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S&P Global Ratings

# Argo Properties N.V.

**January 20, 2022**

## New Rating

# 'ilA' Rating Assigned, Outlook Positive; 'ilA+' Rating Assigned To Loan From Institutional Investor

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## New Rating

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## Rating Action Overview

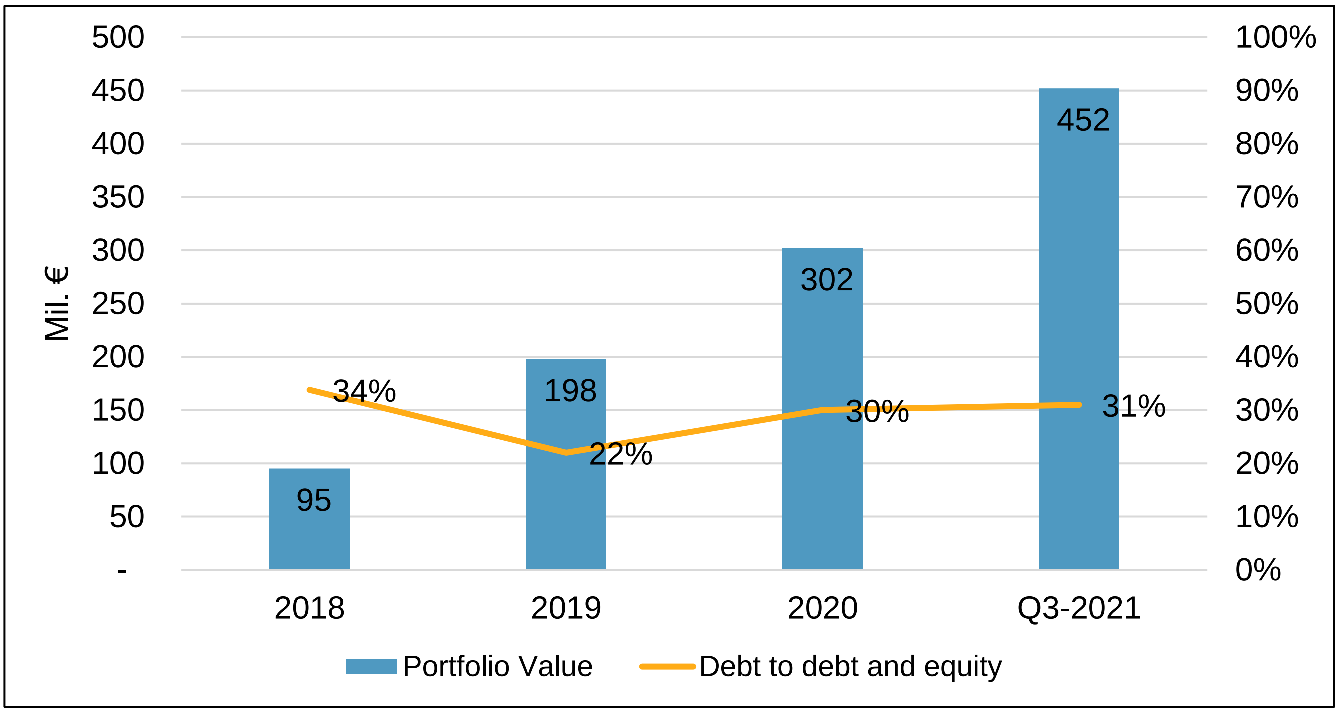
- Argo Properties NV ("Argo Properties" or "the Company") is an income-producing real estate company engaged in the purchase, rental, management and improvement of quality residential buildings in emerging city centers in Germany, an activity supported by the market conditions in the German rental residential real estate sector. On September 30, 2021, the Company’s asset portfolio was valued at about €452 billion, encompassing about 2,352 residential units.
- Since its foundation in 2018, the Company significantly expanded its income-producing property portfolio while presenting strong operating performance, as reflected in strong growth of approximately 7%-9% in like-for-like rental income, higher than rated peers in the German rental residential sector, while maintaining high occupancy rates of about 96%-97%.
- The rapid growth in the Company's operations was accompanied by capital growth, mainly through capital issuances and positive revaluations, which were mainly due to the successful implementation of the Company's asset improvement business strategy. As a result, the Company presented rapid portfolio growth while maintaining low leverage.
- The rating reflects our assessment that the Company will continue rapidly growing its operations while maintaining a gross debt-to-debt-and-equity ratio of 50% and below, based in part on expected additional material acquisitions, alongside continued positive revaluations resulting from rent increases, in accordance with the Company's business and financial policy.
- On the other hand, the rating is constrained by the Company’s limited operations at this stage, as reflected in a low EBITDA base and cash flow compared with peers. In addition, the Company's operation in the German rental residential industry, which is characterized by low yields, and the fact that the Company is growing rapidly, lead to a very high debt-to-EBITDA ratio compared with rated peers.
- On January 20, 2022, we assigned our ‘ilA’ issuer rating to Argo Properties N.V. We also assigned our ‘ilA+’ rating to an unsecured loan of up to NIS 220 million to be provided to the Company by an institutional investor.
- The positive outlook reflects our assessment that in the next 12 months the Company will continue to successfully implement its business strategy of rapid portfolio growth and strong operating performance. The positive outlook is also based on our estimates that the conditions in the German rental residential market will support the Company's ability to maintain high

occupancy rates and positive like-for-like rent growth. Based on this scenario and on the Company's financial policy, we estimate that the Company will maintain adjusted EBITDA interest coverage exceeding 2.4x and a debt-to-debt-and-equity ratio of up to 50%.

## Rating Action Rationale

The Company's rating reflects the rapid expansion of the Company's operations in recent years, which has been carried out through the acquisition of rental residential properties in Germany, for an annual amount of about €80 million - €120 million. This expansion was accompanied by capital growth, inter alia through capital issuances and material positive revaluations, which we believe mainly reflect the significant increase in like-for-like rental income.

**Chart 1: Portfolio And Leverage Development**




In the first nine months of 2021, the Company completed the acquisition of 654 units in 64 properties for a total consideration of approximately €110 million, which contributed to a 54% increase in NOI (net operating income) in this period compared with the same period last year. The Company entered into additional transactions for the purchase of 304 residential units for a total consideration of approximately €47 million, which are expected to support the continued growth in its operations.

The Company focuses on the acquisition of income-producing properties in emerging centers in German cities (Leipzig, Dresden and Magdeburg), supported by market conditions in the German rental residential real estate segment, and by expected increase in demand for housing and limited supply, especially in Leipzig and Dresden. The Company's business strategy focuses mainly on single-asset acquisitions from private investors of buildings for preservation that underwent complete renovation in the late 1990s but were not optimally managed, and that embody an improvement potential. In our opinion, the Company's asset portfolio is characterized by high quality assets in good maintenance condition and in central locations, which support the Company's business profile. In addition, these advantages involve the potential for future profitability from the sale of apartments (privatization), since most of the apartments owned by the Company have the potential to become condo apartments. However, the Company's policy includes non-significant apartment sales, which are not expected to materialize in the next two to three years, and are currently outside the outlook range.

The Company's business profile is supported by strong operating performance, which includes, among other things, very high growth of about 7%-9% per year in like-for-like rental income, alongside high occupancy rates. In our opinion, the high growth compared to rated peers is mainly due to the focus on cities with less restrictions on raising rents, lack of social housing in the Company's asset portfolio and the focus on acquisition of properties with improvement potential. This potential is reflected in 30%-40% rent increases on new leases in 2018-2020. Moreover, during the coronavirus crisis, starting March 1, 2020, until last November, the Company signed over 450 new leases at 40%-50% higher rents, on average, than the rent of the previous tenants in the same apartments. The high rent growth for new tenants, alongside tenant turnover of about 13%-16% per year, support the Company's ability to materially increase like-for-like rent income.

Long-term experience and management's acquaintance with the field and country of operations support our assessment of the Company's ability to continue posting strong performance. It should be noted, however, that Leipzig and Dresden are considering adopting stricter regulation on rent increases. We understand that management does not anticipate a significant impact on its ability to raise rents on existing properties in the medium term, given average rents in its areas of operation.

The ongoing improvement of the Company's asset portfolio is reflected in positive revaluations that match its high like-for-like rent growth, and supports the Company's ability to refinance while creating positive free cash flow. For example, in January 2022 the Company engaged with a banking corporation for a €40 million refinancing, to replace about €24 million in existing loans secured by the same assets, thus allowing a cash flow of about €14 million after expenses, while improving the weighted interest rate.

On the other hand, the business risk profile is constrained by the size of the asset portfolio and the very low EBITDA base compared to rated peers operating in the German rental residential market.

The Company's diversity of operation is low as it operates in a single segment and exposed to a small number of cities in Germany alone. However, the diversification of properties and tenants is high compared to other segments of income-producing real estate, and the German residential real estate market is developed and benefits from relatively stable demand.

The Company has two projects in the planning stages for office development in Berlin: a project to convert commercial spaces into modern office spaces of approximately 6.1 thousand square meters net, and a project to plan and construct two office buildings of approximately 15.3 thousand square meters net, so as of today, its exposure to development activity is low and limited.

The Company's financial risk profile is supported by its financial policy to maintain balance sheet leverage levels of up to 50%, so that the portfolio is expanded alongside capital growth. The Company's capital base grew by about 40%-130% per year in the past three years, inter alia through capital issuances totaling about €220 million in 2018-2021, profit accumulation mainly due to positive revaluations amounting to about 8%-20% per year, and avoiding dividend distributions. At the end of the third quarter of 2021, the Company's balance sheet leverage ratio was approximately 31%, similar to December 2020, and in our base case scenario we estimate that it will increase as far as 50%, in accordance with the Company's business plans and financial policy.

The Company's EBITDA interest coverage ratio was about 3.5x in the first nine months of 2021, similarly to 2020. We estimate that in the next two years the ratio may gradually decrease to about 2.7x, given the expected increase in debt due to investments, as part of the continued growth in operations, and given an institutional loan expected to be taken out in the upcoming year, at a higher interest rate than secured bank debt. We estimate that even given the expected erosion in the coverage ratio, the Company will maintain a margin from the ratio commensurate with the current rating.

On the other hand, the rating is constrained by lower EBITDA base and cash flow compared to peers. This is due to the low yields in the German residential rental market, especially in high-quality properties (on which the Company focuses), which lead to the relatively low cash flow generation. These low yields, together with the fact that the Company is growing rapidly, lead to a very high debt-to-EBITDA ratio compared with rated peers.

## Outlook

The positive outlook reflects our assessment that in the next 12 months the Company will continue to successfully implement its business strategy of rapid portfolio growth and strong operating performance. The positive outlook is also based on our estimates that the conditions in the German rental residential market will support the Company's ability to maintain high occupancy rates and positive like-for-like rent growth. Based on this scenario and on the Company's financial policy, we estimate that the Company will maintain adjusted EBITDA interest coverage exceeding 2.4x and a debt-to-debt-and-equity ratio of up to 50%.

### Upside Scenario

We may take a positive rating action if the Company posts sufficient growth in operations, in accordance with its business plans, while maintaining its current financial policy and commensurate financial ratios as noted above.

### Downside Scenario

We may change the outlook to stable or lower the rating if the Company fails to implement its business plan or to maintain financial ratios commensurate with the current rating. This scenario may materialize, inter alia, if the Company makes leveraged acquisitions, if its operations growth is insufficient, or if it executes transactions that do not match the mix and quality of the current asset portfolio and the Company's business strategy.

## Company Description

Argo Properties NV is an income-producing real estate company engaged in the purchase, rental, management and improvement of residential buildings in Germany, in particular in Leipzig, Dresden and Magdeburg. The Company has materially expanded its scope of operations since its foundation in 2018. On September 30, 2021, the Company’s asset portfolio was valued at about €452 billion, encompassing about 2,352 residential units. The Company also develops and converts office spaces in Berlin, which are currently at the planning stages, and do not constitute a material share of its operations.

Argo Properties is a public company traded on the Tel Aviv Stock Exchange. The Company's stakeholders are private entities (with shares of up to 15%), institutional entities (39%) and the public.

## Base Case Scenario

**Our base case scenario is underpinned by the following assumptions:**

- Expected economic recovery in Germany in 2021, to be reflected in ~3.2% GDP growth and a ~2% inflation rate. Expected ~3.7% GDP growth and a ~1.3% inflation rate in 2022.
- An increase of about 40%-65% in NOI from rental housing in 2021-2022, based on contribution from new properties and expected growth of about 6%-7% in like-for-like rental income, in line with recent years’ trends, and based on expected tenant turnover and material rent increases in new leases. Our assessments are supported by the potential for a ~25%-50% rent increase as of

September 2021, which reflects the difference between market prices and the average rent on the Company's assets.

- NOI share from rental income of about 82%-86%, in line with recent years' trends.
- General and administrative expenses of approximately €2.5 million - €3.5 million in 2021-2022, which reflect a more moderate increase in general and administrative expenses compared with the expected increase in revenues.
- New asset acquisitions and capital expenditure (capex) of €100 million - €125 million per year in 2021-2022, in accordance with the Company's business strategy.
- Positive single-digit revaluations, based on expected like-for-like rent increases.
- Receipt of a €60 million (about NIS 220 million) loan from an institutional entity in 2022, in accordance with the Company's financial strategy.
- No dividend distribution in upcoming years.

**Under our base case scenario, the expected leverage and debt coverage ratios are expected to be as follows:**

- Adjusted debt to debt and equity of about 40%-43% in 2021 and about 45%-49% in 2022.
- Adjusted EBITDA interest coverage of about 3.2x-3.4x in 2021 and about 2.5x-3.0x in 2022.

## Liquidity

According to our criteria, Argo Properties's liquidity is "adequate", as we expect the ratio between the Company's highly certain sources and uses to exceed 1.2x in the 12 months beginning October 1, 2021. Our assessment is supported by the Company's cash on hand and by financial flexibility supported by an average LTV (loan to value) ratio below 40% on its encumbered assets.

**In our base case scenario we assume the main sources at the Company's disposal in the 12 months beginning October 1, 2021, to be:**

- About €50 million in cash and cash equivalents.
- About €5 million - €8 million in cash FFO (funds from operations) (our estimate).
- Net receipts from refinancing amounting to about €14 million (signed in January 2022).

**Our assumptions regarding the Company's main uses for the same period are:**

- Ongoing maturities of long term loans of about €6 million.
- Capital expenditure of about €2 million - €3 million.
- Payment for the purchase of assets that have been completed or are in binding stages totalling about €34 million.

## Covenant Analysis

The Company has several covenants on its bank debt. We understand that, as of September 30, 2021, the Company had sufficient headroom on its financial covenants. We expect the Company to maintain sufficient headroom on all covenants.

## Modifiers

Diversification/portfolio effect: Neutral

Capital structure: Neutral

Liquidity: Neutral

Financial policy: Neutral

Management and governance: Neutral

Comparable ratings analysis: Negative

## Recovery Analysis

### Key analytical factors

- We are assigning our ‘ilA+’ rating, one notch above the issuer rating, to an unsecured loan the Company will receive from an institutional investor. The recovery rating for this loan is '2'.
- Our recovery assessment is constrained to the 70%-90% range despite the simplified waterfall, mainly because the loan is unsecured and at the current rating level, the likely default event is at a later date, and changes may occur in the scope of debt and its mix.

### Simulated default assumptions

- Year of hypothetical default: 2025
- A deep recession in the German economy will result in a considerable drop in occupancy rates, a decrease in rental income and material devaluation of the portfolio.
- The Company will continue to operate as a going concern, an assessment supported by the quality and locations of its properties which would enable it to refinance and repay part of its obligations.
- The value of the Company's residential rental portfolio will decrease by 30%, given its tenant and asset diversification, and the value of its commercial assets will decrease by 50%.

### Simplified Waterfall

- Gross enterprise value according to DAV method: about €410 million
- Administrative costs: 5%
- Enterprise value available for secured debt: about €390 million
- Senior Secured Debt: about €230 million*
- Enterprise value available for unsecured debt: about €160 million

- Unsecured debt (loan from institutional investor): about €65 million*
- Recovery expectations for unsecured debt: 70%-90% (constrained as noted above)

*All debt amounts include six months' prepetition interest. We usually assume credit facilities would be used up at default.

**Mapping Recovery Percentages To Recovery Ratings**

| Recovery expectations (%) | Description | Recovery rating | Notching above/below issuer rating |
|---|---|---|---|
| 100% | Full recovery | 1+ | +3 notches |
| 90%-100% | Very high recovery | 1 | +2 notches |
| 70%-90% | Substantial recovery | 2 | +1 notch |
| 50%-70% | Meaningful recovery | 3 | 0 notches |
| 30%-50% | Average recovery | 4 | 0 notches |
| 10%-30% | Modest recovery | 5 | -1 notch |
| 0%-10% | Negligible recovery | 6 | -2 notches |

Recovery ratings are capped in certain countries to adjust for reduced creditor recovery prospects in these jurisdictions. Recovery ratings on unsecured debt issues are generally also subject to caps (see Step 6, paragraphs 90-98 of Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016, for further detail). ICR--Issuer credit rating.

## Related Criteria And Research

- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, November 13, 2012
- Methodology: Industry Risk, November 19, 2013
- Country Risk Assessment Methodology And Assumptions, November 19, 2013
- Corporate Methodology, November 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, December 16, 2014
- Recovery Rating Criteria For Speculative-Grade Corporate Issuers, December 7, 2016
- Key Credit Factors For The Real Estate Industry, February 26, 2018
- Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Group Rating Methodology, July 1, 2019
- Environmental, Social, And Governance Principles In Credit Ratings,October 10, 2021
- S&P Global Ratings Definitions, November 10, 2021

## Ratings List

| Argo Properties NV | Rating | Date when the rating was first published | Last date when the rating was updated |
|---|---|---|---|
| **Issuer rating(s)** | | | |
| Long term | ilA/Positive | 20/01/2022 | |
| | | | |
| **Issue rating(s)** | | | |
| Senior Unsecured Debt | | | |
| Loan from an institutional body | ilA+ | 20/01/2022 | |
| | | | |
| **Issuer Credit Rating history** | | | |
| Long term | | | |
| January 20, 2022 | ilA/Positive | | |
| | | | |
| **Additional details** | | | |
| Time of the event | 20/01/2022 10:18 | | |
| Time when the event was learned of | 20/01/2022 10:18 | | |
| Rating requested by | Issuer | | |

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