Europe's commercial real estate: Corporate credit metrics flash green as cycle nears end

Europe's real estate sector is in a stronger financial position than 10 years ago, with leverage cut by nearly half, reassuring investors as they look ahead to higher interest rates and the end of the current economic upswing.

While the overall outlook is comforting, investors will still need to play close attention to individual company credit risk, says Scope Ratings. Scope's analysis is based on the credit risk profiles of the top 50 commercial real estate corporates ('peer group') by market capitalisation at the end of 2017 compared with the end of 2008.

The prospect of tighter monetary policy across Europe, pockets of weakness in some property segments, such as high-street retailing in the UK, and the vulnerability of smaller residential-property developers to any abrupt economic slowdown are non-negligible factors for the future.

For now, market conditions remain favourable. Around USD 64bn in investment capital was available for deployment in commercial real estate in Europe last year compared with USD 36bn in 2008, according to data from Prequin.

One reason for such investor appetite for real estate is that interest rates remain at rock bottom, ensuring that the spread of prime office yields to government bond yields, for example, are around three times wider at 300-350bp than they were 10 years ago.

Figure 1: European real estate benefits from transformation in interest-rate environment

2008		2017
4.10%	Risk free rate	-0.17%
4.12%	3M Euribor	-0.38%
4.00%	Base rate ECB	0.00%
5.50%	Base rate BoE	0.50%
4.25%	Base rate Fed	1.38%
0-100bp	Spread Prime yields	300-350bp
100-120bp	Spread IG rated corporate bonds	80-100bp

Data for 2008 as at 12/2007 I 01/2008 // data for 2017 as at 12/2017, Risk free rate euro area yield curve spot rate 5-year maturity, Prime Office Yields vs. Risk free rate, PMA, Schroders. Sources: Euribor-rates.de, European Central Bank, Bank of England, Federal Reserve, Barclays EU Agg Corporate AVG OAS

Enticing property yields also reflect strong demand, keeping rents high and rising. The capital value[1] of European real estate stock has risen by roughly 8% since 2007.

In addition, fair values of the peer groups unit property prices remain below the cost of new construction in many European cities, ensuring that rents have more room to rise before they incite much more new building. One illustration is residential property prices in Germany, where existing housing stock is valued on average between EUR 800-1,500 a square meter compared with the new-build cost of EUR 2,500/m[2].

[1] Change in capital value of commercial real estate stock in Europe (income return adjusted) 2017 vs. 2008
Sources: 'MSCI Real Estate Market Sizes 2017' June 2018 and 'Global Real Estate Performance in 2017' May 2018

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Greater financial discipline among real estate corporates?

Cost of debt down to 2.1% from 4.8%

Real estate companies themselves have showed financial discipline in taking advantage of lower funding costs, to create fatter financial buffers, leaving them well positioned for when the economic cycle finally turns. The median cost of debt for Europe’s top 50 companies in the sector by market capitalisation was 2.1% last year compared with 4.8% in 2008.

Share of fixed or hedged debt up to 91% from 86%

Corporate treasurers have tried to lock in these gains, with the sector’s funding tilted even further toward fixed or hedged interest rates, standing at around 91% of total borrowing last year compared with 86% in 2008.

Leverage ratios have fallen

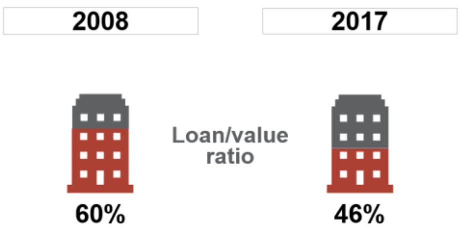
Loan-to-value ratios have fallen, down to around 46% last year from 60% in 2008 for the biggest companies. Leverage, measured by net debt-to-EBITDA multiples, has dropped to around 3.6 times from 6.8 times, hence much improved interest cover, up at 7.8 times from 1.4 times.

Average debt maturity of six years

Other indicators of the sector’s financial health include the respectable six year average maturity of interest-bearing debt for the top 50 companies and their broad choice of funding, made up roughly half by bank debt.

Figure 2: European commercial real estate companies reduce leverage and improve debt protection

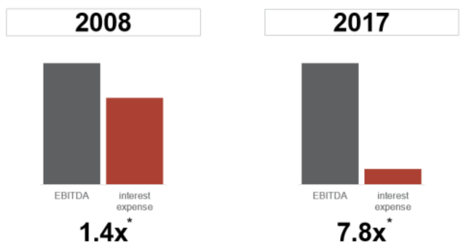
Loan/value ratio



Basis top 50 commercial real estate corporates by market capitalisation (median)

Source: public information October 2018

EBITDA interest expense cover



Basis top 50 commercial real estate corporates by market capitalisation (median)

Source: public information October 2018

Margins must not exceed two lines

The improved credit metrics also reflect industry consolidation which has led to more broadly diversified companies—by geography and/or sector—than in the past. Unibail-Rodamco, Europe’s largest real estate firm, and others such as Vonovia, Klépierre and Covivio have all made important acquisitions in recent years.

The end of the current cycle: Potential trigger points

Solid as the sector looks today, there are many factors that might contribute to bringing the cycle to an end:

- Higher interest rates
- Winding down of the European Central Bank’s bond-buying programme (QE)
- Deeper European political crises: Italy, Brexit
- Shift in investors’ risk appetite
- Liquidity drought
- Worsening supply/demand imbalance
- External economic shocks

Will credit metrics turn sour if interest rates increase?

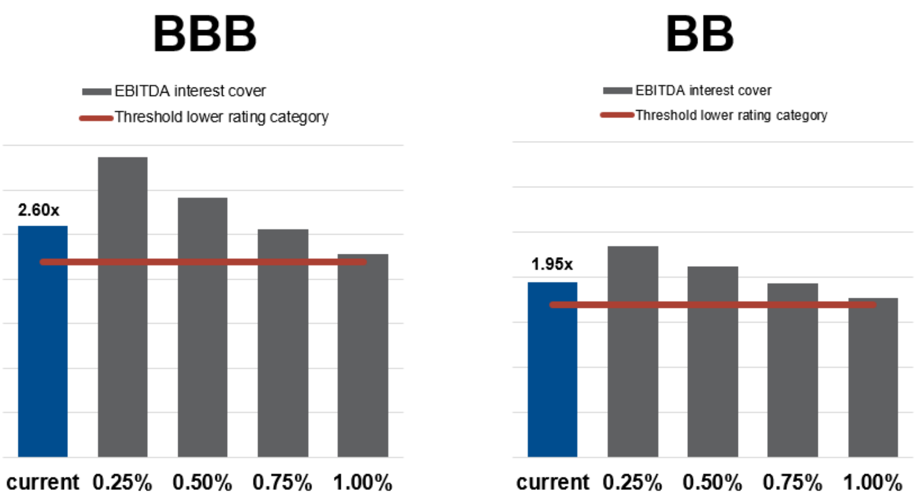
Rising interest rates nearer-term threat

For Scope, it is rising interest rates that are the clear nearer-term threat, though it would take an increase to 0.75% to 1% from today's zero or near-zero rates to raise the prospect of possible credit downgrades for Europe's BBB (low investment grade) and BB (junk) rated real estate companies.

Scope has modelled the impact of 0.25pp increments in interest rates on these two categories of real estate companies on their respective interest-cover multiples and loan/value ratios.

Figure 4 displays the change in EBITDA interest expense cover, if a company has to refinance all its debt over night. Even if interest rates increase by 25 to 50pp treasurers have the opportunity to reduce the company's weighted average cost of debt as market rates are still significantly below the median cost of debt of the top 50 companies.

Figure 3: Credit metrics: Impact of higher interest rates on interest cover



Current interest rate /market rates calculated as follows: 5Y euro area bond + spread applicable (BB: 225bp / BBB: 150bp), current EBITDA interest expense cover mid-point in accordance with Scope's Rating Methodology for European Real Estate Corporates.

Cash flows better protected than 10 years ago

Cash flows of the top 50 companies are better protected than they were 10 years ago, as the companies have a thicker buffer, in terms EBITDA to interest payable ratios, that are 5 to 6 times higher compared with 2008.

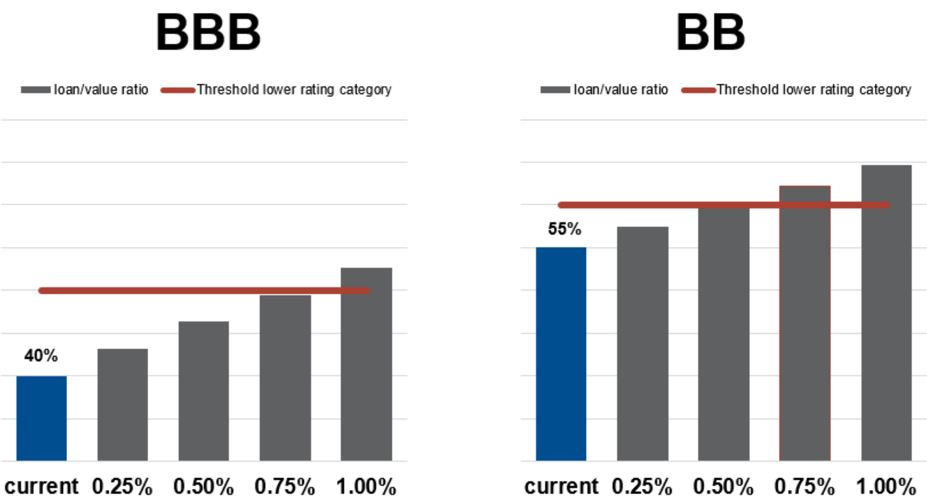
In addition, corporate cash flows should benefit from:

- Around four years of weighted average unexpired lease duration;
- Average debt maturities of six years;
- Low levels of speculative construction;
- Growth in 'new' asset classes backed by sound demographic or economic fundamentals such as nursing homes, student apartments and logistics.

Price adjustments represent more threatening credit metrics

Figure 4 shows the impact on loan/value ratios, if investors are not willing to take a hit on their spread to risk-free rates when interest rates rise again. Thus an increase in interest rates of 25bp would directly translate into a same sized increase of cap rates.

Figure 4: Credit metrics: Impact of higher interest rates on leverage



Implicit yields according to BBB Scope rating: 3.1% / BB: 5.7%, current loan/value ratio medium score as per Scope's Rating Methodology for European Real Estate Corporates.

Sources: ECB, Scope

Technical defaults or failed refinancing dependent on country and segment exposure

A slump in prices could potentially lead to technical defaults or failed refinancing. Thus we believe corporates facing the highest risk of a material deterioration of credit metrics are those:

- With reduced access to unsecured financing (typically exposed to loan/value covenants with on average higher leverage);
- Exposed to lower debt maturities or with low profitability, leaving them vulnerable to a change in interest rates which might directly eat into cash flows, such as developers;
- Exposed to asset classes and regions with shrinking demand such UK high-street retail.

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