Research Update:

Outlooks On Vonovia And Deutsche Wohnen Revised To Stable On Tougher Market Conditions; 'BBB+' Ratings Affirmed

November 11, 2022

Rating Action Overview

- Vonovia's third-quarter results were strong and show performance within our base-case expectations, but we believe the company will face tougher market conditions next year, including more difficult asset sales, probable revaluations losses, and significantly higher costs for refinancing debt.
- As a result, its S&P Global Ratings-adjusted debt-to-debt plus equity and EBITDA-to-interest ratios should be weaker than anticipated, and we no longer think that they could materially exceed our previous deleveraging expectations by year-end 2023. Although debt to EBITDA should gradually improve, it will likely remain too high for a higher rating.
- We therefore revised our outlooks on Vonovia and its core subsidiary Deutsche Wohnen to stable from positive, and affirmed the 'BBB+/A-2' ratings on both entities.
- The stable outlooks reflect our view that the group will continue generating robust rental growth, supported by strong housing undersupply in Germany, while allocating more cash flow to debt repayments, such that Vonovia's debt to EBITDA improves and EBITDA interest coverage (excluding revenue from asset sales) and debt-to-debt-plus-equity ratios remain above 1.8x and lower than 60%, respectively, for at least the next two years.

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Rating Action Rationale

We expect Vonovia to post stable operating performance in 2023-2024 following solid third-quarter results. On Nov. 4, 2022, the company reported sustained rental growth, with 3.3% like for like in the first nine months of the year (following 3.4% in first-half 2022 and 3.1%-3.9% in the previous three years). This was supported by indexation, record low vacancies (2.1%), and modernization investments, which enabled Vonovia to increase rents. At the same time, the company revealed record high tenant satisfaction results from its survey. We think market-driven rent adjustments from Mietspiegel's lagging indexation should progressively increase and support rental growth in 2023-2024. Vonovia also maintained its sales momentum, with EBITDA from developments up 41%, boosted by increasing sales (60.3%) and gross margins (270 basis points) on built-to-sell products. We believe the ongoing shift to built-to-sell products, from built-to-hold will support revenue in the next two years. EBITDA from value-added business (mostly craftsmen) was stable, since the revenue increase (9.1%) was offset by higher operating costs due to labor shortages, pushing the company to spend more on outsourcing. EBITDA from recurring sales remained stable, since lower volumes were offset by higher prices and stable fair value margins. For 2023, we think the company's plans to lower its fair value minimum step-up (to 25% from 35%) should limit potential volume declines.

We no longer think Vonovia's credit metrics will reach levels in line with a higher rating by year-end 2023, in light of the higher debt financing costs and potential revaluation losses we expect for 2023-2024. The company is sticking to its publicly stated financial policy to contain its reported loan-to-value (LTV) ratio to a maximum of 45% (comparable to S&P Global Ratings-adjusted debt to debt plus equity of 55%). However, we no longer think it can deleverage beyond that in the short term, because of: (i) the new rates environment, which currently limits REITs' access to capital market issuances and weighs on their funding costs; (ii) the challenging investment market, which will test Vonovia's ability to deliver large noncore asset disposals; and (iii) the revaluation losses the company may potentially incur. As a result, Vonovia will likely not achieve debt to debt plus equity below 55%, EBITDA to interest above 3x, and debt to EBITDA in line with its historical average (10x-15x). We continue to see Vonovia's debt to EBITDA as higher than the average for peers, mostly due to the low-yield nature of residential assets, especially in good locations of Germany, and its recent acquisitions, and we capture this through a one-notch negative ratings adjustment.

Still, we expect ratios to remain within our expectations for the current rating in 2023-2024. Over the next two years, debt to debt plus equity (55.1% as of Sept. 30, 2022) should rise to 55%-59% (corresponding to a reported LTV of about 45%-49%) and EBITDA to interest (4.4x as of Sept. 30, 2022, excluding recurring sales and development) should decline to 2.6x-3.5x. This is below our 60% and above our 1.8x thresholds, respectively. Debt to EBITDA (excluding recurring sales and development), which has been elevated since the acquisition of Deutsche Wohnen in late 2021, should continue to decrease progressively but remain above 17x by year-end 2023 (19.4x as of Sept. 30, 2022). These ratios are at the weaker end of our significant financial risk category, which is reflected by a one-notch negative ratings adjustment.

Our revised assumptions conservatively include a higher cost of funding, limited noncore disposals, and valuation losses. Our underlying assumptions conservatively include a value correction of up to 10% from June 30, 2022's peak, although management has not yet seen value fluctuations. We also assume a 4.5% refinancing coupon on all upcoming debt maturities based on management's track record of raising debt cheaper than unsecured bonds. In addition, we assume significantly lower capital expenditure (capex) in 2023 than in 2022, down to €850 million (0.9% gross asset value [GAV]) in 2023, from €1,350 million (2.3% GAV) in 2022. We note that 2022 spending is already significantly lower than the company's initial guidance of €2.5 billion. In our base-case scenario, we don't assume the sale of Deutsche Wohnen nursing homes or the large joint venture portfolio sale, which the company is strongly contemplating and could strengthen credit metrics beyond our current base case.

The company's good cash position, free operating cash flow (FOCF) generation, staggered debt maturities, and debt covenant headroom should limit risks related to debt refinancing and its interest coverage ratio. In addition to a healthy cash position (€1.2 billion as of Sept. 30, 2022) and a large available revolving credit facility (€3.2 billion), the company will significantly reduce capex and investments in 2023-2024 and generate more FOCF to repay its upcoming bond maturities, limiting the need to raise new expensive debt.

Additionally, Vonovia's overall debt maturities are manageable given their length (7.7 years on average) and staggered nature, with no more than 10%-11% debt (about €3.5 billion-€4.5 billion) maturing each year. We also recognize some flexibility toward dividends, which could either be distributed in shares or suspended in case of stress. We do not expect financial covenant breaches or for headroom to become very tight, despite the risk of valuation declines, since the company's ratio headroom would be sufficient to address a more than 30% decline in fair value and 194% increase in interest charge in the short term, which we view as unlikely.

Our outlook revision on Vonovia also applies to Deutsche Wohnen, which we continue to view as a core subsidiary of the group. We align our ratings on Deutsche Wohnen with those on its parent Vonovia. This is because we continue to regard Deutsche Wohnen as a core subsidiary of Vonovia following the takeover. We understand that Deutsche Wohnen is now fully integrated as a core division of Vonovia and part of the group's long-term identity and strategy. With a 86.87% stake, we believe Vonovia is likely to continue exerting material influence over Deutsche Wohnen.

Outlook

The stable outlooks on Vonovia and Deutsche Wohnen reflect our view that group will continue generating robust rental growth, supported by strong undersupply of housing in Germany, increasing rent indexation, and low tenant defaults. This should enable the group's EBITDA interest coverage and debt to debt plus equity to remain above 1.8x and below 60%, respectively, for at least the next two years.

We expect Vonovia to preserve a sound liquidity cushion and adjust its capital-allocation strategy to the fast-evolving financial market conditions. We also assume that management will take necessary steps to decrease leverage and comply with its publicly stated financial policy, which is centered on a maximum reported LTV of 45% (comparable to S&P Global Ratings-adjusted debt to debt plus equity of 55%).

Downside scenario

We could consider a negative rating action on both entities if the group's:

- Debt to debt plus equity increases to 60% or above for a prolonged period, because of higher revaluation losses or lower asset sales than expected;
- The liquidity cushion significantly decreases, for example, because of a late refinancing of upcoming maturities or the issuance of debt with shorter maturities;
- EBITDA to interest moves toward 1.8x; or
- Outstanding secured debt exceeds 40% of the company's asset value, which may lead to notching down of unsecured debt.

Upside scenario

We could raise our ratings on both entities by one notch if:

- The group is able to dispose substantial assets or development projects or raise enough equity such that its debt to debt plus equity would sustainably stay below 55% while maintaining EBITDA interest coverage at 3x or above; and
- Vonovia increases its payback capacity by internal cash flow generation, so that its debt-to-EBITDA ratio (excluding revenue from sales) returns to its historical levels (mid-teens or below) sustainably.

Company Description

Vonovia SE operates as an integrated residential real estate company in Europe. It operates through five segments: Rental, Value-Add, Recurring Sales, Development, and Deutsche Wohnen. The company offers property management services; apartments and property-related services; and value-added services, including maintenance and modernization of properties, craftsmen and residential environment organization, condominium administration, cable TV, metering, energy supply, and insurances services. It also engages in the sale of individual condominiums and single-family houses; and project development activities. At Dec. 31, 2021, the company had 565,334 residential units; 168,015 garages and parking spaces; and 9,289 commercial units, and managed 71,173 residential units for other owners in Germany, Austria, and Sweden. The company was formerly known as Deutsche Annington Immobilien SE and changed its name to Vonovia SE in August 2015. Vonovia SE was founded in 1998 and is headquartered in Bochum, Germany.

Our Base-Case Scenario

Assumptions

- Capex of €850 million in 2023 and 2024, down from €1,350 million in 2022.
- A hypothetical value correction of 10% from June 30, 2022's peak.
- A 4.5% coupon on all debt refinancing.
- Disposals of €1 billion in 2023-2024.
- Full cash dividend payments.

Key metrics

- Debt to EBITDA of 19x-20x in 2022-2024, compared with 25.5x at Dec. 31, 2021.
- Debt to debt plus equity of 56%-58% in 2022-2024, compared to 56.4% at Dec. 31, 2021.
- EBITDA to interest of 2.6x-3.5x in 2022-2024, from 3.8x at Dec. 31, 2021.

Liquidity

The company has adequate liquidity, with sources exceeding uses by more than 1.2x.

We estimate that liquidity sources from Sept. 30, 2022, include:

- About €1,245 million of unrestricted cash and equivalents, excluding €600 million of deposits that will be released on Dec. 21, 2022.
- Undrawn credit lines available of €3,252 million, maturing in more than 12 months.
- Our forecast of €1.4 billion-€1.5 billion of cash funds from operations, excluding revenue from development and recurring sales.

For the same period, we estimate liquidity uses include:

- About €3.7 billion of short-term debt maturities.
- Total capex of roughly €850 million for the next 12 months.

Covenants

Vonovia enjoys large headroom under its debt covenants, namely a maximum LTV of 60% (reported 43% as of Sept. 30, 2022), a maximum secured LTV of 45% (reported 12% as of Sept. 30, 2022), a minimum interest coverage ratio of 1.8x (reported 5.3x as of Sept. 30, 2022), and a minimum unencumbered assets ratio of 125% (reported 162% as of Sept. 30, 2022).

Ratings Score Snapshot

Vonovia SE

Issuer credit rating: BBB+/Stable/A-2

Business risk: Excellent

- Country risk: Very low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: a-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)

- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

ESG credit indicators: E-2, S-2, G-2

Deutsche Wohnen SE

Issuer credit rating: BBB+/Stable/A-2

Business risk: Strong

- Country risk: Very low
- Industry risk: Low
- Competitive position: Strong

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: a-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: a-

- Group credit profile: BBB+
- Entity status within group: Core

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed		
Vonovia SE		
Senior Unsecured	BBB+	
Deutsche Wohnen SE		
Senior Unsecured	BBB+	
Vonovia Finance B.V.		
Senior Unsecured	BBB+	
Ratings Affirmed; Outlook Action		
	To	**From**
Vonovia SE		
Deutsche Wohnen SE		
Issuer Credit Rating	BBB+/Stable/A-2	BBB+/Positive/A-2