FCR Immobilien AG
Germany, Real Estate

Corporate profile

FCR Immobilien AG (FCR) is a real estate company focussing on the trading of 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	**2016**	**2017**	**2018E**	**2019E**
EBITDA/interest cover (x)	2.2x	2.0x	1.9x	4.6x
SaD/EBITDA	9.7x	13.2x	11.1x	5.5x
Scope-adjusted FFO/SaD	5%	3%	4%	10%
Loan/value ratio (%)	50%	51%	49%	74%

Rating rationale

Scope Ratings assigns an initial issuer rating of B+ to FCR Immobilien AG. Senior secured debt is rated BB-. The Outlook is Stable.

The issuer rating is predominately driven by the company's dependence on its trading business to secure sufficient coverage of both operational and financial expenses.

Positive rating drivers include the company's moderate leverage with a loan/value (LTV) ratio of around 50% as well as its geographically well diversified property portfolio within regions that are expected to have stable tenant demand leading to predictable recurring income.

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 both of FCR's dependence on 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.

The bonds (ISINS: (i) DE000A12TW80; (ii) DE000A1YC5F0; (iii) DE000A2BPUC4; (iv) DE000A2G9G64) benefit from a pledge on investment properties at a value representing the bonds' outstanding nominal and the interest payable up to the bonds' maturity. This security improves credit risk for the bonds over that of the issuer.

Outlook

The Outlook for FCR is Stable and incorporates Scope's view of weakening leverage with LTV reaching 70% by YE 2019 as a result of the company's aggressive growth plans for the next few years with negative free operating cash flows. We also incorporate persistent debt protection volatility, however, of around 1.7x supported by 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 sustainable basis 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 FCR's recurring EBITDA, while the company's leverage as measured by its LTV ratio remained at around 50%.

Ratings & Outlook

Corporate rating	B+/Stable
Senior secured debt	BB-

Analyst

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Related methodology

Corporate Rating Methodology, January 2018

Rating Methodology: European Real Estate Corporates January 2018

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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. • FCR addresses operational risk with regard to asset acquisitions in advance supported by its existing relationships with major food retailers in Germany. • Good credit quality and moderate tenant industry diversification with some cyclical exposure. • Adequate occupancy rate of 87% • Moderate leverage as measured by the company's LTV of around 50%, although this is likely to increase to finance aggressive growth plans. • Good relationship with local banks (saving banks and Volksbanken) and relatively low senior LTV's of below 40% support availability of secured bank financing if markets weaken.	• Small company with limited access to capital markets, but ambitious growth plans in niche market with net expansion capex of EUR 500m up to 2020 helping to support visibility to tenants and investors. • Concentrated tenant portfolio with top three accounting for 32% of rental income. • Portfolio with high economic age of about 30 years resulting in relatively low attractivity to tenants and high capex needs and exposed to a rather short weighted average unexpired lease term of 3.6 years. • 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. • Volatile EBITDA interest cover heavily dependent on asset disposals as the company has a recurring EBITDA interest cover of around 1x.

Rating-change drivers

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

Financial overview

			Scope estimates	
Scope credit ratios	**2016**	**2017**	**2018E**	**2019E**
EBITDA/interest cover (x)	2.2x	2.0x	1.9x	4.6x
recurring EBITDA/interest cover (x)	*0.9x*	*1.1x*	*0.2x*	*0.4x*
SaD/EBITDA (x)	9.7x	13.2x	11.1x	5.5x
Scope-adjusted FFO/SaD (%)	5%	3%	4%	10%
Loan/value ratio (%)	50%	51%	49%	74%
Scope-adjusted EBITDA in EUR m	**2016**	**2017**	**2018E**	**2019E**
EBITDA	3.2	4.9	7.8	35.4
Operating lease payment in respective year	0.1	0.1	0.1	0.1
Other	0.0	0.0	0.0	0.0
Scope-adjusted EBITDA	3.3	5.0	7.8	35.4
Scope funds from operations in EUR m	**2016**	**2017**	**2018E**	**2019E**
Scope-adjusted EBITDA	3.3	5.0	7.8	35.4
less: (net) cash interest as per cash flow statement	-1.5	-2.5	-4.0	-7.6
less: interest component operating leases	0.0	0.0	0.0	0.0
less: cash tax paid as per cash flow statement	-0.2	-0.7	-0.7	-7.9
Change in provisions	0.2	0.3	0.0	0.0
Other changes (e.g. non-cash staff costs)	0.0	0.0	0.0	0.0
Scope funds from operations	1.7	2.1	3.1	19.9
Scope-adjusted debt in EUR m	**2016**	**2017**	**2018E**	**2019E**
Reported gross financial debt	37.5	70.2	89.5	198.2
less: cash, cash equivalents	-6.3	-4.9	-3.0	-3.0
Cash not accessible	0.0	0.0	0.0	0.0
add: pension adjustment	0.0	0.0	0.0	0.0
add: operating lease obligations	0.4	0.4	0.4	0.4
Scope-adjusted debt	31.6	65.7	86.9	195.7

Business risk profile

Industry risk: BB

While the real estate industry is often associated with cyclical features compared to industries with inelastic demand patterns, these vary considerably depending on the individual business model used. In general, commercial property companies especially face higher cyclicality due to their potential exposures to industries that are inherently vulnerable to changes in demand. Demand increases when the economy grows, and declines when it shrinks, as tenants may find themselves under severe financial pressure which leads to defaults. However, these companies generally benefit from long-term lease contracts which partially mitigate the impacts of economic downturns. Also, companies operating across Europe with a strong focus on retail agglomerations (such as shopping centres and retail parks), or with large shares in 'high street' locations, benefit from highly diverse tenancies and more stable demand, even during economic downswings. Scope believes that the real estate industry tends to have low barriers to entry although significant investment is needed to buy, maintain or develop properties. Thus, either: i) significant internal resources; or ii) good access to third-party capital is required. We observe a high level of fragmentation within the real estate industry and good general access to credit due to collateral-eligible assets. Both are indicators that barriers to entry are relatively low. However, given diverse real estate regulations in Europe – especially in the residential sector – knowledge of local taxes and laws is important. Furthermore, technical know-how is essential for almost the whole value chain. This includes the performance of technical due diligence before buying a property, the implementation of refurbishment measures or ongoing maintenance. Consequently, property companies need to maintain in-house (or purchase external) know-how in order to remain up-to-date or to enter more markets. We therefore assess market entry barriers for commercial real estate corporates as medium. Substitution risk is judged to be medium for commercial property companies, because demand could decline as activities in physical locations (such as purchasing goods or working in an office building) may shift to e-commerce or virtual 'home' offices.

Figure 1: Industry risk assessment: European commercial real estate corporates

Cyclicality \ Barriers to entry	Low	Medium	High
High	CCC/B	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Source: Scope

Stable sector Outlook

Scope's 2018 Outlook for the real estate sector is Stable. Our view is based on still-lively investor and tenant demand which has a positive influence on business risk profiles. In addition, companies have been able to make use of the ECB's ongoing ultra-loose monetary policy (with an all-time high of capital market debt issuance at very low interest rates) to enhance their financial risk profiles. However, our assessment emphasises the further heightening of sensitivity to changes in politics, economic conditions and interest rates.

For more information please refer to Scope's 2018 Corporate Outlook (click here).

Small company with limited access to capital markets

FCR has experienced fairly strong growth of its asset base since its foundation in 2012. However, the company is very limited in terms of size as evidenced by total assets of EUR 80m (book value according to German GAAP accounting standards) at YE 2017 and funds from operations of EUR 2.1m for the FY 2017.

Limited size burdens the company's access to capital markets (it is not publicly listed) as evidenced by: i) coverage from only one tier 5 equity analyst (SMC Research); and ii)

limited capital market debt exposure of only EUR 33m in straight bonds as at 31 March 2018.

Ambitious growth planned in niche market with net expansion capex of EUR 500m up to 2020

FCR plans an initial public offering in 2018 to finance its ambitious growth strategy for the next three years including expansion capex of EUR 500m (net), according to the company. However, we believe that the targeted growth in the niche market of tertiary retail properties will only be possible either: i) at a higher cost (with lower net initial yields); ii) at a slower pace; or iii) by losing the focus on retail properties. The latter is already demonstrated by mixed portfolios including student apartments and hotel properties.

Business model with high associated operating expenses

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

Good geographical diversification with assets spread across Germany

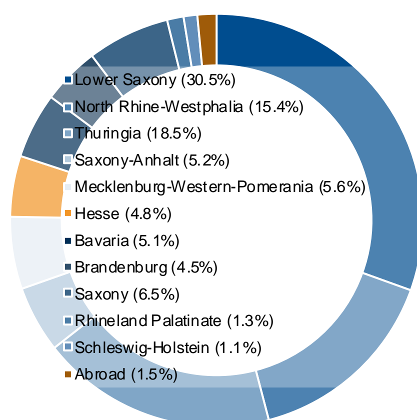
FCR's geographical diversification supports its business risk profile as the company's portfolio is spread across Germany (Figure 2) including some exposure to Austria (Kitzbühel). As a result, FCR is able to benefit from slightly different demand patterns, influenced by the varying industry exposures of these regions. This diversification should help to mitigate effects of cyclical swings to a certain extent.

According to FCR, it has targeted Austria and Spain as markets for international expansion. International expansion should be beneficial with regard to diversification as demand patterns in Spain especially are different to those in Germany. However, Scope believes that FCR will not be able to gain a meaningful foothold in Spain in the next two years given the company's current size.

Moderate tenant industry diversification with some cyclical exposure

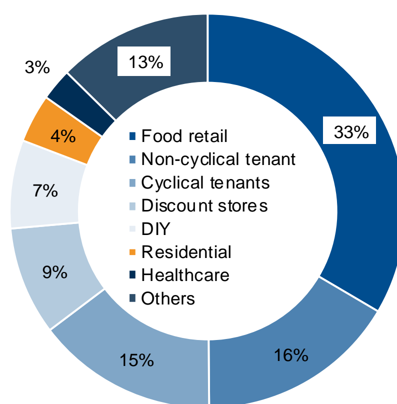
Tenant industry diversification is judged to be moderate, with 33% of net rental income (NRI) stemming from food retailers, followed by 16% from non-cyclical tenants and 15% from cyclical tenants (Figure 3). We view the company's overall exposure to non-cyclical industries positively (non-cyclical includes food retail, DIY, drugstores, bakeries, residential and healthcare), accounting for approx. 64% of NRI. However, the remaining 36% is judged by Scope to be 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 2: Geographical diversification by NRI as at March 2018



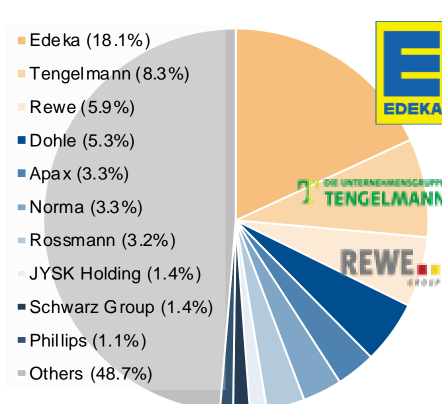
Source: FCR, Scope

Figure 3: Diversification (NRI by tenant industry as at March 2018)



Source: FCR, Scope

Figure 4: Tenant diversification by NRI (%) at YE 2017



Source: FCR, Scope

Concentrated tenant portfolio with top three accounting for 32% of rental income, somewhat mitigated by their good credit quality

FCR's tenant diversification is judged to be weak with the top three tenants accounting for 32.3% and the top ten for 51.3% of NRI respectively as at YE 2017 (Figure 4). This leaves the company very vulnerable to single tenant defaults and or 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 37% of NRI including the top three 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 if the current cycle ends, liquidity in these investment markets is expected to dry up quickly. 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 thus harming the company's profitability and business model.

With regard to locations – as perceived by existing and potential tenants – we judge FCR's portfolio as positive, especially as retail parks and 'Nahversorgungszentren' benefit from limited competition with strict rules for zoning and planning, thus ensuring that existing food retail locations will remain viable.

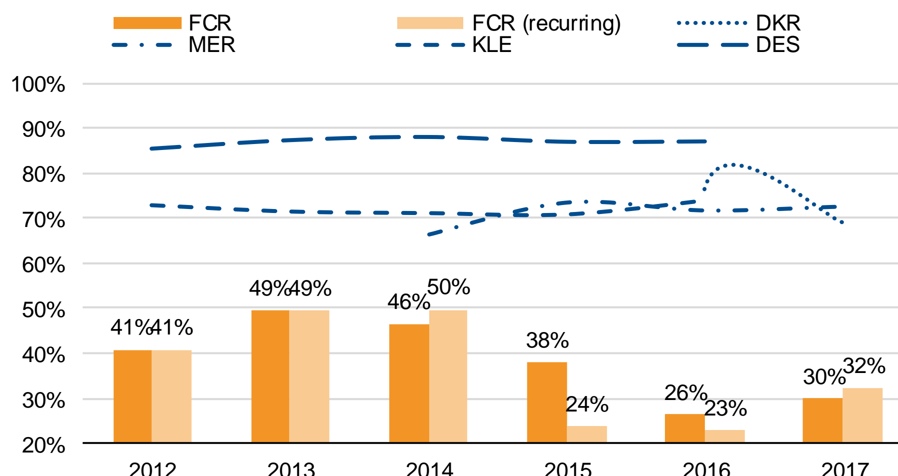
Asset portfolio with relatively low attractivity to tenants and high capex needs reflecting the company's business model

FCR's property portfolio suffers from a relatively high economic age of about 30 years which leads to: i) potentially higher capex and maintenance expenses; and ii) lower attractivity to tenants. Even though FCR benefitted from a moderate occupancy rate of 87% at Q1 2018 it faces a relatively low weighted average unexpired lease term of only 3.6 years. The latter is a result of the portfolio's comparably low attractivity to tenants as well as – according to FCR – undermanagement by the previous owner.

In general, we assume that the portfolio's property quality will remain in the current condition, as FCR targets properties with relatively low quality 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 such properties are of limited availability, we doubt that FCR will be able to source them in the quantities targeted by the company.

Volatile and comparatively low EBITDA margin as a result of business model with limited economies of scale

Figure 5: EBITDA margin vs. peers[1]



Source: FCR, public information, Scope

[1] FCR = FCR Immobilien AG I DKR = Deutsche Konsum REIT-AG I MER = Merlin Properties SOCIMI SA I KLE = Klépierre SA I DES = Deutsche Euroshop AG

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, as we believe that FCR will generate most of its annual EBITDA with property trading in future, profitability is expected to remain volatile between 25% and 50%. As a result, the company's EBITDA margin is also weaker than that of peers (Figure 5).

Financial risk profile

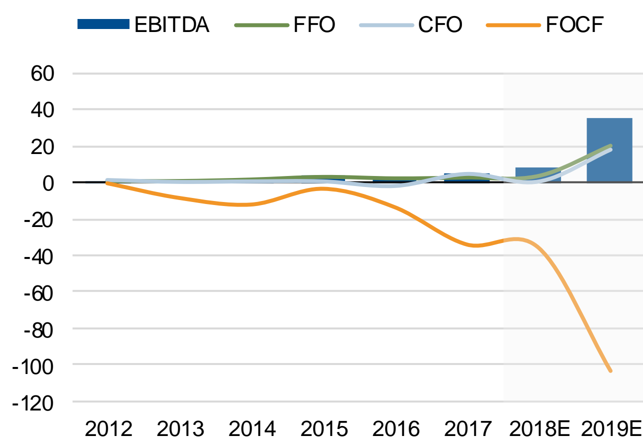
Our rating scenario assumes the following:

- Like-for-like rental growth of 1.6% in 2018 and 2019
- Portfolio disposals in line with company expectations of EUR 42m in 2018 and EUR 60m in 2019
- Operational expenses to increase by 2% per year
- Capital expenditure of EUR 70m in 2018 and EUR 150m in 2019
- Portfolio acquisitions at a net initial yield 50bp below that of 2018 acquisitions
- IPO in 2018 with EUR 15m net proceeds
- Dividend distribution of 30% of German GAAP result

Negative free operating cash flows as a consequence of aggressive growth, resulting in dependence on external financing

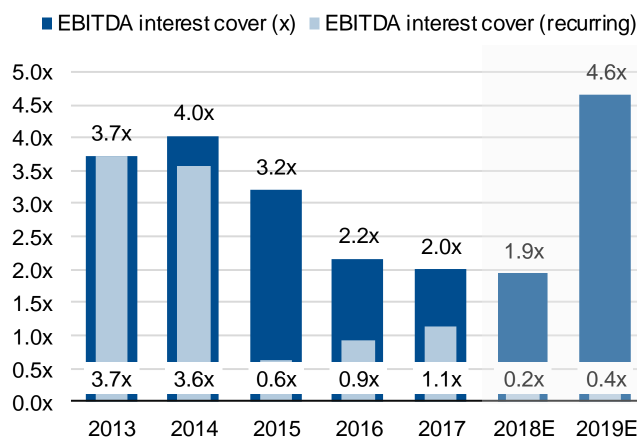
After its foundation in 2012, FCR slowly built up its asset portfolio leading to persistently negative free cash flows (Figure 6). According to FCR, the pace of expansion should increase even further with expansion capex amounting to EUR 310m (net) for the period up to YE 2019 (Scope's rating case: EUR 118m). As a result, the company will continue to be heavily dependent on external financing to execute its aggressive growth plans. We believe secured bank financing to be available given the company's good relationship with local banks (saving banks and Volksbanken) and a relatively low weighted average senior LTV ratio of 38.9% in March 2018. However, 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 14%.

Figure 6: Cash flows



Source: FCR, Scope

Figure 7: Debt protection – EBITDA interest cover



Source: FCR, Scope

Volatile EBITDA interest cover strongly dependent on asset disposals

FCR is heavily reliant on successful asset disposals, as its recurring EBITDA is not sufficient to meet regular interest payments (Figure 7). Dependence on asset disposals is a result of comparatively high operating expenditure coupled with a relatively steep weighted

average interest rate of 4.11% at March 2018. In order to compensate for the high-yielding corporate bonds (weighted average interest rate of 7.17%) and to avoid prepayment penalties with regard to its disposal activities, almost 60% 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 even more unlikely, thus, in all likelihood, leading to a greater frequency of asset sales.

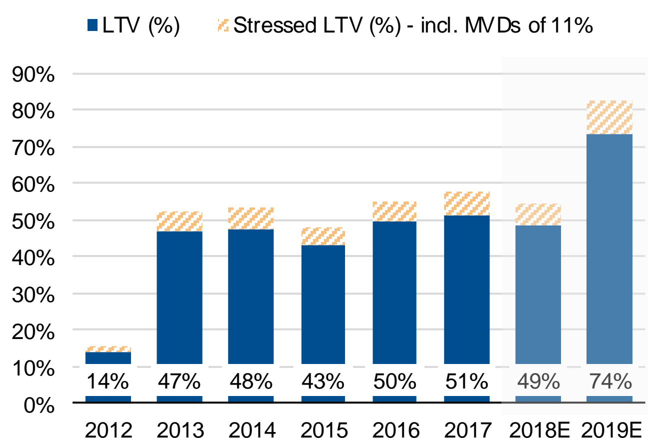
Moderate leverage as measured by the company's LTV, although this is likely to increase given the company's aggressive growth plans

Given FCR's use of the German accounting standards (German GAAP), Scope adjusted the property portfolio's book values including hidden reserves as disclosed by the company. Scope adjusted these hidden reserves using discounts reflecting the nature of the evidence/proof ranging from 0% for a full valuation up to 25% for the issuer's calculations. For the period prior 2017 we used an asset value multiplier based on the results for the adjusted hidden reserves for 2017.

The company has moderate leverage as measured by its LTV ratio of around 50% since it was founded in 2012 (Figure 8). Supported by the planned IPO in 2018 we believe that LTV will remain around 50%. However, due to anticipated aggressive growth which will without potential support from equity issuance. We believe that an LTV of over 60% will make FCR vulnerable to cyclical downswings limiting refinancing probability.

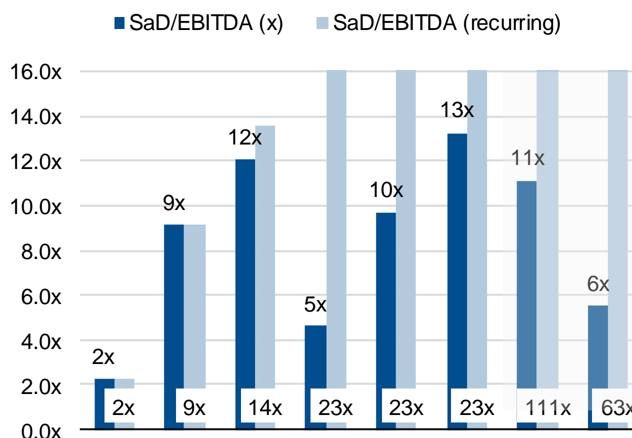
The company's Scope-adjusted debt (SaD)/EBITDA stands at around 13x which is comparatively low. Nevertheless, this ratio depends on FCR's disposal activity comparable to its debt protection measure, as evidenced by the recurring SaD coverage leverage numbers (Figure 9).

Figure 8: Leverage – loan/value ratio (%)



Source: FCR, Scope

Figure 9: Leverage – SaD/EBITDA



Source: FCR, Scope

FCR's liquidity is judged to be adequate, even if EUR 3.1m in debt due in the 12 months to YE 2018 is not covered by free operating cash flows. However, coverage is estimated at 4x, excluding discretionary expansion capex and including executed asset sales, namely in Dresden, Twistringen, Wismar and Schwedt as well as executed asset acquisitions in Magdeburg, Brandis, Gera and Altena for instance. In detail:

Position	YE 2017
• Unrestricted cash	EUR 4.9m
• Open committed credit lines	EUR 0.0m
• Free operating cash flow (t+1)[2]	EUR 0.5m
• Executed asset sales and acquisitions[3]	EUR 7.0m
• Short-term debt (t+1)	EUR 3.1m

With first maturities in 2019 (EUR 5.7m in bonds and EUR 2.1m in bank debt plus EUR 2.9m in scheduled amortisations) and the majority of debt coming due from 2021 onwards (87%), FCR benefits from a relatively backloaded maturity profile leaving sufficient time to address the refinancing of debt due at the property company level (special purpose vehicle). We have an adverse view of FCR's aggressive growth ambitions resulting in negative free operating cash flows, heightening dependence on external financing particularly for its holding level debt. This is especially the case as: i) the servicing of related debt is solely dependent on disposal activity (as opposed to debt at special purpose vehicle level which mostly benefits from a direct pledge on rental income); and ii) the company has a relatively low unencumbered asset ratio of only 14% representing limited headroom for the refinancing of senior unsecured debt.

Secured debt

Senior secured: BB-

As at March 2018 FCR had EUR 33m in secured bond debt outstanding. All 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. This would have a positive impact on recovery rates in a default scenario. According to our methodology and reasonable discounts on the company's asset base (as described below), Scope expects an 'above-average recovery' thus allowing for a one-notch uplift on the company's issuer rating of B+.

Recovery is based on a hypothetical default scenario in FY 2019 with the company's liquidation value amounting to EUR 150m. This value is based on a 37% haircut applied to FCR's assets, reflecting a market value decline of one standard deviation of the German property price index as well as liquidation costs of approx. 26% for assets and 10% for insolvency proceedings. This compares to secured financing of a forecasted EUR 204m including EUR 33m in secured bonds.

Outlook

Outlook: Stable

The Outlook for FCR is Stable and incorporates Scope's view of weakening leverage with LTV reaching 70% by YE 2019 as a result of the company's aggressive growth plans for the next few years with negative free operating cash flows. We also incorporate persistent debt protection volatility, however, of around 1.7x supported by successful disposal activity and ongoing adequate liquidity.

Rating-change drivers

A negative rating action would be possible if EBITDA interest expense were to fall below 1.7x on a sustainable basis 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 FCR's recurring EBITDA, while the company's leverage as measured by its LTV ratio remained at around 50%.

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[2] Excl. discretionary expansion capex of EUR69.4m
[3] Executed asset sales EUR8.9m // executed asset acquisitions (excl. debt financed portion) EUR2.3m.

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