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Corporates Outlook 2019
Real Estate: Credit risk evenly balanced for deleveraged European sector

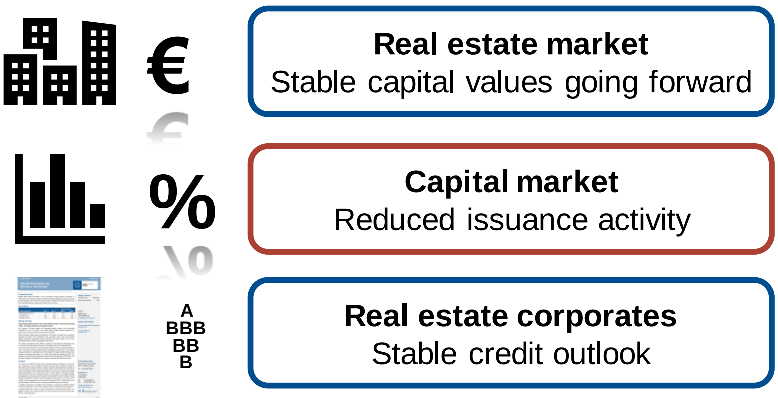
The 2019 credit outlook for the European real estate sector is stable, with risks evenly balanced for now, though there are monetary, economic and political clouds on the corporate horizon, says Scope Ratings.

Market conditions remain fair for Europe's real estate corporates. Demand from property investors and tenants looks robust and likely to stay that way. Scope forecasts smaller property price increases in 2019 than in the past couple of years. Rental growth is expected to become more muted, as tenants seek instead to use rented space more efficiently while slowing economic growth is set to coincide with an increase in development activity, leading to increased supply.

The long-running compression of prime yields came to an end in H1 2018, with the exception of the light-industrial/logistics sector where the shift to e-commerce continues drive demand for new space. Yields are unlikely to rise given the backdrop of still low interest rates, improving job markets and domestic consumption across Europe, and the favourable supply-demand balance for commercial and residential property.

Corporates themselves are in a far stronger financial position than 10 years ago, with corporate leverage cut by nearly half. Leverage, measured by loan/value, has dropped to 46 percent from 60 percent, hence much improved interest cover, up at 7.8 times from 1.4 times, in the 10 years after the Global Financial Crisis.

The question is how Europe's real estate corporate now use that extra financial headroom. Growth through acquisition looks less attractive than it did. Take the tentative merger plan between Klépierre's and Hammerson of the UK for GBP 5bn that was withdrawn; Hammerson's own cancelled merger with Intu Properties for GBP 3bn; and the abandoned Immofinanz, CA Immo EUR 2bn deal. Peak-cycle valuations and modest economies of scale are likely weighing on shareholders' minds as they assess potential consolidation for large- and mid-caps stocks.



Real estate corporates are also unlikely to have much appetite for further deleveraging, preferring to invest in developing new properties or returning cash to shareholders, mindful that the change in the interest-rate cycle was already visible in higher H2 debt-market financing rates.

Interest-rate risk is one major risk handing over the sector. While 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, that assumes no major political or economic shocks take place.

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Real Estate Market

The real estate super cycle remains intact…

Deflated capital values +10% compared to 2007/08

European real estate prices increased in 2018 for the ninth consecutive year, ensuring that the capital value of the region's real estate stock has now risen by roughly 10% since 2007. Shortages in supply across almost all the different segments of commercial and residential property remain the most important driving force behind higher prices. As expected, prime yields fell in the first half of the year before stabilising. Scope expects yields to remain steady with the exception of those in light-industrial/logistics sector where demand remains particularly healthy, reflecting the further shift toward e-commerce in European retailing. Led by the market in the United Kingdom, light industrial/logistics segment returned the lowest prime yields compared with the office and retail sector in Q2 2018, the first time they have done so since 2000.

Rents grew above 5 years average

Increases in rents in 2018 are expected to have exceeded the average of the past five years according to data from JLL, similarly reflecting the favourable supply-demand balance. Scope forecasts a further if less dramatic increases in rents across most property types, with the notable exception of shopping centres, supported by generally bullish business sentiment in the EU amid a fifth consecutive year of growth of around 2%. According to the European Commission EU (November 2018), GDP is forecasted to grow by 2.1% in 2018, before slowing slightly in 2019 (+1.9%) and 2020 (1.8%). More significantly, job creation has been robust, with the unemployment rate declining to 6.9% in November 2018, down from its peak of 10.9% in 2013. Continued job creation and moderate wage growth should sustain domestic consumption and demand for residential and commercial property.

… but there are the first signs that the sector is cooling down

Stock under development up by 10% between 2018 to 2020

The coming slowdown in economic growth in Europe is set to coincide with signs that developers are finally coming out of hibernation. Real estate stock under development is expected to increase by on average more than 10% for the period from 2018 to 2020 compared to the period from 2015 to 2017 reaching levels comparable to 2012. The increase in commercial building has so far been in step with demand and is unlikely to produce an oversupply in most European cities over the next couple of years, according to Schroders. The slow adaptation of developers to addressing commercial real estate constraints is driven by:

- a focus on residential development within major cities to tackle population growth leading to a shortage in housing,
- a comparably lower willingness from lenders to lend on speculative schemes,
- capacity constraints on the side of construction firms.

Interest rates anticipated to increase

Financing is likely to become more expensive this year following the European Central Bank's decision to end quantitative easing by the end of 2018, a view backed by EPRA research. To be sure, changing monetary policy is not expected to significantly impact the markets as ECB plans to reinvest proceeds from maturing bonds. But interest rates are back in the spotlight for the industry even if most corporates would cope with modest increases in 2019 and beyond. Scope's view could change if there is a major shock to the monetary system.

Scope forecasts much smaller property price increases in 2019 than in the past couple of years, with prices set to plateau for quite some time.

Rental growth is expected to become more muted in 2019 as a result of the following:

- high existing rents, tight labour markets, low vacancy rates favour tenant's exploiting rented space more efficiently,

- slowing economic growth,
- increasing development activity further closing the gap between demand and supply,
- the shift toward flexible working reducing demand for office space.

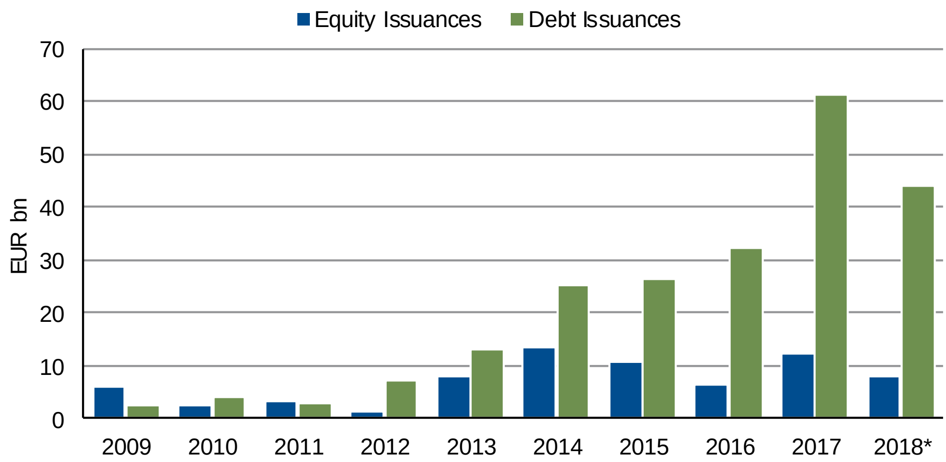
Capital Market

Stabilized capital market debt issuance as debt remains cheap, but aims of considerable cash call have been fulfilled

Stabilized issuance volume

Europe's real estate sector remains awash with liquidity as investors remain eager to take advantage of low interest rates and relatively attractive property yields. The excess liquidity explains not just recent property-price prices and the ease with which real estate corporates have tapped capital markets to raise fresh debt and equity, with EUR 219bn (+EUR 44bn in between YE 2017 and October 2018) and EUR 72bn (+EUR 8bn) of debt and equity issuances, respectively, since 2009. As long as pricing remains competitive, Scope expects real-estate corporates to rely more heavily on debt capital markets than equity.

Figure 1: Capital market issuances



* 2018 = data from 01/2018 up to 10/2018 // Source: public information

European commercial real estate corporates have successfully exploited favourable funding conditions for three principal reasons:

1. to reduce their reliance on bank debt,
2. to benefit from decreasing financing costs (average coupons have reduced by 55% since 2009) and more recently,
3. to finance large-scale acquisitions and development projects.

The scale of fund raising, however, is likely to diminish now that the interest-rate cycle has turned -visible in the higher pricing of fixed-income issues (Figure 2)- with focus among real-estate corporates shifting to refinancing maturing bonds.

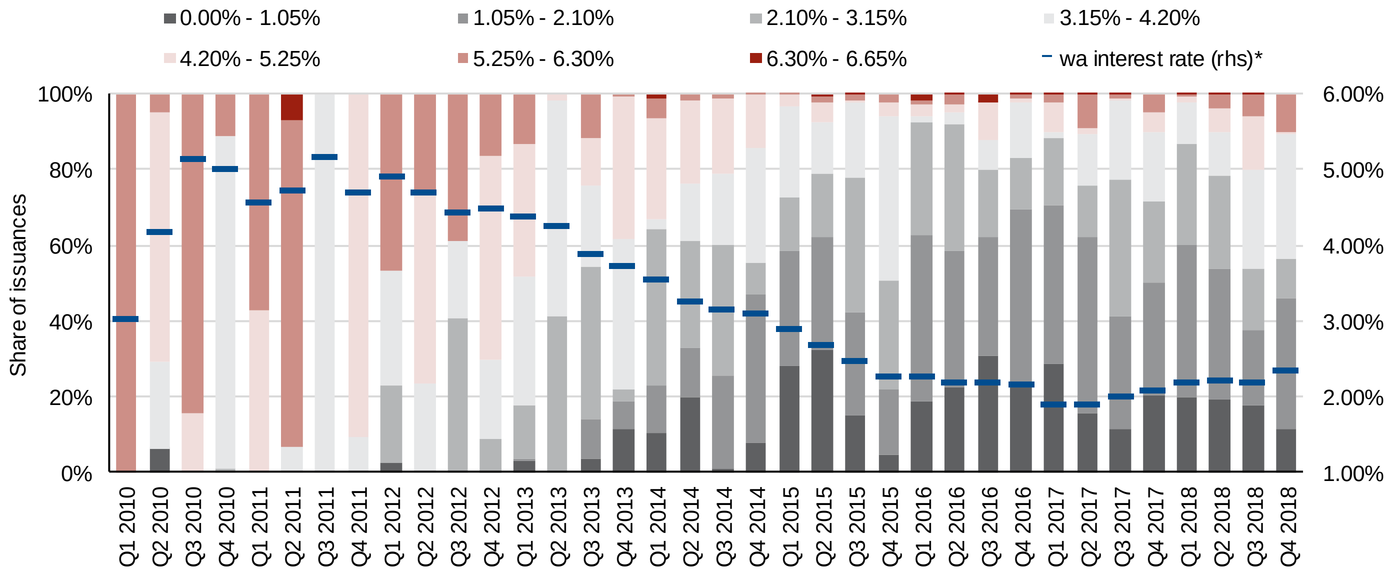
European Real Estate Corporates

Corporate credit metrics improved significantly against 2007/08

Greater financial discipline among real estate corporates

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. However, Scope sees greater financial discipline among real estate corporates in their taking advantage of lower funding costs to create fatter financial buffers, leaving them well positioned for when the economic cycle finally turns.

Figure 2: Pricing fixed income issuance by European commercial real estate corporates



* wa interest rate show the 12 months rolling average // Source: public information

Improved credit metrics compared to 2007/08

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. 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. 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. As such 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.

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. However, a slump in prices could potentially lead to technical defaults or failed refinancing. Especially in light of Scope's expectations of no further deleveraging of European real estate corporates -that was foremost driven by value appreciation in the past.

More subdued M&A activity going forward as current price levels not justified by potential economies of scale with some failed attempts in 2018

Some large sized acquisitions in 2018…

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's merger with Westfield at a cost of USD 16bn, Vonovia acquiring the Austrian BUWOG for EUR 5bn and the Swedish Viktoriapark for EUR 1bn as well as Covivio's takeover of Beni Stabili for EUR 2bn were the among the most important deals in the past year.

... but also some failed attempts

However, there has been evidence that further consolidation could prove more difficult, given recent failed merger attempts: Klépierre's move to acquire Hammerson of the UK for GBP 5bn; Hammerson's own cancelled merger of the latter with Intu Properties for GBP 3bn; and the abandoned Immofinanz, CA Immo EUR 2bn deal. Peak-cycle valuations and only modest economies of scale are likely weighing on shareholders' as they assess potential consolidation for large- and mid-caps, issues raised recently by

EPRA (see EPRA's Assessing Size Effects And Economies Of Scale In European Real Estate Companies, 2016). Scope reiterates its forecast for more subdued largescale consolidation in the coming years, despite the extra financial headroom corporates have created for themselves in recent years.

Increase in development activity

Real estate companies are more likely to use their financial flexibility for increased development activity especially as vacancy rates continue to diminish amid limited availability of and steep price increases for land, especially in dense areas, while prices for developed property continue to rise. Major commercial and residential real estate corporates have either enlarged their development pipeline significantly over the last couple of years or diversified into that sub-segment of the real estate industry. Large real estate corporates with thinner margins are likely to diversify their business horizontally and internalise third-party activities to gain more control over costs and property services, thereby hoping to improve profitability and customer satisfaction.

Credit outlook remains stable for 2019: Tighter monetary policy, slowing growth, politics remain key risks

Real estate companies face an evenly balanced set of risks in 2019 ensuring the credit outlook is stable. The outlook factors in less dramatic increases in property prices as a result of i) slowly rising interest rates; ii) some easing of the supply-demand imbalance for most of the asset classes as development activity picks up; iii) slowing economic growth iv) political uncertainty, notably surrounding Brexit, budget difficulties in Italy, elections for the European Parliament in May 2019, and international trade relations.

Stable credit outlook for 2019

M&A activity is expected to be more muted next year, partly a reflection of slightly more difficult capital-market financing conditions. Scope does not expect companies to use healthy operating cash flows to further deleverage having strengthened their balance sheets over recent years. Instead, cash available will be either used to improve asset quality to push organic growth in rental income or will be distributed to investors. As these measures will at best negligibly improve the companies' business risk profile in the short-term, Scope expects limited positive impact on credit ratings of investment-grade real estate companies especially as ratings are already driven by stronger business risk profiles compared with financial risk profiles. We foresee continued volatility for sub-investment grade rated peers, with some positive rating adjustments for corporates that manage to deploy capital at hand to improve their business risk profile without impairing credit metrics. We also see an increased likelihood for negative rating adjustments given the slowing growth in property prices as well as some pocket of weaknesses in some countries and asset classes. Scope believe corporates facing the highest risk of a material deterioration of credit metrics are those:

1. With reduced access to unsecured financing (typically exposed to loan/value covenants with on average higher leverage);
2. 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;
3. Exposed to asset classes and regions with shrinking demand such UK high-street retail.

More-volatile credit profile among UK-focused corporates

Political risks have slightly reduced after the UK and the EU agreed on a draft declaration for a Brexit deal on November 25th subject to a vote of the British parliament on December 11. However, in an unlikely scenario of the UK tumbling into a hard Brexit, we expect a decline in tenant demand and, as a consequence, in the UK property prices. That in turn could lead to an increased number of defaulted commercial real estate loans, weakening credit profiles of the sponsors. Thus, real estate corporates focusing on UK assets are expected to have a more-volatile credit profile.

Large British commercial real estate corporates well prepared

Large British commercial real estate corporates seem to be well prepared for a possible decline in values and rents as they have learned lessons from the last crisis. Scope notes the sharp reduction of leverage of these corporates compared to 2007/08 as well as a far broader mix of financing sources. In general, Scope does not expect a long-term impact with regard to tenant and investor demand. As soon as the effects of Brexit are quantifiable, the UK is like to resume attracting large amounts of property investment from abroad. With a solution in sight. the UK property market might show the strongest positive developments in the mid-term if compared to continental Europe.

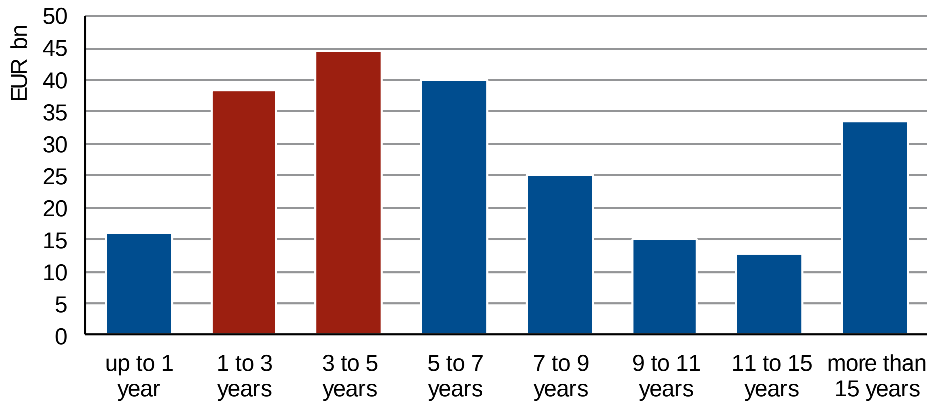
Mid- and long-term credit outlook subdued - Everyone is waiting for the backdrop, but when to expect and how sharp it'll be?

Scope's mid- and long-term credit outlook is more subdued through the heightened sensitivity of the European real estate market to political, economic and money-policy changes. With rising yields on euro area government debt and a steepening yield curve for interest rate swaps, especially for maturities up to 5 years, Scope forecasts greater refinancing risk for commercial real estate debt for the mid- to long-term.

EUR 83bn to be refinanced between 2020 and 2023

As potential for backdrop of prices would impair key financial metrics, which especially will increase leverage. Even this will not materialise in the short term; EUR 83bn of maturing debt from European real estate corporates will face higher refinancing risk until 2023, with higher default rates anticipated for 2019 onwards (Figure 3).

Figure 3: Maturing capital market debt of European real estate corporates



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