Creditreform Rating AG Rating Sub-Methodology

Real Estate Companies

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Creditreform Rating

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1 Introduction

To enhance the understanding of rating opinions by Creditreform Rating AG (CRA) for companies, investors, and the public, we disclose this supplementary rating methodology for corporate entities in the real estate sector. The methodology will be updated if there are changes to the systems used to prepare ratings. Each CRA rating relies on specific fundamentals and principles, such as the rating process, basic procedures, defined rating scales, and supplements. This supplementary methodology, along with our fundamentals, principles, and Code of Conduct, can be freely accessed on our website at www.creditreform-rating.de.

2 Scope of Application

This supplementary methodology complete our main corporate rating methodology and applies specifically to economically active real estate companies as classified by the CRA. It primarily covers Real Estate Operating Companies (REOCs) that own and manage income generating properties and generate most of their regular revenues and cash flows through leasing activities. It also covers corporates that engage in property development (new constructions or renovations) for either retention (Develop-to-hold) or sale (Develop-for-sale). Additionally, it includes companies combining these business models. This methodology does not cover traditional open or closed real estate funds but includes publicly listed REITs (Real Estate Investment Trusts) which comply with specific legal and regulatory requirements.

The methodology encompasses various sectors and types of real estate, such as office, retail, residential, industrial, hospitality, logistics, and healthcare. It does not include pure infrastructure companies, construction firms, general contractors, asset managers, facility managers, or other service providers, unless these operations are minor and supplementary to their main real estate activities, based on revenue or operational income.

This supplementary methodology takes into account existing and anticipated industry-specific business and financial risks, incorporating both quantitative and qualitative rating factors. The features and factors relevant to our ratings are not to be interpreted as a rigid formula but as a flexible guideline within a defined yet partly discretionary and company-specific decision-making process, which adapts to dynamic market conditions and business strategies. The importance of a specific factor may vary among companies.

The rating scope for real estate companies on the CRA's corporate rating scale is generally capped at the 'A' class (A-/A/A+), known as a Soft-Cap. This cap reflects the sector-specific and cyclical nature of real estate companies, which are particularly susceptible to economic cycles and other external influences such as interest rate movements and supply-demand dynamics. These factors often lead to significant volatility in asset valuation, impacting the companies' financial and liquidity positions and their ability to secure financing, which we consider inherent industry risks addressed by this Soft-Cap.

AA- or higher ratings are generally only achievable for property companies with exceptional ratios and fundamental factors or under the conditions specified in our supplementary methodology 'Sovereign companies'. Additionally, other CRA supplementary methods may apply and influence the rating outcome for real estate companies.

3 Rating Methodology

3.1 Fundamentals of the Real Estate Industry

This supplementary methodology aims to account for the unique characteristics of the real estate market and its operating companies during the rating process. Typically, the real estate market consists of numerous regional submarkets. A key feature is its low supply elasticity, mainly due to generally long construction periods and limited land availability. The industry is capital-intensive, often requiring significant investments for purchasing, developing, building, or renovating properties. Real estate companies typically have high capital needs and corresponding financing requirements, with most investments funded through debt.

However, it's important to consider that these companies hold relatively valuable and marketable assets, although the value and liquidity of a property depend on its quality (location, age, type of use, tenant mix, etc.) and other external factors such as interest rates, supply and demand dynamics, timing in the property cycle, and economic conditions in the market. Knowledge of regional market structures and regulatory/legal frameworks is crucial for success, leading most companies to focus their operations on specific countries, regions, and types of properties.

We assume that a typical real estate company is organized as a holding company with a capital structure that includes a high proportion of secured (i.e., mortgaged) liabilities, which inherently have priority over unsecured liabilities. Despite these structural considerations in the real estate industry, an issuer's rating generally matches the rating of its non-subordinated unsecured (senior unsecured) liabilities and is based on the credit risk profile of the consolidated company, including its subsidiaries, and using

consolidated financial statements. For handling potential structural subordination of liabilities at the holding level, refer to our "Non-Financial Corporate Issue Ratings" methodology.

3.2 Rating Process

Based on the application of the CRAG Rating Methodology for Corporate Ratings (main methodology), the following supplementary or alternative quantitative and qualitative factors specific to the real estate industry are incorporated into the rating. These factors can adjust the outcome during various steps of the corporate rating analysis. They are listed and described below. For details on the main methodology, please refer to our CRA website (www.creditreform-rating.de).

3.3 Business Risk Assessment

3.3.1 Business Model / Strategy

Real estate business models vary but generally involve property leasing/management and/or development, possibly including marketing. Depending on the model and property usage, companies exhibit different cash flow volatilities and dependencies on economic cycles. Leasing typically generates stable, predictable rental income, positively influencing the rating. In contrast, property development carries higher project and financing risks with potentially volatile cash flows, generally dampening the rating. Additionally, property developments, which often span several years, can be completed at an unfavorable time, negatively affecting their marketability, lease potential, or pricing. We categorize real estate companies by their business model/strategy and particularly by the proportion of property development in their total portfolio, with increased development exposure translating to higher risks that can negatively affect the rating.

The percentage of development in the portfolio affects our assessment of business risk and thus the rating, with shares of 15% or more often suggesting a rating below BBB- (non-investment-grade).

Factors such as the company's risk appetite, the robustness of the project pipeline, and the company's track record in meeting timelines and budgets are also crucial. Additionally, the experience of management and expertise in relevant markets are significant success factors. It's also important to distinguish between speculative project developments and commissioned projects (for clients/investors). The latter, while sharing the same implementation risks, face lower or no marketing, leasing, or sales risks, enhancing the predictability and stability of cash flows, although this also depends on the client's creditworthiness.

Depending on these factors, the risk assessment related to the development share can be adjusted. For instance, a real estate company with a high development share can offset associated risks through a well-filled and balanced project pipeline and high pre-leasing or pre-sales rates, which significantly contribute to cash flow stabilization. A strong track record in project implementation, extensive management experience, and a balanced financing of the project portfolio can also positively influence the rating within certain limits.

3.3.2 Relevant Market and Diversification

The risk profile of a real estate company is influenced by its activity in specific subsectors, regions, and countries. Besides country risk, which can be assessed using a CRA Sovereign Rating or CRAS Score, other factors to consider for market assessment include supply and demand dynamics, price levels and stability, market transparency and liquidity, and regulatory conditions. Regulatory factors may include rent control, land-use planning, building permits, or other restrictions related to development activities. Additionally, market entry barriers and potential substitution risks are important. Entry barriers often arise from high investment and capital requirements, access (or lack thereof) to capital markets, and diverse regulatory conditions requiring specific technical and legal expertise. Substitution risks, particularly in commercial real estate, may increase due to trends like remote working and online retail, as well as competitor offerings.

A strong market position or significant market share in various subsectors of the real estate sector generally indicates a competitive advantage and enhances a company's resilience during economic downturns or competitive environments. Such a position improves opportunities to participate in real estate transactions, attract and retain creditworthy tenants, and strengthen negotiation power with tenants, construction companies, regulatory agencies, banks, and other external financiers. Additionally, a strong market position aids in acquiring and retaining skilled professionals.

In assessing diversification, we consider significant concentrations or dependencies related to geographical regions, industries, types of property use, or tenants. A real estate company with a portfolio heavily concentrated on a specific industry/segment or tenant is more susceptible to volatilities or downturns. Conversely, sufficient diversification increases the likelihood of stable business performance throughout economic cycles. Real estate companies with leading positions across various regional markets, a balanced portfolio of different property types, and a diversified, creditworthy tenant base typically exhibit less volatile cash flows, which positively influences our assessment.

3.3.3 Property Quality

The quality of a real estate portfolio (asset quality) significantly affects the level and stability of operational cash flows and property values. Generally, high-quality properties—new or like-new buildings in prime locations of major, globally significant cities, leased to creditworthy tenants—tend to have lower to no vacancy rates and higher average rents, resulting in more stable cash flows and higher profitability compared to lower-quality properties. The following key factors that determine property quality are considered in our assessment. When available and appropriate, external valuations are also taken into account:

1. Location quality (both micro and macro aspects)
2. Economic age or residual useful life
3. Lease duration (WALT) and tenant mix
4. Leasing rate for existing properties and/or pre-leasing or pre-selling rate for property developments

3.3.3.1 Location Quality (Macro and Micro Location)

Location quality assessment involves classifying property sites into three city rankings (A, B, and C cities). A cities include metropolitan areas and major cities of international and national significance with large, functional markets across all segments, exhibiting high market liquidity and thus, generally lower investment risks. B cities are major cities with national and regional importance, smaller market volumes and turnover, and somewhat higher investment risks. C cities are primarily of regional/local importance with relatively small markets that do not cover all segments. These cities have lower market liquidity and higher investment risks, with smaller area stocks and turnover compared to B cities. These criteria are particularly applicable to commercial properties. For residential properties, population growth is a critical factor for city ranking; continuous growth increases demand for properties and subsequently prices, and vice versa.

For smaller property portfolios or individual properties, it is also advisable to consider the micro location—local conditions such as transportation links and parking availability—, which can affect the attractiveness to potential tenants, buyers, and even lenders.

3.3.3.2 Economic Age or Residual Useful Life

The economic age of a property is determined by its construction year or the year of its last major renovation, providing insights into its current physical condition. This includes the building structure, amenities, and requirements emerging from current developments, such as energy efficiency or ESG/sustainability aspects of the property. Generally, as the economic age of the property or portfolio increases, operational and maintenance costs rise and its attractiveness to existing and potential tenants, as well as buyers, decreases. It is important to consider the economically viable lifespan of a building, which can vary significantly depending on its use.

3.3.3.3 Lease Duration (WALT) and Tenant Structure

The average lease term of a property portfolio is a key indicator of the stability and predictability of future cash flows. Longer average lease terms generally imply more predictable and stable cash flows compared to portfolios with shorter lease terms. They also reduce the risk of re-leasing and associated costs (such as costs for initiating contracts, negotiations, brokerage fees, advertising, or increased vacancy periods) as well as the risk of dealing with changing market conditions. Higher tenant turnover typically leads to higher costs. While opportunities from short-term expiring leases, such as conducting renovations or capitalizing on potential rent increases (e.g., adjusting to current higher market rents), should be considered, the uncertainties and risks generally outweigh these benefits in portfolios with short average lease durations.

For commercial properties, we assess the "weighted average lease term" (WALT), which compares the total contractually agreed rental income over the remaining lease term to the total annual rental income. This metric is less relevant for residential properties, which typically have indefinite lease terms. Instead, the average duration of tenancy can be used as a reference, although it does not directly correlate to vacancy risk.

A long average lease duration serves as a reliable indicator for evaluating a property or portfolio in terms of rental income stability and, by extension, value stability, assuming tenants fulfill their contractual obligations. Therefore, it is prudent to consider tenant structure and creditworthiness when assessing lease duration and property quality. High tenant granularity typically indicates reduced risks. Particularly in cases of tenant concentration, the creditworthiness of major tenants is examined to assess the risk of potential defaults or vacancies.

3.3.3.4 Qualitative Leasing and Sales Ratios

For existing properties, the current leasing status is a critical factor in assessing property quality. A low leasing ratio may indicate poor property quality. The significance of the leasing ratio (qualitative) increases when combined with other relevant property quality factors. Typically, the average leasing ratio based on square footage is considered. However, this is purely quantitative and somewhat limited. Since leasable spaces differ in quality and can command varying rental prices, it is more meaningful to link leasing status to rental prices or revenues. The qualitative leasing ratio compares the contractual rental revenues to the estimated/potential rental revenues at full occupancy of the property or portfolio.

In the case of development projects, we consider the pre-leasing or pre-sales ratio. For a real estate company (developer) holding properties for its own portfolio (develop-to-hold), the pre-leasing ratio is a strong indicator of property quality. A high pre-leasing ratio secures future cash flows and reduces the risks of vacancies post-completion. Market comparison of rental prices per square meter is essential. For properties being developed for sale (develop-for-sale), the pre-sales ratio is a key quality indicator. A high pre-sales ratio generates/secures cash inflows during construction, reducing external capital needs and capital engagement. It also lowers the sales risk after completion. However, in a forward-sale, rising construction costs pose a profitability risk if escalator clauses are not included in contracts.

3.3.4 Profitability and Efficiency

Assessing profitability is key to determining whether a company can sustainably generate profits and to adjust or confirm its competitive positioning. We assume that sustainably high profitability indicates competitive advantages and a solid market position.

Profitability is primarily assessed through the EBITDA adjusted margin, focusing on long-term profitability that excludes property portfolio value changes and non-operating income and expenses. In principle, rental income is considered a recurring revenue stream. A higher proportion of rental income to total revenues implies less volatility in operational cash flows and profitability. Low volatility in EBITDA adjusted margins typically indicates stable earnings and internal financing capabilities, positively affecting our rating assessment if the margins are sufficiently high.

Developers may have higher EBITDA adjusted margins than property holders, but their revenues and margins are generally more volatile and riskier. It is particularly useful to consider the volatility of profitability over several years.

Property type (sub-sector) also affects profitability. Commercial properties often have higher EBITDA adjusted margins due to economies of scale and a higher share of reimbursable costs (especially in triple-net leases, which pass nearly all property-related operating costs to tenants), compared to residential properties. Residential properties, however, exhibit higher granularity in tenant structure and less economic dependency, leading to more stable profitability.

Operational efficiency assessment, such as cost structure, business processes, and property management, is crucial, especially for smaller companies with scale disadvantages or those with significant development or renovation projects. Smaller companies can offset size disadvantages through high operational efficiency. For property developers, it is critical that projects are completed on time and within budget to fully realize the associated profit potential. A company's management expertise and experience influence its ability to adapt to changing market conditions, generate new business, maintain a competitive portfolio over the long term, and expand potential investment opportunities.

3.4 Financial Risk Assessment

A company with a low financial risk profile is typically better equipped to manage economic downturns, unfavorable industry trends, or unexpected factors. We assess the financial risk of real estate companies according to the "CRAG Rating Methodology Corporate Ratings." Additionally, selected financial metrics related to the financing structure, especially in relation to profitability and financial flexibility, are adjusted in our financial analysis to consolidate into an analytical result that forms the basis for further analysis steps. Key industry-specific financial metrics include:

Table 1: CRA Real Estate Financial Key Figures

Ratio	Dimension	Calculation
Loan-to-Value (LTV)	%	Net Debt / (Total Assets - Liquidity)
Net Debt/ EBITDA adj.	Factor	Net Debt / EBITDA adj.[1]
EBITDA adj. interest coverage	Factor	EBITDA adj. / interest expenses
Debt service capability	Factor	Operating cash flow (before changes in working capital) / (interest expenses + repayments + distributions)

[1] See 4.2Definition of Relevant Metrics

CRA calculates the Loan-to-Value (LTV) ratio, which compares net financial liabilities including hybrid capital (e.g., equity-like instruments) to the total assets adjusted for liquidity. A lower LTV ratio suggests a lower perceived risk. Another key factor in the rating is the assumption that the further company's creditworthiness and the loan conditions may vary based on this value.

It is important to note that using different accounting standards/frameworks can pose challenges in comparability with other companies. Particularly in the real estate sector, the basis of property valuation in financial statements must be considered. Companies reporting under IFRS typically use fair value for property valuation. In contrast, companies using local accounting principles might use historical cost minus depreciation. Adjustments are then made by adding back accumulated depreciation to the property portfolio, ensuring that the resulting book values do not exceed current market values, which may be verified by appraisals, or using appraisal values as a reference point.

Table 2: Example of an LTV calculation for a hypothetical real estate company

Assets (Value) in million EUR		**Net debt (Loan)**	
Investment Properties	15.000	Credit Debt	8.500
Investments (at Equity)	500	Bonds	1.500
Other Assets	1.000	Other financial liabilities	500
Assets held for sale	200	Participation certificates	750
Other	50	Liquidity	-250
Total value	**16.750**	**Net debt (Loan)**	**11.000**
Loan-to-value (LTV)	**65,67%**		

In the real estate sector, especially among property holders, a substantial portion of properties is financed with long-term debt. Given the high capital intensity of the business relative to operational revenues, the debt metric (Net Debt/EBITDA adjusted) tends to be higher than in other industries. However, the property assets, generally considered valuable and marketable, counterbalance this debt. The quality of the assets, market cycle, interest rates, and other factors like leasing rates influence their marketability and valuation.

The ratio of net debt to adjusted EBITDA is a leverage metric that indicates the years required for a company to repay its debt if net debt and EBITDA are maintained constant. In real estate firms, significant value fluctuations in the property portfolio are common; therefore, adjusting EBIT for depreciations and revaluations is crucial to arriving at more liquid, operational results usable for debt repayment. Higher values generally impact the rating negatively.

The EBITDA adjusted interest coverage ratio assesses financial solidity by examining whether a company is profitable enough to cover its interest expenses with its operating earnings before interest, taxes, depreciation, and amortization, adjusted for non-operating income and expenses.

Debt service capability evaluates whether a company can generate sufficient operational cash flows to meet its capital service, defined as interest, repayments, and distributions. This is derived from analytically structured cash flow statements over several years, taking into account specific circumstances and business models. Continuous dividend payouts, while not mandatory except for REITs that must distribute a significant part of their profits, are seen as a consistent liquidity drain and are thus considered in debt service capability assessments.

This sub-analysis aims to gauge the company's credit and capital market capacity to refinance maturing loans, though refinancing depends on various lender criteria and comes with uncertainties. This evaluation helps predict the company's ability to meet its financial obligations, using historical debt service capability calculations to provide balanced assessments and identify trends.

3.5 Supplementary Rating Factors

In addition to business and financial risk factors, other considerations and factors can influence the (Issuer) rating of a real estate company. If a supplementary factor has a significant and material impact on the assessment of a real estate company, it can either positively or negatively alter the rating. The following sections provide examples of such supplementary rating factors.

3.5.1 Liquidity and Supplementary Financial Potential

Given the high capital intensity in the real estate sector, liquidity management and access to liquidity are critical factors. Generally, the importance of maintaining liquidity increases as the rating weakens. We consider a company's liquidity situation adequate if its generated cash flow, available liquid assets, and contracted financial facilities are sufficient to meet its short-term liquidity needs (over the next 12 months). This assessment is part of our Short-term Methodology, which is referenced here.

In addition to access to capital markets and the ability to secure financing, supplementary financing potentials are crucial for real estate companies. Notably, unencumbered assets—properties not pledged as loan collateral—represent significant liquidity resources that can be leveraged through secured borrowing or selling. To evaluate supplementary financial potential, we look at the value of unencumbered real estate assets relative to the total property assets. Other assets that could be collateralized, such as cash and securities, may also be considered. The greater the proportion of

unencumbered assets, the higher the company's financial flexibility for potential repayment of unsecured debt and the better the expected recovery in the event of insolvency, positively influencing the rating assessment.

3.5.2 Financial Policy

The financial policy of a real estate company indicates its general risk appetite and typically includes a commitment to maintaining a solid credit profile. Financial policy significantly impacts liquidity, debt levels, maturity profiles, capital allocation, and potential financial risks arising from these areas. We derive implications for the rating by comparing the company's publicly communicated financial policy and its targeted credit risk profile against its track record in risk and liquidity management and compliance with related obligations. We also consider how the company or its management has acted during different phases of the real estate cycle or responded to changing competitive, financial, and regulatory conditions. This includes assessing whether the company maintains its covenants or secures necessary follow-up financing, rollovers, or refinancing well ahead of maturity versus just before due dates, with a focus on long-term maturity profiles.

Additionally, we evaluate how well the company balances the interests of shareholders and creditors. Prioritizing shareholder returns, such as dividends or share buybacks, at the expense of creditors typically negatively affects our assessment of its financial policy and thus the rating. High distributions that significantly consume operational cash flow and liquidity can reduce a company's financial flexibility, potentially limiting investments in modernization, acquisitions, or development. Furthermore, distributed funds are not available to reduce debt, increasing the need for refinancing and dependence on external financing.

3.5.3 Capital Structure

Assessing the capital structure of real estate companies, it is important to consider not only the equity-to-debt ratio but also the mix of secured and unsecured debt. Real estate companies often have a high proportion of secured financing, which takes precedence over unsecured debt. This subordination can negatively impact the Issue Rating due to structural subordination. Furthermore, a high proportion of encumbered assets reduces financial flexibility, as these assets are typically harder to finance or sell compared to unencumbered assets.

Additionally, we take into account the maturity profile, interest rate risks, and potential currency risks of the financial debt. A balanced and long-term maturity profile is advantageous, given the cyclical nature of the real estate market and the sometimes volatile access to capital markets. The mix of fixed and

variable interest debt is also crucial, along with strategies to hedge against interest rate changes. Particularly since most revenue for these companies comes from long-term lease agreements, which may not adjust well to rising costs if not indexed, variable-rate financing poses a higher risk during periods of rising inflation and interest rates. The interplay of several factors, such as expiring financing at a time of rising interest rates or ending leases with major tenants, poses significant risk potential for real estate companies.

3.5.4 Governance and Corporate Structure

Governance and corporate structure are generally considered in our main "CRAG Rating Methodology Corporate Ratings." Given that real estate companies can have complex structures, there is increased focus on these areas. We assume that companies maintain adequate and functional governance and corporate structures, and we only identify a rating impact in cases of significant negative deviations. This includes complex corporate structures with insufficient governance frameworks, lack of transparency, and conflicts of interest within the company or group. These issues may arise from dominant ownership structures or financial and operational entanglements with direct and indirect shareholders and affiliates. Conversely, financially robust owners can act as a source of funding, especially during challenging market cycles or when external financing options are limited.

3.6 Additional Notes

CRA may deviate from the above criteria and calculations, or use other/additional criteria for the assessment of a Real Estate Company, if it is convinced that this will ensure a more plausible rating assessment. The CRA will justify this and disclose it in the published documents.

4 Appendix

4.1 Sector specific Risk Factors

The factors listed below are associated with specific rating classes based on their quantitative or qualitative characteristics. These indicative values interact in combination. Consequently, the presence of a specific factor does not automatically result in a rating within the assigned class.

Table 3: Financial Risk Factors by Rating Categories

Rating Class	Loan-to-Value (LTV)	Net Debt / EBITDA Adj.	EBITDA Adj. Interest Coverage
A	<35%	<3.0	>4.5
BBB	35% - 50%	3.0 – 5.5	4.5 – 3.0
BB	>50% – 60%	>5.5 – 8.0	<3.0 – 2.0
B	>60% - 85%	>8.0 – 13.0	<2.0 – 1.3
CCC	>85%	>13.0	<1.3

Table 4: Property Quality Factors by Rating Categories:

Rating Class	Location and Site Quality	Occupancy Rate	WALT
A	Exclusively prime locations	>97%	>10 years
BBB	Mainly prime and good locations	97% - 90%	10 – 7 years
BB	Good locations	<90% - 80%	<7 – 5 years
B	Mainly good and average locations	<80% - 65%	<5 – 3 years
CCC	Predominantly average locations	<65%	<3 years

Table 5: Location Classification and Criteria:

Prime Locations (A-Sites):	Good Locations (B-Sites):	Average Locations (C-Sites):
Metropolitan regions and major cities with international and national significance, featuring large, functional markets across all segments, exhibiting very high market liquidity Population growth over the last 5 years (for residential properties): noticeably positive.	Large cities with national and regional importance. Population growth over the last 5 years (for residential properties): stable (slightly positive or slightly negative).	Cities of primarily regional/local importance, with relatively small markets not covering all segments. Population growth over the last 5 years (for residential properties): noticeably negative.

Table 6: Factors Influencing Development Quality

Rating Class	Development Share of Total Portfolio	Budget and Schedule Adherence	Pre-sales / Pre-leasing Rate
A	0% - <5%	Full budget adherence and no schedule overruns	>95%
BBB	5% - 15%	Full budget adherence with minor schedule overruns	95% - 85%
BB	>15% - 30%	Minor budget and schedule overruns	<85% - 70%
B	>30% - 50%	Notable budget and schedule overruns	<70% - 55%
CCC	>50%	Regular significant budget and schedule overruns	<55%

4.2 Definition of Relevant Metrics

The following factors are associated with specific rating classes based on their quantitative or qualitative characteristics. These are indicative values that interact in combination. Therefore, a single factor's characteristic does not automatically determine the associated rating class.

Table 7: Relevant Metrics

Metric	Calculation/Definition
Adjusted EBITDA	Operating profit + Depreciation including goodwill amortization - Revaluations + Non-operating expenses - Non-operating revenues
WALT (Weighted Average Lease Term)	Contractually secured rental income over remaining lease term / Current annual rental income
Unencumbered Assets	Unencumbered real estate assets / Total real estate assets
Qualitative Leasing Rate	Contractually secured rental income / (Contractually secured rental income + Potential rental income from vacant spaces)