Aareal Bank AG

Ratings

Foreign Currency	
Long-Term IDR	BBB+
Short-Term IDR	F2
Derivative Counterparty Rating	A-(dcr)
Viability Rating	bbb+
Government Support Rating	no support

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 (November 2021)

Related Research

Fitch Affirms Aareal at 'BBB+'; Outlook Negative (November 2021)

Global Economic Outlook (September 2021)

Analysts

Markus Glabach
+49 69 768076 195
markus.glabach@fitchratings.com

Roger Schneider, CIIA
+49 69 768076 242
roger.schneider@fitchratings.com

Key Rating Drivers

Pandemic Drives Negative Outlook: The Negative Outlook on Aareal Bank AG's Long-Term Issuer Default Rating (IDR) reflects remaining risks from the pandemic. Fitch Ratings believes these risks could result in greater-than-expected asset-quality and profitability challenges.

CRE-Focused Business Model: Aareal's Viability Rating (VR) reflects the bank's established business model focusing on the cyclical commercial real estate (CRE) sector and its exposure to associated risks. These risks include immediate pressure from the pandemic, as the bank's asset quality is vulnerable to pressure on borrowers' performance in the hotel and retail segments, the areas most affected by the pandemic so far. The VR benefits from Aareal's good geographical diversification relative to peers, sound capitalisation and diversified funding mix.

Asset Quality Pressure: Aareal's reported non-performing loan (NPL) ratio (which includes off-balance sheet exposures, NPLs at fair value and IFRS Stage 3 loans) declined to 4.9% at end-3Q21 from a peak of 6% at end-1H21, but is above its pre-pandemic level of 4.1% at end-2019 and above that of peers. UK retail properties and, to a lesser extent, hotels, have driven new NPLs since end-2019 (32% of Aareal's loans are to hotels and 20% to retail properties).

We expect the four-year average Stage 3 ratio (5.4% at end-1H21) to be close to 4% by end-2022. The bank should be able to reduce NPLs as recovering consumer spending, the easing of travel bans and the vaccine roll-out should support the performance and valuations of retail and hotel assets. However, Fitch's negative outlook on asset quality reflects the uncertain pace of the recovery of hotel and retail asset performance, especially in light of the current resurgence of the pandemic, while state support (e.g. furlough schemes) has been scaled back.

Earnings Stabilising: The bank's operating profit/risk-weighted assets (RWAs) rebounded to 1.5% in 9M21 from minus 0.6% in 2020, when high pandemic-driven loan impairment charges (LICs) triggered an annual loss despite only a slight decrease in net interest income. We expect earnings to recover over the next 24 months, supported by profitable loan growth, the downward normalisation of LICs and steadily rising income at the Aareon subsidiary.

Strong Capitalisation: The common equity Tier 1 (CET1) ratio of 21.5% at end-3Q21 was well above the regulatory CET1 requirement of 8.28%. Despite atemporary dip due to ECB TLTRO drawings, Aareal is not constrained by its leverage ratio of 5.7%, which is higher than that of other specialised CRE lenders. CRE lending is particularly exposed to RWAs inflation from the planned Basel III revisions. However, with a pro forma Basel III CET1 ratio of 12.5%, Aareal is well positioned to absorb the application of the output floor without mitigating measures.

Diversified Funding: Aareal's funding consists primarily of Pfandbriefe and resilient, stable deposits from the institutional housing sector. This limits the bank's reliance on unsecured market funding, which mostly consists of private placements from an established investor base.

Rating Sensitivities

Receding Pandemic-Related Risks: We could revise the Outlook on the Long-Term IDR to Stable if Aareal weathers the challenges arising from the pandemic while strengthening its asset quality and profitability and maintaining stable capitalisation.

Prolonged Stress in CRE Markets: We could downgrade the VR and the Long-Term IDR if the Stage 3 ratio exceeded 5% for an extended period with no credible reduction plan, combined with an operating profit/RWAs ratio sustainably below 1.5%. This could result from prolonged stress in key property markets leading to unexpectedly high asset quality pressure.

Debt Rating Classes

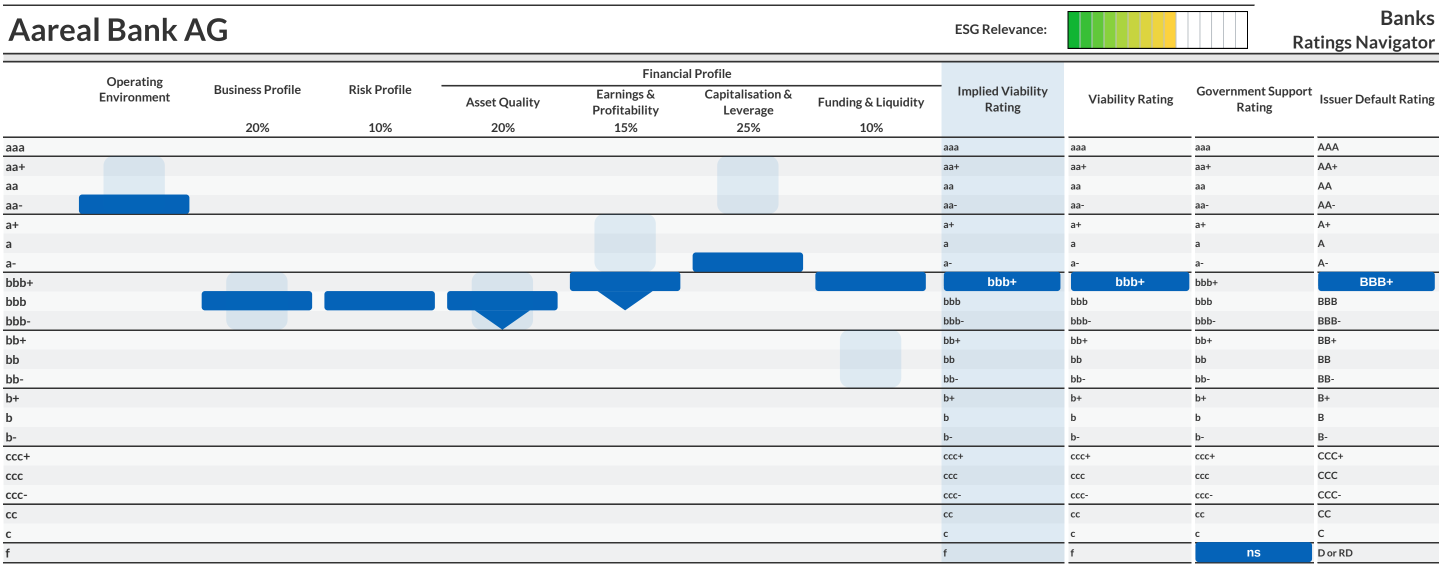
Rating level	Rating
Deposits	A-/F2
Senior preferred (SP) debt	A-/F2
Senior non-preferred (SNP) debt	BBB+
Tier 2 subordinated debt	BBB-
Additional Tier 1 notes	BB

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 ratings of 'A-'. This is 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 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 to reflects our expectation that Aareal will maintain large capital buffers above the notes' mandatory coupon omission triggers.

Ratings Navigator



VR Adjustments

The earnings and profitability score of 'bbb+' has been assigned below the 'a' category implied score to reflect the bank's low revenue diversification and high reliance on CRE lending. The capitalisation and leverage score of 'a-' has been notched down from the 'aa' category implied score to reflect the cyclicality of the dominant CRE asset class. The funding and liquidity score of 'bbb+' has been assigned above the 'bb' category implied score due to Aareal's strong liquidity coverage and stable deposits from the institutional housing sector.

Significant Changes

Improved Economic Prospects Despite Short-Term Pandemic-Driven Uncertainty

Our stable outlook on Aareal's operating environment reflects our view that near-term risk has receded, as state support has considerably limited the impact of the pandemic on Aareal's core markets. The expected economic recovery in 2022 should support earnings stabilisation and loan growth. CRE markets recovered globally in 1H21 as investment activity rebounded in most regions. Transaction volumes are close to pre-crisis levels and yields should stabilise after decreasing in 2020.

Outcome of Takeover Bid Open

Several US financial investors have recently concluded an investment agreement regarding a public offer to acquire a majority stake in Aareal. The outcome of the bid is uncertain but, if successful, the closing of the transaction is likely to happen by mid-2022.

According to Aareal, the potential new owners support the bank's current strategy and set-up including Aareon. The bidders' intention to accelerate Aareal's existing growth plans without implementing strategic shifts should be commensurate with the bank's current ratings as long as the growth target remains reasonable. However, the emergence of a majority shareholder driving aggressive loan growth or profit distribution to the point of significantly depleting the bank's capital ratios could weigh on the VR and, consequently, on the Long-Term IDR.

Brief Company Summary and Key Qualitative Assessments

Diversified Presence in International Markets Supports Margins

Aareal operates in three core segments: Structured Property Finance (SPF), Banking and Digital Solutions (BDS) and Aareon. SPF provides CRE lending (EUR29 billion at end-3Q21) 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.

Aareal's above-average geographic diversification and conservative underwriting standards mitigate its vulnerability to the CRE markets' cyclicality and its higher NPL ratio than Germany-focused peers. Its sizeable presence in the higher-margin US CRE market mitigates the intense margin pressure in Germany, where the bank's exposure is modest. The bank's expertise in structuring cross-border loans backed by multi-assets is a competitive strength that supports lending margins. Taking advantage of its rather moderate reliance on single jurisdictions, Aareal also has a sound record of flexible capital allocation in response to local market developments.

BDS supplies software solutions and banking services to the institutional housing sector, for which Aareal also manages stable deposits of EUR11 billion at end-1H21. These deposits are a funding strength relative to peers as they lower Aareal's reliance on wholesale funding and strengthen its net stable funding ratio. However, these deposits also mean that BDS's profit contribution is likely to remain immaterial as long as the low interest-rate environment lasts.

Aareon is a software company and the German market leader in integrated Enterprise Resource Planning (ERP) systems for the housing sector, managing more than 10 million housing units in Germany and western Europe. Aareal intends to diversify its revenue and reduce its reliance on CRE lending by investing in Aareon's growth. Investments include expanding its scalable digital business offerings, adding new products for Enterprise-Resource-Planning (ERP) systems, optimising processes and extending Aareon's scope to the utility sector. Given its low-risk, stable, capital-light model, Aareon's contribution to Aareal's profits should become increasingly material and support the bank's return on equity and operating profit/RWAs in the longer term.

Pandemic Challenges Execution

As one of few pure CRE lenders not backed by a large universal banking group, Aareal has a limited margin of error to protect its viability through the cycle, especially in adverse market conditions. The loss incurred in 2020 exposed the vulnerability of Aareal's business model to unexpected shocks in the property market. The management has a good record of meeting its strategic objectives pre-pandemic, and the new CEO since 3Q21 has extensive domestic and international CRE expertise.

Sound Underwriting Criteria

We expect Aareal to maintain prudent underwriting standards, including a regional approach and strict lending criteria. Aareal's 2Q21 new business includes a high share of portfolio transactions (63% of new loans backed by multiple assets) and a cross-border share of 23%, which supports granularity and regional diversification. CRE loans' average maturities of up to five years make regular prolongations necessary, especially under adverse market conditions when secondary market transactions are scarce. The bank has maintained strict lending criteria in its core markets during the pandemic. It has no risk appetite for CRE development and retains only a small legacy development portfolio (1% of total loans). Aareal uses interest rate and cross-currency swaps to hedge its loans and securities investments.

Summary Financials and Key Ratios

	30 Jun 21		31 Dec 20	31 Dec 19	31 Dec 18
	(USDm)	(EURm)	(EURm)	(EURm)	(EURm)
Summary income statement					
Net interest and dividend income	333	280	512	533	535
Net fees and commissions	140	118	234	229	215
Other operating income	-20	-17	-19	62	45
Total operating income	453	381	727	824	795
Operating costs	318	268	458	486	462
Pre-impairment operating profit	134	113	269	338	333
Loan and other impairment charges	48	40	344	90	72
Operating profit	87	73	-75	248	261
Tax	48	40	-6	85	90
Net income	39	33	-69	163	226
Other comprehensive income	30	25	-48	-82	-28
Fitch comprehensive income	69	58	-117	81	198
Summary balance sheet					
Assets					
Gross loans	35,809	30,132	29,847	28,656	29,257
- Of which impaired	1,917	1,613	1,549	944	1,587
Loan loss allowances	557	469	588	383	577
Net loans	35,251	29,663	29,259	28,273	28,680
Interbank	1,223	1,029	1,029	1,363	1,000
Derivatives	1,840	1,548	2,218	1,794	1,934
Other securities and earning assets	8,458	7,117	6,919	6,995	9,031
Total earning assets	46,772	39,357	39,425	38,425	40,645
Cash and due from banks	6,938	5,838	4,744	1,494	1,265
Other assets	1,722	1,449	1,309	1,218	777
Total assets	55,432	46,644	45,478	41,137	42,687
Liabilities					
Customer deposits	13,021	10,957	13,680	12,404	13,421
Interbank and other short-term funding	10,444	8,788	5,629	906	858
Other long-term funding	25,316	21,303	20,428	21,928	22,815
Trading liabilities and derivatives	2,083	1,753	1,906	2,165	1,934
Total funding	50,865	42,801	41,643	37,403	39,028
Other liabilities	1,011	851	868	873	731
Preference shares and hybrid capital	357	300	300	300	300
Total equity	3,199	2,692	2,667	2,561	2,628
Total liabilities and equity	55,432	46,644	45,478	41,137	42,687
Exchange rate		USD1 = EUR0.841468	USD1 = EUR0.821963	USD1 = EUR0.89015	USD1 = EUR0.873057

Source: Fitch Ratings, Fitch Solutions, Aareal

Summary Financials and Key Ratios

	30 Jun 21	31 Dec 20	31 Dec 19	31 Dec 18
Ratios (annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	1.2	-0.6	2.2	2.0
Net interest income/average earning assets	1.4	1.3	1.3	1.4
Non-interest expense/gross revenue	70.2	63.1	59.1	58.1
Net income/average equity	2.5	-2.7	6.3	8.7
Asset quality				
Impaired loans ratio	5.4	5.2	3.3	5.4
Growth in gross loans	1.0	4.2	-2.1	5.1
Loan loss allowances/impaired loans	29.1	38.0	40.6	36.4
Loan impairment charges/average gross loans	0.3	1.2	0.3	0.3
Capitalisation				
Common equity Tier 1 ratio	19.2	18.8	19.6	17.2
Tangible common equity/tangible assets	5.1	5.4	5.8	5.8
Basel leverage ratio	5.7	5.9	6.3	6.1
Net impaired loans/common equity Tier 1	49.8	42.0	25.6	45.1
Funding and liquidity				
Loans/customer deposits	275.0	218.2	231.0	218.0
Liquidity coverage ratio	271.6	246.9	221.3	234.3
Customer deposits/funding	26.5	34.2	34.9	35.9

Source: Fitch Ratings, Fitch Solutions, Aareal

Key Financial Metrics – Latest Developments

Asset Quality of Hotel and Retail Sectors Recovers

Aareal's hotel loan portfolio (EUR9.3 billion at end-3Q21) is well diversified by region, brand and type, with a focus on four-and-five star hotels and over 90% managed by large international hotel brands. The average loan-to-value (LTV) ratio rose to a still sound 61% from 56% pre-pandemic. 3.4% of the hotel loan book was non-performing at end-3Q21, and we expect asset quality to stabilise with limited further deterioration. The hotels' income generation recovered in 3Q21, with an average yield on debt rebounding to 4.1% from 2.7% in 2Q21.

The retail property book (EUR5.8 billion at end-3Q21) is predominantly in Europe (80%), mainly in UK, US, Germany, Spain and Italy, where tenants have benefited from large-scale state support during the pandemic, though 15.7% of the retail book (predominantly in the UK) was non-performing at end-3Q21. Vulnerable UK shopping malls tend to have non-food retailers as dominant anchor tenants. Some have suffered from successive lockdowns, accelerating the secular shift to online shopping. As economic activity normalises, we expect asset quality to improve from 2022 and, as state support phases out, NPL inflows should be temporary and manageable.

Adequate New Business Margins and Volumes Support Earnings

We expect Aareal's average operating profit/RWAs to stay above 1.5% through the crisis. This assumes decreasing LICs, robust loan growth, tight cost management and more adequate net interest margins than that of domestic peers, owing to its international diversification. New business increased to EUR6.1 billion in 9M21 from EUR4.2 billion yoy. The bank expects to reach the upper end of its target range of EUR7 billion-8 billion in 2021 and its SPF loan book to exceed EUR30 billion at end-2021 (end-2020: EUR27.8 billion).

Sound Capitalisation

The CET1 ratio rose to 21.5% at end-3Q21 as RWAs fell to EUR10.8 billion from EUR12 billion at end-1H21 owing to retroactive collateral recognition and a reduction in NPLs.

Low Reliance on Unsecured Market Funding; Sound Liquidity

Aareal derived 59% of its funding mix from deposits and Pfandbriefe and 13% from TLTRO at end-1H21. Private placements fund a high share of its cover pools' over-collateralisation and limit the bank's reliance on the unsecured debt market. Aareal's institutional housing deposits (EUR11 billion at end-1H21) have been highly resilient during the pandemic. The inelastic pricing of these deposits would provide a natural hedge and a significant funding cost advantage relative to other CRE lenders in a rising interest-rate environment.

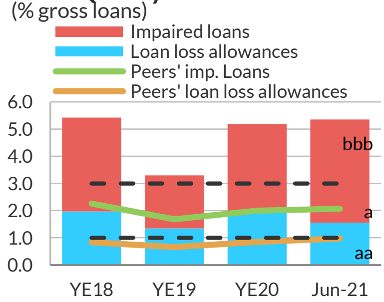
Aareal's liquid asset portfolio is funded by repos, money-market and institutional housing deposits. The treasury portfolio (EUR7.3 billion or 16% of total assets at end-3Q21) consists of highly rated, unencumbered, ECB-eligible assets and covers liquidity gaps and unexpected withdrawals of short-term funds.

Note on Charts

Dashed lines: indicative ranges and implied scores for Fitch's core financial metrics for banks operating in environments that Fitch scores in the 'aa' category like Germany.

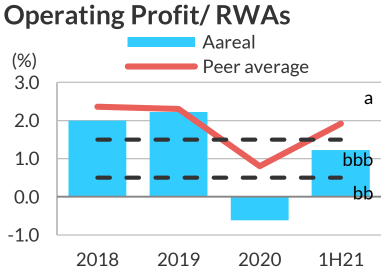
Peer averages include Aareal, Berlin Hyp AG (VR: bbb+), Landesbank Saar (bb+), NIBC Bank N.V. (bbb) and de Volksbank N.V. (a-).

Asset Quality



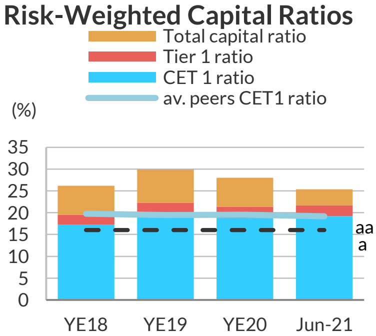
Source: Fitch Ratings, banks

Operating Profit/ RWAs



Source: Fitch Ratings, banks

Risk-Weighted Capital Ratios



Source: Fitch Ratings, banks

Government Support Assessment

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.

GSR Key Rating Drivers

Typical D-SIB GSR for sovereign's rating level (assuming high propensity)	a+ to a-
Actual country D-SIB GSR	ns
GSR	**ns**
Government ability to support D-SIBs	
Sovereign Rating	AAA
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

Source: Fitch Ratings

Key Rating Drivers' influence on GSR	
Red	Higher
Blue	Lower

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

			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 left-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 the [number of] general 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 and sub-sector ratings criteria and the General Issues and the Sector-Specific Issues have been informed with SASB's Materiality Map.

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.

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