



RATING ACTION COMMENTARY

Fitch Affirms Aareal at 'BBB+'; Outlook Negative

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Fitch Ratings - Frankfurt am Main - 08 Nov 2022: Fitch Ratings has affirmed Aareal Bank AG's Long-Term Issuer Default Rating (IDR) at 'BBB+' with a Negative Outlook and Viability Rating (VR) at 'bbb+'.

KEY RATING DRIVERS

CRE Sector Risks: Aareal's ratings reflect its focus on lending to the cyclical commercial real-estate (CRE) sector, which is offset by the bank's good geographical diversification relative to peers, sound capitalisation, recovering post-pandemic profitability, and adequate funding and liquidity profile.

The Negative Outlook on the Long-Term IDR reflects downside risks and second-round effects from the Ukraine war and the related energy crisis in Europe that could spill over to the CRE sector. Due to the bank's CRE-focussed business model, with particularly high concentration in the retail and hotel segments, this could result in greater-than-anticipated asset-quality pressures and profitability challenges.

Diversified CRE Presence: Aareal's business profile benefits from a diversified presence in international markets and across different market sectors. It is underpinned by the bank's flexible approach to respond to changing market conditions and transaction volumes and leverage on higher margin international lending.

Good Risk Controls: Aareal's risk profile reflects its prudent risk appetite for credit exposure with moderate loan-to-value ratios. Credit standards are broadly in line with

market practice, underpinned by the group's centralised, sophisticated risk control framework. Aareal's structural interest rate and foreign-currency risks are modest.

Downside Risks to Asset Quality: Aareal's asset quality has improved post-pandemic, largely driven by ongoing recovery in the hotel segment. We believe it will be challenging for Aareal to pursue its impaired loans reduction strategy in the current environment. The negative outlook on the asset quality score reflects downside risks that could particularly materialise in the retail segment, as high inflation and energy prices drag on private households' consumption power and the debt servicing ability of SME tenants.

Satisfactory Profitability: Aareal's current operating profit is recovering, reflecting strong business growth, rising interest rates and higher commission income from its subsidiary Aareon, a housing software provider, despite increased loan impairment charges (LICs). We expect Aareal to achieve operating profit/risk-weighted assets (RWA) above 1.5% through the cycle. However, cost inflation, higher funding costs and potentially higher LICs could challenge Aareal's ambitious profit growth trajectory until 2024.

Sound Capitalisation: Aareal is well capitalised and its capital ratios comfortably exceed regulatory requirements, although our assessment takes into account the high business and risk concentration. Its leverage ratio of 5.9% end-1H22 is also well above peers. We believe that the new owners' commitment to profit retention will balance the expected impact from higher RWA under the bank's envisaged growth strategy.

Diversified Funding, Good Liquidity: Aareal's funding profile benefits from a sound deposits base from the institutional housing sector and the bank's plans to gather additional retail funds through online platforms. The bank's status as a regular covered bond issuer lowers its reliance on unsecured debt market funding. Aareal's liquidity profile is underpinned by a large pool of highly-rated, unencumbered, and ECB-eligible assets.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

We could downgrade the ratings if the impaired loans ratio exceeds 5% for an extended period with no credible reduction plan. Asset quality would constitute a weakest link and would no longer be commensurate with a 'bbb+' VR. In this scenario we would also expect that the operating profit/RWA ratio could drop below 1.5%. This could result from stress in the property market in general or specific sectors leading to unexpectedly high asset quality pressure. Significantly higher than expected LICs could also impair

Aareal's profitability. Aareal's Short-Term IDR would be downgraded if both its Long-Term IDR and funding and liquidity score were downgraded.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The Outlook on the Long-Term IDR could be revised to Stable if the bank weathers the challenges arising from a recessionary environment with high inflation and geopolitical risks, limiting risks to its asset quality and profitability, while maintaining broadly stable capitalisation.

An upgrade of the ratings is unlikely in the near term, given the unclear impact of the operating environment on the CRE markets. In the longer term, an upgrade would require successful execution of its strategic plan leading to stronger profitability, higher revenue diversification, as well as strengthened asset quality. Operating profit/RWA sustainably above 2% combined with an impaired loans ratio sustainably below 3% could result in an upgrade.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

DCR, Deposit and Senior Debt Ratings: Aareal's Derivative Counterparty Rating (DCR) and long-term deposit and senior preferred debt ratings are one notch above its Long-Term IDR. This reflects the large and sustainable layer of senior non-preferred (SNP) debt that provides preferred creditors and counterparties with additional protection in a resolution. The short-term senior-preferred debt and deposit ratings are the baseline options mapping to the 'A-' long-term ratings. This is because the bank's funding & liquidity score does not warrant higher short-term ratings.

Subordinated Debt: Tier 2 subordinated notes are rated two notches below the VR to reflect the notes' higher loss severity relative to senior creditors in a resolution. The Capital Requirements Regulation-compliant AT1 notes are rated four notches below the VR (two notches for loss severity and two notches for non-performance risk) to reflect our expectation that Aareal will maintain large capital buffers above the notes' mandatory coupon omission triggers.

Government Support Rating (GSR): Aareal's GSR of 'no support' reflects Fitch's view that senior creditors can no longer rely on full extraordinary state support. This is driven by the EU's Bank Recovery and Resolution Directive and the Single Resolution Mechanism, which provide a resolution framework that is likely to require senior creditors participating in losses, if necessary, instead, or ahead, of a bank receiving government support.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

A downgrade of the Long-Term IDR would trigger a downgrade of the DCR, long-term senior preferred and SNP debt and deposit ratings. We could also downgrade the long-term senior-preferred and SNP debt ratings if the bank no longer retains a SNP and junior debt buffer that is large enough to cover its total resolution buffer requirement, and if at the same time the SNP and junior debt buffer declines below 10% of RWA.

An upgrade of Aareal's IDRs would trigger an upgrade of the DCR, senior preferred and SNP debt and deposit ratings, unless the buffer of junior and SNP debt decreases below the level required to maintain the senior preferred ratings' one-notch uplift above and the SNP debt's alignment with the Long-Term IDR.

A downgrade of the VR would lead to a downgrade of the Tier 2 and AT1 notes. The ratings of AT1 notes could also be downgraded if we perceive a heightened risk that capital cushions above the maximum distributable amount trigger points could fall below 100bp.

Aareal's GSR is at the bottom of Fitch's rating scale and therefore cannot be downgraded.

An upgrade of the GSR would require a higher propensity of sovereign support. While not impossible, the Banking Recovery and Resolution Directive makes this highly unlikely.

VR ADJUSTMENTS

The Capitalisation & Leverage score of 'a-' has been assigned below the 'aa' category implied score due to the following adjustment reason(s): Risk Profile and Business Model (negative).

The Funding & Liquidity score of 'bbb+' has been assigned above the 'bb' category implied score due to the following adjustment reason(s): Deposit Structure (positive), Liquidity Coverage (positive)

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to

determine sector-specific best- and worst-case scenario credit ratings, visit

<https://www.fitchratings.com/site/re/10111579>

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

| ENTITY / DEBT ⚡ | RATING ⚡ | | | PRIOR ⚡ |
|--------------------|--------------------|------------------------------|----------|------------------------------------|
| Aareal Bank AG | LT IDR | BBB+ Rating Outlook Negative | | BBB+ Rating Outlook Negative |
| | Affirmed | | | |
| | ST IDR | F2 | Affirmed | F2 |
| | Viability | bbb+ | Affirmed | bbb+ |
| | DCR | A-(dcr) | Affirmed | A-(dcr) |
| | Government Support | ns | Affirmed | ns |
| long-term deposits | LT | A- | Affirmed | A- |

| | | | | |
|----------------------|----|------|----------|------|
| Senior preferred | LT | A- | Affirmed | A- |
| subordinated | LT | BBB- | Affirmed | BBB- |
| subordinated | LT | BB | Affirmed | BB |
| Senior non-preferred | LT | BBB+ | Affirmed | BBB+ |

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[Bank Rating Criteria \(pub. 07 Sep 2022\) \(including rating assumption sensitivity\)](#)

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Aareal Bank AG

EU Issued, UK Endorsed

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