FitchRatings

Banks
Wholesale Commercial Banks
Germany

Aareal Bank AG

Update

Key Rating Drivers

CRE Sector Risks: Aareal Bank AG's ratings reflect its focus on lending to the cyclical commercial real-estate (CRE) sector, which is mitigated by the bank's geographical diversification relative to peers. The ratings also reflect the bank's recovering profitability since the height of the pandemic, sound capitalisation, and adequate funding and liquidity profile.

The Negative Outlook on the Long-Term Issuer Default Rating (IDR) reflects higher interest rates and related risks to the CRE sector, and second-round effects from the Russia–Ukraine war.

Diversified CRE Presence: Aareal's business profile is underpinned by its operations in several countries and CRE segments. It benefits from higher-margin international lending and from the bank's flexible response to changing market conditions and transaction volumes.

Good Risk Controls: The bank's moderate average loan-to-value (LTV) ratios in its CRE loan book reflect its prudent risk appetite. Credit standards are broadly in line with market practice, underpinned by the group's centralised, sophisticated risk control framework. Structural interest rate and foreign-currency risks are modest.

Asset Quality Risks: Aareal's asset quality has improved since the height of the pandemic, largely driven by ongoing recovery in the hotel segment. However, Fitch Ratings believes it will be challenging for the bank to execute its impaired loan-reduction strategy in the current adverse environment. The negative outlook on the asset quality score reflects risks in the office and retail property segments, as rising interest rates drive increase refinancing risk and inflation weighs on households' purchasing power and SME tenants' debt-servicing ability.

Satisfactory Profitability: Aareal's operating profit has been recovering over recent quarters thanks to strong business growth, rising interest rates and higher commission income from its subsidiary Aareon, and despite increased loan impairment charges (LICs). We expect Aareal to achieve an operating profit/risk-weighted assets (RWAs) of more than 1.5% through the cycle. However, cost inflation, higher funding costs and potentially higher LICs could challenge the bank's ambitious profit growth trajectory up to 2024.

Sound Capitalisation: The bank is well capitalised, with capital ratios comfortably exceeding its regulatory requirements, although our assessment considers the bank's high sector and single-borrower concentration. Its leverage ratio of 6.0% at end-1Q23 compares well with peers. We believe that the new owners' commitment to profit retention will balance the expected impact from higher RWAs from negative rating migration.

Stable Funding, Comfortable Liquidity: Aareal's funding benefits from stable housing industry deposits, which are complemented by online term retail deposits. As a regular covered bond issuer, the bank is moderately reliant on unsecured market funding. Its liquidity profile is underpinned by a large pool of cash and highly rated public-sector bonds, which together account for about 30% of total assets.

Ratings

Aareal Bank AG

Long-Term IDR	BBB+
Short-Term IDR	F2
Derivative Counterparty Rating	A-(dcr)
Viability Rating	bbb+
Government Support Rating	ns

Sovereign Risk (Germany)

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 (September 2022)

Related Research

Aareal Bank AG (November 2022)

Fitch Affirms Aareal at 'BBB+'; Outlook Negative (November 2022)

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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+' Viability Rating (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 withstands the challenges arising from a recessionary environment, which comes 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

Rating level	Rating
Deposits	A-/F2
Senior non-preferred	BBB+
Senior preferred	A-/F2
Long-term subordinated (Tier 2)	F2
Long-term subordinated (AT1)	BB

Source: Fitch Ratings

Aareal's Derivative Counterparty Rating (DCR) and its long-term deposit and senior preferred debt ratings are one notch above its Long-Term IDR, and its long-term senior non-preferred debt rating is aligned with the Long-Term IDR. This reflects the large and sustainable layer of non-preferred 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, because the bank's funding & liquidity score does not warrant higher short-term ratings.

The Tier 2 subordinated notes are rated two notches below the VR to reflect their higher loss severity relative to senior creditors in a resolution. The additional Tier 1 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.

Significant Changes from Last Review

Falling Market Valuations and Higher Interest Rates Increase Refinancing Risks

Rising interest rates and tighter lending conditions have caused CRE transaction volumes and valuations to decline in Europe and in the US in the past year. Fitch believes CRE property prices could fall significantly further, in particular for older properties. At the same time, refinancing risks are increasing. However, this should not result in outsized credit losses for most German banks, nor for Aareal, at least in the near term, due to adequate collateralisation, long average maturities and predominantly fixed-rate loans in banks' CRE portfolios.

Remote working also pressures the valuations and rents of office properties. Office vacancy rates in Germany were fairly low, at less than 5% according to Bundesbank data in 2022, but increased to about 19% in the US, where vacancy rates are exacerbated by layoffs in the tech sector. The US accounted for 49% of Aareal's EUR8 billion office portfolio at end-1Q23, with a focus on large cities, and 91% of the loans in this segment had a layered LTV below 60%, which we view as credit positive. Average debt yields of 6.6% in the US office property portfolio also help support against a further increase in interest rates.

Resilient 1Q23 Performance

Aareal generated an operating profit of EUR62 million in 1Q23 – this equalled about 2.5% of RWAs on an annualised basis considering the pro-rata allocation of the EUR25 million bank levies paid in 1Q23. This puts Aareal on track to reach its targeted 2023 operating profit of EUR240 million–280 million (2022: EUR239 million), provided LICs are moderate.

Slow deposit repricing and yoy loan growth supported revenue, while administrative expenses increased 30% yoy due to restructuring charges booked at Aareon and inorganic growth.

LICs were a moderate EUR32 million (42bp of gross loans) despite the booking of EUR21 million additional management overlay for the US office property portfolio on the back of the assumption of a 20% valuation decline. The bank will book EUR60 million LICs this year to further reduce its stock of non-performing loans (which includes off-balance-sheet exposure, impaired loans at fair value and IFRS Stage 3 loans) to below 3% of gross loans (end-1Q23: 3.4%; end-2020: 5.9%).

Aareal's capitalisation, which is a rating strength, remained above that of peers, with a CET1 (Basel IV phase-in) ratio of 19.4 % and a total capital ratio of 23.8%. We believe the bank's capitalisation will remain solid as it intends to retain profits for 2023.

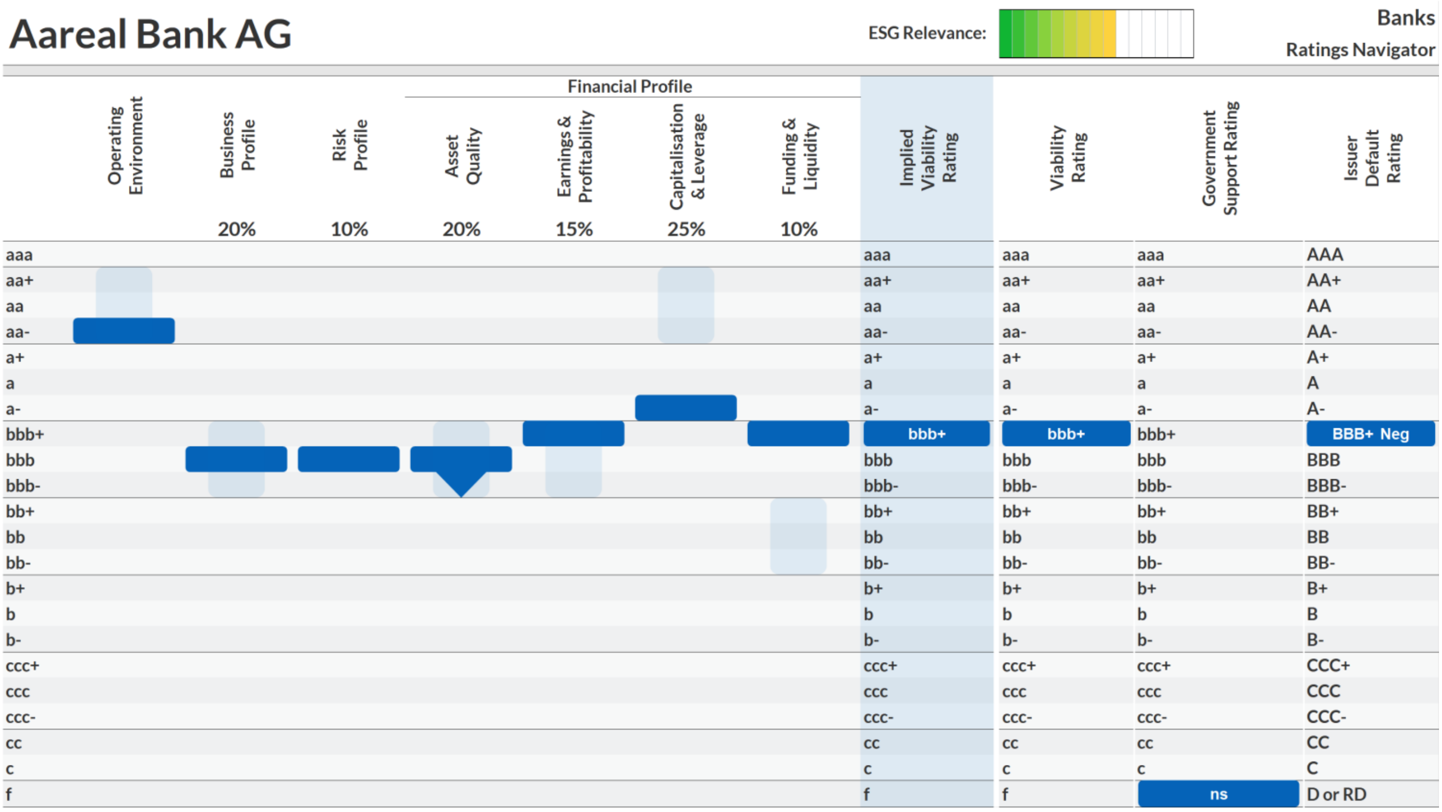
Diversified Funding, Comfortable Liquidity

Aareal's EUR21.3 billion long-term capital market funding, EUR13.7 billion granular, sticky housing industry deposits and EUR1.4 billion online retail deposits give it a diversified and stable funding base. The liquidity coverage ratio (end-1Q23: 240%) and the net stable funding ratio (123%) were also at comfortable levels. The treasury portfolio investments are in very liquid, mainly public-sector, bonds. Aareal also hedges its balance sheet against interest rate risk, and unrealised losses in its bond portfolio amounted to only 3% of the bank's equity at end-1Q23. Aareal has also only EUR1 billion outstanding central bank tenders (TLTRO).

New Ownership Approved by Regulators

Atlantic BidCo GmbH's takeover of Aareal Bank in June 2022, acquiring about 90 % of the bank's shares, received the final outstanding regulatory approval by the ECB in May 2023. We expect the new owner to be committed to the bank's long-term strategy, based on the three-year investment agreement as of the transaction's closing.

Ratings Navigator



The Key Rating Driver (KRD) weightings used to determine the implied VR are shown as percentages at the top. In cases where the implied VR is adjusted upwards or downwards to arrive at the VR, the KRD associated with the adjustment reason is highlighted in red. The shaded areas indicate the benchmark-implied scores for each KRD.

VR - Adjustments to Key Rating Drivers

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).

Financials

Financial Statements

	31 Dec 22		31 Dec 21	31 Dec 20	31 Dec 19
	(USDm)	(EURm)	(EURm)	(EURm)	(EURm)
Summary income statement					
Net interest and dividend income	749	702	597	512	533
Net fees and commissions	295	277	245	234	229
Other operating income	25	23	-38	-19	62
Total operating income	1,069	1,002	804	727	824
Operating costs	609	571	516	458	486
Pre-impairment operating profit	460	431	288	269	338
Loan and other impairment charges	205	192	133	344	90
Operating profit	255	239	155	-75	248
Tax	92	86	87	-6	85
Net income	163	153	68	-69	163
Other comprehensive income	57	53	56	-48	-82
Fitch comprehensive income	220	206	124	-117	81
Summary balance sheet					
Assets					
Gross loans	33,833	31,720	31,723	29,847	28,656
- Of which impaired	1,051	985	1,505	1,549	944
Loan loss allowances	519	487	489	588	383
Net loans	33,313	31,233	31,234	29,259	28,273
Interbank	2,041	1,914	1,264	1,029	1,363
Derivatives	1,947	1,825	1,132	2,218	1,794
Other securities and earning assets	5,684	5,329	6,705	6,919	6,995
Total earning assets	42,985	40,301	40,335	39,425	38,425
Cash and due from banks	5,785	5,424	6,942	4,744	1,494
Other assets	1,713	1,606	1,451	1,309	1,218
Total assets	50,483	47,331	48,728	45,478	41,137
Liabilities					
Customer deposits	18,020	16,895	15,109	13,680	12,404
Interbank and other short-term funding	2,113	1,981	6,109	5,629	906
Other long-term funding	22,452	21,050	21,705	20,428	21,928
Trading liabilities and derivatives	3,748	3,514	1,882	1,906	2,165
Total funding and derivatives	46,333	43,440	44,805	41,643	37,403
Other liabilities	675	633	862	868	873
Preference shares and hybrid capital	320	300	300	300	300
Total equity	3,155	2,958	2,761	2,667	2,561
Total liabilities and equity	50,483	47,331	48,728	45,478	41,137
Exchange rate		USD1 = EUR0.93756	USD1 = EUR0.884173	USD1 = EUR0.821963	USD1 = EUR0.89015

Source: Fitch Ratings, Fitch Solutions, Aareal Bank AG

Key Ratios

	31 Dec 22	31 Dec 21	31 Dec 20	31 Dec 19
Profitability				
Operating profit/risk-weighted assets	1.9	1.2	-0.6	2.2
Net interest income/average earning assets	1.7	1.5	1.3	1.3
Non-interest expense/gross revenue	56.9	64.0	63.1	59.1
Net income/average equity	5.3	2.5	-2.7	6.3
Asset quality				
Impaired loans ratio	3.1	4.7	5.2	3.3
Growth in gross loans	0.0	6.3	4.2	-2.1
Loan loss allowances/impaired loans	49.4	32.5	38.0	40.6
Loan impairment charges/average gross loans	0.6	0.4	1.2	0.3
Capitalisation				
Common equity Tier 1 ratio	19.3	18.2	18.8	19.6
Tangible common equity/tangible assets	4.9	4.9	5.4	5.8
Basel leverage ratio	6.0	5.5	5.9	6.3
Net impaired loans/common equity Tier 1	20.2	43.7	42.0	25.6
Funding and liquidity				
Gross loans/customer deposits	187.8	210.0	218.2	231.0
Liquidity coverage ratio	210	255.4	264.9	221.4
Customer deposits/total non-equity funding	42.0	35.0	34.2	34.9

Source: Fitch Ratings, Fitch Solutions, Aareal Bank AG

Support Assessment

Commercial Banks: Government Support	
Typical D-SIB GSR for sovereign's rating level (assuming high propensity)	A+ to A-
Actual jurisdiction D-SIB GSR	ns
Government Support Rating	ns
Government ability to support D-SIBs	
Sovereign Rating	AAA/ Stable
Size of banking system	Negative
Structure of banking system	Neutral
Sovereign financial flexibility (for rating level)	Positive
Government propensity to support D-SIBs	
Resolution legislation	Negative
Support stance	Negative
Government propensity to support bank	
Systemic importance	Negative
Liability structure	Neutral
Ownership	Neutral

The colours indicate the weighting of each KRD in the assessment.
Higher influence Moderate influence Lower influence

Aareal's Government Support Rating (GSR) of 'no support' reflects Fitch's view that, due to the EU's Bank Recovery and Resolution Directive, senior creditors can no longer rely on full extraordinary support from the sovereign if the bank becomes non-viable.

Environmental, Social and Governance Considerations

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	Business Profile (incl. Management & governance); Risk Profile; 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	Business Profile (incl. Management & governance); Risk Profile	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; Business Profile (incl. Management & governance); Risk Profile	4
Labor Relations & Practices	2	Impact of labor negotiations, including board/employee compensation and composition	Business Profile (incl. Management & governance)	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	Business Profile (incl. Management & governance); Financial Profile	1

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference	G Scale
Management Strategy	3	Operational implementation of strategy	Business Profile (incl. Management & governance)	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	Business Profile (incl. Management & governance); Earnings & Profitability; Capitalisation & Leverage	4
Group Structure	3	Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Business Profile (incl. Management & governance)	3
Financial Transparency	3	Quality and frequency of financial reporting and auditing processes	Business Profile (incl. Management & governance)	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.

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

For information on the solicitation status of the ratings included within this report, please refer to the solicitation status shown in the relevant entity's summary page of the Fitch Ratings website.

For information on the participation status in the rating process of an issuer listed in this report, please refer to the most recent rating action commentary for the relevant issuer, available on the Fitch Ratings website.