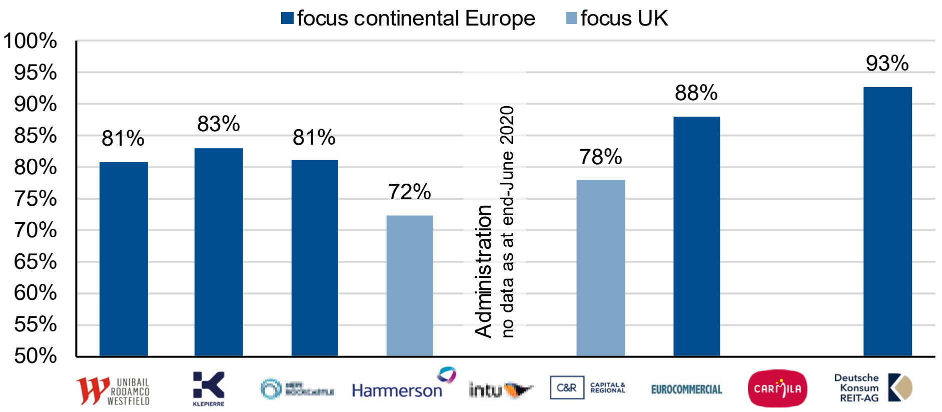
# Commercial real estate: the retail challenge
## Outlook for sub-segment remains negative

**Retailing-exposed commercial real estate companies face difficult months ahead in Europe, with renewed downward pressure on rental income and non-prime property values amid the prolonged economic fallout of the Covid-19 crisis. Our outlook for this part of the CRE sector remains negative.**

After a roller-coaster H1, in which the slump in rental income was not as severe as first expected, the sector is bracing for the winding down of various forms of government support for Europe's economy. They contributed to the retail sector recovering faster than expected mid-year from the shock of lockdowns and other restrictions in March and April. Footfall fell drastically in the first half. However, individual consumers have spent relatively heavily as shops steadily re-opened in recent months while governments maintained financial support for households and business. To take fast fashion, Swedish retailer H & M Hennes & Mauritz AB and Inditex SA's Zara unit returned to profitability mid-year.

We expect rent collection to improve in the second half after falling to 70-90% in H1 2020 (see **Figure 1**) - assuming Europe's economies continue to reopen, with no further widespread lockdowns. Real estate investment trusts (REITs) exposed to food retailing but not overly exposed to the UK and US markets recorded the most resilient H1 rental income. However, looking at the full year compared with 2019, we expect rental income will come under downward pressure again as various rent deferrals, waivers and other relief come to an end for retailing tenants. This will trigger retailer defaults and more pressure on property owners from tenants looking for rental support so that they can stay in business.

**Figure 1: Rent collection rates in H1 2020 (excl. deferred rents)***




* No public information available for Carmila

Source: public information, Scope

As for asset valuations, we expect negative fair value adjustments to continue through the second half after accelerating in H1. Prime assets will hold their value better than secondary retail-sector assets, hence the likelihood of further asset sales as REITs reshuffle their portfolios. Germany's leading department store chain Galeria Karstadt Kaufhof GmbH announced the closure of 47 of its 172 stores. In the case where owners decide against a sale and defer re-investment to reconfigure and modernise, we see a danger of a repeat of the vicious cycle in the US where shopping centres slowly die as anchor tenants leave, footfall declines, and vacancies increase, leading to "dead" malls.

These trends for rents and asset valuations are likely to spill over in 2021 until there is more certainty about when the Covid-19 health crisis will end.

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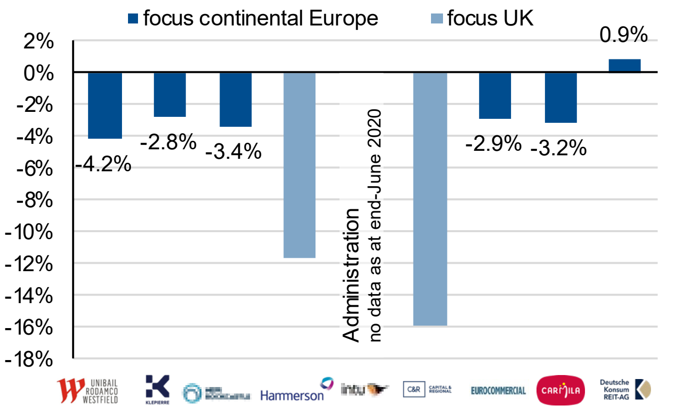
## Earnings review, outlook: rents slump, fair values adjusted

The stand-out feature of the H1 earnings season for Europe's leading commercial real estate companies was the steep slide in rent collection, falling to 70-90%. Retail-exposed REITS whose rent collection held up tended to be those focused on food retailing and those without heavy exposure to the UK or US, thereby benefiting from limited shop closures or a more rapid re-opening of commercial activity, after the initial lockdowns, that has been accompanied by strict health measures.

We forecast improving rent collection in H2 as a result of shop re-openings across Europe. While footfall will likely remain below levels of the previous year, we expect overall retail sales to rebound - subject to no further lockdowns.

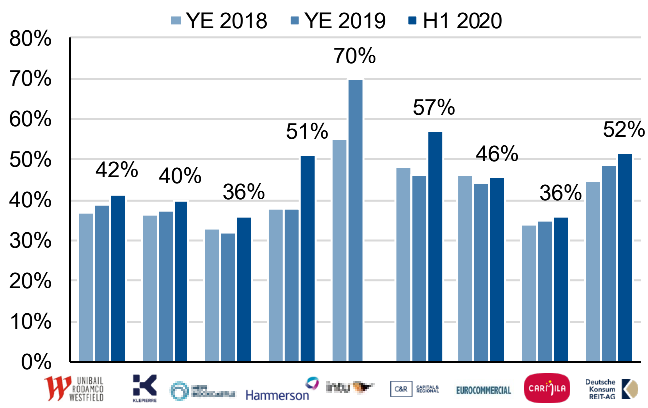
We assume rental income in 2020 will shrink by 20-30% on a comparable basis, despite positive rent reversion[1] observed in H1 as some landlords have been able to increase rents on re-letting or for lease extensions, without providing additional incentives compared to 2019, for the most part. However, some real estate companies are still renegotiating important parts of existing leases to deal with the Covid-19 impact on retailers. The full economic impact on businesses is yet to be seen with tenant protection having ended in Q3 in many countries: rent deferrals/waivers in Germany and France, suspension of lease contracts in Poland or government subsidies in many countries, among other measures. A combination of lease renegotiations and an increase in vacancies will likely lead to a further decline in rental income for the full year.

**Figure 2: Change in gross market value H1 2020**




Sources: public information, Scope

**Figure 3: reported loan/value ratio**




Sources: public information, Scope

**Property valuations on the slide, mostly for second-tier sites**

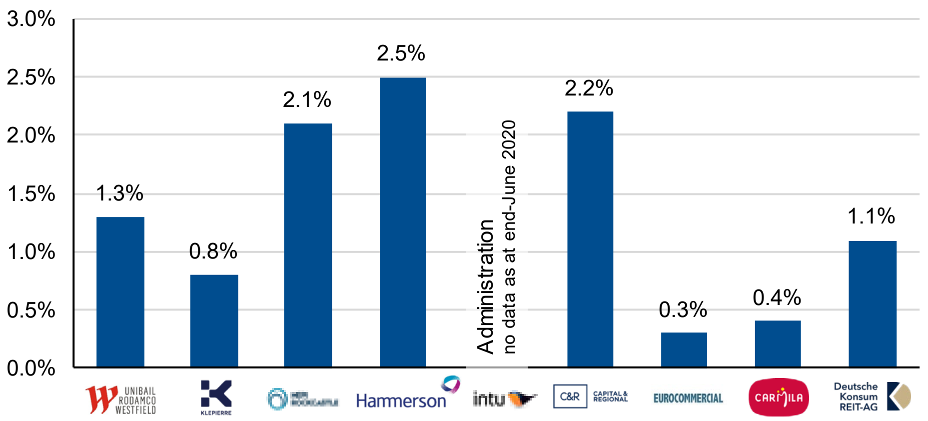
Adverse fair-value adjustments have accelerated, with peak LTVs reached at end-June 2020 (see **Figure 2, Figure 3**). The biggest impact was on UK-centric REITs such as intu Properties PLC, Hammerson PLC, Capital & Regional PLC. The REITs face shrinking headroom under debt covenants especially in the UK where intu Properties has been in administration since June 2020. The problem looks particularly acute in the UK where the health crisis and the economic impact of government measures to address it have proved relatively severe compared with other advanced economies in Europe. We believe that refinancing risk for properties in the UK is rising sharply, with UK lenders (regulated and private) calling for significantly higher risk premiums compared with pre-crisis levels. UK lenders are also refraining from enforcing on loans with covenant breaches, as they see limited upside potential if they put these assets on their balance sheet.

[1] Rent reversion: adjustment of rentals to market rentals, either on expiry or at a predetermined period as the terms of the lease dictate.

We believe negative fair value adjustments will continue through the year as market participants gain more clarity on the outlook for rental growth perspectives - renegotiations of most leases will be finalised by end-2020 - and how customer demand has changed as a result of the pandemic.

Vacancies in the retailing segment of commercial real estate have risen across the board (see **Figure 4**), though not as sharply as expected at the peak of the health crisis in April. We expect an increase in defaults following the end in Q3 of government measures to protect tenants which will lead to further increases in vacancies in H2, very likely above the rate in H1.

**Figure 4: Change in vacancies in H1 2020 compared with YE 2019**




Source: public information, Scope

Crisis-response: companies improve liquidity, bolster balance sheets, sell non-core assets

## Europe's REITs use full financial toolkit to bolster balance sheets

Europe's leading real estate companies have resorted to a mix of measures to cope with the economic consequences of the pandemic and ensuing lockdowns.

Larger REITS such as Unibail-Rodamco-Westfield SE, Hammerson PLC, and central and east European shopping centre specialist NEPI Rockcastle PLC have all announced capital increases. They have also curtailed dividends and sold assets to bolster liquidity, shore up long-term finances and raise funds for capital spending.

The companies have also focused on reducing variable costs, taken advantage of government support – such as furlough schemes – and adopted monthly invoicing of rent to adapt to tenant's payments capacities.

The companies have also turned to Europe's capital markets to raise funds – debt in addition to equity - given the easy financing conditions encouraged by the accommodative monetary policy of the European Central Bank and other central banks across the region.

Medium-term response: Covid-19 crisis points to strategic shift

## Medium-term challenge: rethinking leases, use of retailing space

The pandemic has delivered a drastic demand and supply shock to Europe's economies but also accelerated secular trends for retailers, most clearly the shift toward e-commerce and multi-channel sales and away from bricks-and-mortar retailing, while triggering new ones, such as in the workplace with the move away from city-centre offices.

Anchor tenants for which online sales have increased tremendously are expected to scale back their least profitable brick-and-mortar foothold in an even more pronounced manner than before Covid-19. This will put owners of weakly performing real estate assets at a crossroads: either increase spending to 'weatherproof' their portfolios or risk a downwards spiral of falling footfall and retailer sales that limit rental income growth and trigger further strong devaluations.

**New focus on logistics, public services may be essential**

Consequently, the integration of last-mile delivery systems into commercial buildings to facilitate the shift toward multichannel commerce is one of the important ways to ensure the future resilience of retail space in face the digital transformation of the sector.

We also expect to see changes in lease contracts such as increased use of sales-based rent formulas and more flexible and shorter leases. This trend is credit negative, as it makes rental cash flow more volatile, though it might align landlords and tenants more closely, and shifts part of tenant sales risk to landlords.

Pressure is intensifying on owners of shopping centres to rethink more fundamentally how the retail space can be better used. Introducing more public services – from doctors' surgeries and pharmacies to libraries and municipal offices – to replace shops and ensure more constant footfall would be credit positive as it would also provide rental income not tied to sales.

Another possibility is greater use of outdoor areas for entertainment and social gathering - outdoor cinemas - as well as enlarging public space inside shopping centres and spending more to address health concerns regarding concentrations of people in enclosed spaces – such as improving the flow of pedestrian traffic.

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