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Research Update:

Luxembourg-Registered Commercial Property Group CPI Assigned 'BBB' Preliminary Rating; Outlook Stable

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Overview

- CPI Property Group SA owns and manages a property portfolio valued at about €6.7 billion, consisting mainly of office and retail properties in the Czech Republic and Germany.
- We expect demand for CPI's properties to remain relatively high, supported by the good quality of the group's assets.
- We are assigning our 'BBB' preliminary ratings to CPI and its senior unsecured debt, and our 'BB+' preliminary rating to CPI's proposed hybrid bond.
- The stable outlook reflects our view that underlying macroeconomic fundamentals and positive demand trends in CPI's main locations should enable the group to generate resilient cash flows over the next 24 months and that the group will demonstrate financial discipline, such that its debt to debt plus equity remains less than 50%.

Rating Action

On April 20, 2018, S&P Global Ratings assigned its 'BBB' preliminary long-term issuer credit rating to CPI Property Group SA. The outlook is stable.

In addition, we assigned our preliminary 'BB+' issue rating to the proposed benchmark size perpetual hybrid bond to be issued by CPI. We also assigned our preliminary 'BBB' issue rating to CPI's senior unsecured debt.

Final ratings will depend on our receipt and satisfactory review of all final transaction documentation of the proposed hybrid bond issuance. Accordingly, the preliminary ratings should not be construed as evidence of final ratings. If S&P Global Ratings does not receive final documentation within a reasonable timeframe, or if final documentation departs from materials reviewed, we reserve the right to withdraw or revise our rating. Potential changes include, but are not limited to, utilization of bond proceeds, maturity, size and conditions of the bonds, financial and other covenants, and security and ranking of the bonds.

Rationale

Our preliminary rating on CPI reflects our view of the group's relatively large scale and portfolio size compared with rated peers in the commercial real estate segment, and its fair geographic diversification. This makes its revenue stability less vulnerable to asset or tenant rotation. The group owns and manages standing assets with a total value of €6.7 billion in 11 countries. CPI is focused on offices (41% of portfolio value) and retail (31%) real estate assets; the remainder are hotel assets (10%) and residential real estate (10%). Its primary focus is the Czech Republic (54% of portfolio value) and Germany (24%, mostly in Berlin). It also operates in Hungary, Poland, Slovakia, Croatia, France, Italy, and Switzerland.

The group's business risk profile is underpinned by its position as the largest retail property owner in the Czech Republic and the largest office property owner in Prague. It manages a portfolio of high quality office and retail assets. CPI enjoys a good degree of geographic and segment diversity, which we believe compares favorably with that of most peers we rate in the same business risk category. Most of the group's tenants are creditworthy multinational companies or regional leaders with triple-net-lease contracts fixed in euros.

CPI reported an occupancy ratio of 93% as of Dec. 31, 2017, which is close to that of most rated peers in the European office and retail market. In the Czech market, we understand that CPI's occupancy is 94%, outperforming the market average of 92%, and it is particularly strong in the Prague office market, at 97.5% occupancy. The relatively low occupancy rate of 89% in the Berlin office market weighs on the group's average, but we take into account recent efforts to improve and, in line with the group's strategy, we expect this ratio will rise further over the next two years.

We estimate that the macroeconomic fundamentals in the majority of CPI's locations are favorable, with positive demand trends for the commercial real estate sector, relatively low unemployment rates, and sound GDP growth. We also understand that obtaining approval for building construction in the Czech Republic is relatively difficult compared both with developing and developed countries. Therefore we believe that risks of substantial new supply coming onto the Czech market are limited.

The top-10 assets represent 18% of total market value, with the largest asset accounting for 3%. The group's average lease term of 3.85 years is slightly below other rated commercial real estate players (five years or longer). Overall, we see limited risk of tenant concentration, as the group's top-10 tenants account just for 19% of its total rents. However, we note higher tenant concentration in some of CPI's individual segments, such as the Czech office segment, where the top-ten tenants account for 53% of total rents.

CPI has material exposure to the office, retail, and hotel property segments, which we view as more volatile and cyclical than residential for example, because they are closely linked to corporate business conditions and consumer confidence.

We note that there is limited development risk in the portfolio, because the share of assets under development will remain less than 10% of the current portfolio value. CPI's retail tenants have a relatively modest occupancy cost (or rent-to-sales ratio) of less than 15%, which somewhat mitigates the risk of increasing rent burden from currency movements (rents are contracted in euros, while some of tenants' revenues are in local currencies, such as Czech koruna).

Our assessment of CPI's financial risk profile is underpinned by its moderate debt leverage, with an adjusted ratio of debt to debt plus equity of 48% and an adjusted EBITDA-to-interest ratio of 2.4x at the end of 2017. We expect these ratios will gradually improve and will be in the range of 44%-47% and 3.0x-3.5x, respectively, in 2018-2019. The group's prudent financial policy is centered on a loan-to-value (LTV) ratio of less than 45%, which corresponds with an S&P Global Ratings-adjusted debt-to-debt-plus-equity ratio below 50%. The average debt maturity is 5.6 years. CPI is 91% owned by Radovan Vitek and is listed on the Frankfurt stock exchange.

In our base case, we assume:

- An improving occupancy rate, to 94%-95% in 2018-2019, reflecting the strong demand anticipated for CPI's assets.
- Like-for-like rental income growth of 2.0%-3.0% through 2018-2019, supported by positive inflation trends in the Czech Republic and Germany, occupancy increase, and potential rent increases following refurbishments.
- Gradually improving profitability on the back of an improving cost structure.
- A low-single-digit increase in portfolio value, assuming a moderate uplift in property values in most of CPI's locations.
- Asset acquisitions will be of similar quality to the current portfolio and good operating metrics.

Based on these assumptions, we arrive at the following credit measures for CPI in 2018-2019:

- Debt to debt plus equity of 44%-46%.
- An EBITDA interest coverage ratio of 3.0x-3.5x.

We expect that CPI's secured debt will remain lower than 40% of total assets. As a result, although unsecured debt issuance is structurally subordinated to other debt obligations, the subordination doesn't affect the rating on the unsecured debt.

We classify the proposed perpetual hybrid bond as having intermediate equity content until its first call date. This is because it meets our criteria in terms of subordination, permanence, and optional deferability during this period. Consequently, in our calculation of CPI's credit ratios, we will treat 50% of the principal outstanding and accrued interest under the hybrids as equity rather than debt. We will also treat 50% of the related payments on these notes as equivalent to a common dividend. Both treatments are in line with our hybrid capital criteria.

We arrive at our 'BB+' issue rating on the notes by deducting two notches from our 'BBB' long-term rating on CPI, specifically:

- One notch for the subordination of the notes, because the rating on CPI is investment grade (that is, 'BBB-' or above); and
- An additional notch for payment flexibility to reflect that the deferral of interest is optional. We deduct only one notch because we consider that there is a relatively low likelihood that CPI will defer interest payments. Should our view on this likelihood change, we may significantly increase the number of notches we deduct to derive the issue rating.

Liquidity

We anticipate that liquidity sources will likely cover liquidity uses in 2018 by 1.76x. We assess debt covenant headroom as adequate. CPI has sound relationships with a diverse group of banks, and a generally satisfactory standing in capital markets. At the same time, we believe that the group's financial flexibility and access to capital markets are somewhat weaker compared with larger peers in Western Europe, and it would be challenging for CPI to absorb high-impact, low-probability shocks. Consequently, we continue to view CPI's liquidity as adequate, rather than strong.

Principal liquidity sources on Dec. 31, 2017:

- Unrestricted cash balances of about €239 million;
- Undrawn revolving facilities of €150 million;
- Funds from operations of about €120 million for the next 12 months; and
- Expected proceeds from the hybrid bond issuance.

Principal liquidity uses as of the same date:

- About €372 million of short-term debt;
- Capital expenditure needs of approximately €170 million in the next 12 months for the development pipeline; and
- About €30 million of working capital outflow in the next 12 months.

Outlook

The stable outlook on CPI reflects our view that the group should continue to benefit from healthy economic trends in the Czech Republic and Germany, thanks to its quality assets. We also believe its debt to debt and equity will be less than 50% and EBITDA interest coverage higher than 2.4x over the next two years, supported by the group's resilient cash flows and conservative financial policy. We expect CPI will maintain a large liquidity buffer.

Downside scenario

We could consider taking a negative rating action if, in particular, CPI's debt to debt plus equity increased above 50% as a result of unexpected asset devaluations or if its EBITDA interest coverage fell below 2.4x. Downward rating pressure might also materialize if we see negative dynamics in its operating performance.

Upside scenario

An upgrade would hinge on CPI materially improving its portfolio in terms of size and diversification, while generating like-for-like rental income growth and showing a positive portfolio revaluation. Rating upside might also come from a revision of the group's financial policy to a more conservative one with a debt-to-debt-plus-equity ratio lower than 35%.

Ratings Score Snapshot

Issuer Credit Rating: BBB(prelim)/Stable/--

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb

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

Stand-alone credit profile: bbb

Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

New Rating	
CPI Property Group SA	
Issuer Credit Rating	BBB(prelim)/Stable/--
Senior Unsecured	BBB(prelim)
Subordinated	BB+(prelim)

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.