3.5 billion-€4.5 billion) matures each year. The company should generate €1.4 billion-€1.5 billion of funds from operations this year and currently has a healthy cash position (€1.2 billion as of Dec. 31, 2022), a large available revolving credit facility (€3.0 billion), and a credit line of €0.6 billion from the European Investment Bank to cover its €3.4 billion of debt maturities and reduced €850 million investment plan in 2023. In the future, an increase in free cash flow should cover upcoming bond maturities, limiting the need to raise new expensive debt. We do not anticipate financial covenant breaches or very tight headroom, despite the risk of valuation declines. This is because, in the unlikely event of a more than 28% decline in fair value or a 205% increase in interest charges in the short term, the company has sufficient covenant headroom to absorb it.

**The public prosecutor's investigation of a group of former employees linked to awarding third-party contracts is credit neutral at this stage.** On March 7, 2023, Vonovia announced an investigation by Germany's public prosecutor of a group of individuals at the operational level in the group's technical area. According to the statement, there were alleged procedural breaches in the awarding of contracts to subcontractors, to Vonovia's detriment. We understand Vonovia is actively cooperating with authorities and may press charges against the suspects. We also understand that Vonovia may have suffered potential financial damage, but no adverse implications for tenants have been identified at this stage. The total orders with the third-party contractors potentially affected would have represented a very small portion of the company's investments. Vonovia subsequently launched an independent investigation, in which Deloitte Hengeler Mueller will seek to clarify potential control issues so the company can remedy them. Therefore, we do not expect a strong or lasting negative impact on Vonovia's reputation although we will monitor future developments closely.

**Lower dividends and investments this year should help protect the balance sheet in the absence of large disposals.** Vonovia's debt-to-debt-plus-equity and debt-to-EBITDA (excluding recurring sales) ratios remained elevated in 2022 at 56.7% (56.4% in Dec. 31, 2021) and 19.9% (25.5x as of Dec 31, 2021), respectively, although the latter declined strongly thanks to steady revenue growth and reduction of debt by about €2 billion. The company has not yet executed a large, planned disposal. However, we view as positive its decision to cut the dividend to 30% of funds from operations and to propose a scrip dividend this year. We also expect the company to further decrease its investments, by about €500 million in 2023, and generate stronger free operating cash flow. The company should therefore be able to maintain a debt-to-debt-plus-equity ratio of about 55%, despite negative revaluations, and progressively improve its debt-to-EBITDA (excluding recurring sales) ratio to 17x-19x in 2023-2024, absent large disposals. We believe these levels are consistent with our benchmarks for the rating, such as debt to debt plus equity below 60%. In our assumptions, we do not factor in a disposal of Adler's shares or a sale of the health care assets at Deutsche Wohnen, although we understand this could be an option.

## Related Research

- German Residential REITs Face A Mixed Outlook In 2023, Feb. 20, 2023
- Outlooks On Vonovia And Deutsche Wohnen Revised To Stable On Tougher Market Conditions; 'BBB+' Ratings Affirmed, Nov. 11, 2022