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Research Update:

French Residential Property Owner in'li Assigned 'BBB+' Rating; Outlook Positive

May 22, 2019

Rating Action Overview

- in'li manages a €7.9 billion portfolio of intermediary residential housings in the greater Paris region (Ile-de-France), and has moderate indebtedness, with its debt to debt plus equity (fair value adjusted) expected at below 25% over the next 24 months.
- We consider in'li's business model and cash-flow generation predictability as robust, with the company renting housing units in undersupplied geographical areas and at below-market levels, ensuring high occupancy at all times.
- We are therefore assigning our 'BBB+' long-term issuer credit rating to in'li.
- The positive outlook reflects our view that we may upgrade in'li within the coming 24 months, assuming that its parent Action Logement group and its key subsidiaries improve their financial reporting over this period and provide greater transparency regarding their financial performance, strategy, and governance.

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Rating Action Rationale

Our assessment of in'li's business risk profile is underpinned by its strong business model, under which the company rents residential assets located in undersupplied areas at below-market rents. As defined by law, intermediary housing players' assets need to be located in areas the French government specifically defines as being undersupplied. The shortage is most significant in "Zone A bis,"--comprising Paris city--and "Zone A"--comprising the outskirts of Paris. More than 98% of in'li's portfolio is concentrated in these two zones. Another requirement for intermediary housing is to offer rents at 15%-20% below market level. According to the Institut d'Aménagement et d'Urbanisme (IAU), demand in Ile-de-France should remain particularly high, as about 517,100 households are eligible in terms of incomes, out of which 203,600 are living in higher free-market rent apartments. As a result, we expect in'li's occupancy level will remain stable at around 97%, providing robust predictability of future cash-flow generation. in'li is already the largest player in the Ile-de-France intermediary housing market, with a large portfolio of 42,000 units, worth a total of €7.9 billion. This compared with CDC Habitat, the second-largest player, which has less than 25,000 units in its portfolio in Ile-de-France.

In order to pursue the aims of intermediary housing, in'li plans to cover about 50% of Ile-de-France's unmet needs by producing 80,000 new intermediary housing units in the region over the next 10 years. More precisely, the company intends to produce 37,200 housing units by 2023, of which 19,100 would be owned by in'li and 18,100 by investment funds in which in'li would maintain a minority stake (about 25%). As the production for in'li's portfolio will be partly funded by asset rotation, its total number of housing units will increase to about 45,000 by 2023 from approximately 42,000 units as of end-2018. About one-third of the units will be new construction. We see the social purpose of in'li's business model as a clear competitive advantage, given the increasing social demand for higher purchasing power in France. At the same time, this upcoming portfolio reshuffle should enable the company to benefit from a significant upside in rental income generation, since the rent level for new housing assets entering in'li's portfolio will likely be much higher than that on existing assets, with average market rents increasing at a rate well above inflation over the past decade. in'li already aims to increase its portfolio's average rent from a current €10 per square meter (/sqm) to €11/sqm in the next two years. In Paris city, where in'li currently has 25% of its portfolio value, the portfolio average rent is currently €12.43/ sqm, translating into a 95% upside potential at current market level.

Eighty percent of in'li's progressive investment plan, which totals €4.3 billion over the next five years, will be project acquisitions under the French VEFA legal framework ("Vente en l'Etat Futur d'Achèvement", or forward-sale contract), which sets payments schedules throughout the construction phase and protects buyers by means of a final completion guarantee, limiting the development risk borne by the company. We also note that in'li benefits from advantageous acquisition prices, partly due to the favorable tax regime for intermediary housing providers, and because block acquisitions allow the company to negotiate discounts when compared with individual units transactions.

We acknowledge these future large investments may create some development risk, especially for the remaining 20% of the development pipeline that will be realized in "Maitriste d'Ouvrage Directe," under which in'li directly supervises the construction process as a property developer. That said, the committed pipeline as of January 2019 only represents about 5% of the total portfolio value and should not exceed 10%, therefore remaining limited.

Due to the low rents and yields nature of the intermediary housing segment, and the high proportion of nonrecoverable costs, in'li's expected EBITDA margins of below 50% in the coming two years compare negatively with those of rated real estate peers. However, margins should improve thereafter thanks to the company's portfolio rejuvenation strategy, which should result in higher average rents (currently at a low €10/sqm per month) and lower maintenance needs. Moreover, in comparison with some of its peers with the same business risk assessment, such as Vonovia, in'li's portfolio is smaller and more geographically concentrated, focused primarily on Ile-de-France. Therefore, we view in'li's business risk profile at the lower end of our strong business risk category.

Our view of in'li financial risk profile reflects the company's prudent and public financial policy to maintain a loan-to-value ratio below 35%-40%, and our expectations of EBITDA-interest-coverage of 3.0x-3.5x over the next 24 months. The company's S&P Global Ratings-adjusted debt to debt plus equity (fair value adjusted) was 16.2% at end-2018, and we expect it to remain below 25% over the next 24 months, which is very low compared with the average in the industry (35%-50%).

That said, in'li's core strategy is to produce 37,200 new housing units by 2023, out of which 19,100 will be owned by in'li. These will be partly funded (about two thirds) by additional debt, as well as capital injections from its parent Action Logement group, and progressive disposals of mature or noncore assets. We understand that this will result in a gradual increase of in'li's debt-to-debt-plus-equity ratio to 20%-25% in the coming three years, getting closer to its financial policy target of 35%-40%. We anticipate that EBITDA interest coverage will stabilize at 3.0x-3.5x, which is commensurate with our intermediate financial risk assessment. We expect our adjusted debt-to-EBITDA ratio will stabilize at a relatively high level--currently about 12.5x--as a result of low yields on residential assets across Europe.

We currently regard in'li as a strategically important subsidiary of Action Logement group via Action Logement Immobilier (ALI). This points to our assessment that the group would likely provide financial support to in'li in the case of need. We believe it is highly unlikely that ALI will sell in'li. This is because we understand that, given the nature of in'li's operations, it plays an important role in meeting one of Action Logement group's key objectives of providing affordable housing solutions for employees across France's most economically dynamic region. We also recognise Action Logement group's commitment to provide in'li with sizable capital injections and long-term, subsidised loans over the coming years, under the terms of Action Logement group's 2018-2022 contract with the French government that aims to correct a market failure in the provision of affordable housing, reflecting significant sector undersupply.

The rating on in'li does not include any uplift from potential parental support at this stage, mainly because of limited information on ALI's financials, strategy, and governance. We understand the Action Logement group and its key subsidiaries, including ALI, will develop its financial reporting during 2019, which should provide more transparency. That said, we do not foresee any adverse impact on the rating on in'li, mainly because we view ALI's credit quality as benefiting from a solid enterprise profile, and because of in'li importance to Action Logement group's--and ALI's--own strategy as a result of its contract with the central government. We also take into account the limited dividend payout from in'li required by the group observed over recent years and that we anticipate in the future.

Outlook

The positive outlook reflects the possibility that we could upgrade in'li in the next 24 months if Action Logement group provided greater transparency regarding its financial performance, strategy, and governance. We understand Action Logement group and its key subsidiaries, including ALI, will develop their financial reporting during 2019. Demonstrated potential support from the French government to in'li, either via the group or directly, may also positively influence our assessment of the company. In addition, we could raise the ratings if in'li improved its financial profile, for instance through a tighter financial policy and stronger credit metrics than currently envisaged, subject to greater transparency regarding Action Logement group's financials and its strategy concerning in'li.

Downside scenario

We could revise the outlook to stable if Action Logement group does not provide clarity on its financials, strategy, and governance. Rating pressure could also come from any deterioration of in'li stand-alone credit profile, which could result from higher-than-expected leverage or a change of business strategy.

Company Description

France-based in'li owns a portfolio worth €7.9 billion (appraisers' valuation is conservatively based on block rather than unit sales) comprising residential assets solely located in the greater

Paris region (Ile-de-France). in'li's assets are in the intermediary market segment ("logement intermédiaire"), defined under French law since 2014, and reserved for households with specific tranches of income. Against a favorable tax regime, French intermediary housing providers offer housing to middle-income households, i.e. those with too high an income to have access to highly-subsidised French social housing, but too low to afford free-market rents, especially in high-demand and congested areas such as the greater Paris region.

in'li is a 99.28%-owned subsidiary of the Action Logement group via ALI, a key player in France's social housing sector. ALI manages about 20% of the French social housing park. We view in'li as a strategically important subsidiary of ALI.

Our Base-Case Scenario

In our base case, we assume:

- Like-for-like growth in rental income of about 1.5% in 2019 and 2020, in line with our forecast consumer price index in France over the coming years, which should be close to the Indice de Référence des Loyers (IRL) index. We also expect occupancy will remain stable at about 97%, even if in'li is able to favorably renegotiate the terms of some of its outstanding leases.
- Disposal proceeds of €230 million in 2019, including a portfolio of assets considered less core to the company's strategy, and some disposals, unit by unit, to individuals, including in-place tenants. We assume €1,388 million disposals in 2020, including additional unitary disposals, but mainly the block sale of 6,000 housings to the investment funds that in'li should have by then set up.
- Development capital expenditure (capex) of about €544 million in 2019 and €749 million in 2020, as part of in'li's strategy to produce about 37,200 new housings by 2023, of which 19,100 housings will be owned by in'li. We understand the development plan will be phased in to match the pace of the company's completed disposals.
- Capital increases from ALI of €65 million in 2019 and €50 million in 2020, as part of the five-year agreement with the French government ("Convention quinquennale").

Based on these assumptions, we arrive at the following credit measures:

- Debt to debt plus equity remaining below 25% in 2019-2020, increasing thereafter;
- EBITDA interest coverage of 3.0x-3.8x in the next two years; and
- Debt-to-EBITDA ratio of 12.0x-13.0x in the next two years.

Liquidity

We assess in'li's liquidity as strong. We anticipate that liquidity sources will likely cover uses by more than 1.5x for the 12 months started Jan.1, 2019, and by more than 1.0x over the 24 months from the same date.

We estimate the company's principal liquidity sources for the 12 months started Jan. 1, 2019, as follows:

- €380 million of cash and liquid investments;
- €842 million of undrawn bank lines;

- Our estimate of about €80 million cash funds from operations;
- A €65 million capital injection from ALI; and
- More than €90 million of proceeds from contracted asset sales.

We estimate the company's principal liquidity uses for the same period as:

- About €100 million of debt maturities for the next 12 months; and
- About €300 million of committed development capex, as part of the strategy to produce new housing.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Positive/--

Business risk: Strong

- Country risk: Low
- Industry risk: Low
- Competitive position: Strong

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb+

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+

- Entity status within group: Strategically important

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Governments | General: Methodology For Rating Public And Nonprofit Social Housing

Providers, Dec. 17, 2014

- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

New Rating	
in'li	
Issuer Credit Rating	BBB+/Positive/--