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Research Update:

Real Estate Investment Company Grand City Properties Assigned 'BB-' Rating; Outlook Stable

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Overview

- Luxembourg-incorporated real estate investment company Grand City Properties S.A. (GCP) focuses on investing in and managing German residential properties.
- We assess GCP's business risk profile as "fair" and its financial risk profile as "aggressive," reflecting the company's ability to achieve continuous like-for-like revenue growth and generate positive free cash flow.
- We are assigning our 'BB-' long-term corporate credit rating to GCP.
- The stable outlook reflects our forecast that GCP's rental income growth will support interest coverage of 1.5x-2.0x in the near term.

Rating Action

On Feb. 20, 2013, Standard & Poor's Rating Services assigned its 'BB-' long-term corporate credit rating to Luxembourg-incorporated real estate investment company Grand City Properties S.A. (GCP). The outlook is stable.

Rationale

The rating on GCP reflects our assessment of the company's business risk profile as "fair" and its financial risk profile as "aggressive." GCP focuses on the German residential real estate market. The company owns and manages a property portfolio of 15,000 residential units (including signed pipeline transactions), mostly located in Nordrhein-Westfalen in the west of Germany. The company estimates its total annual rental income at €70 million and its portfolio value at €655 million. GCP's business focus is to buy and turn around underperforming apartment blocks by renovating and re-tenanting the flats.

GCP's "fair" business risk profile reflects our view of the lower volatility of the German residential sector compared to other property sectors like commercial real estate. We consider that GCP's properties benefit from solid demand from a large pool of tenants in most of its locations across West Germany. We view the company's operating efficiency, evident in its high collection and tenant retention rates, as a positive factor for the rating. GCP's focus on buying underperforming apartment blocks means that rental income growth derives from the initial under-renting of the portfolio compared to the market average. We think this confers on GCP some income protection from any drop in rent and therefore in property value should tenant demand

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soften across the market.

The business risk profile is mainly constrained by the company's relatively high vacancy rate (17%) and geographic concentration; the average quality of the apartment blocks; and the likelihood of ongoing renovation expenses that are necessary to increase the profitability of the property portfolio. We see the company as being in an expansion phase, which in our opinion carries risks of overextension or overpayment for acquisitions as investor interest continues to rise. Capital gains from the sale of renovated properties at a lower yield than GCP originally purchased them are an integral part of the company's growth funding, constituting roughly 5%-6% of its annual asset rotation. However, we think these gains could dry up should market conditions reverse quickly. We understand that if property prices decline or financing costs rise, GCP would take a conservative view on acquisitions.

We assess GCP's profitability as stable, but lower than that of its industry peers. We estimate the company's EBITDA margin at about 50% for full-year 2012, versus about 65% for similarly rated peers. We attribute this in part to the cost of renovations, turnaround, and limited economies of scale, in light of the size and scattered locations of the properties throughout West Germany.

GCP's "aggressive" financial risk profile reflects its current leverage of about 60%, which includes the proportional reconsolidation of joint ventures. GCP's leverage is high relative to its European rated peers and is one of the main rating constraints. However, in our opinion this is mitigated by: the company's financial policy that limits leverage at about 55% of the loan-to-value (LTV) ratio; its policy of fixing interest rates on loans; and its long-dated debt maturity profile, with no significant debt maturities until 2016-2017. We also view the company's practice of not making new purchases without committed equity or financing as giving it some flexibility in terms of liquidity.

In our opinion, GCP's capital structure is only partly exposed to changes in market yields because of the high-yield nature of most of its portfolio assets. We see the company as exposed to potential rising interest rates when the bulk of its debt matures in 2016-2017, but it has no immediate refinancing needs. GCP also depends on favorable financing conditions from two German mortgage banks, which in in our view may not last. Furthermore, GCP has a limited track record in accessing the capital markets. However, we note that GCP has diversified its debt sources over the past 12 months, having obtained funding from four additional lenders and from the capital markets (latterly raising €35 million of equity on Feb. 18, 2013).

In our base-case scenario for 2013, we expect supply and demand for rental apartments in Germany to remain stable. Demand in Dusseldorf, Koln, and Berlin is rising, and rents in these cities increased by about 5% in the past year. We therefore expect GCP to post like-for-like rental income growth of about 4% in the next two years. This rate includes growth in income from assets whose renovation is complete and that are now occupied at high rents, alongside assets that are still undergoing renovation. In view of rising rental values in the portfolio and continued high investor demand in the residential segment, we assume a positive asset revaluation of about 4%.

We assume that GCP's EBITDA margin will remain stable at 50% because we do not anticipate significant improvements in terms of administrative and renovation costs. Interest expenses should increase slightly following the issuance of €100 million of convertible bonds in October 2012. We therefore project that GCP will post an interest coverage ratio of about 1.9x and a ratio of debt to capital of about 60% in 2013.

Liquidity

We assess GCP's liquidity as "adequate" under our criteria. We estimate that the ratio of liquidity sources to uses will be more than 1.2x in 2013. We note that the company has no large debt maturities in the next three years and has a high degree of flexibility to undertake acquisitions, depending on its ability to secure bank financing for specific transactions. We do not include property assets as a source of liquidity since the properties are mostly under renovation with a high level of vacancies.

We forecast that GCP will have the following liquidity sources in 2013:

- Unrestricted cash balances of €79 million on Dec. 31, 2012;
- Free operating cash flow (FOCF) of about €20 million;
- Asset disposals of €30 million; and
- Undrawn committed credit lines of €5 million maturing in more than a year.

We forecast that GCP will have the following liquidity uses in 2013:

- Acquisition spending (net of financing) of about €100 million;
- Debt maturities of €5 million within one year, and €5 million within one-two years; and
- Dividend payments of €4 million.

Almost all the loans are secured against assets (88% of assets are encumbered) and are nonrecourse to the holding company Grand City Properties S.A. We understand that GCP was in compliance with all its debt covenants on Dec. 31, 2012. We observe that headroom under the debt covenants is relatively tight for a small amount of properties. However, we understand that these covenants apply to the newest projects, which are in the early stages of the improvement cycle, and that headroom is likely to improve over the next 12 months.

Recovery analysis

The issue rating on GCP's €100 million senior secured convertible bonds due in 2017 is 'BB-', in line with the corporate credit rating on GCP. The recovery rating on the senior secured convertible bonds is '3', indicating our expectation of meaningful (50%-70%) recovery for debtholders in the event of a payment default.

The issue and recovery ratings on the senior secured convertible bonds are supported by the company's exposure to the growing German real estate market, its high number of properties and tenants, and the German insolvency regime, which we consider to be favorable for creditors. In addition, the ratings also incorporate our valuation of the company as a going concern, supported by its significant tangible asset base. Nonetheless, the ratings are constrained by the relatively high amount of senior secured bank debt that ranks structurally senior to the senior secured convertible bonds.

In order to determine recoveries, we simulate a hypothetical default scenario. Our simulated default scenario projects a deterioration in the quality of the properties by the time of default, which would lead to lower occupancy rates and rental incomes. Assuming such events, we foresee operating costs rising at a faster rate than rental income, and a significant increase in capital expenditure (capex). In addition, our scenario assumes that any weakening in the macroeconomic environment leads to a material deterioration in property market prices in Germany, and results in the company's inability to refinance its maturing debt. Based on this scenario, we project a default in 2016.

We believe that most of GCP's value lies in its significant real estate asset base. We therefore value the company primarily using a discrete asset valuation approach. We base our starting valuation mainly on the company's estimation of the portfolio value as of Dec. 31, 2012, which is similar to a fair value of about €527 million. We apply haircuts in the 30-40% range to the property portfolio, depending on the stage of development of each asset, to reach our gross stressed enterprise value of about €350 million.

After deducting enforcement costs of about €18 million from our gross enterprise value of €350 million, we arrive at a net enterprise value of about €332 million. Therefore, we assess recovery prospects in the 50%-70% range for the senior secured convertible bondholders. This equates to a recovery rating of '3', assuming that the full amount of the bonds is outstanding at default.

Outlook

The stable outlook reflects our opinion that GCP should post stable recurring cash flow and benefit from stable property yields in 2013. The outlook takes into account the solid demand from tenants and investors in most of GCP's asset locations, and our understanding that the company does not commit to residential acquisitions before it can secure financing or equity. Under our base-case scenario for 2013, we forecast positive like-for-like net rental income and asset revaluation of about 4%, with stable renovation and financing costs. Rating stability depends on GCP maintaining an interest coverage ratio of more than 1.8x and a debt-to-capital ratio of less than 65%.

We could lower the rating if GCP's interest coverage ratio falls to 1.5x on sustained basis. We believe recurring cash flow could fall if like-for-like rental income growth declines, if renovation costs increase, and if the time lag between large asset acquisitions and disposals widens. The rating could also come under pressure from a sharp increase in debt, leading to a debt-to-capital ratio of more than 65%. This could occur if the company undertakes a large leveraged acquisition, experiences significantly higher renovation capex, or if property yields rise due to falling investor demand.

Conversely, we could raise the rating if GCP is able to post interest coverage of much more than 2x on a sustained basis. Factors supporting this level of coverage include sustained rental income growth, higher return on renovation costs, and a lower cost of financing. Equally, we could raise the rating if the debt-to-capital ratio falls to about 55%, most likely due to high rental growth supporting lower property yield and a higher amount of equity-financed acquisitions. We would also view positively a more diversified debt structure.

Ratings List

New Rating; CreditWatch/Outlook Action

Grand City Properties S.A.	
Corporate Credit Rating	BB-/Stable/--
Senior Secured	BB-
Recovery Rating	3

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