30 August 2019 Corporates

EUROBODEN GmbH
Germany, Real Estate

SCOPE B+ STABLE

Corporate profile

EUROBODEN GmbH is an owner-managed residential real estate developer with a focus on the high-quality segment. Its activities cover the entire development process, from site evaluation and project planning to implementation and marketing. The company develops architecturally valuable residential real estate properties and works with a pool of famous architects, such as David Chipperfield and Jürgen Mayer H.

Key metrics

			Scope estimates	
Scope credit ratios	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
EBITDA/interest cover (x)	2.1x	3.1x	8.5x	2.6x
Loan/value ratio	51%	44%	46%	53%
SaD/EBITDA	16.6x	10.7x	3.6x	10.3x
Scope-adjusted FFO/SaD	3%	7%	17%	4%

Rating rationale

Scope affirms issuer rating of EUROBODEN GmbH at B+, Outlook Stable

The B+ issuer rating on EUROBODEN, a real estate developer with a focus on the high-quality segment, is supported by the company's: i) 'A' location, highly liquid properties; ii) good growth prospects in its core markets of Munich and Berlin; iii) profound market knowledge; iv) high profitability compared with the industry average; and v) strong brand recognition allowing it to make off-market deals.

The issuer rating is negatively affected by EUROBODEN's position as a small niche player in high-quality residential property development as well as its volatile cash flows. Full exposure to the cyclical real estate market and dependence on external financing are also credit negative.

Outlook

The Outlook for EUROBODEN is Stable and incorporates further growth of the company's top line (forecasted by Scope to reach EUR 100m in FY 2018/19) and its development portfolio without impairing credit metrics. Specifically, we anticipate a loan/value ratio (LTV) remaining around 50% and EBITDA interest cover substantially above 1.0x as well as ongoing adequate access to capital markets and bank debt to finance short-term debt positions.

A positive action would require the company to grow significantly in size, as measured by its development pipeline, leading to greater diversification and more stable cash flows, while leverage as measured by the company's LTV would have to decrease to below 40% on a sustained basis. Both of these possibilities are judged to be remote at present.

A negative rating action is possible if the company's LTV were to approach 60% or if access to bank financing weakened.

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Ratings & Outlook

Corporate ratings	B+/Stable
Senior unsecured rating	BB

Analysts

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Related methodology

Corporate Rating Methodology

Rating Methodology European Real Estate Corporates

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Bloomberg: SCOP

Rating drivers

Positive rating drivers	Negative rating drivers
• Lack of supply in EUROBODEN's core markets of Munich and Berlin as well as a strong German economy support stable demand for the next few years • Very good market knowledge and standing due to established brand enabling off-market deals • EUROBODEN's 'A' located development portfolio supports price stability and fungibility • EBITDA interest cover expected to remain substantially above 1.0x (LTM H1 2018/19 9.1x). • Moderate LTV of below 50% expected to remain at this level going forward	• Small sized company in a highly fragmented market leading to more volatile cash flows and limited economies of scale • Focus on niche market of predominately high-priced residential real estate keeps EUROBODEN exposed to more elastic demand and potential margin deterioration • Still concentrated but improving development pipeline (EUR 0.6bn in August 2019 +25% YoY) with a limited geographical diversification focusing on Munich and Berlin • Full exposure to the cyclicality of the real estate market with almost all sources of revenue directly linked to the company's development activity • Key person risk associated with the managing directors holding 100% of EUROBODEN's shares. • Continued high refinancing risk with EUR 40m of debt (33% of total debt) falling due in the next 12 months to end-August 2020. However, this is partially mitigated by available credit lines of EUR 23.5m as at August 14, 2019.

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Significant deleveraging with LTV of below 40% on a sustainable basis • Considerable growth of the company's project pipeline leading to higher diversification and more stable cash flows	• LTV approaching 60% • Weakening access to external financing

Financial overview

			Scope estimates	
Scope credit ratios	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
EBITDA/interest cover (x)	2.1x	3.1x	8.5x	2.6x
Loan/value ratio	51%	44%	46%	53%
SaD/EBITDA	16.6x	10.7x	3.6x	10.3x
Scope-adjusted FFO/SaD	3%	7%	17%	4%
Scope-adjusted EBITDA in EUR m	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
EBITDA	5.2	10.7	32.8	13.5
Operating lease payment in respective year	0.7	1.1	0.5	0.6
Other	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	5.8	11.8	33.4	14.1
Scope funds from operations in EUR m	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
Scope-adjusted EBITDA	5.8	11.8	33.4	14.1
less: cash interest as per cashflow statement	-2.8	-3.8	-3.9	-5.4
less: interest component operating leases	0.0	-0.1	-0.1	-0.1
less: cash tax paid as per cashflow statement	0.0	0.4	-8.8	-2.4
Δ Provisions	-0.4	0.2	0.0	0.0
Scope funds from operations	2.6	8.6	20.6	6.2
Scope-adjusted debt in EUR m	**2016/17**	**2017/18**	**2018/19E**	**2019/20E**
Reported gross financial debt	106.8	134.3	128.9	147.9
less: cash, cash equivalents	-11.6	-9.2	-10.8	-5.2
Cash not accessible	0.8	0.5	0.5	0.5
add: operating lease obligation	0.7	1.2	1.2	1.2
Scope-adjusted debt	96.7	126.9	119.8	144.5

Business risk profile: B+

Industry risk: B

Industry risk for EUROBODEN is very high (highest risk sub-segment of highly cyclical industry), as the company is exposed to the highly cyclical real estate industry. The company's main segment, the development of residential real estate buildings is judged to be the highest risk sub-segment of the industry.

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.

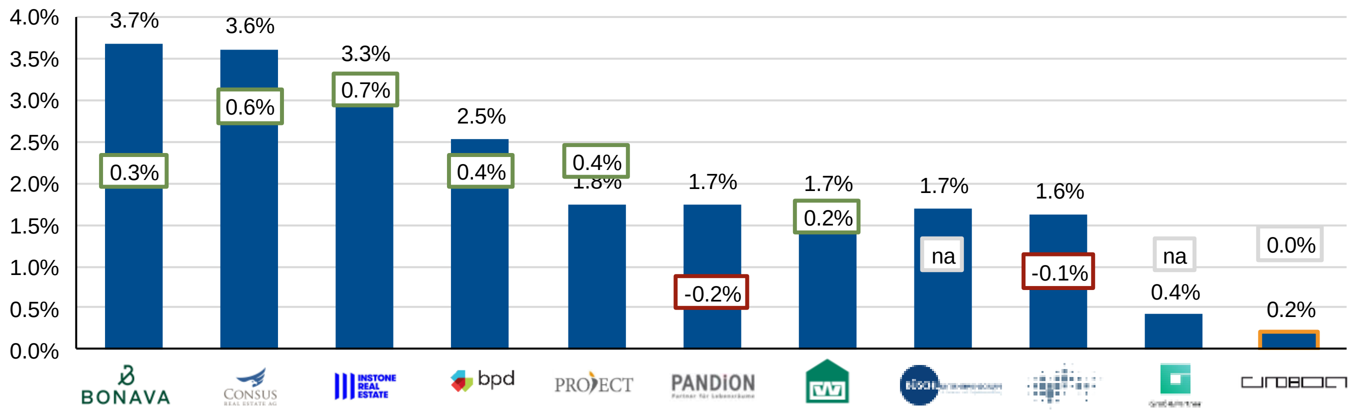
For more information, refer to our corporate outlook for real estate (*click here*).

Small sized company in a highly fragmented market

With a total asset value of greater than EUR 0.2bn (including significant hidden reserves as at end-March 2019) and funds from operations of EUR 38m for the last twelve months to end-March 2019, EUROBODEN is a small property company in a highly fragmented market. The company's top line is expected to grow further in the next two years based on its EUR 0.6bn (+25% YoY) project pipeline as of August 2019 (including already acquired projects with the transfer of property not executed as at August 2019). Despite the increasing focus on larger projects as well as additional locations, we expect EUROBODEN to remain concentrated on its niche market of luxury (high-quality) residential real estate while gradually adding commercial properties to its development pipeline.

EUROBODEN's still relatively small size is a negative rating driver, because it implies heightened sensitivity to unforeseen shocks, greater cash flow volatility and higher key person risk.

Figure 1: EUROBODEN and its competitors (market share trading development based on residential area under development I YoY change in boxes)



Sources: Public information, Scope

Niche market player in the high-quality segment benefitting from increasing brand awareness and a solid economic environment…

As a niche market player, EUROBODEN has small market shares in Germany as well as in its core markets of Munich and Berlin. However, the company has achieved top 15th position in both competitive markets, increasing its visibility in both cities.

A stable economy, the ongoing low interest rate environment and a lack of supply supports stable demand for the next few years. However, in the event of an economic downturn or a significant decrease in demand – most likely induced by changes in

German regulation and tax incentives – fierce competition would probably lead to a declining number of market participants.

EUROBODEN's sees itself as an 'architectural brand' supported by an established network of well-known architects. According to the company, self-positioning and brand building support its activities by facilitating off-market deals, avoiding bidder competition when sourcing land and properties and allowing EUROBODEN to carry out its pricing policy.

… however, exposed to more elastic demand

However, we believe that EUROBODEN's focus, especially in Munich, on the high-quality, high-price niche market segment greatly exposes it to adverse market movements. This opinion is based on more elastic demand and price levels in the luxury property segment, with higher peak-to-trough declines in crisis periods compared to price movements for total stock.

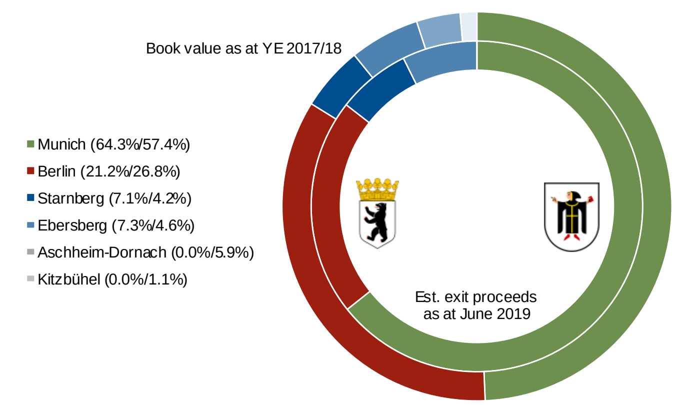
Limited geographical diversification with a focus on Munich and Berlin

Geographical distribution of the company's revenues is limited, driven by EUROBODEN's small size and 'chunky' development pipeline exposed to the cities of Munich and Berlin. We judge this localised geographical diversification to be a credit risk, given the very similar demand patterns of both markets. In FY 2016/17 EUROBODEN expanded its geographical outreach to Frankfurt am Main. However, new projects from this city are not in the development pipeline yet. Thus, improving outreach has not impacted the company's business risk profile so far.

Heavily dependent on real estate development for the next few years

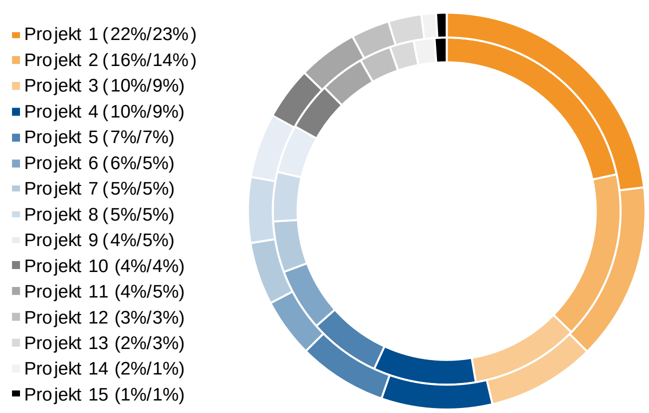
EUROBODEN generates the majority (around 90% on average for the last five years) of its income from its development activities. Other revenue sources such as rental income or property management fees contribute to a lesser extent. However, the latter is also directly linked to the company's development activities. This very modest diversification of revenue sources fully exposes the company to the cyclicality of the real estate market and is seen as a credit negative. From FY 2015/16 on, income from other businesses, particularly hotel operations (Kitzbühel) and letting has provided a more visible income stream of EUR 1m p.a. partially mitigating the volatility of the development business. Portfolio acquisitions that benefit from existing lease contracts (Mauritiuskirchstraße, Berlin) and the development (build-to-hold) of an office building in Aschheim are expected to further increase the recurring income stream by an estimated EUR 3.2m from 2021/22 on. We do not anticipate the share of recurring income to increase to the extent that it will cover recurring operational expenditure.

Figure 2: Geographical diversification of project pipeline as at May 2019[1]



Sources: EUROBODEN, Scope estimates

Figure 3: Project pipeline by expected costs (inner) and exit proceeds (outer circle) as at May 2019[1]



Sources: EUROBODEN, Scope estimates

[1] Including acquired projects with the property not transferred as at end-May 2019

Improving but still concentrated development pipeline of 15 projects

EUROBODEN has a very concentrated development pipeline with 15 projects in its portfolio (around 550 apartments) at present. Even this represents a gradual widening of diversification within the company's development pipeline. The top three projects still account for 47% of planned investments (August 2018: 50%). This may negatively affect future cash flow generation if projects are delayed or suffer from a cost overrun. However, the company benefits from: i) decent pre-sale ratios for some of its largest development schemes including Erhardstraße 10 (73%), Kolbergerstraße 5 (23%) and Lützowstraße (100%), all of which represent 25% of total committed investment volume; and ii) invoicing according to the German real estate agent and commercial construction regulation (MaBV). We believe this should reduce the risk of high working capital allocation to these specific projects, which could lead to a shortfall of liquidity.

'A' located development portfolio supports price stability and fungibility

EUROBODEN's development portfolio is situated in the mature and very liquid markets of Munich (64% of expected sales volume including Aschheim, Ebersberg and Starnberg) and Berlin (35%). Furthermore, both cities benefit from favourable demand for residential real estate, with a forecasted increase in population of at least 7.5% between 2012 and 2025, as well as healthy underlying macroeconomic fundamentals. The company focusses its activities on 'A' locations in these cities, supporting the fungibility of its properties and lowering potential price haircuts in a distressed sales scenario. With Frankfurt am Main as the next targeted market, we expect no dilution of asset quality going forward.

Volatile EBITDA margin in line with peers

With an EBITDA margin of 18% for FY 2017/18, EUROBODEN's profitability increased for the fifth consecutive year. We expect the margin to remain above 10% going forward, supported by the high-quality project pipeline with net profit margins aimed between 10% and 30% (weighted average of 22%).

EUROBODEN has clearly benefitted from the strong demand for residential real estate development in Munich and Berlin and has been able to crystallise significant hidden reserves accumulated in the past. However, strong demand also impacts the company's acquisition pipeline. Projects added more recently are expected to be less profitable in terms of net margins, but still in line with or slightly above most peers' margins.

Financial risk profile: B+

Our rating scenario assumes the following:

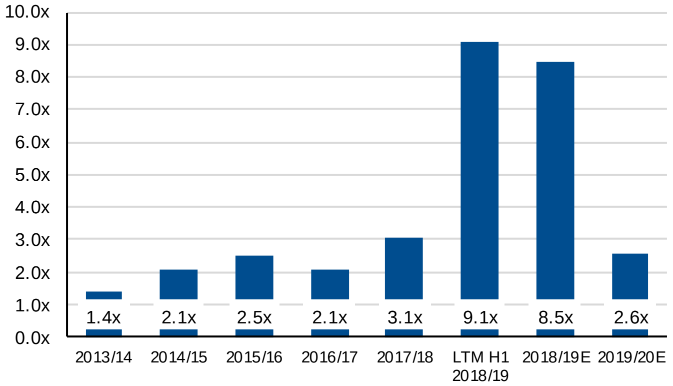
- New debt always short-term except for the EUR 25.7m signed in H1 2018/19 or for drawings on existing loans
- Decrease in market prices of up to 7.50% by FY 2019/20
- Increase in material costs of up to 12.50% by FY 2019/20
- Rise in operational expenses of 1.50% per annum
- Increase in interest rate for new and floating debt by 50 bp per year (weighted average interest rate as at May 2019: 2.32%)
- Dividend payout of 20% of net profit or EUR 2m (the lower of the two)
- Capex/acquisition of new projects in FY 2018/19: EUR 38m I FY 2019/2020: EUR 32m

EBITDA interest cover expected to remain substantially above 1.0x (LTM H1 2018/19 9.1x)

EUROBODEN's EBITDA interest cover stood at a strong 9.1x for the last twelve months (LTM) at end-March 2019 and is expected to remain above 1x. However, this ratio will fluctuate, depending on the timely delivery and disposal of projects. If projects are delayed, EUROBODEN may have to rely on external financing to cover interest payments. We believe external financing is readily available, thanks to: i) committed, undrawn credit lines of EUR 15m as at March 2019 which can be drawn upon without restrictions; and ii) hidden reserves, which allow existing credit lines to be increased.

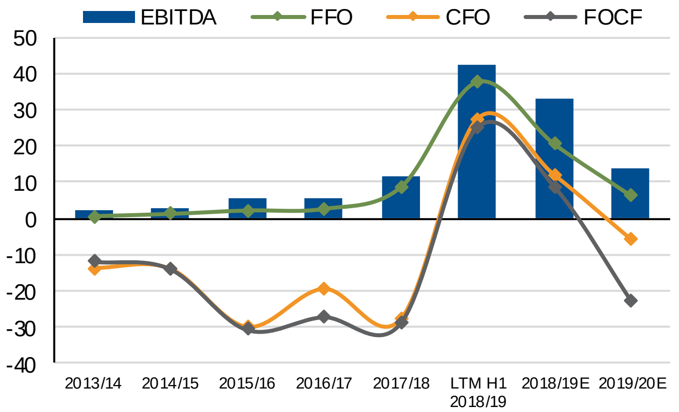
The company's cash flow generation has been volatile, with negative free operating cash flow driven by business expansion over the last few years. We expect free operating cash flow to remain negative, owing to anticipated further growth, as well as to the nature of real estate development, the company's core activity. Accordingly, cash in- and outflows are not necessarily matched during the lifetime of each project. Furthermore, EUROBODEN suffers from its limited size, which creates a 'chunky' project pipeline. The latter amplifies the volatility inherent in EUROBODEN's business model.

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



Sources: EUROBODEN, Scope estimates

Figure 5: Cash flows (EUR m)

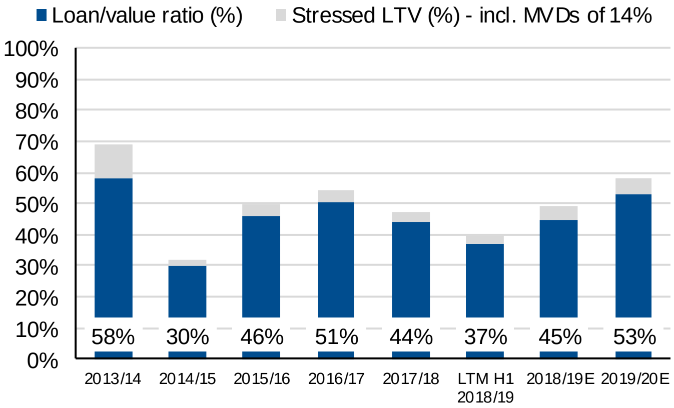


Sources: EUROBODEN, Scope estimates

Moderate LTV of below 50% expected to remain at this level going forward

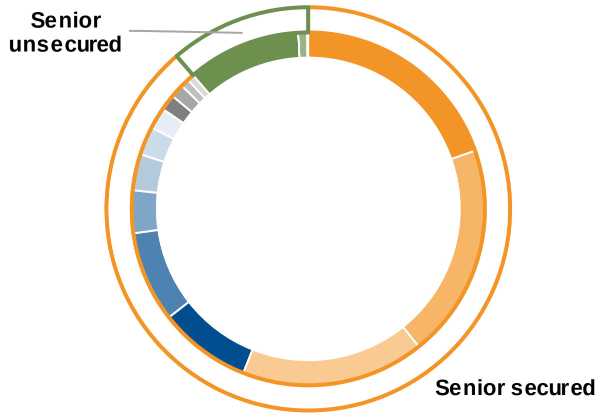
At the end of March 2019, the company's LTV stood at 38% (including Scope-adjusted hidden reserves). The interim reduction of Scope-adjusted debt (SaD) to below EUR 100m (reduction of EUR 24m YoY) was in line with our expectations as at September 2018, with the exit proceeds from two sales, namely Crailsheimstraße and Infanteriestraße used to repay debt, reducing LTV. However, we anticipate that SaD will increase to EUR 120m by end-September 2019 due to the further expansion of business activities with projects acquired for EUR 50m (transfer date in H2 2018/19) and the financing of existing development projects. We therefore forecast that LTV will return to close to 50% – a level seen in the past. This is adequate for a developer of this size, leaving enough headroom to either tap external financing sources to cover construction costs or to tackle a moderate downturn in the properties' fair values. Consequently, we would not necessarily change our view on the company's leverage if market value declines of 14% (reflecting around one standard deviation in the German house price index) occur. We do not believe that the company will be able to significantly reduce its leverage over the next few years.

Figure 6: Loan/value ratio (%)



Sources: EUROBODEN, Scope estimates

Figure 7: Debt composition as at 31 May 2019



Sources: EUROBODEN, Scope

The company's SaD/EBITDA of 11x (end-September 2018) implies a level commensurate with a B financial risk profile. The ratio will continue to fluctuate. However, we judge this volatility to be typical for a developer, with projects considered and financed over the whole development period rather than in annual tranches.

We consider liquidity to be adequate. In detail:

Position	H1 2018/19		FY 2018/19	
Unrestricted cash	EUR	9.5m	EUR	10.3m
Open committed credit lines[2]	EUR	15.0m	EUR	28.5m
Free operating cash flow (t+1)	(EUR	20.2m)	(EUR	5.8m)
Short-term debt	EUR	40.9m	EUR	61.0m
Coverage		**0.1x**		**0.5x**

EUROBODEN's liquidity – subject to substantial fluctuations in the past – is expected to stay below 100% for the next two years. We do not believe that the company will be able to repay debt due in the next 13 months using free operating cash flow and available cash. In detail: a forecasted EUR 61.0m of debt is due in 2019/20, not covered by a forecasted EUR 10.3m of cash available at end-September 2019 and EUR 28.5m of undrawn credit lines as at August 14, 2019. The company will therefore have to rely on external funding to redeem maturing debt. However, we believe EUROBODEN will be able to manage related refinancing risk. This is evidenced by the company having managed to extend all short-term secured financing credit facilities well before maturity. We believe the company has moderate access to external financing and a broadening pool of lenders.

Senior unsecured debt: BB

In November 2017, EUROBODEN issued a EUR 25m bond with a five-year tenor (ISIN DE000A2GSL68). In October 2019 EUROBODEN intends to issue a new, EUR 30m bond maturing in 2024 (ISIN: DE000A2YNXQ5). Scope's recovery analysis indicates an 'excellent recovery' which translates into an instrument rating of BB. Recovery is based on a hypothetical default scenario in FY 2019/20 with a company liquidation value based on a haircut of approx. 40% applied to EUROBODEN's assets, reflecting a market value decline representing one standard deviation in the German property price index as well as liquidation costs of approx. 26% for the assets and 10% for insolvency proceedings. This compares to secured financing of a forecasted EUR 93m as well as the unsecured EUR 55m bond.

[2] Scope only considers undrawn credit lines with a remaining term of greater 12 months within its assessment of liquidity.

Outlook

Outlook: Stable

The Outlook for EUROBODEN is Stable and incorporates further growth of the company's top line (forecasted by Scope to reach EUR 100m in FY 2018/19) and its development portfolio without impairing credit metrics. Specifically, we anticipate an LTV remaining around 50% and EBITDA interest cover substantially above 1.0x as well as ongoing adequate access to capital markets and bank debt to finance short-term debt positions.

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