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## Research Update:

# French Real Estate Company Societe Fonciere Lyonnaise Upgraded To 'BBB+' Following Leverage Reduction; Outlook Stable

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## Research Update:

# French Real Estate Company Societe Fonciere Lyonnaise Upgraded To 'BBB+' Following Leverage Reduction; Outlook Stable

## Overview

- French real estate company Société Foncière Lyonnaise S.A. (SFL) has announced the sale of its mature IN/OUT building and proceeds will be used to repay a €300 million bond maturing in November 2017 as well as to fund the acquisition of the Emile Zola building. In addition, SFL should also benefit from positive asset revaluation by the end of the year, mostly driven by strong market momentum in Paris.
- As a result, SFL's leverage has reduced further and we expect the company to maintain its adjusted debt-to-debt-plus-equity ratio firmly below 40% in the next two years.
- We are therefore raising our long-term corporate credit ratings on SFL to 'BBB+' from 'BBB'.
- The stable outlook reflects our view that the positive momentum in the Paris office market should support the continuation of SFL's strong operating performance over the next 24 months. It captures our expectation that the company will have some headroom at current rating level with debt-to-debt-plus-equity sustainably below 40% and EBITDA interest coverage around 3.5x or above over the coming two years.

## Rating Action

On Oct. 27, 2017, S&P Global Ratings raised its long-term corporate credit rating on French property investment company Société Foncière Lyonnaise S.A. (SFL) to 'BBB+' from 'BBB' and affirmed the 'A-2' short-term rating. The outlook is stable.

At the same time, we raised the issue rating on SFL's senior unsecured debt to 'BBB+' from 'BBB'.

## Rationale

The upgrade reflects a further improvement in SFL's credit metrics and our anticipation that they will remain strong in the next two-to-three years. This follows SFL's recent announcement that it is selling the IN/OUT building (35,000 square meters located west of Paris, in Boulogne Billancourt). SFL sold this asset, which we consider to be mature, to Primonial for a net sale price of €445 million, with a disposal yield of 3.7% including transfer costs. The resulting proceeds will be used to repay a €300 million bond maturing in

November 2017 as well as to fund the €145 million acquisition of the Emile Zola building (21,000 square meters located in central Paris, 15th arrondissement). We also anticipate further valuation uplift in SFL's portfolio by the end of 2017 (8.0%-10.0% expected by year-end, with 7.1% already reached as of June 2017) due to the positive momentum in the Paris office market and SFL's concentration on the high-occupancy central business districts. The average market vacancy rate for the Paris region has been stable at 6.5% in 2016, with a significant difference between the Paris central business district, where it was 3.1%, and less resilient areas such as the Western Crescent at 11.6% or La Défense at 8.6%.

Immediately after the disposal by year-end 2017, our adjusted debt-to-debt-plus-equity could reduce to around 30%, while EBITDA interest coverage should be around 4.3x. Our assessment incorporates potential moderate leveraging over 2018-2019 as a result of future acquisitions and development projects, in line with SFL's strategy of investing in prime office assets in Paris. We consider that, at current levels, SFL has some material headroom and should be able to maintain debt-to-debt-plus-equity firmly below 40% and EBITDA interest coverage above 3.5x in the coming two years. We also understand from the company that it will consider asset rotation transactions to maintain credit metrics at these levels. We view positively SFL's established track record of disciplined leverage, with our adjusted debt-to-debt-plus-equity maintained below 40% since 2014, while EBITDA interest coverage has steadily improved since then as result of the low interest rate environment. We now view SFL's financial risk profile at the higher end of our intermediate category.

Our assessment of SFL's business risk profile remains unchanged, and encompasses SFL's relatively large portfolio of prime office assets in Paris market, reaching €6.2 billion as of June 2017. We also view positively SFL's strong focus on Paris' central business district, where about 79% of its portfolio is concentrated and which has proven to be more resilient to the economic downturn than secondary locations in Paris' peripheries.

The occupancy rate remained strong at 96.4% as of September 2017, which compares well with other rated peers in the Paris office sector, such as Gecina. Gross rental income amounted to €147.8 million for the nine months to Sept. 30, 2017, increasing by 3.3% on like-for-like basis since last year for the same period. As a result, we continue to assess SFL's business risk profile as strong.

That said, we still consider SFL's asset concentration as higher than peers'. This is because it only has 20 assets, and as a result, its earnings have tended to be more volatile than rated peers' in the strong category. This is partly mitigated by the majority of its assets having multiple tenants.

We no longer apply a one-notch downward adjustment to our initial analytical outcome on SFL. We consider that its moderate leverage when compared with most peers in the intermediate financial risk profile category (which could be more in the 40%-45% debt-to-debt-plus-equity range) offsets the slightly higher

volatility of its earnings.

Our base-case assumptions are as follows:

- The occupancy rate declining slightly on the assumption that recently refurbished buildings could remain vacant for some time.
- Rent rates increasing by about 1.0% per year on a like-for-like basis due to inflation-related indexation adjustments in the next two years, in line with our forecasts for the French consumer price index.
- Like-for-like positive asset revaluation of 8.0% in 2017 and of 2.0% in 2018, reflecting our expectation of further yield compression in the Paris central business district this year, and some stabilization thereafter.
- The €165 million acquisition of the Emile Zola building mainly paid out in 2017, as well some additional acquisitions--€150 million-€200 million every year from 2018--considering that SFL will seek new growth opportunities in the Paris office market.
- The €445 million disposal of the IN/OUT building in 2017.
- Development capital expenditure (capex) of about €140 million in total for the 2017-2018 period for renovation and ongoing refurbishment projects, in line with the management's business plan.
- The repayment of a €300 million bond in late 2017 largely from disposal proceeds.
- Over 80% of the outstanding debt balance bearing a fixed rate or being hedged.
- Based on these assumptions, we arrive at the following credit measures:
- EBITDA interest coverage of 3.6x-4.3x in 2017-2019.
- Our adjusted ratio of debt-to debt-plus-equity of about 30% in 2017, and 31%-33% in 2018-2019.

## **Liquidity**

We have revised our assessment of SFL's liquidity to strong from adequate. This is based on our expectation that its liquidity sources will exceed uses by more than 1.5x over the next two years. The company's liquidity benefits from relatively low amounts of debt maturing in the next two years and from large undrawn committed credit lines worth €785 million maturing beyond 12 months.

We estimate that liquidity sources over the 12 months started Sept. 30, 2017, will mostly consist of:

- Our forecast of around €110 million-€120 million of funds from operations.
- €785 million available under the revolving credit facility.
- €306.9 million of cash.

This compares with our estimate of liquidity uses for the same period of:

- €300 million of short-term debt maturities.
- About €100 million in maintenance and renovation capex in the next 12 months.
- About €100 million of forecast dividends in the next 12 months, in line with previous years' levels.
- €145 million of acquisition of the Emile Zola building, which should

materialize in fourth quarter 2017.

We consider SFL to have well-established and solid relationships with banks and generally prudent financial risk management. Our assessment also includes our expectation that it will maintain strong headroom (above 15% in line with our real estate criteria) under all maintenance covenants, and that it should have some ability to absorb high-impact, low-probability events without refinancing.

## **Group Support**

The Spanish real estate company Inmobiliaria Colonial S.A. (Colonial; BBB/Stable/A-2) has a 59% controlling ownership in SFL and accounts for the majority of SFL board members (eight out of 15). As a result, we apply our group rating methodology to SFL and view it as a core entity of Colonial.

We understand that Colonial views SFL as a long-term investment and intends to remain a controlling shareholder for the foreseeable future. We consider, however, that SFL is somewhat insulated from Colonial's group credit profile thanks to its strong minority shareholders and the benefits from some protective mechanisms as it is listed under French law. The relationship between the two entities has a well-established track record; we note that in recent difficult economic times in Spain in 2009-2013, Colonial has not extracted any financial resources from its subsidiary. In light of this degree of insulation from the parent, we rate SFL one notch above Colonial.

Colonial's office real estate portfolio amounts to about €8.3 billion, of which about 75% relates to SFL's assets. Our rating on Colonial is therefore based on a consolidated view of SFL's assets. Our view on Colonial is affected by the group structure, where most assets and cash flows are located at the level of SFL, whose assets and cash flow may be constrained by its minority shareholders. Therefore, our 'BBB' rating on Colonial is unaffected by today's rating action on SFL.

## **Outlook**

The stable outlook reflects our view that SFL's rental income from its prime office buildings in Paris should benefit from steady demand and support stable cash flow generation over the next 24 months. Our stable outlook further assumes that SFL's occupancy rate will stay close to 95% over the next two years.

Our base case assumes that the positive momentum in the Paris office market, as well as the significant headroom at current leverage level, should allow the company to maintain credit measures in line with the new rating, such as debt-to-debt-plus-equity sustainably below 40% and EBITDA interest coverage around 3.5x or above.

The stable outlook is also based on our expectation that SFL will remain core and insulated to Colonial, and that the latter's credit quality will remain stable.

### **Downside scenario**

We could consider a negative rating action if SFL were unable to maintain debt-to-debt-plus-equity firmly below 40%. This could happen as a result of large debt-funded acquisitions, higher-than-anticipated development projects, or materially higher shareholder remuneration than currently expected.

We could also lower the rating if EBITDA interest coverage fell below 3.5x. This could result from a decrease of occupancy as a result of the departure of one or a few material tenants, possibly combined with significant negative rent revisions, which we currently view as unlikely.

Another downside scenario could come from the deterioration of the business risk profile that could be caused by unexpected material reduction of portfolio size, number of assets, or tenants.

### **Upside scenario**

An upgrade could come from a significant improvement in SFL's business risk profile, which we view as unlikely under our base-case scenario. This would require a significant increase in the company's portfolio size, number of assets and tenants, or geographical diversity.

## **Ratings Score Snapshot**

Corporate Credit Rating: BBB+/Stable/A-2

Business risk: Strong

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

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)

- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+

- Group credit profile: bbb
- Entity status within group: Core and Insulated (+1 notch)

## Related Criteria

- 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: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, 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

## Related Research

- Real Estate Trends In Europe: 2017 Update - French Office Market, Oct. 2, 2017
- Spanish Property Investment Company Inmobiliaria Colonial Upgraded To 'BBB/A-2' On Strong Performance; Outlook Stable, April 19, 2017
- French Property Investment Co Societe Fonciere Lyonnaise Outlook Revised To Positive On Continuing Strong Credit Metrics, April 19, 2017

## Ratings List

Upgraded; Outlook Action; Short-Term Rating Affirmed

	To	From
Societe Fonciere Lyonnaise S.A.		
Corporate Credit Rating	BBB+/Stable/A-2	BBB/Positive/A-2
Senior Unsecured	BBB+	BBB

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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

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to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://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](http://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.

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