SCOPE

Scope Ratings

2020 Real Estate Outlook

The 2020 credit outlook for the European real estate sector is stable. Strong investor demand, rising rents and falling yields contrast with a gloomier economic outlook and relatively tough conditions in the retailing sector.

Corporates, Scope Ratings GmbH

Executive summary

The credit outlook for the European real estate sector in 2020 is stable, unchanged from a year ago. Corporates will benefit from strong investor and occupier demand and rising rents which are stabilising cash flow and leverage. Upbeat business sentiment and falling unemployment should underpin the outlook despite slowing economic growth in Europe. Yields will fall in some segments, though the retail sector remains a weak spot.

The main trends we expect for 2020 are:

- Rental income will continue to grow steadily, supported by improving occupancy and the imbalance between supply and demand across real estate segments, except for high-street retail, shopping centres and remote locations.
- A lack of capacity in the construction industry is constraining growth in office, logistics and residential space in the main markets in Europe.
- Shopping mall operators are reducing their development pipelines to focus on better-performing assets and locations.
- Yields will fall in many sectors, notably logistics and light-industrial property, but also in markets which recovered only slowly after the euro area financial crisis in 2010-12. Demand from yield-hungry investors remains strong - for larger properties in particular - in Europe's continuing low interest-rate environment. Yields will be more stable in mature markets. Yields in the retail sector will widen.
- Leverage will be stable, as real-estate companies deploy spare cash and take advantage of appreciating property values to re-invest in their portfolios rather than reduce debt.
- M&A activity will be driven mostly by institutional investors (insurances, pension funds, private equity) against which real estate corporates, with comparatively less financial fire power, will find it hard to compete at today's elevated acquisition multiples.

Figure 1: European REITs leverage

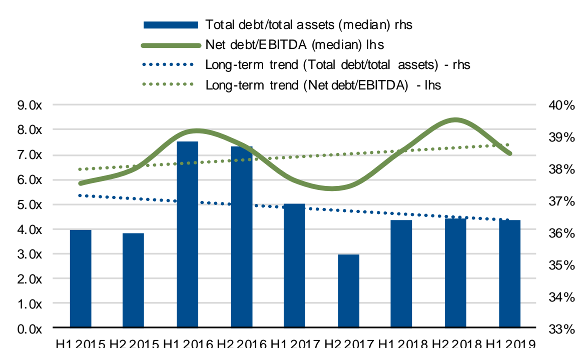
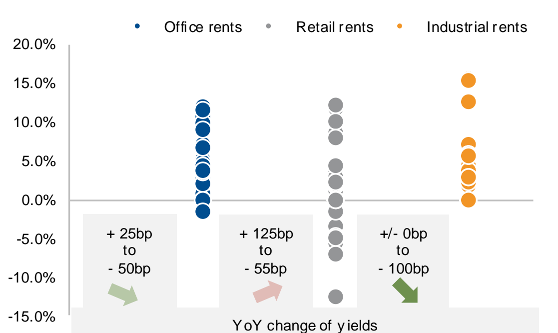


Figure 2: Yield & rents YoY Q3 2019



Source: public information, Cushman & Wakefield, Scope Ratings

Scope Corporate Ratings

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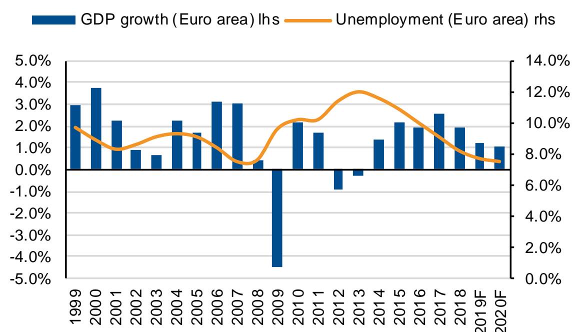
Key themes for 2020

The real estate super cycle remains intact

European real estate prices increased in 2019 for the 10th consecutive year, ensuring that the capital value of the region's real estate stock has now risen by roughly 11% since 2007. Shortages in supply across almost all segments of commercial and residential property remain the most important driving force behind higher prices. Mostly in line with previous year's forecast, prime yields fell further for light-industrial/logistics property where demand remains particularly healthy, reflecting the further shift toward e-commerce in European retailing. Yields rose for retail properties, reflecting the structural shift in the retailing industry, and will continue to do so this year, particularly in continental Europe. Otherwise, we expect that property yields will remain steady.

Rents rose steadily in 2019 across property types reflecting the favourable supply-demand balance due in part to capacity constraints in the construction sector. We forecast further if less dramatic increases in rents across most property types in 2020, with the notable exception of shopping centres. Broadly positive business sentiment in the EU should support the market despite slowing growth. GDP grew by around 1.2% in 2019, and will slow further to 1.1% in 2020 (Sovereign Outlook 2020). More significantly, job creation remains robust, with EU unemployment rate declining to 6.3% in November 2019 from its peak of 10.9% in 2013. Falling unemployment and moderate wage growth should sustain domestic consumption and demand for residential and commercial property.

Figure 3. EU GDP growth and unemployment

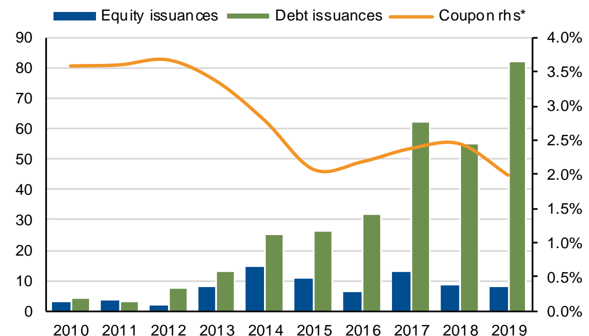


Source: EUROSTAT, Scope Ratings

Capital markets: all-time high issuance volume in 2019

Europe's real estate sector continues to benefit from accommodative monetary policy across Europe. Investors are taking advantage of low interest rates and relatively attractive property yields. Plentiful liquidity explains the ease with which real estate corporates have tapped capital markets, raising EUR 82bn in debt and EUR 8bn equity in 2019, taking the amounts raised cumulatively to EUR 311bn and EUR 76bn respectively between 2010 and 2019. As long as pricing remains competitive, real-estate corporates will to rely more heavily on debt than equity.

Figure 4. Equity, debt capital raised by real estate sector (EUR bn)



*Average coupon of senior unsecured debt of European real estate corporates

Source: public information, Scope Ratings

European commercial real estate corporates have taken advantage of favourable funding conditions with three goals in mind:

1. reduce their reliance on bank debt,
2. benefit from decreasing financing costs (average coupons have fallen by 159 basis points since 2010),
3. more recently, finance large-scale acquisitions and development projects.

Real estate investment trusts have jumped in number in the past 10 years after the creation of REIT regimes across Europe in the years before and after the global financial crisis. Their growth explains the steep rise in real estate sector bond issuance in recent years. The scale of fund raising on Europe's debt-capital markets is likely to steady at elevated levels in 2020, even though the average coupon fell sharply in last year as many REITs refinanced maturing bonds.

Retail: Transformation on its way

Main trends in 2020:

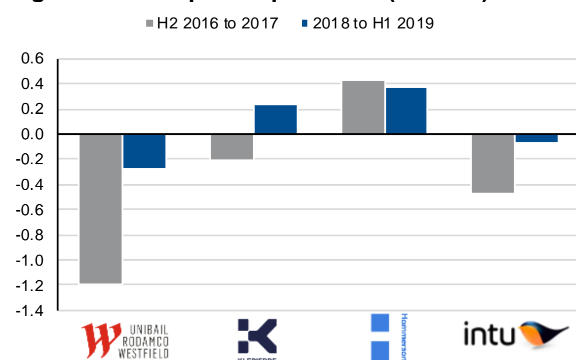
- Limited rental growth
- Increase in vacancy
- Widening yields
- Increase in leverage
- Reduction of development pipeline
- Streamlining of portfolios
- Grocery and drugstores shielded best against downswing

Retail was one of the weakest performing commercial real estate classes in 2019. Rents in Europe's largest economies mostly moved sideways in 2019, albeit with some exceptions such as shopping centres in Spain whose economy remained one of the fastest growing in the euro area. We forecast more muted, if not negative

rental growth in 2020, given the limited reversionary potential for new lettings or lease extensions.

Shrinking revenues among bricks-and-mortar retailers, faced with the relentless growth in online shopping, will lead to further shop closures in 2020, especially in but not limited to the UK. We expect more defaults among retailers to contribute to shop closures or downsizing on the high street in addition to measures by multinational companies such as H&M, in clothing, Bose, in consumer electronics, and Ceconomy (rated BBB-/Stable), in electronic goods, to streamline their property portfolios to focus on top-performing locations.

Figure 5. Net capital expenditure (EUR bn)[1]



Source: public information, Scope Ratings

Store closures will likely impair free operating cash flow at real estate companies exposed to the retail segment as they face the challenge of investing in their portfolios to keep or re-establish competitiveness while revenues remain flat. Management will focus on sales of non-strategic assets and pare back development plans – for example, Unibail-Rodamco-Westfield SE reduced its retail development pipeline by 23% YoY as at end-June 2019 – to try to generate at least break-even discretionary cash flow by recycling capital (Figure 5) instead of further leveraged growth. Corporates will likely issue bonds to refinance existing debt rather than to fund expansion.

Figure 6. Reported leverage (YE 2015 vs H1 2019)

	Loan/value ratio	Net debt/ EBITDA
Unibail-Rodamco-Westfield S.E.	41% / 45%	10.9x / 12.7x
Klépierre S.A.	40% / 39%	9.6x / 8.9x
Deutsche Konsum REIT-AG	51% / 51%	6.7x / 11.6x
Hammerson plc	38% / 40%	9.6x / 10.2x
intu Properties plc	43% / 58%	11.9x / 13.9x

Source: public information, Scope Ratings

The retail segment's poor economic prospects are visible in yields, which have widened, notably for shopping centres. Muted growth in rental income will lead to more negative fair value adjustments. Leverage at real estate corporates will increase, ensuring the rising trend continues for loan to value ratios and Scope-adjusted debt/Scope-adjusted EBITDA multiples of recent years (Figure 6). Financing costs will start to increase too. However, larger continental European retail REITs remain relatively well prepared for the downswing, having stabilised or extended the weighted average maturity of their debt and reduced financing costs, in contrast with UK-focused REITs (Figure 7).

Figure 7. Financing metrics (Year-end 2015 vs H1 2019)

	Cost of debt	weighted average maturity
Unibail-Rod.-Westfield S.E.	2.2% / 1.6%	6.5 / 8.0 years
Klépierre S.A.	2.5% / 1.5%	5.5 / 5.7 years
Deutsche Konsum REIT-AG	3.0% / 2.0%[2]	4.9 / 5.0 years
Hammerson plc	3.8% / 2.5%	5.8 / 4.9 years
intu Properties plc	4.6% / 4.3%	7.8 / 5.4 years

Source: public information, Scope Ratings

Real estate corporates exposed to markets with lower rates of e-commerce penetration, such as Central and Eastern European and Spain, will benefit from relatively strong growth in rents – underscored by increases in consumer spending – which will help offset the impact of widening yields, thus keeping leverage stable.

In contrast with the overall sub-sector, commercial real estate companies owning portfolios with a high proportion of grocers and pharmacies will prove relatively resilient. Tenant revenue growth remains robust. We see less risk of shop closures.

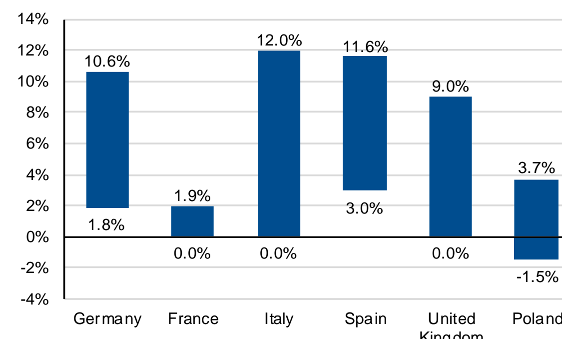
Office: Pursuit of scale

Main trends in 2020:

- Stable rental growth
- Stable occupancy
- Stable yields
- Stable leverage
- Portfolio expansion via M&A activity

European office properties performed best among real estate asset classes in 2019, with strong rental growth in the 12 months to end-September 2019 in many European cities: Barcelona (10%), Berlin (9%), Milan CBD (4%), according to Cushman & Wakefield data. Vacancy rates continued to fall, down 40bp YoY[3].

Figure 8. Rental growth Q3 2019 (YoY)



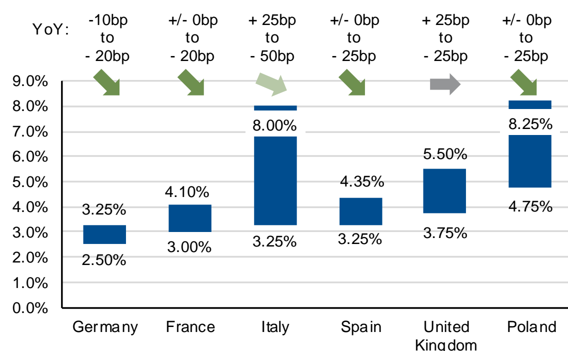
Source: Cushman & Wakefield, Scope Ratings

[1] GBP:EUR 1.1169 as at June 30, 2019
[2] 2016 vs H1 2019

[3] Average vacancy of prime office in Germany, France, Italy, Spain, the United Kingdom and Poland. Source Cushman & Wakefield

Management still remembers lessons learned from the global financial crisis, hence the reduced the amount of speculative developments, even after demand started to pick up again at the beginning of the decade. Lease area under construction grew across all major European office markets[4] in 2019 (+1.9% YoY), but we believe demand will still exceed supply in general. This will bolster rental growth and lead to slightly improving occupancy rates. Combined with reduced financial costs, the financial impact will be to boost real estate corporates' funds from operations and improve cash-flow visibility.

Figure 9. Office yield spreads, Q3 2019



Source: Cushman & Wakefield, Scope Ratings

Asset values have improved on the back of rental growth while yields have continued to narrow despite our expectations of the contrary a year ago. London was the only exception, with uncertainty around Brexit impairing values in the City as well as in the West End (yields widened by 25bp YoY).

Stable loan-to-value ratios of major European companies, despite appreciating property values, point to an increase in total indebtedness. Corporates are continuing to take advantage of ample liquidity on debt-capital and, to a lesser degree, equity-capital markets. Management is ploughing the funds raised into further portfolio expansion by:

i. acquiring portfolios (e.g. Omega portfolio acquired by Imfarr Beteiligungs GmbH and SN Beteiligungen Holding, part of which they sold on; Siemens Campus acquired by Aroundtown SA for EUR 0.6bn) with an increasing share of forward deals;
ii. targeting large-scale mergers (e.g. Aroundtown and TLG Immobilien AG in a EUR 3.1bn deal; Henderson Park Capital acquiring Green REIT for EUR 1.3bn).

Figure 10. Reported leverage (YE 2015 vs H1 2019)

	Loan/value ratio	Net debt/ EBITDA	Dividend payout ratio
Aroundtown S.A.	35% / 36%	8.2x / 9.8x	65%[5]
TLG Immobilien AG	34% / 28%	6.1x / 7.4x	65%[5]
Gecina S.A.	36% / 38%	11.9x / 14.0x	50%[6]
Land Securities plc	22% / 28%	5.8x / 7.8x	76%[7]

Source: public information, Scope Ratings

We forecast another busy year of debt-capital-market activity, as corporate treasurers use the financial headroom provided by gains in fair value in their portfolios to raise finance for more acquisitions.

The impact on the credit outlook for sector will not necessarily be benign:

i) peak-cycle asset valuations,
ii) the modest use of equity; bond issues outnumbered equity issues by four to one in the past 10 years,
iii) only modest economies of scale to be gained from mergers, portfolio growth (see EPRA's Assessing Size Effects and Economies of Scale in European Real Estate Companies, 2016)

Credit risk profiles are set to deteriorate in the medium-term. Loan-to-value ratios are likely to come under pressure if yields widen and rental growth flattens out. Net debt/EBITDA multiples are also on the rise (Figure 8) as management has tended to return spare cash to investors rather than reduce debt.

Industrial: an asset class on the verge of institutionalisation

Main trends in 2020:

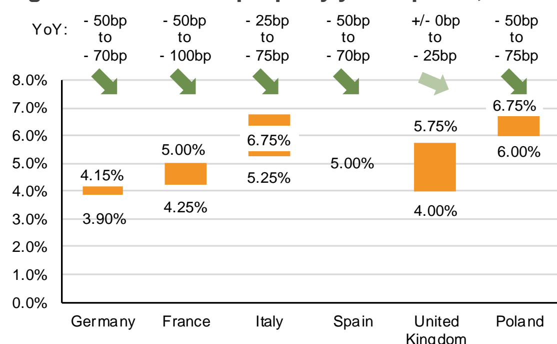
- Improving rental growth
- Stable occupancy
- Decreasing yields
- Stable leverage
- Logistics outperform light industrials

Industrial properties showed the strongest yield compression among all asset classes in 2019. This reflects the sheer amount of money looking for investment opportunities with comparatively high yields as well as shortages of new property in the sub-sector.

[4] Average growth of sq m in office space under construction in Germany, France, Italy, Spain, the UK and Poland. Source Cushman & Wakefield

[5] of FFO I
[6] of RNR
[7] of adjusted diluted earnings

Figure 11. Industrial property yield spread, Q3 2019



Source: Cushman & Wakefield, Scope Ratings

Investors also see reversionary potential for rents (the possibility that current rents will rise to meet the market value of market rents) in the segment where large real estate corporates have historically been under-represented. Light industrial and logistics facilities are still mostly owned by occupiers or small regional players. For now, bullish market sentiment is yet to translate into higher rents: growth in Europe was subdued in 2019 with the exception of Germany and Poland, home to continental European logistics hubs.

Demand for logistics facilities will be the feature of growth in the industrial property segment this year. We see rental-income growth at logistics facilities and hubs with international reach, such as London Heathrow, Hamburg, Barcelona, Berlin/Leipzig, Amsterdam Schiphol and at those of regional importance, such as Stockholm, Geneva and Oslo. Rental growth at light industrial facilities will be sluggish in the context of weaker European and global growth. As such we expect occupiers to put expansion plans on hold.

Yields for these properties in continental Europe will drop further, mimicking the trend in the UK where yields for industrial property tend to run in line with those of retail properties.

We expect credit metrics to improve, if management refrains from deploying its spare financial resources for growth at any cost. The risk of breakneck expansion seems low, given the scarcity of available sites and fierce competition from deep-pocketed asset managers and insurers. Blackstone Group, for example, has EUR 8.0bn invested or to be invested in logistics properties. AEW – a unit of France's Natixis - has EUR 2.3bn, French insurer Axa SE has EUR 1.4bn, and Germany's Allianz SE has EUR 6.6bn. Corporates will devote an increasing amount on capex to modernise premises to meet the demands of logistics operators for multi-storey, easy-to-automate sites with large floor space.

Residential: Regulatory scrutiny forces corporates to diversify

Main trends in 2020:

- Stable rental growth
- Stable occupancy
- Stable yields
- Stable leverage
- Diversification by country, segments and services amid increasing regulatory scrutiny

The lack of new housing stock continues to push residential rents higher across European metropolitan areas, while keeping occupancy high. Yields in Germany and the UK remained almost flat during 2019. We expect further steady growth of rents in 2020 where capacity constraints in the construction sector remain an important reason why supply is catching up only slowly with demand in many countries.

Rising rents are drawing increasing regulatory scrutiny as Berlin landlords found out with last year's rent freeze.

Residential real estate corporates are eager to diversify and expand. Rising rents and property prices provide extra financial firepower to i) invest in future growth and ii) minimise single-market regulatory exposure without impairing credit metrics. These efforts include i) broader geographical diversification (e.g. Vonovia SE's [rated A-/Stable] expansion mainly in Austria and Sweden since 2018), ii) horizontal diversification (e.g. Deutsche Wohnen acquiring nursing-home operator Katharinenhof) and iii) vertical diversification by bringing property development in-house (e.g. ADO Properties merger with ADLER Real Estate AG [rated BB/Positive] and simultaneous acquisition of strategic share in Consus Group).

Such initiatives will support healthy credit-risk profiles of larger or more agile companies, while smaller, regional residential landlords may have to cope with more regulatory scrutiny. In Germany, for example, if the country's federal constitutional court approves the Berlin rent freeze, that might become a blueprint for other Germany cities. Ironically, it may be large, multinational property companies which benefit from government intervention in residential property markets if new regulations lead to falls in prices and rents, putting pressure on smaller real estate companies and driving consolidation in a still fragmented sector.

Outlook 2020 and medium-term risks

We expect credit quality will remain stable on average in 2020 and beyond for Europe's real estate corporates. Companies' business-risk profiles are improving at the margin, driven by i) further increase in rents, ii) higher occupancy ratios and iii) broader diversification as management takes advantage of ample, relatively cheap funding to seek extra scale.

However, the sector's financial risk profiles, especially leverage, are expected to remain as is, with management using any spare financial headroom for investment in pursuit of growth despite frothy asset prices. With operating cash flows not improving as fast as values and indebtedness, we expect pressure on company's leverage ratios as soon as structural (retail), political (residential) and economic (all asset types) risks materialise.

Annex I: Scope's 2019 real estate ratings and rating actions

Figure 12: Scope's real estate ratings, as of December 31st, 2019

Europe				Other Countries
EU		EFTA		
ADLER Real Estate AG	BB/Positive	JSC Lisi Lake Development	B+/Positive	
Appenin Holding Nyrt.	B+/Stable	Steen & Strøm ASA*	---	
Budapesti Ingatlan Nyrt.	B+/Stable			
Cordia International Zrt	BB/Stable			
Deutsche Konsum REIT-AG	BB+/Stable			
EUROBODEN GmbH	B+/Stable			
FCR Immobilien AG	B+/Stable			
Klépierre S.A.*	---			
Merlin Properties SOCIMI S.A.*	---			
Proform Ingatlanbefektetesi Zrt.	B+/Stable			
SkyGreen Buildings Kft.	B+/Stable			
Unibail-Rodamco-Westfield S.E.*	---			
Vonovia S.E.	A-/Stable			
Wingholding Zrt.	BB/Stable			

Figure 13: Scope's rating actions in 2019 as of December 31st, 2019

	Date	Issuer	Rating Action	Rating & Outlook
Q1	02.01.2019	Unibail-Rodamco-Westfield S.E.*	Initial rating	---
	28.01.2019	Klépierre S.A.*	Initial rating	---
	08.02.2019	JSC Lisi Lake Development	Outlook change	B+/Positive
	11.02.2019	Merlin Properties SOCIMI S.A.*	Affirmation	---
	25.02.2019	Deutsche Konsum REIT-AG	Upgrade	BB+/Stable
Q2	16.04.2019	ADLER Real Estate AG	Affirmation	BB/Positive
Q3	15.08.2019	EUROBODEN GmbH	Affirmation	B+/Stable
	27.08.2019	Wingholding Zrt.	Initial rating	BB/Stable
	03.09.2019	Proform Ingatlanbefektetesi Zrt.	Initial rating	B+/Stable
	11.09.2019	FCR Immobilien AG	Affirmation	B+/Stable
	12.09.2019	Cordia International Zrt	Initial rating	BB/Stable
Q4	01.10.2019	Appenin Holding Nyrt.	Initial rating	B+/Stable
	04.10.2019	SkyGreen Buildings Kft.	Initial rating	B+/Stable
	04.10.2019	ADLER Real Estate AG	Affirmation	BB/Positive
	18.11.2019	Budapesti Ingatlan Nyrt.	Initial rating	B+/Stable
	13.12.2019	Vonovia S.E.	Initial rating	A-/Stable
	20.12.2019	Steen & Strøm ASA*	Affirmation	---

* available for subscribers to Scope's subscription platform (ScopeOne) only.

Annex II: Related research

"Berlin rent freeze: bigger property companies may benefit from market intervention more than tenants," published October 2019, available here

"Berlin freezes rents: City risks consequences for property sector," July 2019, available here

"Germany's privately held property firms reap gains from investment strategy," April 2019, available here

"Further growth still expected in German residential house prices," February 2019, available here

"Real Estate: Credit risk evenly balanced for deleveraged European sector," November 2018, available here

"Presentation: Corporate Outlook Real Estate 2019," November 2018, available here

"Europe's commercial real estate: Corporate credit metrics flash green as cycle nears end," October 2018, available here

"Presentation: Logistics – A New Hope?," April 2017, available here

"Logistics – A New Hope? How the Rise of E-commerce Impacts Real Estate," March 2017, available here

"German housing companies invest heavily in existing portfolios," April 2015, available here

"German Residential Real Estate Corporates: Consolidation Underway," January 2015, available here

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