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NON-RATING ACTION COMMENTARY

Aareal's Loss in Line with IDR if Asset Quality Recovers Fast

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Fitch Ratings-London-24 February 2021: Aareal Bank AG's net loss of EUR69 million in 2020 exposes the vulnerability of commercial real estate lending to the coronavirus pandemic, Fitch Ratings says. However, the loss is commensurate with Aareal's Long-Term Issuer Default Rating (IDR) of 'BBB+'/Negative as Fitch expects profitability and asset quality to recover swiftly and capital buffers to remain large.

Aareal's ratings are primarily sensitive to asset quality pressures, and the Negative Outlook on the IDR reflects the uncertain operating environment, particularly the stress in the property market caused by the pandemic. A downgrade of the Long-Term IDR could occur due to a lack of a clear improvement path for the NPL ratio from the high end-2020 level, or if another asset quality-driven poor performance in 2021 threatens to substantially erode Aareal's capital buffers.

Aareal previously had guided to an annual operating profit in the mid double-digit million euro range, but additional loan impairment charges in 4Q20 caused an annual loss. These additional charges reflect the recent intensification of the pandemic, as tighter lockdowns affect most of the bank's core markets and make the recovery path of the hotel and non-food retail markets more uncertain. Beside increasing allowances for Stage 3 loans under IFRS 9, in 4Q20 Aareal reclassified all loans that had received liquidity support since the start of the pandemic to Stage 2, thus recognising impairments for potential, but not yet incurred, defaults.

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Total Stage 2 loans rose to EUR6.1 billion at end-2020 from EUR0.5 billion at end-2019, mainly driven by Aareal's hotel loan portfolio (80% of provisions for Stage 2 loans related to hotels at end-2020). This increase in Stage 2 loans reflects that commercial real estate in general remains vulnerable in the current crisis. It also highlights wider uncertainty around asset quality in the banking sector (see "Eurozone Banks' Asset Quality Is ECB's Main Concern for 2021", published by Fitch on 1 February 2020 on www.fitchratings.com).

Aareal's reported non-performing loan (NPL) ratio rose to 6.1% at end-4Q20 from to 3.9% at end-3Q20. The large NPL inflow of EUR616 million in 4Q20 was mainly driven by UK retail properties now classified as Stage 3 - this follows negative re-appraisals of property values that increased the loan-to-value ratios of some UK retail assets above 100%. Aareal is exposed to hotel (32% of total loans at end-2020) and retail (21%) properties, including in more volatile regions. We consider these segments to be vulnerable to the effects of the pandemic, and additional NPL inflows could be triggered when state support measures are phased out.

However, an improving NPL ratio in 2021 would support Aareal's asset quality score of 'bbb'/negative. The bank should be able to reduce its legacy NPLs in the foreseeable future. Its management is likely to consider de-risking measures similar to 2019 amid a recovering operating environment in 2021 supported by the vaccine rollout. Recovering consumer spending and business travel should support the performance and valuation of retail and hotel properties.

Aareal's capitalisation is a rating strength despite the annual loss and RWA inflation from the recent asset quality deterioration. The CET1 ratio of 18.8% at end-2020 is down from 20.4% at end-3Q20 but remains sound and already reflects Aareal's intention (subject to supervisory approval) to pay EUR90 million of dividends for 2020.

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