Maroon CRE loan: autopsy of a default
UK retail gloomy environment and loan legacy weaknesses

The default in March 2020 of the Maroon loan backing the Elizabeth Finance CMBS highlights the challenges arising in the UK retail sector and exacerbates the loan's specific legacy weaknesses. The default, caused by a sharp 34% drop in collateral value since the loan was originated in 2018, was in fact the second default.

Defaults of loans backing European CMBS have historically been low, but the Maroon loan default was not totally surprising. This case study, which can inform future analysis, first provides an overview of the current turmoil surrounding the UK retail industry and shopping malls specifically. Second, we conduct retrospective credit risk analysis, which highlights Scope's approach to rating CRE securities in the context of the key lessons learned from the Maroon CRE loan default.

1. UK retail market: a gloomy picture

The UK retail sector has been hit by Brexit uncertainty, the rise of e-commerce, a supply and demand imbalance and more recently the Covid-19 pandemic. Two consequences can be observed, which reflect the sector's negative outlook:

i) Growing pressure on rental income resulting from rising tenant credit risk.

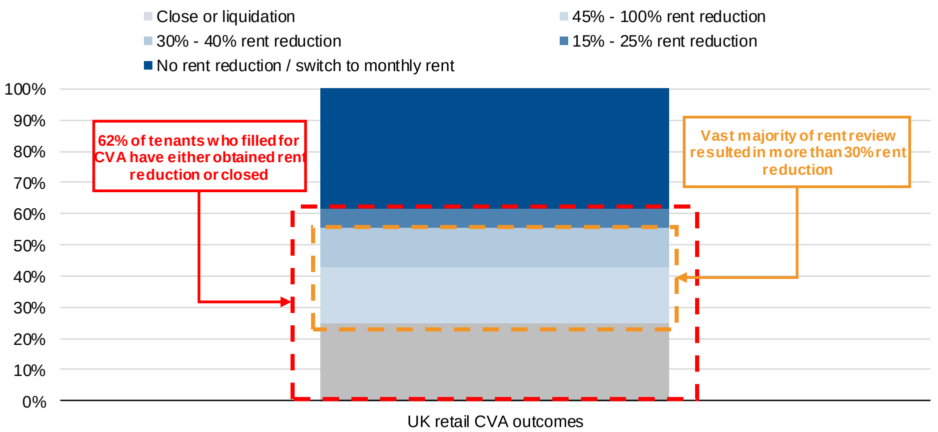
ii) Widening yields, especially for regional secondary shopping malls.

1.1. Growing pressure on UK retail rental income and the impact of CVA

Pressure on the rental income of UK retail landlords results from i) rising tenant insolvencies (3.2% higher in 2019), resulting in a wave of rent reductions and store closures; ii) re-letting difficulties highlighted by a continuing increase in vacancy rates (12.7% as at 2019 year-end).

A total of 249 UK retailers went into administration in 2018 and 2019, an 18.5% increase compared to the two previous years. A total of 671 used Company Voluntary Agreements (CVAs) as an insolvency strategy. CVAs are voluntary insolvency procedures that give businesses the chance to renegotiate debts with creditors, repay their own liabilities while continuing to trade. CVAs have crystallised the already-negative trend in UK retail real estate. Large multi-site retail insolvencies impacted over 50,000 employees in 2019, twice as many as the previous year. Landlords face immediate adverse consequences, since retailers that go through CVAs can exit contractual rental agreements overnight. CVAs successfully resulted in rent reduction in 37% of cases and in 25% in closed shops.

Figure 1: UK retail CVA outcomes



Source: Colliers, Scope Ratings

[1] Deloitte, January 2020

Analyst
Florent Albert
Associate Director
+49 30 27891 164
f.albert@scoperatings.com

Team leader
David Bergman
Head of Structured Finance
+39 02 30315 838
d.bergman@scoperatings.com

Investor Outreach
Michael John MacKenzie
+44 20 3714 4981
m.mackenzie@scopegroup.com

Media
Keith Mullin
k.mullin@scopegroup.com

Related Methodologies
General Structured Finance Rating Methodology

Related Research
Leasehold property: attractive investment opportunities with diverse risk drivers
January 2020

Healthcare: an attractive segment for alternative real estate investment
December 2019

Scope Ratings GmbH
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Shopping centre yields have widened compared to other retail asset types. Yields widened by 100bp between the Maroon loan appraisal and the Elizabeth Finance CMBS issuance

1.2. UK retail and shopping centres: a clear path to credit risk differentiation

UK prime regional retail yields have widened to 5.8% since bottoming at 4.6% in 2015 (see Figure 2). This reflects the negative sector outlook illustrated by decreasing rents since 2017. Meanwhile, the market differentiates between credit risk between retail sub-sectors, especially in secondary locations. Secondary UK shopping centre yields have widened by 280bps since 2015 and their spreads by 75bp and 125bp versus secondary high street and secondary bulky goods respectively (see Figure 3).

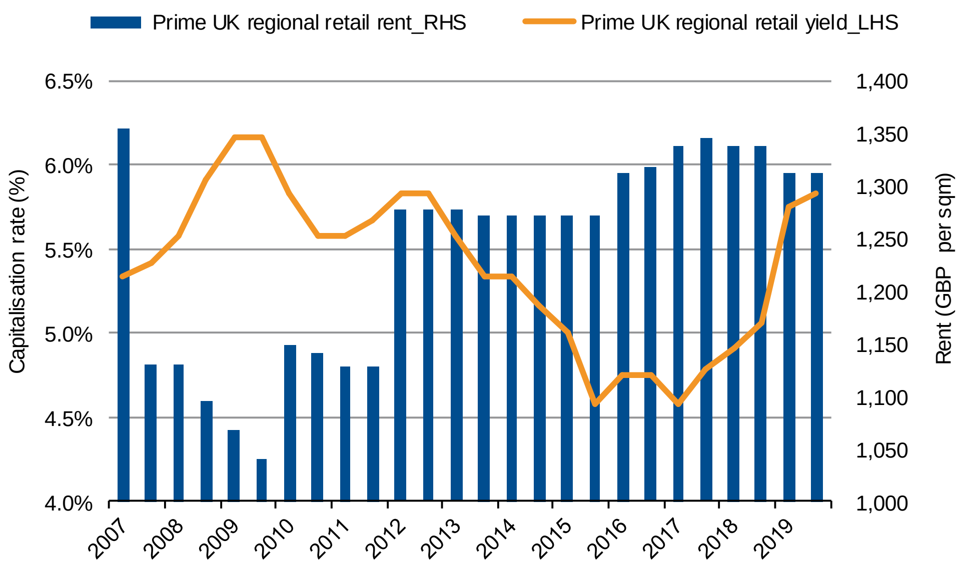
The trend is driven by:

i) Online disruption: internet sales represent 20% of total UK retail sales, out-performing by far all other European markets. Covid-19 will likely speed-up the trend with behavioural changes for consumption of both online groceries and non-essentials.

ii) A supply-demand imbalance both in terms of potential tenants/available units and potential buyers/assets for sale. Again Covid-19 impacts may worsen the trend driven by store shutdowns and a rise in expected tenant insolvencies.

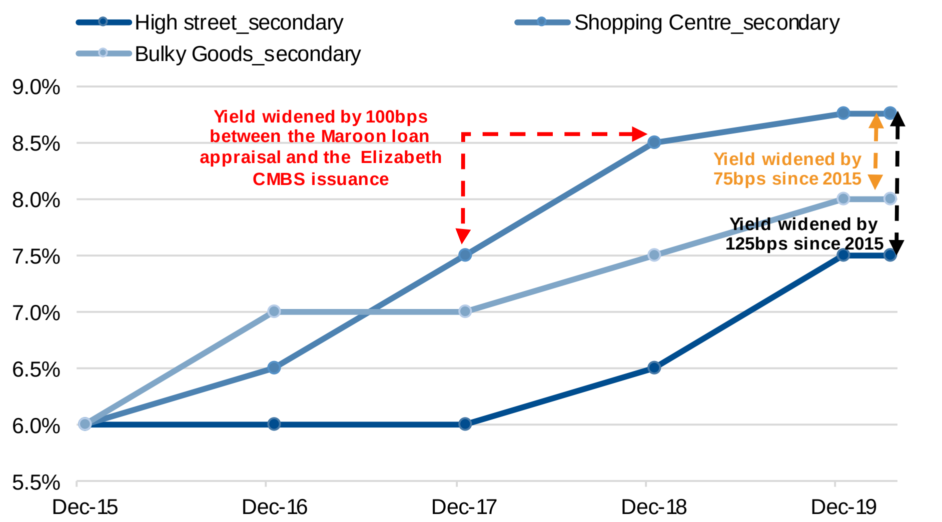
iii) The Brexit effect, with reduced consumer confidence, weaker sterling, and retailers holding off decisions to expand or not in the UK.

Figure 2: UK regional prime retail yield and rent



Source: Colliers, Scope Ratings

Figure 3: Secondary UK shopping centre yield versus high street and bulky goods



Source: Knight Frank, Scope Ratings

2. Maroon loan: autopsy of a default

The Maroon case study illustrates Scope's approach to rating CRE loans. Although it applies retrospectively, it highlights key lessons that should be applied in forward-looking credit analysis, namely:

- The disruption potential of the general turmoil affecting the UK retail sector and secondary shopping centres;
- the importance of factoring tenant credit quality into net operating income,
- necessary cautiousness around re-letting assumptions,
- the sensitivity of appraised value to capitalisation-rate movements and net operating income projections.

Based on this analysis the Maroon loan would have therefore been perceived as risky from issuance and negatively impacting our view on the Elizabeth Finance 2018 CMBS.

2.1. Maroon loan credit history

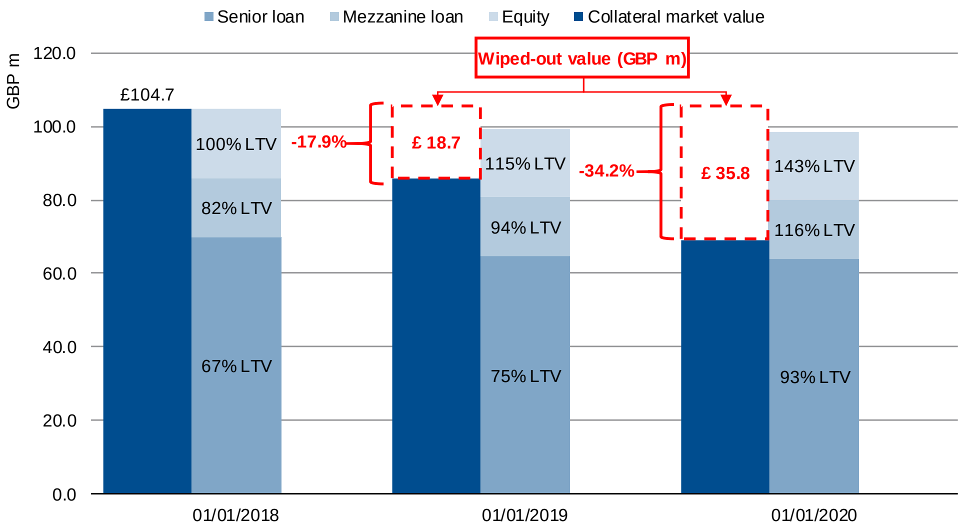
Maroon loan secured collateral value dropped by 34.2% within two years, reflecting gloomy UK secondary shopping mall sector

The GBP 69.9m Maroon senior loan is one of two loans backing the Elizabeth Finance 2018 CMBS, which is secured by three UK secondary regional shopping malls of similar values. The financing also included a GBP 16.1m mezzanine loan.

The secured real estate portfolio was initially appraised at GBP 104.7m and it has been reassessed twice since then, owing to rising vacancies and yields and declining rental income. As a result, the market value dropped by GBP 18.7m and GBP 35.8m respectively. This triggered two breaches of default covenants; the first in June 2019 cured by the mezzanine lender; the second in March 2020 before the Covid-19 crisis.

The total collateral market value decreased by 34.2% over two years and roughly GBP 35.8m of market value has been wiped out in two years.

Figure 4: Maroon loan asset and liability



Source: Global Capital, DBRS, Scope Ratings

2.2. Situation as at issuance: speculative Top 10 tenants

At issuance, 76% of the top 10 tenants were non-investment grade tenants.

At closing, the 10 top tenants represented 40.4% of the rent of 131 in-place tenants with an eight-year weighted average unexpired lease to break (WAULB). This relatively long WAULB provided limited comfort, because the credit quality of the top 10 tenants was weak; 76% of the rent was coming from non-investment-grade tenants, including 58% in the highly speculative rating bucket (B and below). In addition, Tesco, the largest tenant with 7.4% of total in-place rent had a short 1.6-year WAULB.

Concerns about the tenants' low credit quality materialised quickly, as the share of top tenants with highly speculative ratings increased to 74% after year one assuming exercise of break options, highlighting the gloomy picture of the UK´s retail sector.

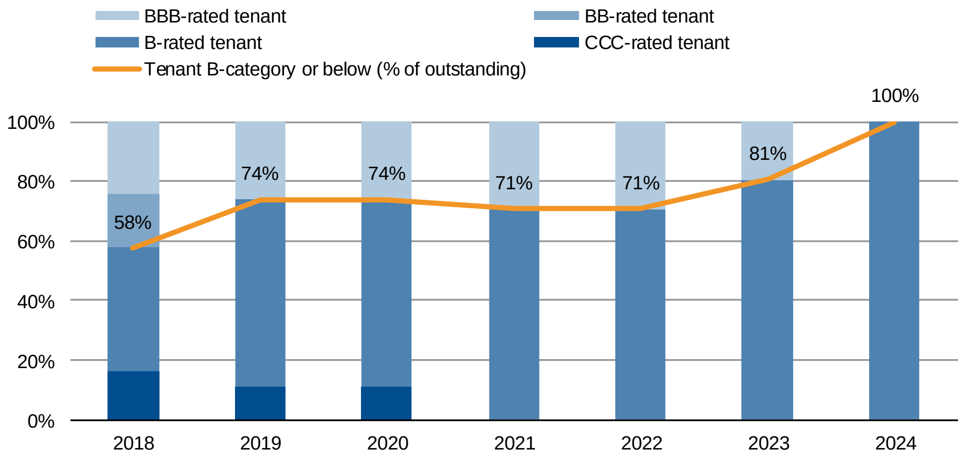
Figure 5: Highly speculative Top 10 tenancy

Tenant	In place-rent (% total)	In place-rent (% Top 10 tenant)	WAULB (year)	2018 rating category	Rating action since 2018 (notch)
Tesco	7.40%	18.3%	1.6	BB-rated tenant	Upgrade (1)
Debenhams	5.70%	14.2%	15.1	CC-rated tenant	Downgrade (-5)
APCOA	5.30%	13.2%	17.5	B-rated tenant	Affirmed (0)
TK Maxx[2]	4.00%	9.9%	6	BBB-rated tenant	Affirmed (0)
Poundland[3]	3.70%	9.2%	1	CCC-rated tenant	Withdrawn
Wilko[4]	3.00%	7.4%	6.7	B-rated tenant	N/A
New Look	2.90%	7.1%	3.3	CCC-rated tenant	Upgrade (1)
Argos[5]	2.90%	7.1%	1.2	BBB-rated tenant	N/A
Marks & Spencer	2.90%	7.1%	5.3	BBB-rated tenant	Affirmed (0)
Mall Income[6]	2.60%	6.5%	20.8	B-rated tenant	N/A
Top Ten tenants	**40.40%**		**8.0**		

Source: DBRS, Scope Ratings

[2] TJX A2 company rating assumed minus two notches
[3] Steinhoff International Holdings N.V accounting scandal
[4] B+ equivalent rating assumed
[5] Sainsbury's BBB- credit rating assumed
[6] B+ equivalent rating assumed

Figure 6: Highly speculative Top 10 tenancy



Source: DBRS, Scope Ratings

2.3. Application of Scope's rating approach

2.3.1. Rental income projections

Scope's considers contractual rental income until the earliest of a tenant-simulated default, the first lease break-up option date and the lease maturity date. After the contractual rental period, Scope assumes a void period and re-letting rental income. The re-letting rental income is the estimated rental income (ERV) adjusted by external factors like sector outlook.

Accordingly, the assumed average credit rating of the Top 10 tenants would have worsened to B+ from BB- by 2019, considering the execution of Tesco's lease break-up option and the CVA application from Debenhams. Our re-letting assumptions would have factored in the CVA outcomes at that time. A total of 61% of CVAs resulted either in a tenant exiting the rented unit or a rent reduction of more than a third in 31% of cases (Figure 1). Finally, the remaining units would also have suffered a reduction in footfall from the two anchor tenants vacating their units or reducing their space.

Figure 7 shows the Maroon loan's projected rental income based on the following assumptions:

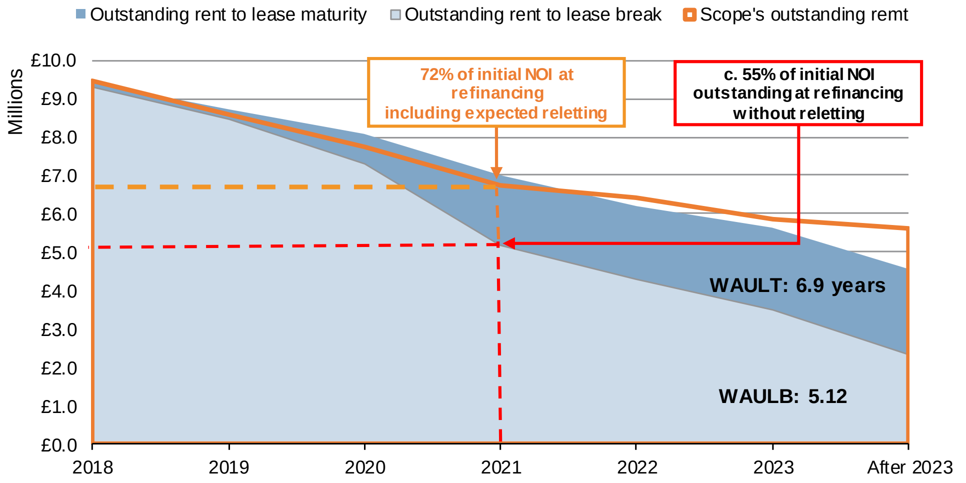
i) In-place rent multiplied by the annual survival rate of the Top 10 tenants based on their weighted average default probability[7]; and

ii) Re-letting assumptions at 70% of in-place rental levels after 12 months of marketing (including rent-free/tenant improvements), based on the UK CVA outcomes explained above and the gloomy UK retail environment, which was already clear in 2018 with in-place rent likely above expected rental values and higher expected vacancies.

The resulting annual projected portfolio net operating income is GBP 6.75m at refinancing in 2021, net of approximately GBP 500K of expected rental losses due to tenant defaults. Thereafter it continues declining to approximately GBP 5.8m per annum by 2023.

[7] The default probability of a B+ rating portfolio is commensurate with a 15.3% likelihood of default over a four-year-horizon (See Scope Idealised tables for further details)

Figure 7: Maroon loan rental income projection profile



Sources: DBRS, Scope Ratings

2.3.2. Property value sensitivity analysis

The simplified sensitivity analysis below presents the estimated portfolio value subject to two variables: i) net operating income per annum and ii) capitalisation rate.

In 2018, the appraiser valued the secured portfolio at GBP 104m based on a sustainable GBP 8.6m p.a. NOI and a 8.2% capitalisation rate (Figure 8 in black bold with green borders below).

Applying the GBP 6.75m per annum NOI calculated previously on the 8.2% capitalisation rate used by the valuer (Figure 8 in black bold with blue borders below), would have resulted in a Scope base case portfolio value of GBP 82.3m and a 85% LTV.

The negative outlook on secondary UK shopping malls would likely have been addressed through sensitivity analysis. This is typically factored in through an increase in the capitalisation rate. Secondary shopping centre capitalisation rates widened by 100bp between the Maroon loan appraisal and issuance of the Elizabeth Finance CMBS (Figure 3). An additional premium of 100bp to the capitalisation rate would have resulted in a stressed portfolio value of GBP 73.4m and a 95% LTV (Figure 8 in black bold with red borders below).

The Maroon loan exhibited high credit risks at issuance

Figure 8: Valuation assumptions

Maroon loan assumptions/metrics	Valuer appraisal	Scope's base	Scope's sensitivity
Estimated NOI net of tenant defaults (GBP m p.a.)	**8.6**	**6.75**	**6.75**
Capitalisation rate (%):	**8.20%**	**8.20%**	**8.70%**
Collateral market value (GBPm)	**104.8**	**82.3**	**73.4**

Figure 9: Market value sensitivity to yield / net operating income change (GBP m)

	Market value		Net operating income (GBP m p.a.)						
			8.6	7.98	7.36	6.75	6.14	5.52	4.91
0%	Yield (%)	8.2%	**104.8**	97.3	89.8	**82.3**	74.8	67.4	59.9
6%		8.7%	98.7	91.7	84.6	77.6	70.5	63.5	56.4
12%		9.2%	93.4	86.7	80.0	**73.4**	66.7	60.0	53.4
18%		9.7%	88.6	82.2	75.9	69.6	63.3	56.9	50.6
24%		10.2%	84.2	78.2	72.2	66.2	60.2	54.2	48.1
30%		10.7%	80.3	74.5	68.8	63.1	57.4	51.6	45.9

Figure 10: Maroon loan-to-value sensitivity to yield / net-operating income change (%)

	LTV impact		Net operating income (GBP m p.a.)						
			0%	-7%	-14%	-21%	-29%	-36%	-43%
			8.6	8.0	7.4	6.8	6.1	5.5	4.9
0%	Yield (%)	8.2%	**67%**	72%	78%	**85%**	93%	104%	117%
6%		8.7%	71%	76%	83%	90%	99%	110%	124%
12%		9.2%	75%	81%	87%	**95%**	105%	116%	131%
18%		9.7%	79%	85%	92%	100%	110%	123%	138%
24%		10.2%	83%	89%	97%	106%	116%	129%	145%
30%		10.7%	87%	94%	102%	111%	122%	135%	152%

3. Scope's insights

3.1. Scope's approach to rating commercial real estate

Scope's CRE expected-loss approach combines term default risk and refinancing default risk analysis.

Scope's ratings reflect an expected loss associated with payments contractually promised by a rated instrument until its legal maturity.

Credit analysis of commercial real estate loan is a bottom-up process that focuses on four steps: i) sponsor and business plan analysis, ii) tenancy analysis, iii) property analysis and iv) loan analysis.

The credit risk of CRE securities is two-fold

i) Term default risk: borrower's failure to service its contractual obligations;

ii) Refinancing default risk: borrower's failure to refinance at the maturity of the loan

The core of the analysis focuses on the cashflow-generating capacity of the assets and the key financial metrics which drive term default risk (debt service coverage ratio), refinancing default risk (exit debt yield) and the loss severity upon default (loan-to-value)

We underwrite secured assets via an income valuation approach by discounting future estimated net operating income.

Our approach does not apply mechanistic caps on sovereign rating, counterparty rating or minimum liquidity level, while our assumptions are transaction specific and rely on more than a decade of recognised valuer data.

3.2. Scope's commercial real estate snapshot

Figure 11: Asset type coverage

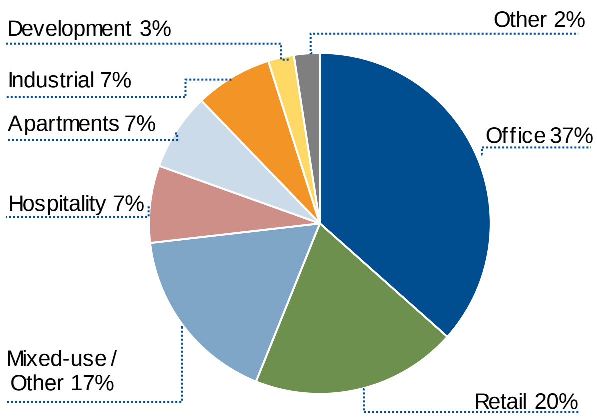


Figure 12: Financing type coverage

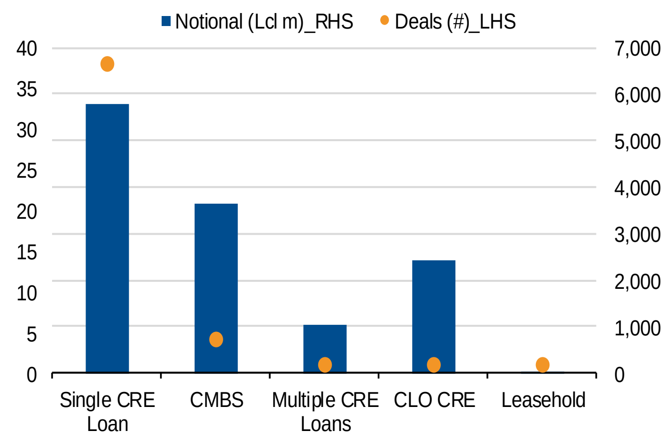


Figure 13: CRE rating evolution

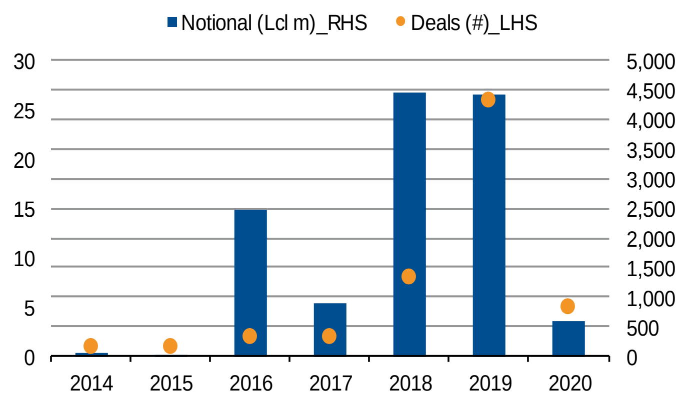


Figure 14: Geographic coverage (USA excl.)

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London
3rd Floor
111 Buckingham Palace Road
UK-London SW1W OSR

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com