FitchRatings

Banks
Wholesale Commercial Banks
Germany

Aareal Bank AG

Key Rating Drivers

Pandemic Drives Negative Outlook: Fitch affirmed Aareal Bank AG's Long-Term Issuer Default Rating (IDR) at 'BBB+' and Viability Rating (VR) at 'bbb+', and removed them from Rating Watch Negative, in November 2020. This reflects our view that the economic fallout from the Covid-19 crisis represents a medium rather than a short-term risk to Aareal's ratings.

The Negative Outlook on the Long-Term IDR reflects risks to our expectation of Aareal's relative resilience. In particular, a materially slower or weaker economic recovery than expected could weigh more on the bank's profits and asset quality than our base case suggests.

CRE-Focused Business Model: Aareal's VR reflects its established business model focusing on the cyclical commercial real estate (CRE) sector as well as its exposure to associated risks. The bank's hotel and retail CRE portfolios are the most exposed to the pandemic. However, Aareal's resilient recent performance, geographical diversification, diversified funding mix and sound capitalisation continue to support the VR.

Pandemic Weighs on Asset Quality: Aareal's asset quality has been relatively resilient since the start of the pandemic, with only few defaults and a non-performing loan (NPL) ratio falling to 3.9% at end-3Q20 owing to a de-risking initiated in mid-2019. However, the bank's exposure to hotels (33% of its CRE portfolio at end-3Q20) and retail properties (23%), partly in more volatile regions, is still high. We expect NPL inflows to rise in 2021 when state support measures recede and the effect of the crisis on asset quality materialise.

Earnings Pressure: Aareal's operating profit/risk-weighted assets (RWAs) fell significantly in 9M20 yoy, as loan impairment charges (LICs) more than doubled to EUR167 million, EUR111 million of which related to management overlays reflecting pandemic-induced risks rather than actual defaults. We expect the bank's robust pre-impairment profits to remain a sufficient first line of defence through the crisis. Profitability should recover in 2021 as business volumes increase, although this depends on the length and severity of further lockdown restrictions.

Rating Strength Capitalisation: Aareal maintained a sound common equity Tier 1 (CET1) ratio of 20.4% at end-3Q20. The sale of a 30% stake in its IT subsidiary Aareon in November 2020 adds about EUR180 million to the bank's equity and about 150bp to its CET1 ratio pro-forma. The very large buffer of senior non-preferred (SNP) and more junior debt (43% of RWAs at end-2Q20) much exceeds the bank's minimum requirement for own funds and liabilities (MREL) requirements and limits its reliance on market funding

Diversified Funding Mix: Stable, price-inelastic institutional deposits from the German housing sector cut Aareal's reliance on unsecured market funding and enhances cross-selling. The bank's mortgage covered bonds ensure cheap and resilient access to secured market funding. Housing deposits and covered bonds account for almost 60% of the bank's funding mix. A large pool of ECB-eligible assets ensures adequate liquidity to deal with reasonable market stress scenarios.

Rating Sensitivities

Outlook Revision Hinges on Recovery: We could revise the Outlook on the Long-Term IDR to Stable if the operating environment stabilises and Aareal successfully addresses the challenges from the pandemic, limiting asset quality and profitability risks and stabilising its capital ratios.

Weaker Financial Profile: Prolonged stress in the CRE market driven by the pandemic could trigger a downgrade of the VR and, consequently, of the Long-Term IDR and long-term debt ratings. This would be the case if it makes the NPL ratio rise more rapidly or severely than we currently expect, potentially exceeding 6% without a clear recovery path, or if it weighs on earnings to the extent that it ultimately reduces Aareal's substantial capital buffers.

Ratings

Foreign Currency	
Long-Term IDR	BBB+
Short-Term IDR	F2
Derivative Counterparty Rating	A-(dcr)
Viability Rating	bbb+
Support Rating	5
Support Rating Floor	NF
Sovereign Risk	
Long-Term Foreign-Currency IDR	AAA
Long-Term Local-Currency IDR	AAA
Country Ceiling	AAA

Outlooks

Long-Term Foreign-Currency IDR	Negative
Sovereign Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Local-Currency IDR	Stable

Applicable Criteria

Bank Rating Criteria (February 2020)

Related Research

Fitch Ratings 2021 Outlook: Western European Banks (December 2020)

Fitch Affirms Aareal Bank at 'BBB+'; Negative Outlook (November 2020)

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Debt Rating Classes

Rating level	Rating
Deposit rating	A-/F2
Senior preferred (SP) debt	A-/F2
SNP debt	BBB+
Tier 2 subordinated debt	BBB-
Additional Tier 1 notes	BB

Source: Fitch Ratings

Aareal's Derivative Counterparty Rating (DCR) and its long-term deposit and SP debt ratings are one notch above its Long-Term IDR. This reflects the large and sustainable layer of SNP debt that provides preferred creditors and counterparties with additional protection in a resolution.

The short-term SP debt and deposit ratings are the baseline options mapping to the long-term preferred rating of 'A-'. This is because the bank's Funding & Liquidity score of 'bbb+' does not warrant higher short-term ratings.

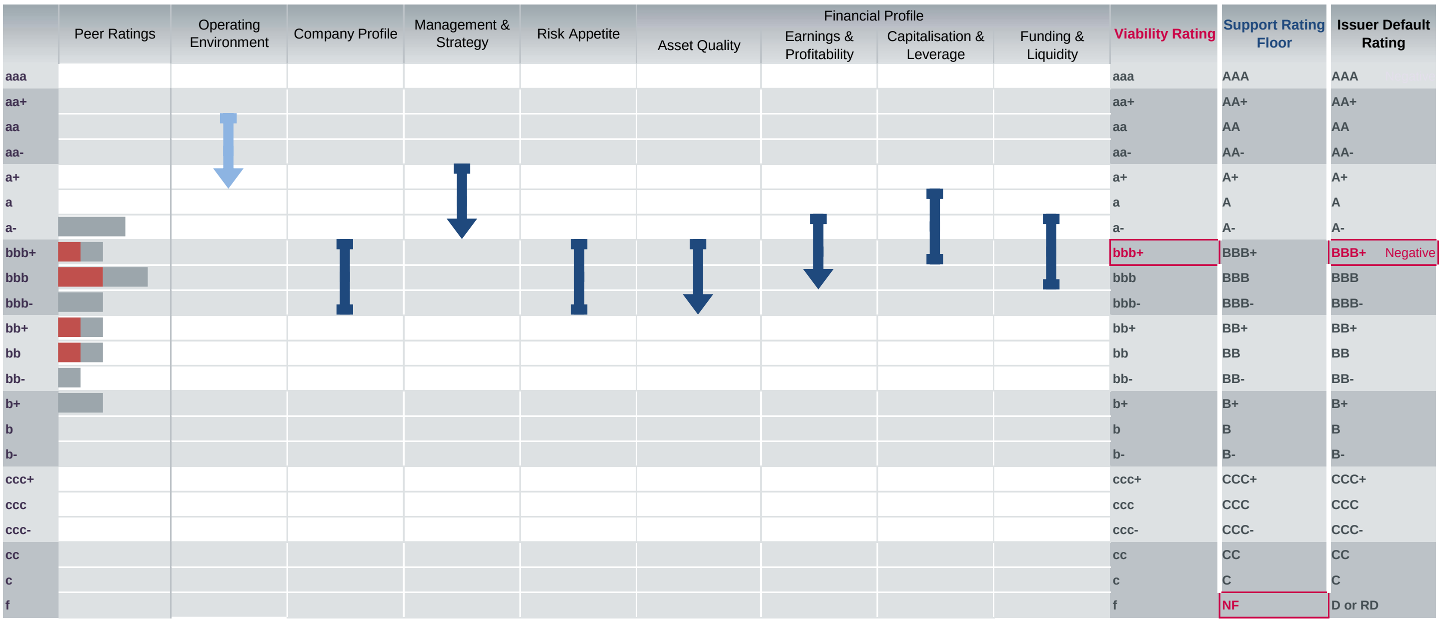
The Tier 2 subordinated notes are rated two notches below the VR to reflect the notes' higher loss severity relative to senior creditors upon a default or bail-in. The Capital Requirements Regulation (CRR)-compliant AT1 notes are rated four notches below the VR to reflects Aareal's large capital buffers above the notes mandatory coupon omission triggers, which we expect to be maintained.

Ratings Navigator

Aareal Bank AG

ESG Relevance:

Banks
Ratings Navigator



Significant Changes

Pandemic Could Weaken Aareal's Credit Profile

Germany has launched large fiscal measures including aid programmes to support companies and households affected by the crisis. These programmes and regulatory forbearance for the classification of pandemic-driven NPLs, strongly mitigated rating migration, RWAs inflation and provisioning needs in 9M20. However, German banks' asset quality is likely to deteriorate in line with corporates and SMEs' credit profiles in 2021 as some vulnerable borrowers will not fully recover, and many others will emerge permanently weaker from the crisis.

We changed the outlook on our 'aa-' score for German banks' operating environment to Negative in March 2020 to reflect the sector's structural weaknesses, notably a lack of diversified business models and consolidation, which had led to underperformance before the pandemic despite years of strong economic development in Germany. We could lower the score further if there are signs that the German economy suffers in the longer term from the pandemic, or if the domestic banking sector is unable to restore acceptable profits above pre-pandemic levels.

Aareal's geographical diversification makes it much less reliant on Germany than its domestic peers. However, the pandemic has weighed on the global economic outlook with Fitch forecasting material GDP contractions in the bank's main markets in 2020.

Additional LICs in 4Q20 to Drive Manageable Loss in 2020

In January 2021, Aareal announced, amid rising LICs, a double-digit million-euro loss for 2020 compared to a previous operating profit guidance in the mid-double-digit euro million range. This reflects the recent intensification of the pandemic, as tighter lockdowns have affected most of its core markets and make any recovery for hotel and retail properties more uncertain. Aareal prudently classified as Stage 2 all loans that received liquidity support, recognising impairments for potential but not yet incurred defaults. It also increased its allowances for Stage 3 loans; thus, Fitch expects an inflow of NPLs in 4Q20.

In addition, the bank announced plans to pay a dividend for 2020 (subject to supervisory and regulatory requirements), which is likely to be split in two over 2021. The bank already had deducted the planned EUR90 million payout from its 2020 result. These plans are neutral to our assessment of the bank's strong capital position.

Bar Chart Legend

Vertical bars – VR range of Rating Factor

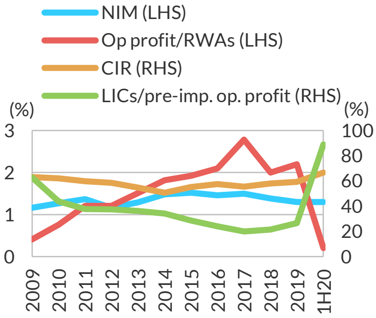
Bar Colors – Influence on final VR

- Higher influence
- Moderate influence
- Lower influence

Bar Arrows – Rating Factor Outlook

⇧ Positive ⇩ Negative
⇳ Evolving ▫ Stable

Increasing LICs



Source: Fitch Ratings, Aareal

Aareal will announce in February the outcome of a strategic review that identifies opportunities from the pandemic. Preliminary information does not suggest a major strategic shift but rather a focus on existing objectives, eg investments in Aareon to pursue organic growth and M&A opportunities. Aareal expects to return to a consolidated operating profit of about EUR300 million in 2023, subject to the pandemic. This target is based on organic growth in the CRE portfolio increasing to the higher target of EUR30 billion by end-2022, the optimisation of the funding mix and capital structure, as well as a cost/income ratio of about 40% in its CRE segment.

Sale of Aareon's Minority Stake to Accelerate Growth

Aareon, the domestic market leader in integrated enterprise resource planning systems for the housing sector, manages more than 10 million housing units in Germany, Austria, Switzerland, Netherlands, France, UK and Scandinavia. Aareal intends to reduce its reliance on CRE lending by investing in Aareon's growth, expanding its scalable digital business offering, adding products for ERP systems, building on its consulting services, and extending Aareon's sales to utilities.

Aareal's sale of a 30%-stake in Aareon to a private equity investor for EUR260 million in November 2020 will increase the bank's equity by about EUR180 million. The transaction aims to increase Aareon's revenue and client base by accelerating growth (both organic and through M&A), optimising operations and accessing additional expertise. The transaction is neutral to our assessment of Aareal's company profile given that the partnership with the investor is likely to accelerate Aareon's growth. Aareal will forgo 30% of Aareon's future profits.

Company Summary and Key Qualitative Assessment Factors

Geographic Diversification Upholds Margins; CS Segment Provides Stable Deposits

Aareal split its reporting into three segments in 2020 with the launch of its strategy 'Aareal Next Level': structured property finance (SPF), consulting/services (CS) and Aareon. SPF provides CRE lending (EUR26 billion at end-3Q20) in over 20 countries in Europe, Asia and North America. Target clients include property companies, institutional investors and, to a lesser extent, owners of residential property portfolios.

CS provides the insitutional housing sector with software solutions and banking services. It also ensures Aareal's access to stable deposits from the housing sector (EUR11 billion at end-3Q20), a key strength relative to peers. These deposits diversify funding, lower the reliance on wholesale sources and strengthens the net stable funding ratio.

Crisis-Tested Execution Record

As one of the very few pure CRE lenders not backed by large universal banking groups, Aareal has a limited margin of error to protect its viability through the cycle. Since the 2008 financial crisis, the management team has successfully navigated adverse market conditions, owing to its expertise, cautious balance-sheet management and underwriting standards, a good record of integrating acquisitions and steady strategic objectives. This will be a valuable asset during the temporary absence of the CEO, which we do not expect to affect the implementation of the bank's strategy. The negative outlook on the management & strategy score reflects the challenges faced by management in executing its new strategy and alleviate the deterioration of asset quality and earnings from the pandemic.

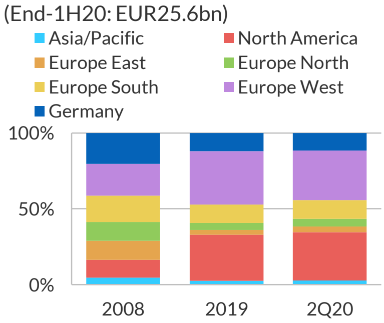
Key Financial Metrics - Latest Developments

Adequate Collateralisation Mitigates Concentration Risk

Aareal's low average loan-to-value (LTV) ratio of 57% at end-3Q20 signals prudent underwriting standards. It also protects the bank against the likely deterioration in asset quality and potential falls in property values owing to the pandemic. Aareal expects the ratio to remain below the 70% it reached before the 2008 financial crisis: 96% of performing loans had LTVs below 60% at end-3Q20.

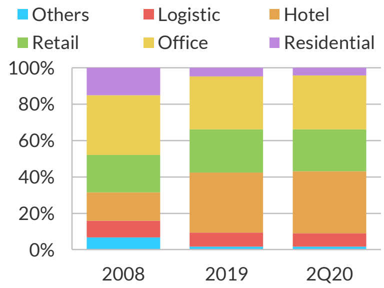
Single CRE loans are inherently large relative to the bank's capital, but large loans are often collateralised with several properties in different locations. This mitigates the bank's high exposure to the hotel and retail property markets, the segment most affected by the pandemic

CRE Book by Region
(End-1H20: EUR25.6bn)



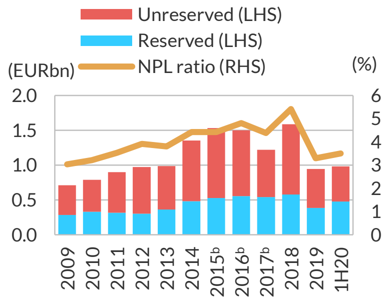
Source: Fitch Ratings, Aareal

CRE Book by Asset Types
(End-2Q20: EUR25.6bn)



Source: Fitch Ratings, Aareal

NPL Ratio Peaked at End-1H19



b Including WestImmo
Source: Fitch Ratings, Aareal

so far. Both segments could remain under pressure for longer if business travel and consumer spending do not rapidly move back towards pre-pandemic levels.

Earnings to Remain Adequate Through the Pandemic Despite Rising Pressure

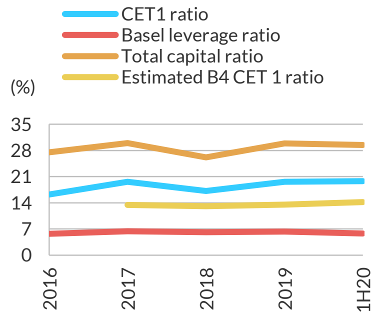
Our base case assumes an average operating profit/RWAs of at least 1.5% through the crisis, in line with Aareal's earnings and profitability score of 'bbb+'. Revenues have been stable since the start of the pandemic as net interest income, the bank's main revenue source, fell only slightly. Margins have held up well so far owing to the bank's good geographical diversification.

Sound Capitalisation but RWAs Inflation Expected

Aareal has re-rated borrowers to which it had granted amortisation holidays or new liquidity lines. The resulting RWAs inflation in 9M20 was mitigated by the implementation of the CRR "quick fix" SME factor in 3Q20. This led to a marginal net RWAs increase when taking all effects into account. We expect more significant RWAs inflation in 2021 as government support is scaled back. However, the bank's sound capital ratio provides comfortable headroom to absorb this, even taking into account the dividend payments announced so far.

Unlike other specialised CRE lenders, Aareal's sound regulatory leverage ratio of 6% at end-3Q20 is not constraining despite its temporary dip due to TLTRO drawings. The CRE lending model is particularly exposed to RWAs inflation from the planned Basel III revisions. However, the very long implementation time, and Aareal's adequate pro-forma CET1 ratio of 13.9% at end-3Q20 under the revised Basell III framework, does not require any mitigating measures.

Strong Capital Ratios



Source: Fitch Ratings, Aareal

Summary Financials and Key Ratios

	30 Jun 20 (EURm)	31 Dec 19 (EURm)	31 Dec 18 (EURm)	31 Dec 17 (EURm)
Summary income statement				
Net interest and dividend income	245	533	535	634
Net fees and commissions	111	229	215	206
Other operating income	1	64	45	81
Total operating income	357	826	795	921
Operating costs	238	488	462	511
Pre-impairment operating profit	119	338	333	410
Loan and other impairment charges	106	90	72	82
Operating profit	13	248	261	328
Tax	-3	85	90	115
Net income	16	163	226	213
Summary balance sheet				
Gross loans	28,400	28,656	29,257	27,845
- Of which impaired	981	944	1,587	1,220
Loan loss allowances	478	383	577	540
Net loans	27,922	28,273	28,680	27,305
Interbank	2,766	1,363	1,000	779
Derivatives	2,055	1,794	1,934	2,253
Other securities and earning assets	7,300	7,332	9,031	8,747
Total earning assets	40,043	38,762	40,645	39,084
Cash and due from banks	4,353	1,494	1,265	2,081
Total assets	**45,322**	**41,137**	**42,687**	**41,908**
Customer deposits	10,332	12,404	13,421	12,987
Interbank and other short-term funding	8,358	906	858	1,914
Other long-term funding	20,737	21,928	22,815	21,432
Trading liabilities and derivatives	2,237	2,165	1,934	1,703
Total funding	41,664	37,403	39,028	38,036
Preference shares and hybrid capital	300	300	300	505
Total equity	2,547	2,561	2,628	2,624
Total liabilities and equity	**45,322**	**41,137**	**42,687**	**41,908**

Source: Fitch Ratings, Fitch Solutions, Aareal

Summary Financials and Key Ratios (Cont.)

	30 Jun 20 (EURm)	31 Dec 19 (EURm)	31 Dec 18 (EURm)	31 Dec 17 (EURm)
Ratios (annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	0.2	2.2	2.0	2.8
Net interest income/average earning assets	1.3	1.3	1.4	1.5
Non-interest expense/gross revenue	66.7	59.2	58.1	55.5
Net income/average equity	1.3	6.3	8.7	8.1
Asset quality				
Impaired loans ratio	3.5	3.3	5.4	4.4
Growth in gross loans	-0.9	-2.1	5.1	-10.8
Loan loss allowances/impaired loans	48.7	40.6	36.4	44.3
Loan impairment charges/average gross loans	0.8	0.3	0.3	0.3
Capitalisation				
Common equity Tier 1 ratio	19.8	19.6	17.2	19.6
Tangible common equity/tangible assets	5.2	5.8	5.8	5.9
Basel leverage ratio	5.8	6.3	6.1	n.a.
Net impaired loans/common equity Tier 1	21.7	25.6	45.1	29.5
Funding and liquidity				
Loans/customer deposits	274.9	231.0	218.0	214.4
Customer deposits/funding	26.0	34.9	35.9	35.3

Source: Fitch Ratings, Fitch Solutions, Aareal

Sovereign Support Assessment

The Support Rating and Support Rating Floor reflect our view that, due to the EU's Bank Recovery and Resolution Directive, Aareal's senior creditors can no longer rely on full extraordinary support from the German sovereign if the bank becomes non-viable.

Support Rating Floor:			NF
Support Factors	Positive	Neutral	Negative
Sovereign ability to support system			
Size of banking system relative to economy			✓
Size of potential problem	✓		
Structure of banking system		✓	
Liability structure of banking system		✓	
Sovereign financial flexibility (for rating level)	✓		
Sovereign propensity to support system			
Resolution legislation with senior debt bail-in			✓
Track record of banking sector support		✓	
Government statements of support		✓	
Sovereign propensity to support bank			
Systemic importance		✓	
Liability structure of bank	✓		
Ownership		✓	
Specifics of bank failure		✓	

Environmental, Social and Governance Considerations

The highest level of ESG credit relevance is a score of '3'. ESG issues are credit-neutral or have only a minimal credit impact on Aareal, either due to their nature or to the way in which they are being managed by the bank. For more information on our ESG Relevance Scores, visit www.fitchratings.com.

FitchRatings **Aareal Bank AG**

Banks
Ratings Navigator

Credit-Relevant ESG Derivation

Aareal Bank AG has 5 ESG potential rating drivers

- Aareal Bank AG has exposure to compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security) but this has very low impact on the rating.
- Governance is minimally relevant to the rating and is not currently a driver.

			Overall ESG Scale
key driver	0	issues	5
driver	0	issues	4
potential driver	5	issues	3
not a rating driver	4	issues	2
	5	issues	1

Environmental (E)

General Issues	E Score	Sector-Specific Issues	Reference	E Scale
GHG Emissions & Air Quality	1	n.a.	n.a.	5
Energy Management	1	n.a.	n.a.	4
Water & Wastewater Management	1	n.a.	n.a.	3
Waste & Hazardous Materials Management; Ecological Impacts	1	n.a.	n.a.	2
Exposure to Environmental Impacts	2	Impact of extreme weather events on assets and/or operations and corresponding risk appetite & management; catastrophe risk; credit concentrations	Company Profile; Management & Strategy; Risk Appetite; Asset Quality	1

Social (S)

General Issues	S Score	Sector-Specific Issues	Reference	S Scale
Human Rights, Community Relations, Access & Affordability	2	Services for underbanked and underserved communities: SME and community development programs; financial literacy programs	Company Profile; Management & Strategy; Risk Appetite	5
Customer Welfare - Fair Messaging, Privacy & Data Security	3	Compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security)	Operating Environment; Company Profile; Management & Strategy; Risk Appetite	4
Labor Relations & Practices	2	Impact of labor negotiations, including board/employee compensation and composition	Company Profile; Management & Strategy	3
Employee Wellbeing	1	n.a.	n.a.	2
Exposure to Social Impacts	2	Shift in social or consumer preferences as a result of an institution's social positions, or social and/or political disapproval of core banking practices	Company Profile; Financial Profile	1

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference	G Scale
Management Strategy	3	Operational implementation of strategy	Management & Strategy	5
Governance Structure	3	Board independence and effectiveness; ownership concentration; protection of creditor/stakeholder rights; legal /compliance risks; business continuity; key person risk; related party transactions	Management & Strategy; Earnings & Profitability; Capitalisation & Leverage	4
Group Structure	3	Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Company Profile	3
Financial Transparency	3	Quality and frequency of financial reporting and auditing processes	Management & Strategy	2
				1

How to Read This Page
ESG scores range from 1 to 5 based on a 15-level color gradation. Red (5) is most relevant and green (1) is least relevant.

The Environmental (E), Social (S) and Governance (G) tables break out the individual components of the scale. The right-hand box shows the aggregate E, S, or G score. General Issues are relevant across all markets with Sector-Specific Issues unique to a particular industry group. Scores are assigned to each sector-specific issue. These scores signify the credit-relevance of the sector-specific issues to the issuing entity's overall credit rating. The Reference box highlights the factor(s) within which the corresponding ESG issues are captured in Fitch's credit analysis.

The Credit-Relevant ESG Derivation table shows the overall ESG score. This score signifies the credit relevance of combined E, S and G issues to the entity's credit rating. The three columns to the left of the overall ESG score summarize the issuing entity's sub-component ESG scores. The box on the far left identifies some of the main ESG issues that are drivers or potential drivers of the issuing entity's credit rating (corresponding with scores of 3, 4 or 5) and provides a brief explanation for the score.

Classification of ESG issues has been developed from Fitch's sector ratings criteria. The General Issues and Sector-Specific Issues draw on the classification standards published by the United Nations Principles for Responsible Investing (PRI) and the Sustainability Accounting Standards Board (SASB).

Sector references in the scale definitions below refer to Sector as displayed in the Sector Details box on page 1 of the navigator.

CREDIT-RELEVANT ESG SCALE

How relevant are E, S and G issues to the overall credit rating?

5	Highly relevant, a key rating driver that has a significant impact on the rating on an individual basis. Equivalent to "higher" relative importance within Navigator.
4	Relevant to rating, not a key rating driver but has an impact on the rating in combination with other factors. Equivalent to "moderate" relative importance within Navigator.
3	Minimally relevant to rating, either very low impact or actively managed in a way that results in no impact on the entity rating. Equivalent to "lower" relative importance within Navigator.
2	Irrelevant to the entity rating but relevant to the sector.
1	Irrelevant to the entity rating and irrelevant to the sector.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.