FCR Immobilien AG
Germany, Real Estate

B+ STABLE

Corporate profile

FCR Immobilien AG (FCR) is a real estate company which trades in retail properties including retail parks, local shopping centres, DIY stores, hypermarkets and discount supermarkets. FCR usually buys properties with significant management needs, redevelops (refurbishment, repositioning, up-letting) and sells them.

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018F**	**2019E**	**2020E**
EBITDA/interest cover (x)	2.0x	2.4x	1.8x	1.6x
Scope-adjusted debt/EBITDA	13.3x	16.2x	16.5x	16.7x
Scope-adjusted FFO/SaD	4%	4%	1%	2%
Loan/value ratio	52%	63%	66%	69%

Rating rationale

Scope affirms B+ issuer rating of FCR Immobilien AG, Outlook Stable

Positive rating drivers include the company's geographically well diversified property portfolio located in regions that are expected to have stable tenant demand, leading to predictable recurring income from those tenants with moderate credit quality. Successful trading activity with total sales of EUR 44m in 2018 and 2019 YTD (representing a 55% premium on the corresponding book value) has helped keep debt protection sufficiently high.

The rating is constrained, however, by the company's small size which results in a lack of economies of scale. Furthermore, we have a negative view of both FCR's dependence on its trading activities to secure sufficient coverage of operational and financial expenses, and of its low-quality assets which could lead to substantial price haircuts in a distressed sales scenario. FCR's weakening access to external financing, especially debt and equity capital markets, is also negative. This drove leverage up earlier than expected, with the company's loan/value ratio increasing to above 60% as at YE 2018.

The bonds benefit from a pledge on investment properties at a value representing the bonds' outstanding nominal and the interest payable up to the bonds' maturity. We expect an 'above average' recovery for the bonds in a default scenario. The security therefore improves credit risk for the bonds over that of the issuer.

Outlook

The Outlook for FCR is Stable and incorporates our expectation that leverage, as measured by FCR's loan/value (LTV) ratio, will remain between 60% and 70% (2018F: 63%) in the coming years. We also incorporate more stable debt protection of around 1.7x supported by a growing portfolio of income-producing properties, further successful disposal activity and ongoing adequate liquidity.

A negative rating action would be possible if EBITDA interest expense were to fall below 1.7x on a sustained basis, the LTV ratio were to reach 70% or if access to external finance weakened. A positive rating action could be warranted if EBITDA interest expense cover were to increase to over 1.7x on a sustainable basis, predominately supported by recurring EBITDA, while leverage as measured by the company's LTV ratio decreased to around 50%.

Ratings & Outlook

Corporate ratings	B+/Stable

Analyst

Philipp Wass
+49 30 27891 253
p.wass@scoperatings.com

Related Methodology

Corporate Rating Methodology

Rating Methodology European Real Estate Corporates

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Rating drivers

Positive rating drivers	Negative rating drivers
• Good geographical diversification with assets spread across Germany • Asset portfolio predominately in illiquid 'D' locations, albeit with largely robust tenant demand leading to stable cash flows • Good credit quality and moderate tenant industry diversification with some cyclical exposure • Adequate occupancy rate of 84% as at YE 2018 and improving weighted average unexpired lease term (5.3 years as at YE 2018) support visibility of future cash flows • Ability to make market value gains supported by organisational setup of acquisition process	• Small company with limited access to capital markets, but ambitious growth plans that should help support visibility to tenants and investors • Concentrated tenant portfolio with top three accounting for 36% of rental income • Portfolio with advanced economic age of about 30 years resulting in relatively low attractivity to tenants and high capex needs • Volatile and comparatively low EBITDA margin as a result of business model with high associated operating expenses and limited economies of scale • Persistently negative free operating cash flow as a consequence of aggressive growth leading to dependence on external financing

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• EBITDA interest expense cover of greater than 1.7x on a sustainable basis predominately supported by FCR's recurring EBITDA, with the LTV ratio decreasing to around 50%	• Decrease in EBITDA interest expense cover to below 1.7x • Weakening access to external financing • LTV increase to around 70%

Financial overview

			Scope estimates	
Scope credit ratios	**2017**	**2018F**	**2019E**	**2020E**
EBITDA/interest cover (x)	2.0x	2.4x	1.8x	1.6x
Recurring EBITDA/interest cover (x)	*1.1x*	*1.1x*	*0.9x*	*0.9x*
Scope-adjusted debt/EBITDA	13.3x	16.2x	16.5x	16.7x
Scope-adjusted FFO/SaD	4%	4%	1%	2%
Loan/value ratio	52%	63%	66%	69%
Scope-adjusted EBITDA in EUR m	**2017**	**2018F**	**2019E**	**2020E**
EBITDA	4.9	12.7	12.1	14.3
Operating lease payments in respective year	0.1	0.2	0.2	0.2
Other	0.0	(3.3)	0.0	0.0
Scope-adjusted EBITDA	**5.0**	**9.6**	**12.3**	**14.5**
Scope-adjusted funds from operations in EUR m	**2017**	**2018F**	**2019E**	**2020E**
Scope-adjusted EBITDA	5.0	9.6	12.3	14.5
less: (net) cash interest as per cash flow statement	(2.5)	(4.0)	(6.8)	(9.1)
less: interest component operating leases	0.0	(0.1)	(0.1)	(0.1)
less: cash tax paid as per cash flow statement	0.0	(0.2)	(3.4)	(1.6)
Δ provisions	0.3	0.3	0.0	0.0
Scope-adjusted funds from operations	**2.8**	**5.7**	**2.1**	**3.8**
Scope-adjusted debt in EUR m	**2017**	**2018F**	**2019E**	**2020E**
Reported gross financial debt	70.2	156.8	203.7	242.5
less: cash and cash equivalents	(4.9)	(4.0)	(2.1)	(1.5)
add: cash not accessible	0.5	1.2	0.0	0.0
add: pension adjustment	0.0	0.0	0.0	0.0
add: operating lease obligations	0.4	1.3	1.3	1.3
Other	0.0	0.0	0.0	0.0
Scope-adjusted debt	**66.2**	**155.4**	**202.8**	**242.2**

Business risk profile: B+

Industry risk: BB

Industry risk for FCR is modest, as the company is exposed to the highly cyclical real estate industry. The company's main segments comprise the leasing and trading of commercial real estate buildings.

Credit outlook stable for 2019: tighter monetary policy, slowing growth, political risks

Real estate companies face an evenly balanced set of risks in 2019, resulting in a stable credit outlook. This outlook factors in less dramatic increases in property prices as a result of: i) slowly rising interest rates; ii) some easing of the supply-demand imbalance for most asset classes as development activity picks up; iii) slowing economic growth; iv) political uncertainty – notably, surrounding Brexit and budget difficulties in Italy; and v) international trade relations.

For more information, refer to our corporate outlook for real estate (click here).

FCR's asset base has grown considerably since the company was founded in 2012. However, the company is very limited in terms of size as evidenced by total assets of EUR 190m (book value according to German GAAP accounting standards) at YE 2018 and funds from operations of EUR 5.7m for the FY 2018.

Growth ambitions constrained by limited capital market access and scarcity of appropriate assets

Limited size burdens the company's access to capital markets (IPO in November 2018) as evidenced by: i) limited capital market debt exposure with EUR 58.5m in straight bonds as at end-August 2019; ii) the issuance of only two-thirds of its new EUR 30m bond four months after its placement began in April 2019; as well as iii) the placement of only one-third (EUR 3.3m) of its authorised capital (186,072 out of 521,156) in the first quarter of 2019. It should be noted that the CEO and majority shareholder participated in this capital increase with EUR 0.5m.

FCR has an ambitious growth strategy for the next few years. However, as highlighted in May 2018, targeted growth in the niche market of tertiary retail properties will only be possible either: i) at a higher cost (net initial yields down to 7.8% for acquisitions in 2018 vs. 16.6% for the portfolio like-for-like); ii) a slower pace (anticipated for the coming years, given weaker access to external financing); or iii) by losing the focus on retail properties. The latter is already apparent in FCR's increasing share of portfolio additions including residential, office and hotel properties (representing 12% of net rental income, NRI, as at YE 2018).

Business model with high associated operating expenses

FCR predominately sources its assets from two pipelines: i) closed-end or open-end funds which liquidate their assets; and ii) insolvency administrators. Consequently, FCR needs a relatively large number of employees to penetrate the market and source assets which meet its requirements. This results in a heavy dependence on its trading business to maintain profitability and interest coverage.

Good geographical diversification with assets spread across Germany

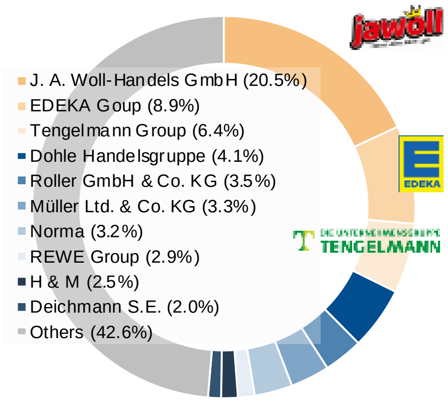
FCR's geographical diversification supports its business risk profile as the company's portfolio is spread across Germany including some exposure to Austria (Kitzbühel), Spain and Italy. As a result, FCR is able to benefit from slightly different demand patterns, influenced by the varying industry exposures of these regions. This diversification should help to mitigate the effects of cyclical swings.

According to FCR, it has targeted Austria and Italy (previous year's targets: Austria and Spain) as markets for international expansion. International expansion should benefit diversification as demand patterns in Spain especially are different to those in Germany. However, we believe that FCR will not be able to gain a meaningful foothold in either Austria or Italy in the next two years given the company's current size.

Modest tenant industry diversification with some cyclical exposure

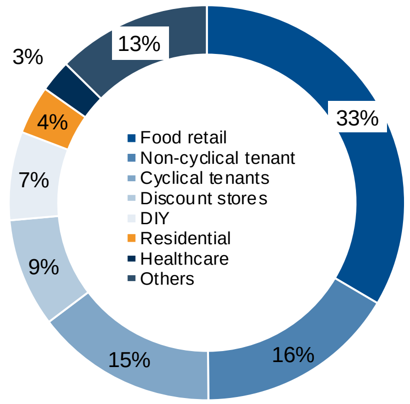
Tenant industry diversification is moderate, with 34% (+1pp YoY) of NRI stemming from food retailers as at YE 2018, followed by 16% from non-cyclical tenants and 15% from cyclical tenants. We view the company's overall exposure to non-cyclical industries positively (non-cyclical includes food retail, DIY, drugstores, bakeries, residential and healthcare), accounting for approx. 64% of NRI. However, the remaining 36% is either cyclical or dependent on strong anchor tenants generating sufficient footfall. Thus, a relatively high share of FCR's rental income would be at risk if the economy weakened.

Figure 1: Tenant diversification by NRI (YE 2018)



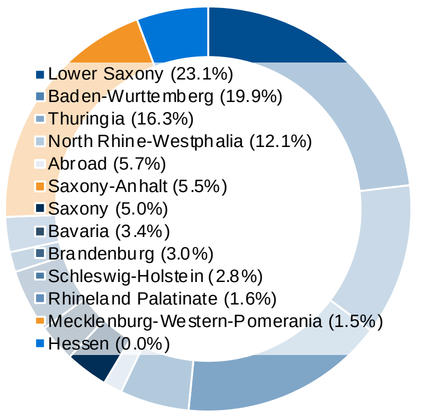
Sources: FCR, Scope

Figure 2: Tenant industry diversification by NRI (YE 2018)



Sources: FCR, Scope

Figure 3: Geographical diversification by NRI (YE 2018)



Sources: FCR, Scope

Concentrated tenant portfolio somewhat mitigated by good credit quality of tenants

We judge FCR's tenant diversification to be weak with the top three tenants accounting for 36% and the top ten for 57% of NRI respectively as at YE 2018. This leaves the company very vulnerable to single tenant defaults and/or the restructuring of distribution channels driven by the transformation of the German retail landscape. Weak tenant diversification is somewhat mitigated by the investment grade character of tenants representing 25% of NRI including Edeka Group, Tengelmann and Rewe Group.

Asset portfolio predominately in illiquid 'D' locations, albeit with primarily robust tenant demand

From an investor view point, FCR's assets are situated in rather illiquid 'D' locations. At present, these locations benefit from some liquidity and investor demand. However, we expect liquidity in these investment markets to dry up quickly if the current cycle ends. As a result, we anticipate either: i) a substantial increase in fire sale discounts in the event of forced liquidation; or ii) a decrease in potential exit proceeds which would harm the company's profitability and business model.

FCR's portfolio locations – as perceived by existing and potential tenants – are positive in our view. Retail parks and local amenities centres benefit from limited competition with strict rules for zoning and planning, thus ensuring that existing food retail locations will remain viable.

Asset portfolio with relatively low attractivity to tenants and high capex needs reflects FCR's business model

FCR's property portfolio has a relatively advanced economic age of about 30 years which leads to: i) high potential capex and maintenance expenses; and ii) low attractivity to tenants. However, FCR had a moderate occupancy rate of 84% at YE 2018 and an improving weighted average unexpired lease term of only 5.3 years (+1.7 years YoY).

In general, we assume that the portfolio's property quality will remain in the current condition. This is because FCR targets relatively low-quality properties in order to implement its business model, including minor capex, lease extensions (supported by the company's good network to retailers), followed by disposals. However, as the availability of such properties is limited, we doubt that FCR will be able to source them in the quantities targeted by the company.

Volatile and comparatively low EBITDA margin due to business model with limited economies of scale

FCR's profitability has been volatile, with EBITDA margins between 25% and 50%. This volatility is a result of the company's business model which focusses on the trading of properties. The EBITDA margin without the company's trading activities (recurring

EBITDA margin) displays the same volatile pattern with even lower margins. This reflects the comparably high operational expenses caused by the company's size and business model, greatly burdening economies of scale with just a few direct property holdings and a relatively large number of full-time employees. However, we believe further portfolio growth will help to stabilise profitability in the next few years, even if FCR is still expected to generate most of its annual EBITDA with property trading in future.

Financial risk profile: B+

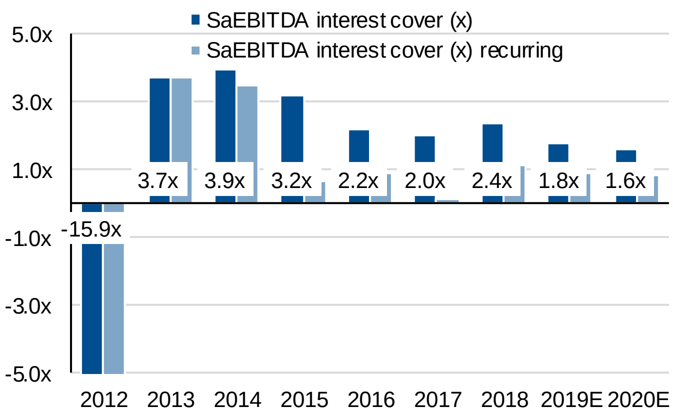
Our rating scenario assumes the following:

- Like-for-like growth of rents incl. vacancy reduction of 1.6% per annum
- Disposals of properties for EUR 67.5m in the period to YE 2020 at a premium of 25% above their current book value. Associated loss in rental income of around EUR 2m per annum
- Expansion capex of EUR 70m for 2019 and 2020 at 6.5% initial yield on net rental income
- Inflation of costs at 1.5% in 2019 and 2020
- Interest rate for newly issued and floating debt to increase by 50 bp based on current weighted average cost of debt
- Dividend representing EUR 0.35 per share for 2018 (payable in 2019) and 50% of German GAAP result for 2019 (payable in 2020)

Negative free operating cash flows point to dependence on external financing

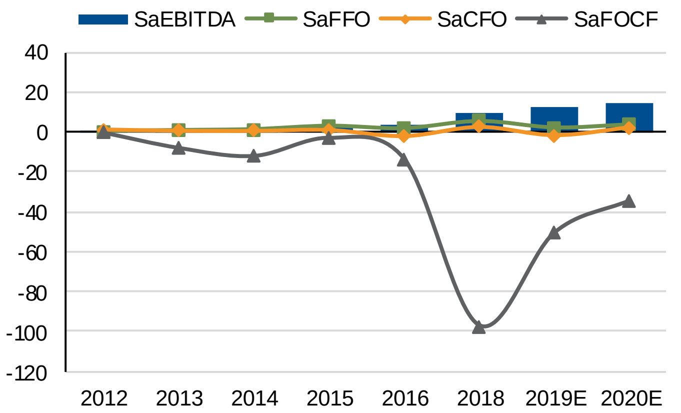
After its foundation in 2012, FCR slowly built up its asset portfolio leading to persistently negative free cash flows. The portfolio is likely to grow further with expansion capex amounting to EUR 85m (net) for the period up to YE 2020. As a result, the company will continue to be heavily dependent on external financing in order to execute its aggressive growth plans. We believe that some secured bank financing is available given the company's good relationships with local banks (saving banks and Volksbanken). This is, however, muted by its modest weighted average senior LTV ratio of 57% as at end-June 2019 (+18pp YoY). Furthermore, access to unsecured or subordinated financing is closely linked to both the economic environment and positive sentiment with regard to the German real estate market as the company has low unencumbered assets of only 10% (EUR 26m) as at end-June 2019.

Figure 4: Scope-adjusted EBITDA interest cover (x)



Sources: FCR, Scope estimates

Figure 5: Cash flows (EUR m)



Sources: FCR, Scope estimates

Volatile EBITDA interest cover dependent on asset disposals

FCR is reliant on successful asset disposals, as it generally does not have sufficient recurring EBITDA to meet regular interest payments. However, we believe that EBITDA interest cover will become more stable going forward. This is because the addition of income-producing assets will provide more certainty on recurring cash flows. We anticipate an ongoing dependence on asset disposals as a result of comparatively high operating expenditure, given the company's business model, coupled with a relatively high weighted average interest rate of 3.35% at YE 2018.

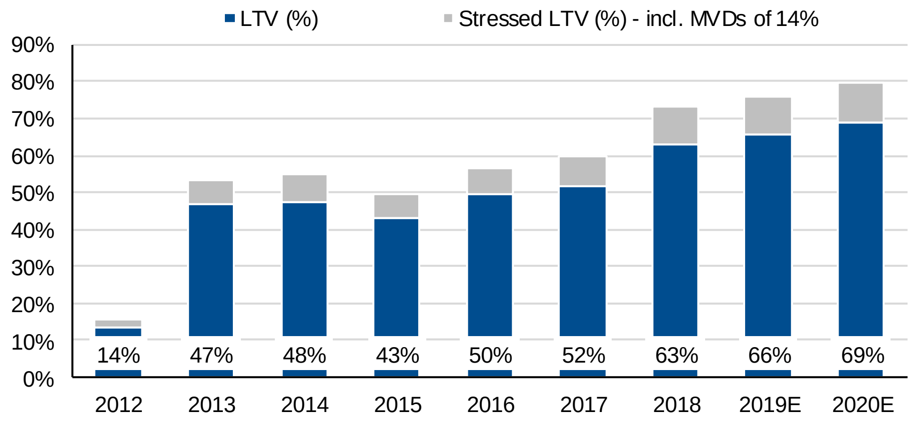
In order to compensate for the high-yielding corporate bonds (weighted average interest rate of 6.3%) and to avoid prepayment penalties with regard to its disposal activities, more than 40% of FCR's debt is unhedged and thus fully exposed to interest rate risk. According to the company, an immediate refinancing of the full portfolio at fixed interest rates should be possible if interest rates increase. Should interest rates increase, a locked coverage of interest payments with recurring income would be unlikely, probably leading to more frequent asset sales.

Leverage is moderate but likely to increase given aggressive growth plans

Given FCR's use of the German accounting standards (German GAAP), we adjusted the property portfolio's book values including hidden reserves as disclosed by the company. We adjusted these hidden reserves using discounts to reflect the nature of the proof of their value, ranging from 0% for a full valuation up to 25% for the issuer's calculations.

The unbalanced financing of the company's aggressive growth took its toll on leverage earlier than expected with the LTV ratio increasing to above 60% by YE 2018. We foresee that FCR will not be able to significantly reduce leverage in the coming months, with aggressive growth being pursued using available financing. We expect FCR to continuously benefit from its ability to crystallise hidden reserves for properties acquired, either through fair value uplifts (+30% for executed acquisitions in 2019) or disposals (+55% for properties sold in FY 2018), allowing it to keep leverage between 60% and 70%. However, an LTV of over 60% will make FCR vulnerable to cyclical downswings, limiting its ability to refinance.

Figure 6: Loan/value ratio (%)



Sources: FCR, Scope estimates

The company's Scope-adjusted debt (SaD)/EBITDA stands at around 16x, which is comparatively high. Nevertheless, this ratio depends on FCR's disposal activity compared to its debt protection measure.

Adequate liquidity

FCR's liquidity is adequate. In detail:

Position	YE 2018		2019E	
Unrestricted cash	EUR	2.7m	EUR	2.1m
Open committed credit lines	EUR	0.0m	EUR	0.0m
Free operating cash flow (t+1)[1]	EUR	13.3m	EUR	6.8m
Short-term debt	EUR	8.2m	EUR	6.2m
Coverage		**2.0x**		**1.4x**

Secured debt: BB-

As at end-August 2019, FCR had EUR 59m in secured bond debt outstanding. All bonds benefit from a pledge on investment properties at a value representing the bonds' outstanding nominal and interest payable up to the bonds' maturity. This could positively impact recovery rates in a default scenario. In accordance with our methodology and reasonable discounts on the company's asset base (as described below), we expect an 'above average recovery' for all bonds issued. This warrants a one-notch uplift on the company's issuer rating of B+.

Recovery is based on a hypothetical default scenario in FY 2020 with the company's liquidation value amounting to EUR 214m. This value is based on a 36% haircut applied to FCR's assets, incorporating market value declines commensurate with a BB rating case as well as liquidation costs of approx. 26% for assets and 10% for insolvency proceedings. This compares to secured bank financing of a forecasted EUR 173m (first rank) and EUR 70m in secured bonds.

Outlook

Outlook: Stable

The Outlook for FCR is Stable and incorporates our expectation that leverage, as measured by the company's LTV ratio, will remain between 60% and 70% (2018F: 63%) in the coming years. We also incorporate more stable debt protection of around 1.7x supported by a growing portfolio of income-producing properties, further successful disposal activity and ongoing adequate liquidity.

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[1] Free operating cash flow excl. net discretionary expansion capex of EUR 49m for 2019 and EUR 37m for 2020. Free operating cash flow incl. net proceeds from executed asset sales of EUR 11m in 2019.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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