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## INVESTORS SERVICE

### Credit Opinion: Redefine Properties Limited

Global Credit Research - 04 Mar 2016

South Africa

#### Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	Baa3
ST Issuer Rating -Dom Curr	P-3
NSR Senior Unsecured MTN	A3.za
NSR LT Issuer Rating	A3.za
NSR ST Issuer Rating	P-2.za
NSR Other Short Term	P-2.za

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#### Key Indicators

##### [1]Redefine Properties Limited

	8/31/2015	8/31/2014	8/31/2013	8/31/2012	8/31/2011
FFO Payout	104.1%	68.7%	136.3%	116.8%	105.8%
Amount of Unencumbered Assets	44.8%	41.8%	47.6%	32.0%	18.8%
Debt / Gross Assets [2]	36.5%	34.8%	31.3%	42.2%	41.9%
Net Debt / EBITDA	5.7x	5.3x	5.0x	8.1x	6.5x
Secured Debt / Gross Assets	27.5%	28.7%	24.8%	38.0%	39.5%
Gross Assets (USD Million)	\$5,516.2	\$5,424.5	\$4,804.4	\$5,605.7	\$6,397.3
Development Pipeline	4.5%	6.1%	6.9%	1.7%	1.2%
EBITDA Margin (YTD)	71.8%	67.8%	72.7%	79.3%	79.3%
EBITDA Margin Volatility	6.8%	8.7%	7.6%	5.6%	4.6%
EBITDA / Fixed Charges (YTD) [3]	2.5x	2.3x	2.9x	3.0x	2.5x
Joint Venture Exposure (YTD)	5.6%	3.0%	1.9%	0.2%	0.4%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics [2] Debt includes a portion of hybrid securities considered to have debt like features as explained in Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations revised December 2010 [3] Fixed Charges includes capitalized interests explained in Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations revised December 2010.

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

#### Opinion

## Rating Drivers

- Diversified property portfolio across key sectors in South Africa, with growing exposure to Europe and Australia
- Stable cash flows supported by moderate vacancy rates and relatively stable operating margins
- Debt funded acquisitions to weaken credit metrics but remain within Baa3 tolerance levels
- Liquidity is sufficient to meet obligations during the next 12-18 months

## Corporate Profile

Redefine Properties Limited ("Redefine" or the company) is the second largest commercial real estate investment trust (REIT) listed on the Johannesburg Stock Exchange (JSE) in South Africa by total assets, ZAR73.2 billion (US\$5.5 billion) as at 31 August 2015. Its activities include direct investments in property assets (ZAR54.6 billion or US\$4.1 billion), as well as investments in the listed securities of other commercial property investment companies totalling ZAR9.3 billion (US\$0.7 billion). Redefine's offshore property exposure is held through its investments in Redefine International Plc (RI Plc, 30.1%) in the UK; Cromwell Property Group (Cromwell, 25.6%) and Northpoint Tower (50% joint venture) in Australia; and its German portfolio (50% joint venture). All data points and credit metrics are as of 31 August 2015 (FYE2015) and are according to Moody's standard definitions and adjustments.

## Rating Rationale

Redefine's Baa3/A3.za rating is underpinned by a material growth of its property portfolio over the past 18 months within South Africa as well as more recently into Europe and Australia. The sizable portfolio of predominantly directly held South African properties (85% of property assets) has moderate and relatively stable occupancy rates of 94.6%, that produced high EBITDA margins of around 88%. The rating is also supported by a well-diversified property portfolio across key sectors in office, industrial and retail with local and offshore property (direct and indirect) exposures in South Africa, United Kingdom, Germany, Switzerland, Netherlands and Australia.

The rating is however constrained by the more complex organisational and reporting structure, a low fixed charge cover of 2.5x and increasing total debt to gross assets ratio (leverage) of 36.5%, which is anticipated to increase towards 38%. Further key constraints on the ratings include the large proportion of secured debt in the company's capital structure, which represents 71% of total debt; and the high level of encumbered assets to gross assets equal to 55%.

## RECENT CREDIT DEVELOPMENTS

On 1 March 2016, Redefine announced that it will acquire (subject to various approvals) up to 50% equity stake in Echo Prime Properties BV (Echo) which owns and operates a property portfolio of mostly retail properties in Poland (A2 stable) for Euro 241 million (ZAR4.1 billion). The acquisition will have no impact on Redefine's ratings because the benefits of increased portfolio size, diversification of cash flows and good asset quality will be offset by the higher pro forma leverage for Redefine, as measured by adjusted debt/gross assets, of around 38% (pro-forma as of 31 August 2015).

Redefine will also benefit from its partnership with Echo, which will retain a 25% equity stake and will provide the local expertise and ongoing management of the properties. Echo has a sizable development pipeline of around EUR500 million which Redefine has a first right of refusal for a 25% participation. However, should Redefine decide to take up its rights it will require additional funding from Redefine, which could be in the form of debt or equity through a possible inward listing of Echo. Given the reduced headroom to accommodate higher debt levels we would expect Redefine to take appropriate steps to manage its credit metrics within the current rating guidance.

## DETAILED RATING CONSIDERATIONS

### SIZABLE PORTFOLIO DIVERSIFIED ACROSS SECTORS

The value of Redefine's direct and indirect property portfolio has grown materially over the past 18 months to ZAR63.9 billion from ZAR36.9 billion as a result of a number of moderately sized property portfolio acquisitions. We expect the property portfolio will increase further to ZAR68 billion, should the acquisition of

Echo be concluded. Redefine's direct property portfolio totals ZAR54.6 billion comprising mostly of South African properties and a small direct exposure in Germany and Australia. Its other investments include sizable strategic holdings of listed REIT securities totalling ZAR9.3 billion, comprising of a 30.1% stake in Redefine International Plc, a 25.6% stake in Cromwell and a 11.5% in Emira Property Fund. We consider Redefine's total property portfolio to be sizable and comfortably positioned within the Baa rating category.

Redefine property exposure in South Africa is diversified across the retail, industrial and office sectors. However, due to its exposures to the office and industrial sectors (30% and 41% of gross lettable area or GLA) it faces risks from the current weak local economic environment. Redefine has taken the necessary steps to increase its exposure in the retail sector, which we view as a less risky and a more resilient sector, most notably through the completion of the Fountainhead Property Trust (Fountainhead) acquisition and the acquisition of Annuity Properties. Redefine is also looking to pursue new opportunities in less traditional sectors such as student accommodation, however this is currently a relatively small exposure.

We anticipate only marginal capital growth on Redefine's property portfolio in the next 12 to 18 months; driven by uncertainties in global markets, weak local demand and slowing consumer confidence, which all restrict capital growth in the South African property market. While it is not our expectations, negative property value growth could weaken the debt to gross assets ratio beyond the levels for the current rating.

#### INCREASING OFFSHORE PROPERTY EXPOSURE DIVERSIFIES PROPERTY EXPOSURE AND CASH FLOWS

Geographically, Redefine's South African properties which represent 85% of group property assets are highly concentrated in two provinces: Gauteng and the Western Cape (66% and 17% of GLA respectively). However, these two provinces are also the wealthiest and the most economically active, as measured by contribution to the South African gross domestic product (GDP) of 34% and 14% respectively and should be more resilient to a weakening economy. Furthermore, the concentration risk is partially offset by its exposure to European and Australian properties representing 15% of group property assets and 17% of group net distributable income. During the 2015 financial year end Redefine completed a direct property investment in Germany, and increased its investment in Cromwell to 25.6% from 12.8%. We anticipate Redefine to pursue direct investment opportunities outside of South Africa (particularly in Europe and Australia) up to around 25% of total property assets providing the company with a Rand hedge exposure. This has been demonstrated by the recent proposed acquisition of Echo which will result in Redefine achieving its stated asset value target of 25% of total portfolio value and will further diversify Redefine's property portfolio in a stronger growth market relative to South Africa. We view Redefine's diversity as good, consistent with a Baa rating factor.

#### STRATEGIC FOCUS ON IMPROVING THE QUALITY OF THE PROPERTY PORTFOLIO

Management's strategy has been to upgrade the core property portfolio in South Africa through disposals of non-core holdings, and reinvesting the proceeds, through redevelopments and acquisitions, in larger, well-located and higher grade properties. In executing this strategic focus, over financial year to 31 August 2015 Redefine disposed of around ZAR2.2 billion smaller and older properties and has identified ZAR5.6 billion of non-core properties to be sold over time. Furthermore, Redefine has made sizable acquisitions over the period totalling ZAR19.8 billion. Notable acquisitions include the purchase of the remaining 34.1% stake in Fountainhead (ZAR3.8 billion), Leaf Capital Property portfolio (ZAR4.1 billion), Annuity Property portfolio (ZAR2.1 billion) and the Macsteel property portfolio (ZAR2.7 billion).

Over the past three years Redefine has improved the size and quality of its portfolio, with average property values increasing to ZAR154 million as of 31 August 2015 from ZAR95 million (FYE2013) with a higher proportion of A and B-grade tenants. 61% (54%: H2 2012) of its tenants were A-grade, 25% (29%: H2 2012) B-grade and 14% (17%: H2 2012) C-grade. Tenant classifications are as follows: A-grade: National, provincial and local government departments, parastatal entities, national retailers and large listed companies; B-grade: Professional firms and medium-sized companies; C-grade: other. We consider Redefine to have a moderately diversified tenant base, with the top ten tenants representing 31% of total gross monthly rental, with the South African government being the largest tenant at 9% of gross monthly income. We understand that management intends to continue to dispose of non-core assets which include its government tenanted office portfolio and older properties outside the main three economic hubs (Johannesburg, Cape Town and Durban) in South Africa, contributing to the improvement of its portfolio quality. Redefine has been successful in reducing its exposure to government tenanted properties and has sold 15 office properties to Delta Property Fund (Delta) in exchange for Delta shares, reducing its direct exposure to government tenant from 12% to 8% of GLA. However, while this does not remove Redefine's overall exposure to government tenanted properties, it has effectively transferred the properties to a more niche property operator who are in a better position to extract

value from the portfolio.

In addition to the above steps Redefine continues to invest in redevelopments and new developments of approximately ZAR3.8 billion. We view the company's approach to development risk as conservative, expanding its portfolio and quality through low risk, purpose-driven developments, with speculative developments not exceeding 3% of its property assets. As of 31 August 2015, development property assets plus planned expenditure represented 4.5% of gross assets, consisting of primarily tenant driven and pre-let developments. Furthermore, Redefine's refurbishment capital expenditure are seen as lower-risk extensions being made to existing successful properties ensuring its property portfolio remains current.

#### MODERATE VACANCIES, ABOVE INFLATION CONTRACTUAL RENTAL ESCALATIONS AND MANAGEABLE ANNUAL LEASE EXPIRIES SUPPORT STABLE CASH FLOWS

Redefine's ratings are underpinned by recurring, contractual rental income. Reported revenues comprised of 92.6% income from property portfolio, 5.1% income from the listed securities of commercial property investment companies, 1.7% from insurance proceeds received and 0.6% from trading and other fee income. EBITDA margins for Redefine of 88.0% is viewed as relatively high for its rating position and in line with other South African REITs rated by Moody's.

Above-inflation price increases of local utilities, electricity concerns and the weak South African economic environment (Moody's GDP growth forecast is 0.5% for 2016 and 1.5% for 2017) will continue to put pressure on tenants. We anticipate that this will continue to be reflected in either higher vacancy levels or lower renewal rental escalations translating into lower operating margins. We expect the office and Industrial sectors to feel the effect more relative to the more defensive retail sector. In order to retain existing tenants and keep vacancy rates low, we anticipate higher tenant incentives which will increase costs and below-inflation rent renewals which will pressure revenue growth and operating margins. Redefine will continue to manage its cost structure through ongoing cost efficiency programmes.

Redefine's overall vacancy rates remained stable at 5.4%; broken down by offices at 8.5% (7.2%: FYE 2014), retail at 4.3% (3.9%: FYE2014) and industrial at 3.8% (5.3%: FYE2014). Redefine's office vacancies are lower than the South African market average of around 11% (Independent Property Database - IPD), while its retail and industrial vacancies were broadly in line with the South African market. We consider Redefine's overall vacancy rate to be broadly in line its domestic rated peers: Growthpoint Properties Limited (4.9%: 31 December 2015) and Fortress Income Fund (6.2%: 31 December 2015).

Over the next 2 years, approximately 14% of Redefine's leases expires each year which we view as manageable. Furthermore, the South African portfolio has a weighted average lease expiry (WALE) of 6 years which is higher than the average in South Africa but lower compared to Europe and Australia. Tenant renewal retention (percentage of leases expiring that are successfully renewed) over the past year was high at 87%, which was due to successful retention strategies employed over the period. Going forward we expect retention rates to remain above Redefine's historical average of around 80%. However, new and renewal rental growth rates of around negative 3% for 31 August 2015 are likely to remain under pressure and well below inflation (January 2016 CPI: 6.2% year-on-year growth). This will however be offset by the annual rent escalation clauses from existing tenant contracts of between 7% and 8%.

Redefine's rent arrears levels remain well controlled at ZAR42 million (ZAR42 million: FYE 2014), representing only 0.7% of contractual rental income. With the current weak economic environment and above inflationary cost pressures on tenants we anticipate some upward pressure in the near term, however we do not expect it to be material given the diversity of Redefine's property portfolio.

#### WEAKENING CREDIT METRICS LIMIT FINANCIAL FLEXIBILITY BUT REMAIN WITHIN THE Baa3 RATING GUIDANCE

Given the number of sizable acquisitions and investments in new developments made during FYE2014 and FYE2015, we have seen a weakening trend in credit metrics, despite Redefine balanced approach to funding the growth. Leverage, defined as gross debt to gross assets, increased to 36.5% from 31.2% (FYE2013), however has reduced to 34.8% on a pro forma basis, mainly due to Redefine underwriting RI plc's rights issue, which it was not called to step in. We expect leverage to increase to around 38% following the debt funded Polish acquisition. While this remains within the Baa rating range, it reduces Redefine's financial flexibility to pursue debt funded acquisitions or accommodate weaker performance.

We note that the organisational and financial complexity of Redefine makes it difficult to fully capture Redefine's strategic equity accounted property exposures from consolidated financials, which tend to have

higher leverage than Redefine. On a full look through basis (as of 31 August 2015), which includes the proportionate consolidation of material equity accounted investments of Redefine International Plc and Cromwell, the debt/gross asset ratio is around 38% compared to 36.5% based on reported financials. Factoring the proposed acquisition of Echo will increase the full look through leverage to around 41%. Further material leveraging of these investments which are not fully reflected in Redefine's consolidated financials may have a negative impact on the credit profile of Redefine.

Redefine's fixed charge ratio increased to 2.5x from 2.3x for FYE2014, but still remains close to our downward rating guidance. We expect to see continued improvement in Redefine's fixed charge cover ratio, as acquisitions and developments contribute for the full 12 months to cash flows.

Management has hedged 81% of its floating interest rate debt to fixed interest rates with average expiry of 2.8 years at an average cost of borrowing of 8.4% (FYE2014 was 8.2%). This compares to a minimum hedging target of 75% of outstanding debt to be fixed and provides a high level of protection against rising interest rates, which would otherwise place downward pressure on the fixed charge ratio.

Redefine's high level of secured debt to gross assets at 27.5% and level of unencumbered assets of 44.8% of gross assets (both equivalent to a Ba rating category), are considered weak for its ratings category. We recognize that management has an ongoing strategy to shift its financing from secured debt towards unsecured borrowings and improve the level of unencumbered assets, which would be positive for the rating positioning.

### **Liquidity Profile**

Redefine's liquidity is deemed sufficient to meet its obligations over the next 12-18 months, supported by positive and stable cash flow from operations and available credit facilities of ZAR3.4 billion. In general, access to debt funding in South Africa and more recently offshore has been good but at increasing funding levels given market conditions. Redefine has also successfully raised funding through the equity markets to fund developments and property acquisitions. Moody's rates Redefine's access to diversified sources of funding as good, consistent with a Baa rating. As per the latest covenant compliance calculation, at 31 August 2015, Redefine had adequate headroom under its South African financial covenants.

In addition, Redefine has introduced a distribution reinvestment plan which, at the option of the investor electing to take units/shares instead of dividends, will free up additional liquidity sources for Redefine.

### **Rating Outlook**

The rating outlook reflects Moody's view that Redefine will continue to produce steady rental income, make well-conceived investments and produce good operating returns. The stable outlook assumes the absence of large transformational acquisitions and that management will maintain an adequate liquidity profile at all times.

### **What Could Change the Rating - Up**

Upward pressure on the ratings could occur if (1) portfolio size and diversification materially improves; (2) shows a good track record as a rated entity; (3) continues to produce consistent credit metrics, maintaining leverage, defined as adjusted total debt/gross assets, sustainably below 35% and fixed charge coverage above 3.0x on a sustained basis; and (4) improves the ratio of secured debt/property assets to substantially below 25%.

Any future upward pressure will also have to be considered in the context of the South African sovereign rating, currently Baa2 with a negative outlook, which may constrain Redefine ratings.

### **What Could Change the Rating - Down**

Downward pressure on the ratings could emerge if (1) adjusted total debt/gross assets exceeds 40% on a sustained basis; (2) fixed charge coverage trends below 2.5x; (3) the ratio of secured debt/property assets remains above 30%; (4) unexpected difficulties integrating acquisitions arise, having a negative impact on the operational performance or cash flows of the company; or (5) there is a deterioration of Redefine's liquidity risk profile.

### **MAPPING TO THE RATING METHODOLOGY**

The principal methodology used in rating Redefine was Moody's Approach for REITs and Other Commercial

Property Firms, published 30 July 2010. Based on the FYE ended 31 August 2015, Redefine's overall performance measurements from the rating grid indicate a rating outcome of Baa2, one notch higher than the long-term issuer rating. We note that the grid implied rating is based on historic financial information while the rating is factoring our expectation of future performance and more complex organisational and financial structure.

## Rating Factors

### Redefine Properties Limited

REITs and Other Commercial Property Firms Industry Grid [1][2]	Current FY 8/31/2015		[3]Moody's 12-18 Month Forward ViewAs of 3/3/2016	
<b>Factor 1: Liquidity and Funding (24.5%)</b>	<b>Measure</b>	<b>Score</b>	<b>Measure</b>	<b>Score</b>
a) Liquidity Coverage	Ba	Ba	Ba	Ba
b) Debt Maturities	Ba	Ba	Ba	Ba
c) FFO Payout	104.1%	B	90% - 100%	Ba
d) Amount of Unencumbered Assets	44.8%	Ba	45% - 50%	Ba
<b>Factor 2: Leverage and Capital Structure (30.5%)</b>				
a) Debt / Gross Assets [4]	36.5%	Baa	35% - 40%	Baa
b) Net Debt / EBITDA	5.7x	Baa	5.5x - 6.5x	Ba
c) Secured Debt / Gross Assets	27.5%	Ba	20% - 25%	Ba
d) Access to Capital	Baa	Baa	Baa	Baa
<b>Factor 3: Market Position and Asset Quality (22%)</b>				
a) Franchise / Brand Name	A	A	A	A
b) Gross Assets(USD Million)	\$5,516.2	Baa	\$5250 - \$5500	Baa
c) Diversity: Location / Tenant / Industry / Economic	Baa	Baa	Baa	Baa
d) Development Pipeline	4.5%	Aa	4% - 6%	A
e) Asset Quality	Baa	Baa	Baa	Baa
<b>Factor 4: Cash Flows and Earnings (23%)</b>				
a) EBITDA Margin (YTD)	88.0%	A	75% - 85%	Aa
b) EBITDA Margin Volatility	4.9%	Ba	3% - 5%	Baa
c) EBITDA / Fixed Charges (YTD) [5]	2.5x	Baa	2.5x - 2.8x	Baa
d) Joint Venture Exposure (YTD)	5.6%	A	4% - 6%	A
<b>Rating:</b>				
a) Indicated Rating from Grid		Baa2		Baa2
b) Actual Rating Assigned				Baa3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 8/31/2015; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures. [4] Debt includes a portion of hybrid securities considered to have debt like features as explained in Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations revised December 2010 [5] Fixed Charges includes capitalized interests explained in Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations revised December 2010.

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