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Research Update:

German Residential Real Estate Company TAG Immobilien AG Assigned 'BBB-/A-3' Rating; Outlook Stable

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Rating Action Overview

- TAG Immobilien AG (TAG) is a German real estate holding company with a gross asset value of about €6.7 billion as of year-end 2021. The company focuses on multifamily residential assets, mainly in Northern and Eastern Germany. More recently it has increased its geographical exposure to Poland, where it aims to develop residential units for build to hold (BTH) and build to sell (BTS).
- TAG's acquisition of ROBYG, a leading Polish developer, is expected to close on March 31, 2022. The transaction will significantly increase TAG's exposure to development activities, with the goal to develop and operate more than 20,000 units in Poland's largest cities by 2028.
- We assigned our 'BBB-' long-term and 'A-3' short-term issuer credit ratings to TAG.
- The stable outlook is based on our expectation of resilient and stable cash flow generation on the back of supportive demand and supply dynamics for residential real estate assets in Germany and Poland.

Rating Action Rationale

Our rating assessment reflects TAG's solid portfolio size, worth €6.7 billion as of year-end 2021, which consists mostly of resilient residential assets, concentrated in Northern and Eastern Germany. With a portfolio in Germany of €6.4 billion and 87,576 units at year-end 2021, and a total portfolio size of €6.7 billion including Polish operations, TAG is comparable with other rated residential real estate peers in the investment-grade category, such as Grand City Properties S.A. (GCP; about €8.9 billion portfolio) and Vesteda Residential Fund FGR (€8.6 billion portfolio). Although the company is one of the leading listed landlords in Germany, TAG's market position remains small, given the fragmented nature of the German residential real estate market.

TAG primarily focuses on multi-family residential assets in or close to large and midsize cities in Northern and Eastern Germany. These include the regions of Berlin (about 15% of portfolio value year-end 2021), Leipzig (13%), Erfurt (12%), Hamburg (10%), and Dresden (9.8%). We believe most of TAG´s locations benefit from solid demand and limited new supply, hence driving rental and price growth. That said, we estimate about 40% of its portfolio is located in cities or regions that are less dynamic than Germany's largest cities, such as Gera or Chemnitz, where vacancy rates and rents tend to be weaker than the German average. We note that most urban regions in Germany suffer from a chronic housing shortage, and we therefore see German residential as a source of resilient rental income generation on the back of the structural supply/demand imbalance.

We view TAG's asset quality as in line with the market average, based on the company's focus on multi-family properties. Most of its properties were built between 1970 and 1989, but about 75% of the portfolio has been renovated since. Still, we expect capital expenditure (capex) will increase significantly in the future to comply with climate neutrality goals. With an average apartment size of about 60 square meters (sqm) and a monthly rent of €5.5 per month per sqm, TAG's rent level is slightly lower than other residential rated peers (such as €7.4/sqm/month for GCP and €7.34/sqm/month for Vonovia), reflecting its strong exposure to Eastern parts of Germany. Occupancy levels for its German portfolio stood at 94.3% at year-end 2021, which we expect to remain stable. Similar to its German rated residential peers, TAG benefits from a regulated rental environment, where actual rents are more than 10% below market level, and tenant stays are long (more than 10 years). This provides very stable and predictable cash flows, with upside potential.

Despite TAG´s takeover of Polish residential developers Vantage and ROBYG, we expect its exposure to the more volatile development industry to not exceed 25% in the medium term. In December 2021, TAG announced its acquisition of ROBYG S.A., a leading Polish residential developer, to enhance its presence in Poland and become a leading player in the Polish residential rental market. TAG first entered the Polish market in 2019 through the acquisition of Polish developer Vantage S.A. TAG's operations in Poland comprise, via Vantage and pro forma closing of ROBYG, the development of both BTS (approximately 44% of the total pipeline) as well as BTH units (56%), the latter to be maintained in TAG's portfolio as yielding assets. In total, the current pipeline comprises about 21,200 BTH projects and about 16,900 BTS units. We understand that 85% of the 2022 handovers and 23% of the planned handovers for 2023 are already sold, thus limiting development risks.

We view development activities as more volatile and less predictable than the renting business. We understand that the exposure to development will peak in 2022 for TAG as a result of the recent takeover, at about 40% of EBITDA (mainly due to the high number of sales this year). That said, with the development pipeline increasingly reflecting BTH versus BTS units, the medium- to long-term exposure is not expected to substantially exceed 25% of TAG's EBITDA. In addition, we understand that a large part of the pipeline is already sold, providing visibility on incoming cash flows, and that sales are all to private individuals with no exposure to institutional buyers.

TAG aims to establish itself as the leading residential landlord in Poland in the medium term. We understand that the market entry in Poland was executed via the acquisition of two Polish developers due to the lack of existing good quality multi-family assets in Poland that would be suitable for block sales. We view the Polish market as largely unregulated, with average one-year fixed term contracts where lessors are entitled to charge for utilities and service charges limiting downside risk of rising energy prices. We believe TAG's development pipeline will enhance the quality of its total portfolio, adding newly built housing stock. All projects are located in Poland's largest and most dynamic cities such as Warsaw, Wroclaw, Krakow, Gdansk, and Lodz, where rents are above average at around €12/sqm, based on a widening supply-demand imbalance for new housing units, since existing housing stock is relatively old and in the hands of individual owners rather than being professionally managed. In addition, we expect the market will continue to benefit from supportive income growth and demographics in Poland. We understand TAG will maintain a long-term average exposure of about 20% of its total portfolio value.

We expect TAG will maintain leverage ratios commensurate with the 'BBB-' rating on the back of stable cash flows and prudently financed capex. Our assessment assumes the successful closing of the ROBYG transaction, which we expect in the coming weeks. While we expect leverage metrics will increase as a result of the transaction, we expect TAG will maintain debt to debt plus equity at 50%-52% through year-end 2022, in line with its financial policy of loan-to-value at about 45% (corresponding to S&P Global Ratings-adjusted debt to debt plus equity of approximately 50%). We expect the company will take measures throughout this year to support its deleveraging plans, following its temporary funding of ROBYG with a bridge facility of €750 million. Debt to EBITDA will benefit from a large contribution of development sales in 2022 and will fall to 10.0x-10.5x, from 13.1x at year-end 2021. That said, we expect debt to EBITDA to stabilize at 12x-13x from 2023, after the ramp up of the BTH capex program. TAG also demonstrates a healthy capacity to cover its interest burden, with EBITDA interest coverage forecast above 4.5x in the next two years, thanks to a low cost of debt of 1.39% as of year-end 2021 and comparatively higher-yielding residential properties (5.3% yield for TAG versus about 3.0% for Vonovia). We view positively that 98.5% of total debt is at a fixed rate as of year-end 2021, mitigating the impact of an interest rate rise. The company has limited refinancing needs (excluding the transaction) over the next three to four years. Its average debt maturity stood at 6.3 years at year-end 2021.

Outlook

The stable outlook reflects our view of TAG's resilient residential real estate portfolio. We expect the company's yielding assets to continue generating stable income over our forecast horizon through 2023,given very favorable market dynamics in Germany.

In our base-case scenario, we forecast that TAG will maintain an adjusted debt-to-debt plus equity ratio of about 50%-52%, debt to EBITDA in the range of 12.0-13.0x, and EBITDA interest coverage of well above 4.5x in the next 12-24 months.

Downside scenario

We could lower the rating if TAG's operating performance deteriorates, for example because of falling occupancy rates or underperforming rental operations in Germany or Poland, resulting in worsening credit metrics, such as:

- Debt-to-debt plus equity remaining above 55% over a sustained period;
- Interest coverage falling significantly below 3.8x; and
- Debt to EBITDA deteriorating materially from our base case over a sustained period.

Similarly, we could lower the ratings on TAG if we saw a marked increase in exposure to development activities to the detriment of rental income generation.

We would also take a negative rating action if TAG failed to maintain a sufficient liquidity cushion to cover its needs.

Upside scenario

We could take a positive rating action if:

- Leverage significantly reduced, bringing debt to debt plus equity sustainably below 45%;
- Debt to EBITDA remained below 13.0x; or
- Exposure to yielding standing assets increased, including successful project deliveries in Poland, with high occupancy levels and resilient operating performance of the overall portfolio, while its exposure to development activities decreased to well below 20%.

Company Description

TAG is a German real estate company that acquires and manages multifamily residential real estate properties, particularly in Northern and Eastern Germany. Since 2020, the company has also been active on the Polish market following the acquisition of a Polish developer of residential properties (Vantage Development). TAG currently owns about 87,576 units with a portfolio size of €6.7 billion. In addition, it had a secured pipeline of 12,557 units in Poland as of year-end 2021.

TAG was founded in 1882 as a railway business and became a listed real estate management company in 1998. It is headquartered in Hamburg, Germany. Since 2012, it has been listed on the MDAX at the Frankfurt Stock Exchange.

TAG's largest shareholder is Massachusetts Financial Services Company (9.9%), followed by Black Rock (8.1%), and The Capital Group Companies Inc. (7.7%). About 59.7% is free float.

Our Base-Case Scenario

Assumptions

- Real GDP in Germany to grow by 4.3% and 2.5% in 2022 and 2023 respectively, and in Poland by 5.3% and 3.3%. We expect unemployment rates to remain at about 3.5% in Germany and 3.4% in Poland this year, with moderate inflation of about 2.2% in Germany and 3.3% in Poland in the next 12-24 months.
- We forecast like-for-like rental income growth of 1.5%-2.0% for the forecast period, supported by an overall stable occupancy level of about 95% for TAG's German assets and some uplift on re-lettings. For the build-to-rent apartments in Poland, we expect a high occupancy in the range of 90%-95%.
- Robust positive portfolio revaluation of about 3%-4% on a like-for-like basis over the forecast year, while assuming conservatively low single-digit valuation growth for TAG's German assets with limited yield compression and the main contribution coming from newly delivered units in Poland.
- We expect EBITDA contribution from development activities to peak in 2022 due to a higher

contribution from BTS assets (about 40%) and to stabilize afterwards at about 20%-25% of total EBITDA.

- Moderate acquisitions of about €100 million in both 2023 and 2024.
- We do not forecast any disposals of investment properties over our forecast period, in line with management's strategy to expand the portfolio.
- Development capex of about €180 million-€200 million (BTH portfolio only) in 2022 and €580 million-€600 million in 2023 as BTH production ramps up.
- Yearly maintenance capex of about €100 million over our forecast period.
- About €140 million dividend distribution in 2022. We forecast dividends will increase as the company expands its cash flow base. TAG targets a dividend payout ratio of 75% of reported funds from operations.
- A balanced funding strategy, containing equity- and debt-like instruments, to maintain its financial policy at 45% reported loan-to-value.
- Overall stable average cost of debt at about 1.5%.

Key metrics

- Adjusted debt to debt plus equity of about 50% in 2022 and trending toward 47% in 2023.
- Adjusted debt to EBITDA in the range of 10.0x-10.5x in 2022 and about 13.0x in 2023.
- EBITDA interest coverage above 4.5x in 2022 and 2023.

Liquidity

We anticipate that TAG's liquidity sources will likely cover liquidity uses by more than 1.2x in the 12 months started Jan. 1, 2022, and we assess liquidity as adequate. TAG's predictable and stable cash flows from rental income stemming from regulated residential assets enhances the company's liquidity profile. In addition, TAG has a long track record of solid bank relationships. We exclude the acquisition of ROBYG from our liquidity calculation since liquidity sources are covered by a committed bridge facility.

We estimate principal liquidity sources for the 12 months from Jan. 1, 2022, as follows:

- €94 million in available unrestricted cash;
- €135 million of undrawn committed credit lines with a maturity of more than 12 months;
- Our estimate of funds from operations of about €170 million;
- Proceeds from already committed development sales for a total of €255.3 million; and
- Completed debt refinancing for €86 million year-to-date.

We estimate principal liquidity sources for the 12 months from Jan. 1, 2022, as follows:

- €140 million of contractual short-term debt maturities, including amortization payments;
- About €330 million of committed capex, including development capex; and
- About €140 million of planned dividends.

Covenants

The group has loans with covenants specifying capital service ratios and equity to debt ratios. As of the reporting date, the group complied with all main financial covenants stipulated in the loan contracts as of year-end 2021.

Existing bonds also carry financial covenants with which TAG also complied as of year-end 2021.

Environmental, Social, And Governance

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

ESG factors are an overall neutral consideration in our credit rating analysis of TAG. We believe that German residential companies like TAG are exposed to social risk on the back of ongoing political and social tensions arising from rents and property prices. That said, TAG also operates in secondary locations in Northern and Eastern Germany where rents and real estate prices have been rising less strongly than in large metropolitan areas, which should limit the impact at this stage.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/A-3

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

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

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

New Rating; CreditWatch/Outlook Action	
TAG Immobilien AG	
Issuer Credit Rating	BBB-/Stable/A-3