Vonovia S.E.
Germany, Real Estate

SCOPE A- STABLE

Corporate profile

Vonovia S.E. is Germany's largest residential real estate company. Vonovia currently owns and manages around 420,000 residential units in Germany, Austria and Sweden valued at approximately EUR 50.3bn. An additional 78,000 or so third-party apartments are also managed by Vonovia.

Key metrics

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**
EBITDA/interest cover (x)	5.0x	4.8x	4.6x	4.7x
Loan/value ratio	39%	42%	41%	41%
SaD/EBITDA	12.0x	14.9x	16.3x	14.4x
Scope-adjusted FFO/SaD	6%	5%	5%	5%

Rating rationale

Scope assigns first time issuer rating of A- to Vonovia S.E., Outlook Stable

Vonovia's strong business risk profile is the key driver for the assigned rating. Vonovia is Europe's largest residential real estate corporate with excellent access to capital and investment markets, a well-diversified portfolio spread across German, Austrian and Swedish metropolitan areas as well as high tenant diversification which, in turn, supports stable rental cash flows. Furthermore, economies of scale and high occupancy rates of over 97% across the company's portfolio support relatively high and stable profitability. Vonovia's financial risk profile benefits from its relatively low Scope-adjusted loan/value (LTV) ratio, its diversified debt structure, and its unencumbered asset position of 53% at end-September 2019, allowing the company to weather potential changes in the lending environment.

The rating is constrained by Vonovia's leverage levels, as measured by its Scope-adjusted debt to Scope-adjusted EBITDA, which make it vulnerable to adverse market movements. The rating is also held back by Vonovia's still-existing but weakening focus on the German market with associated regulatory risk, as well as its high expansion capex leading to negative free operating cash flows going forward.

Outlook

The Outlook for Vonovia is Stable and incorporates our view that credit metrics will remain constant with a loan/value ratio at the lower end of the 40%-45% bandwidth and Scope-adjusted debt/EBITDA of around 14x. We expect Vonovia's policy of financing total capex (investments and acquisitions) with 50% of equity on average to support these levels going forward. Furthermore, we acknowledge the increasing share of rental revenues generated outside of Germany, which is forecasted to reach over 15% by YE 2019 – following the successful execution of the Hembla AB acquisition in Q4 2019. We expect the share of non-domestic revenue to remain at around 15% going forward, as Vonovia is likely to continue the European roll-out started in 2018 and allocate a higher amount of capex to the Swedish portfolio from 2020 on. Profitability, as measured by Vonovia's Scope-adjusted EBITDA margin, should reach 75% by 2020.

A negative rating action would be possible if Vonovia's LTV ratio increased to above 45% on a sustainable basis.

A positive rating action is considered unlikely but could be warranted if Vonovia's LTV ratio were to decrease to below 40% and its Scope-adjusted debt to Scope-adjusted EBITDA were to fall to around 8x, both on a sustained basis.

Ratings & Outlook

Corporate ratings	A-/Stable
Short-term rating	S-1
Senior unsecured rating	A-
Subordinated (hybrid) debt rating	BBB

Analyst

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Related methodologies

Corporate Rating Methodology

Rating Methodology European Real Estate Corporates

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Rating drivers

Positive rating drivers	Negative rating drivers
• Exposed to low-risk, regulated residential real estate industry, which decouples rental growth from Consumer Price Index and GDP development • Tier 1 real estate corporate (largest residential landlord in Europe) with around 420,000 apartments in Germany, Austria and Sweden • Well-diversified portfolio spread across German, Austrian and Swedish metropolitan areas with positive demographics and highly diversified tenant portfolio of average credit quality • Portfolio locations and improving property condition support high like-for-like rental growth as well as high and stable occupancy • Improving profitability with Scope-adjusted EBITDA margin of 73% for FY 2018 in line with peers, driven by economies of scale and increasing like-for-like rental growth • Strong debt protection with Scope-adjusted EBITDA interest expense cover of greater than 4x going forward, backed by EBITDA growth and market-driven reduction of interest rates • Relatively low Scope-adjusted LTV ratio of 42% at YE 2018 forecasted to remain below 50% even if market values drop significantly • Excellent access to external financing, benefitting from highly diversified debt structure and financial headroom with unencumbered assets of 53% at end-September 2019	• Negative Scope-adjusted free operating cash flow since FY 2017 anticipated to continue, driven by total capex (including investments and acquisitions) of EUR 4.1bn in 2019 and EUR 2.5bn in 2020 leaving Vonovia dependent on external financing. However, an estimated two-thirds of capex is judged to be discretionary spending, and so could be withheld if necessary. • Exposed to regulatory risk as predominately focused on Germany (84% of net rental income forecasted for YE 2019), however, anticipated, further European roll-out expected to tackle Vonovia’s dependence on German regulatory framework • Weak SaD/EBITDA, which is forecasted to peak in 2019 at around 16x, but is expected to remain around 14x in the next few years

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• LTV ratio decrease to below 40% and decrease in SaD/SaEBITDA to around 8x	• Increase in LTV ratio to above 45% on a sustainable basis

Financial overview

				Scope estimates	
Scope credit ratios	**2017**	**2018**	**LTM Q3 2019**	**2019E**	**2020E**
Scope-adjusted EBITDA/interest cover (x)	5.0x	4.8x	4.4x	4.6x	4.7x
Loan/value ratio	39%	42%	42%	41%	41%
SaD/EBITDA	12.0x	14.9x	13.8x	16.3x[1]	14.4x
Scope-adjusted FFO/SaD	6%	5%	5%	5%	5%
Scope-adjusted EBITDA in EUR m	**2017**	**2018**	**LTM Q3 2019**	**2019E**	**2020E**
EBITDA	1,171	1,462	1,661	1,743	1,944
Operating lease payment in respective year	30	30	8	0	0
less: disposal gains from fixed assets included in EBITDA	(70)	(207)	(210)	(346)	(260)
Other[2]	87	107	49	69	69
Scope-adjusted EBITDA	1,217	1,391	1,508	1,466	1,753
Scope-adjusted funds from operations in EUR m	**2017**	**2018**	**LTM Q3 2019**	**2019E**	**2020E**
Scope-adjusted EBITDA	1,217	1,391	1,508	1,466	1,753
less: cash interest as per cashflow statement	(228)	(269)	(335)	(310)	(363)
less: pension interest	(9)	(9)	(9)	(9)	(9)
less: interest component operating leases[3]	(7)	(10)	(3)	0	0
less: cash tax paid as per cashflow statement	(51)	(166)	(123)	(97)	(85)
Δ Provisions	14	77	98	104	0
Scope-adjusted funds from operations	935	1,014	1,136	1,154	1,296
Scope-adjusted debt in EUR m	**2017**	**2018**	**LTM Q3 2019**	**2019E**	**2020E**
Reported gross financial debt	15,161	21,237	21,985	24,431	26,267
less: equity credit hybrids	(851)	(851)	(516)	(516)	(516)
add: derivatives	13	111	144	146	146
less: cash, cash equivalents	(266)	(548)	(1,157)	(538)	(939)
Cash not accessible	36	57	57	57	57
add: pension adjustment	238	247	240	247	247
add: operating lease obligations	305	421	0	0	0
Scope-adjusted debt	14,637	20,675	20,753	23,828	25,263

[1] Based on the assumption of a 100% acquisition of shares in Hembla AB by YE 2019, without any P/L contribution for 2019
[2] Others represents non-recurring items
[3] Incremental interest rate on operating lease obligations in 2017 and 2018 at 2.3%

Business risk profile: A

Industry risk: A

Vonovia is exposed to the low-risk, regulated residential real estate industry (industry risk of A) which decouples rental growth from the Consumer Price Index and GDP development.

We maintain our view on the company's industry risk, even if Vonovia has increased its exposure to the development business (industry risk of B) via the acquisition of BUWOG AG in 2018. We believe that an EBITDA contribution from the development business of up to 5% (2018: 2%) is in line with the assigned industry risk of A.

Credit outlook stable for 2020: slowing growth, political risks

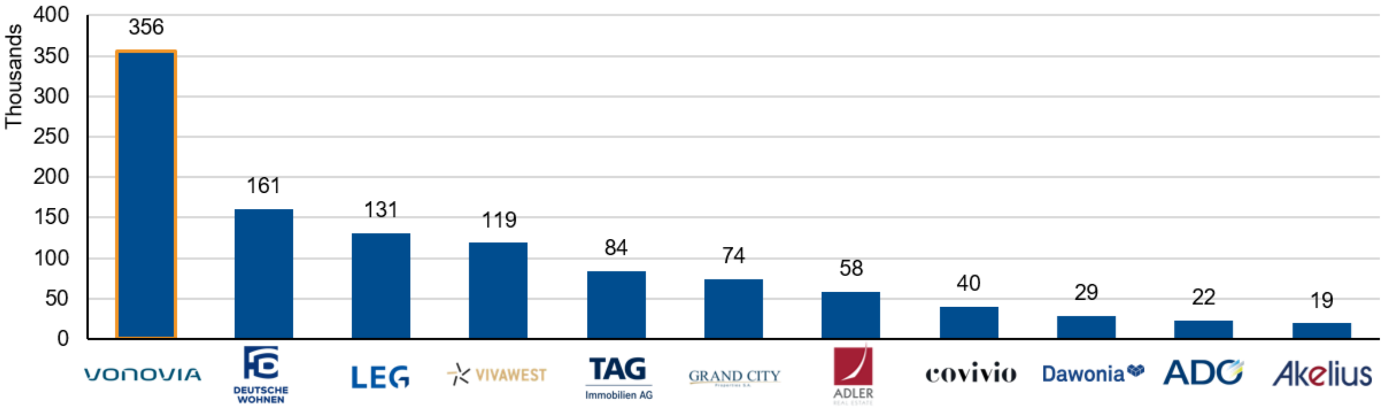
Real estate companies face an evenly balanced set of risks in 2020, resulting in a stable credit outlook. This outlook factors in less dramatic increases in property prices as a result of: i) stable interest rates; ii) some easing of the supply-demand imbalance for most asset classes as development activity has picked up in general; iii) the further slowing of economic growth; and iv) the uncertain development of international trade relations.

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

Tier 1 real estate corporate – largest residential landlord in Europe

In 2018, Vonovia bought (net) 50,000 apartments (+14% YoY) by acquiring Austrian BUWOG AG and Swedish Viktoria Park AB. Following merger clearance for the acquisition of Swedish Hembla AB in November 2019, total holdings amount to around 417,000 apartments spread across Germany (356,000 apartments), Austria (23,000) and Sweden (38,000)[4]. Vonovia is Germany's largest landlord by far (Figure 1), supporting visibility and access to tenants as well as to German and European investment markets for the sourcing of new properties or property portfolios. The size achieved benefits vertical integration efforts as well as providing a good means to streamline the company's portfolio in accordance with Vonovia's strategic plans. Vonovia is the largest European real estate corporate, with a market capitalisation of EUR 25bn at mid-November 2019, affording excellent access to capital markets to source financing.

Figure 1: Vonovia and competitors by no. of residential units in Germany



Sources: public information, Scope

Vonovia's absolute size, as measured by its total assets of EUR 50.9bn at end-September 2019 and Scope-adjusted funds from operations (SaFFO) of EUR 1.1bn for the twelve months to end-September 2019, also leads to stable cash flows supported by good diversification and economies of scale.

[4] Including Swedish portfolio comprising 21,413 residential units of Hembla AB. Acquisition anticipated to be closed by YE 2019.

Further growth anticipated outside domestic market of Germany

However, with an estimated market share of 0.9% Vonovia does not hold a dominant market position in the fragmented German real estate market for residential properties, allowing further growth within its domestic market without the competition authority expected to intervene. However, two factors limit growth in Germany: i) around 91% of German apartments are off-market (45% are owner-occupied, 36% have private landlords and 10% are owned by government-related entities or cooperatives); and ii) increasing uncertainties with regard to future regulations impacting the residential market. We therefore expect further growth to be focused on markets outside Germany, namely Sweden, Austria, France and the Netherlands.

Despite its low overall market share, Vonovia has fairly high market shares in its core markets/cities, where its main competitors are LEG Immobilien AG (North Rhine-Westphalia) and Deutsche Wohnen AG (Berlin). We view relatively large market shares in core markets positively because they allow housing companies to indirectly influence price levels via the rent index (Mietspiegel).

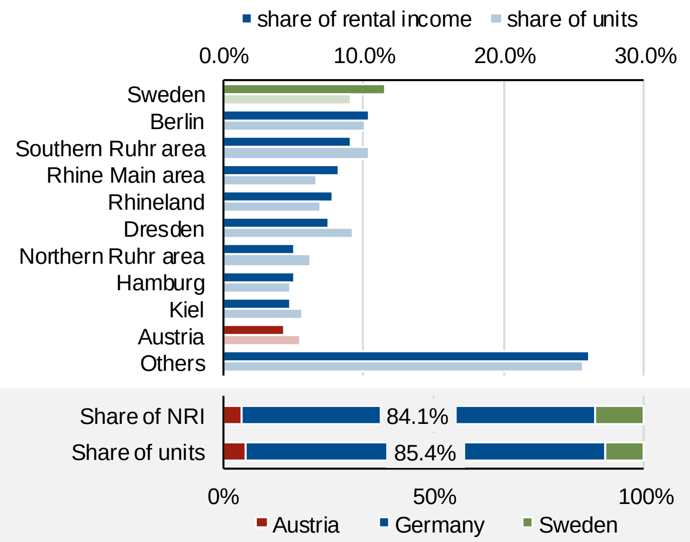
Well-diversified portfolio spread across German, Austrian and Swedish metropolitan areas

Vonovia has a well-diversified investment portfolio, chiefly spread across German, Austrian and Swedish metropolitan areas and midsize cities. Top 10 regions account for 74% of pro-forma[4] net rental income as at end-September 2019. However, we believe that portfolio concentration is negligible because the larger metropolitan areas like the southern Ruhr area (9.1% of pro-forma[4] net rental income), the Rhine-Main area (8.2%), the Rhineland (7.7%) and the northern Ruhr area (5.1%) consist of multiple large cities. We also believe that the city-wide distribution of apartments in Berlin (10.4%), Dresden (7.6%) and Hamburg (5.1%) partially mitigates the dominant exposure to these cities.

European roll-out in 2018/19 reduced Vonovia's dependence on German regulatory framework

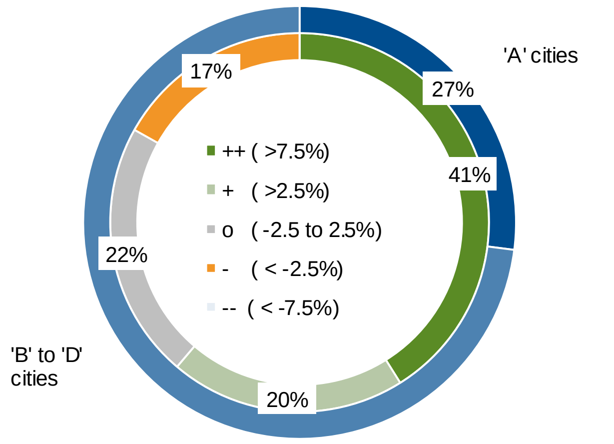
Vonovia has expanded its geographical outreach, with the acquisition of Austrian conwert Immobilien Invest SE (2017), BUWOG AG (2018), Swedish Viktoria Park AB (2018), Hembla AB (2019[4]) and a 10% shareholding in French ICF Novedis (2018). Countries outside of Germany now represent around 15%[4] of residential units and 16%[4] of the company's net rental income, as at end-September 2019. We believe that the European roll-out in 2018, followed by portfolio additions in Sweden this year, will support the company's business risk profile and pave the way for Vonovia to achieve its strategic goal of becoming a European champion. This expansion has also helped tackle the largest risk to Vonovia's business risk profile – its dominant exposure to the German regulatory framework for residential property landlords. Even if regulatory risk in other European countries is no lower than in Germany, we do not expect it to move in the same direction across Europe simultaneously. Thus, an internationally diversified portfolio should partially de-link cash flow predictability and stability from regulatory changes in a single country.

Figure 2: Top 10 locations by rental income and no. of units at end-September 2019[4]



Sources: Vonovia, Scope

Figure 3: Share of units (German portfolio) vs population forecast 2012 to 2025 // share of 'A' cities



Sources: Vonovia, Scope

Highly diversified tenant portfolio of average credit quality

Vonovia has a very highly diversified tenant portfolio thanks to the company's absolute size, with around 417,000 units as at end-September 2019[4], and its focus on the residential segment. This limits the impact of single tenant defaults or delayed rent payments on the company's cash flows – as illustrated by bad debt impairments of below 1% of net rental income for the last couple of years. We judge the credit quality of the company's tenant base to border between moderate and modest, similar to the weighted average credit quality of a German household (Vonovia's target customer profile).

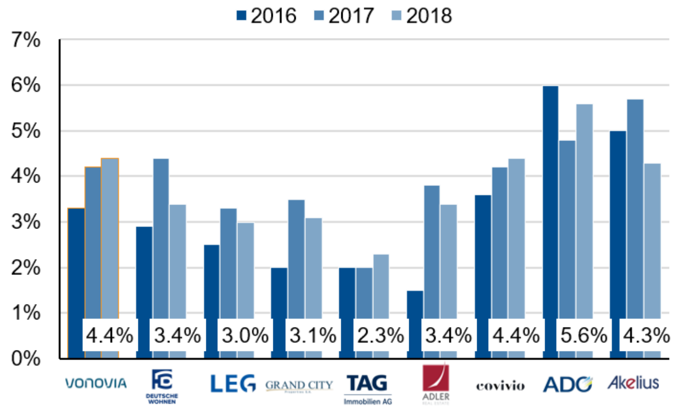
Good property locations with positive demographics and liquidity

Vonovia's properties are distributed across locations with favorable demand for residential real estate and healthy underlying macroeconomic fundamentals. This is evidenced by the following: i) roughly a quarter of apartments are located in 'A' cities, namely Berlin (10%), Hamburg (5%), Stockholm (5%), Stuttgart (3%), Vienna (2%) and Munich (2%); and ii) 83% of the company's portfolio is in cities/regions with at least stable demand expected up to 2025. We judge future tenant demand to be strong, supporting high and stable occupancy as well as like-for-like rental growth. Furthermore, we believe that the portfolio benefits from some liquidity, and will continue to do so in times of economic turmoil. Both of these factors limit potential haircuts on current property values.

Improving property condition backed by substantial increase in capex since 2013

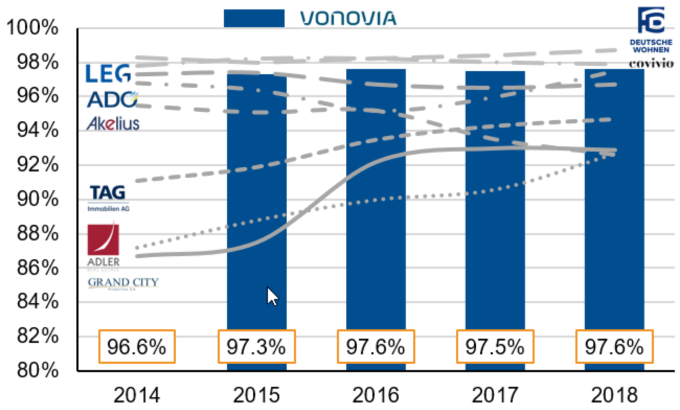
The condition of Vonovia's property portfolio is improving following continuous increases in capex, including maintenance, modernisation and new developments, to EUR 1.6bn in FY 2018 (EUR 61.3/sq m), up from EUR 0.2bn (EUR 20.4/sq m) in 2013. Based on information provided by the company, we expect spending of around EUR 1.4bn this year. This should help to support like-for-like rental growth over the next few years with an increasing share of spending allowing for rent adjustments according to §559 of the Bürgerliches Gesetzbuch, Germany's civil code, (modernisation) or the application of market rents (new developments). With the acquisition of BUWOG AG in 2018, Vonovia purchased experience, a track record and land banks that will benefit the new development of residential units, with a target of 2,000 to 3,000 completions per year. These new developments should help Vonovia to accelerate rental growth in the next couple of years, with a project pipeline consisting of 38,400 units as at end-September 2019, around 80% of which will be added to the company's investment properties.

Figure 4: Like-for-like growth of rents Vonovia vs peers



Sources: Vonovia, public information, Scope

Figure 5: Occupancy rate Vonovia vs peers



Sources: Vonovia, public information, Scope

High and stable occupancy of above 97% supporting cash flow predictability

Vonovia's occupancy rate of 97.6% at YE 2018 is in line with that of competitors, and has improved marginally since 2010. High occupancy supports our assessment of the company's asset quality with: i) the portfolio located in areas with favourable demand; and ii) increasing capex, which supports attractivity to tenants. We do not expect any further improvement in occupancy levels because the unoccupied remainder mainly consists of properties that were vacated due to modernisation efforts. Furthermore, we acknowledge the relatively long average lease length of close to 13 years in the last couple of years. Paired with relatively low tenant turnover (9% to 10%), this indicates that Vonovia is exposed to strained markets. Given the high occupancy and the low fluctuation of tenants, rental cash flows are expected to remain stable going forward, providing sufficient means for further organic growth.

Like-for-like rental growth of around 4% p.a. forecasted to continue

Since 2016, Vonovia has achieved strong and improving like-for-like growth of rents, with a compound annual growth rate of around 4%. We believe like-for-like growth will remain between 3.5% and 4.0% in the coming years, benefitting from: i) a relatively strong diversified portfolio compared to peers like Covivio S.A., ADO Properties S.A. and Deutsche Wohnen S.E.; ii) relatively high capex (modernisation and new developments) – by far the highest in Scope's peer group; and iii) a prevailing exposure to strained markets with a pronounced housing shortage leading to strong fundamental demand.

Improving profitability forecasted to outperform peers

Vonovia's profitability, as measured by Scope's adjusted EBITDA margin, stood at 71% for the last twelve months to end-September 2019. This follows a continuous improvement in profitability since the period up to 2013 with margins of around 60%. The main drivers are: i) economies of scale with costs per unit reduced by 46% since 2013 down to EUR 445 p.a. (German portfolio); ii) comparably high like-for-like rental growth; and iii) an increasing EBITDA contribution from Vonovia's value-add business, via cost savings or additional income.

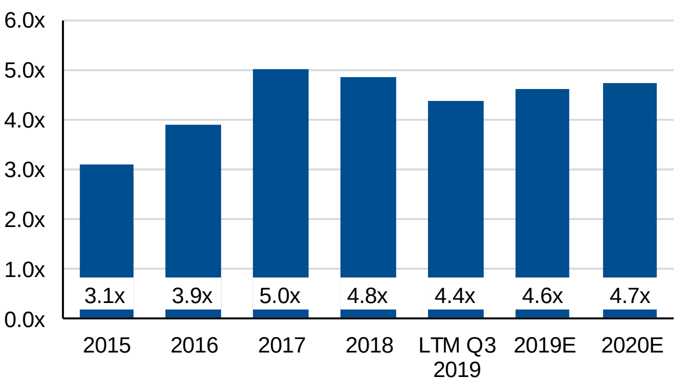
We believe the profitability of Vonovia's buy-and-hold activities will improve further, outperforming the best industry peers in the next couple of years, with more stable and relatively high like-for-like growth of the top line driven by increasing capex and a further roll-out of the value-add business.

Financial risk profile: BBB

Negative FOCF driven by increased capital expenditure

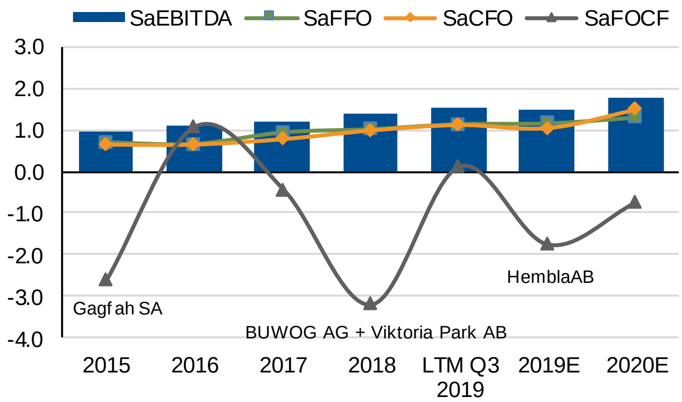
Vonovia's operating cash flows including SaFFO and Scope-adjusted cash flow from operations (SaCFO) have increased since its IPO in 2013. The increase is in line with the growth and improvement of the company's asset base via acquisitions, new developments, modernisation and refurbishments. These capital expenditures have, however, led to volatile and negative Scope-adjusted free operating cash flow (SaFOCF), which has been financed externally with EUR 2.3bn of capital increases (net) and EUR 5.9bn of debt issuances (net) since 2015 up to end-September 2019. For 2019 we forecast that FOCF will be around a negative EUR 1.8bn, driven by **net** capex (investment programme and acquisitions) of an estimated EUR 2.5bn[5]. The company aims to further expand its operations to countries outside the DACH region (Germany and Austria) while stabilising investments for portfolio improvements at around EUR 1.6bn per year. Consequently, we do not expect highly positive SaFOCFs within the next couple of years. However, around 66% of expansion capex is judged to be of a discretionary nature. As a result, the company could stop its related building activities immediately (within three months), if access to external financing were to weaken or if regulatory changes were to impact the profitability of these measures.

Figure 6: Scope-adjusted EBITDA interest cover (x)



Sources: Vonovia, Scope estimates

Figure 7: Cash flows (EUR bn)



Sources: Vonovia, Scope estimates

Strong debt protection

Vonovia's debt protection, as measured by its Scope-adjusted EBITDA interest cover, has stood at a strong 4.4x for the last twelve months to end-September 2019. Debt protection has increased over the past couple of years, reflecting: i) the strong growth of Scope-adjusted EBITDA by EUR 0.5bn since 2015, leveraging scaling effects via large-size acquisitions and a high degree of standardisation; as well as ii) the generally beneficial interest rate environment with the European Central Bank's quantitative easing programme starting in early 2015. The latter led to a decrease in interest rates by 200 bp on average for investment grade rated issuers. Both effects counterbalance the EUR 7.7bn increase in Scope-adjusted debt since 2015.

We expect EBITDA interest expense to remain at around 4x in the next few years, despite a gradual increase in interest rates going forward. This should be counterbalanced by top-line growth on the back of: i) relatively high like-for-like growth of rents; and ii) expansion capex that should lead to the addition of around 25,000 residential units in 2019 (2,340 units acquired by Viktoria Park AB in Q2 2019; 1,400 residential units to be completed from the company's development pipeline and 21,400

[5] 2,340 units acquired by Viktoria Park AB in Q2 2019 (EUR 0.5bn); Vonovia S.E. investment programme 2019E (EUR 1.4bn); assumed acquisition of 100% of shares in Hembla AB by YE 2019 (EUR 1.9bn); divestments in 2019 (EUR 1.3bn)

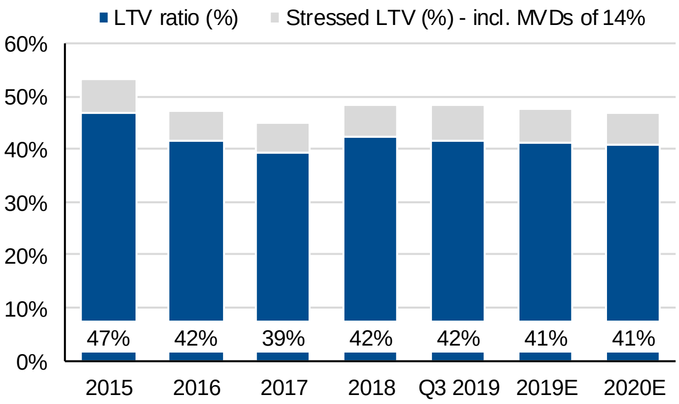
residential units of Hembla AB). Stable debt protection should be further supported by Vonovia's policy of financing expansion capex with 50% of equity on average.

Relatively low LTV ratio forecasted to remain below 50% even if market values drop significantly

Vonovia has benefitted greatly from the current economic and interest rate environment with a EUR 15.1bn value appreciation of its portfolio since 2013. An estimated third of this appreciation is performance-driven (rental growth) and the remainder is related to strong yield compression in the same period. This led to a substantial reduction in the company's Scope-adjusted LTV ratio to 42% at end-September 2019, from 55% at YE 2013, further supported by the EUR 3.5bn of net capital increases. The reduced Scope-adjusted LTV ratio has benefitted Vonovia's financial risk profile and increased its financial headroom. Consequently, the company's leverage as measured by its LTV is expected to remain below 50%, even in a scenario with a hypothetical market value decline that represents one standard deviation of Germany's nominal property price index, thus justifying the assigned BBB financial risk profile. It should be noted that leverage, as measured by LTV, went up in 2018 caused by the purely debt-financed acquisition of BUWOG AG.

LTV is expected to remain close to 40% by YE 2019, backed by asset sales of EUR 0.7bn (shares in Deutsche Wohnen S.E.) with the proceeds used to repay the EUR 0.7bn hybrid bond in April, the executed capital increase of EUR 0.7bn in May 2019 and the scrip dividend for FY 2018 (reducing payouts by EUR 0.3bn). Given the good fundamentals of the German residential real estate market, we believe that there is still room for positive, performance-driven fair value adjustments, even if yield compression is likely to come to an end. Downside potential for properties' fair values is mitigated by the remaining difference between the reinstatement costs for residential real estate of at least EUR 1,800 per sq m and the company's current valuation of roughly EUR 1,150 per sq m (excluding land value and as at end-September 2019).

Figure 8: Loan/value ratio



Sources: Vonovia, Scope estimates

Figure 9: Debt structure at Q3 2019

Sources: Vonovia, Scope estimates

However, there could be adverse effects on the company's portfolio value from changes in the German regulatory environment. These could arise if: i) rent adjustments according to §558 and §559 BGB or rent freezes, such as the freeze recently approved in Berlin, go beyond current expectations and/or ii) the Berlin rent freeze is not overturned on appeal at Germany's Federal Constitutional Court. Vonovia's planned further European roll-out is also likely to support the stability of its financial risk profile.

SaD/EBITDA peaked in 2018 and will fall slightly in the next few years

SaD to Scope-adjusted EBITDA excludes market-driven adjustments of fair value, thus providing a better view of the company's performance-driven deleveraging. For FY 2018, SaD to Scope-adjusted EBITDA stood at 14.9x, broadly in line with industry peers but somewhat higher than FY 2017 following the fully debt-financed acquisition of BUWOG

AG at end-March 2018. There has been some deleveraging in the last twelve months to end-September (13.6x). However, we anticipate an increase back to levels above 14x following the anticipated acquisition of Hembla AB in December 2019. We forecast that absolute indebtedness will remain stable.

Adequate liquidity

Vonovia's liquidity is adequate. In detail:

Position	YE 2018		YE 2019E	
Unrestricted cash	EUR	0.5bn	EUR	0.5bn
Open committed credit lines	EUR	1.1bn	EUR	1.1bn
Free operating cash flow (t+1)[6]	EUR	1.6bn	EUR	0.6bn
Short-term debt[7]	EUR	2.0bn	EUR	2.1bn
Coverage		**1.6x**		**1.0x**

We exclude discretionary expansion capex from our calculation of liquidity, as these investments will only be made if external financing is available.

S-1 short-term rating

Future liquidity is burdened by a relatively high amount of short-term debt of EUR 2.1bn maturing in 2020. We anticipate that this will lead to liquidity of around 1x. However, we believe that liquidity is a manageable risk in the short to medium term with sufficient headroom provided by: i) a fairly high share of unencumbered assets (53% as at end-September 2019) in combination with Vonovia's financial policy; and ii) excellent access to capital markets and good banking relationships with a high diversity of potential funding sources. In detail:

Unencumbered assets

Vonovia's unencumbered asset position of 53% as at end-September 2019 allows for secured funding if access to capital markets weakens or is lost. The company has a financial policy of keeping unencumbered assets at over 50% and an LTV ratio below 45%. This policy provides comfort that traditional bank lenders will step in in such scenarios, as secured financing would be eligible for covered bond refinancing. Please note that the LTV ratio as defined by Vonovia stood at 40.3% at end-September 2019 compared to 41.8% as calculated by Scope.

Excellent access to capital markets and good banking relationships

We believe that Vonovia benefits from excellent access to capital markets and traditional lenders, evidenced by a variety of funding sources as well as strong issuance activity in the last few years. According to the management, it is Vonovia's aim to make use of the entire repertoire of financing sources to maintain access and exposure to secure its long-term financing needs.

Unsecured debt

Senior unsecured: A-
Subordinated (hybrid) debt: BBB

In accordance with our methodology, we rate Vonovia's senior unsecured debt at A- and its subordinated (hybrid) debt at BBB.

Outlook

Outlook: Stable

The Outlook for Vonovia is Stable and incorporates our view that credit metrics will remain constant with an LTV ratio at the lower end of the 40%-45% bandwidth and

[6] Please note that we exclude discretionary expansion capex from our calculation of liquidity, as these investments will only be made if external financing is available. Thus, free operating cash flow for the purpose of liquidity only incorporates mandatory capital expenditure of EUR 0.8bn for modernisation, refurbishment and new developments in FY 2019. This is based on the assumption that, on average, around 40% of capital expenditure is committed the year before or is already under construction. Free operating cash flow also excludes EUR 0.5bn of acquisitions (2,430 residential units in Sweden, that is fully financed as at June 2019 and EUR 1.9bn for the acquisition of 100% in shares of Hembla AB) while it includes executed asset sales, namely the disposal of shares in Deutsche Wohnen S.E. in January 2019.

[7] We also exclude the EUR 0.7bn hybrid bond from the company's short-term debt position, as only the issuer benefitted from a call option in 2019 (executed as at April 2019).

Scope-adjusted debt/EBITDA of around 14x. We expect Vonovia's policy of financing expansion capex with 50% of equity on average to support these levels going forward. Furthermore, we acknowledge the increasing share of rental revenues generated outside of Germany, which is forecasted to reach over 15% by YE 2019 – following the successful execution of the Hembla AB acquisition in Q4 2019. We expect the share of non-domestic revenue to remain at around 15% going forward, as Vonovia is likely to continue the European roll-out started in 2018 and allocate a higher amount of capex to the Swedish portfolio from 2020 onward. Profitability, as measured by Vonovia's Scope-adjusted EBITDA margin, should reach 75% by 2020.

Our rating scenario assumes the following:

- Like-for-like growth of rents in 2020: 3.5%
- Privatisation units sold in line with book value in 2020
- Increase in value-add business EBITDA of 20% per year
- Inflation of operational expenditure at 1.5% for 2020
- Interest rate increase of 50 bp per annum for newly issued debt in 2020
- Fair value gains reflecting organic rental growth and no further yield compression
- 100% acquisition of shares in Hembla AB by YE 2019, without P/L contribution for 2019
- Continuing investment programme with spending of EUR 1.4bn in 2019 and EUR 1.6bn in 2020
- Expansion capex (acquisitions) of EUR 2.7bn in 2019[8] and EUR 0.9bn in 2010
- Dividend payments in 2020: 70% of 2019's FFO
- 50% equity credit for EUR 1.0bn hybrid bond and related interest payments

A negative rating action would be possible if Vonovia's LTV ratio increased to above 45% on a sustainable basis.

A positive rating action is considered unlikely but could be warranted if Vonovia's LTV ratio were to decrease to below 40% and its Scope-adjusted debt to Scope-adjusted EBITDA were to fall to around 8x, both on a sustained basis.

[8] EUR 0.45bn for the acquisition of 2,340 units by Viktoria Park in Q1 2019; EUR 1.87bn for 100% acquisition of shares in Hembla AB; EUR 0.1bn Squeeze-out Viktoria Park; remainder for strategic acquisitions

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