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Europe's Retail Property Market Is Showing Signs Of Weakening

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Key Takeaways

- Europe's retail property market is showing the first signs of weakness as rental uplifts diminish due to growing challenges for retailers.
- Organic growth remains positive, but asset valuations are starting to decline as yields rise, even though risk premiums are peaking at a record high level.
- The structural challenges to retailing from e-commerce could harm retail property landlords' creditworthiness over the next few years.
- While all 12 retail property companies we rate in Europe are facing the same challenges, we have taken a number of actions on six issuers because we consider they have weaker positions within their ratings.

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Until now, landlords we rate on the European continent have been resilient to the gradual increase in e-commerce that is eroding traditional retailers' margins. This is because supply and demand has historically been more favorable to retail property owners in Europe than their peers in the U.S., which have been strongly hit by competition with e-commerce over the past several years.

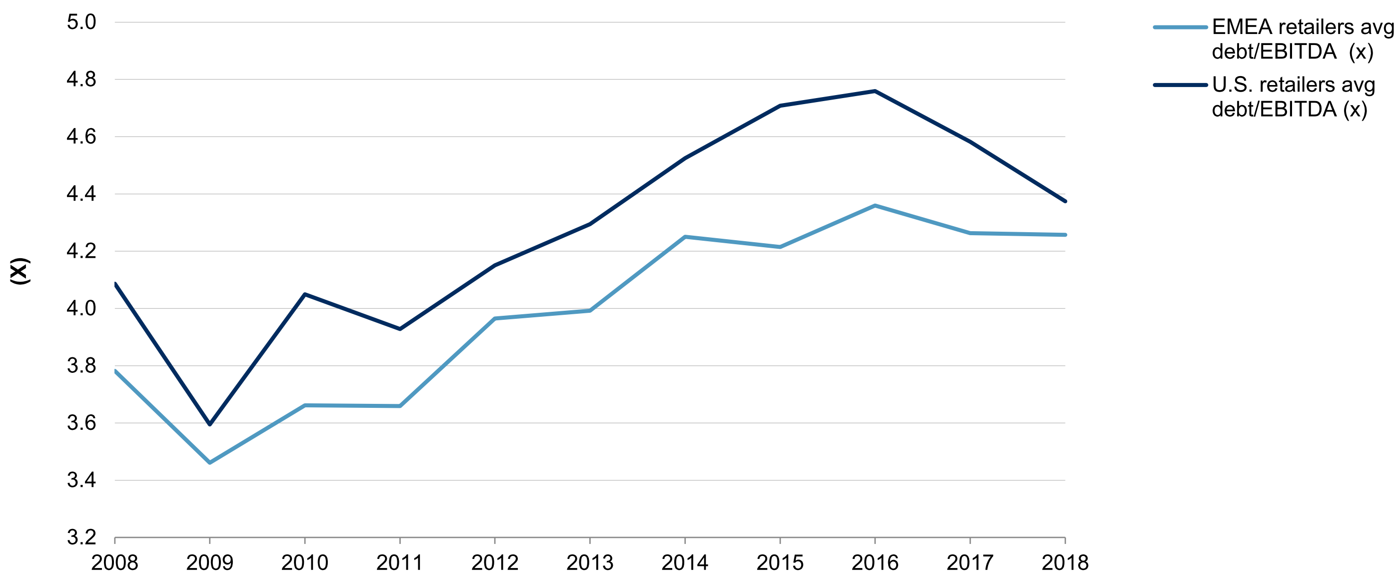
On the supply side, shopping center density--calculated as leasable square meters of shopping center space per thousand inhabitants--is about 5x higher in the U.S. than on this side of the Atlantic. There were 1,274 square meters of gross leasable area per 1,000 people in the U.S. compared to just 216 square meters in Europe in October 2017, according to JLL. High shopping center density translates to low bargaining power for landlords at a time when most traditional retailers are either closing stores or becoming more selective in choosing their physical locations. In Europe, most rated retail landlords long ago initiated a flight to quality in response to changing tenant needs and visitor habits, concentrating toward central locations and focusing more strongly on food and leisure premises that are becoming more popular. As an illustration, the average value of assets held by Klepierre, Mercialys, and Unibail-Rodamco-Westfield has doubled since 2013, while the number of their assets had declined by one-third.

On the demand side, tenant retailers in European shopping centers have demonstrated better use of space than U.S. peers. They have a lower share of inefficient department store formats (46% of lettable space in the U.S. versus 27% in Europe). They have also had relatively low rent burdens as measured by occupancy cost ratio (annual rent charged to retailer divided by annual retailer' sales) in the 8%-11% range. European tenant retailers also exhibit lower leverage on average (see chart 1) and have a lower proportion of private equity-owned companies. They also face less severe competition from e-commerce, evidenced by a lower penetration rate in most European countries. This has allowed European retail property owners to generate organic growth well above indexation rates, maintain low vacancy rates and rent delinquencies, and successfully reallocate capital through pre-let extensions and noncore asset disposals.

However, the situation is now changing. We are perceiving some signs of market weaknesses that could progressively erode retail landlords' capacity either to generate organic growth or dispose of assets for deleveraging purposes. We believe the currently strongly negative sentiment in the financial markets is exacerbating this emerging trend.

Chart 1

European Tenant Retailers Exhibit Lower Leverage On Average Than U.S. Peers



Source: S&P Global Ratings.

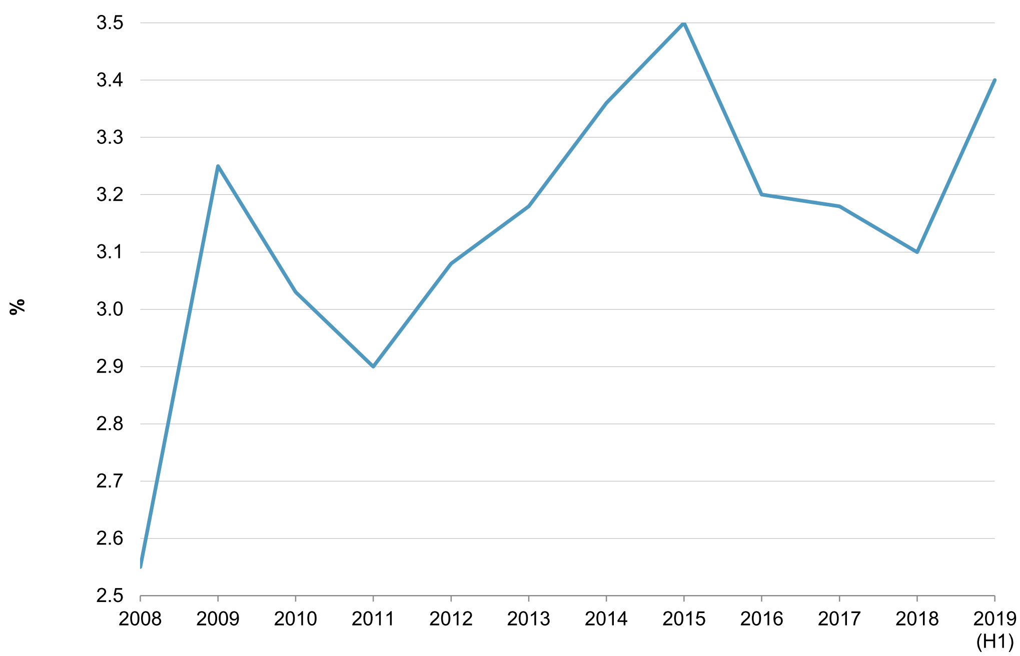
Organic Growth Is Positive, But Weakening

As of June 30, 2019, most of the 12 retail landlords we rate still reported positive rental growth on a like-for-like basis. Yet, the contribution from rental renegotiations and renewals, on top of the indexation effect, was significantly weaker as of June 30 2019, than previously. We believe companies will rely more on indexation to generate revenue growth in the coming quarters and potentially generate lower organic growth overall if premises are renewed or re-let at significantly lower rents. In our view, landlords may be affected if retailers' current credit deterioration continues in Europe, with higher bad debt and potentially a negative impact on rent and occupancy (see chart 2). Retailers are carrying more debt leverage (4.26x in 2018 versus 3.99.x in 2013 on average for food and discounters) and achieving thinner margins (9.21% in 2018 versus

9.74% in 2013). Over the same period, the rent burden as measured by the occupancy cost ratio has continuously increased (see chart 3). This will likely hinder their ability to absorb further rent increases.

Chart 2

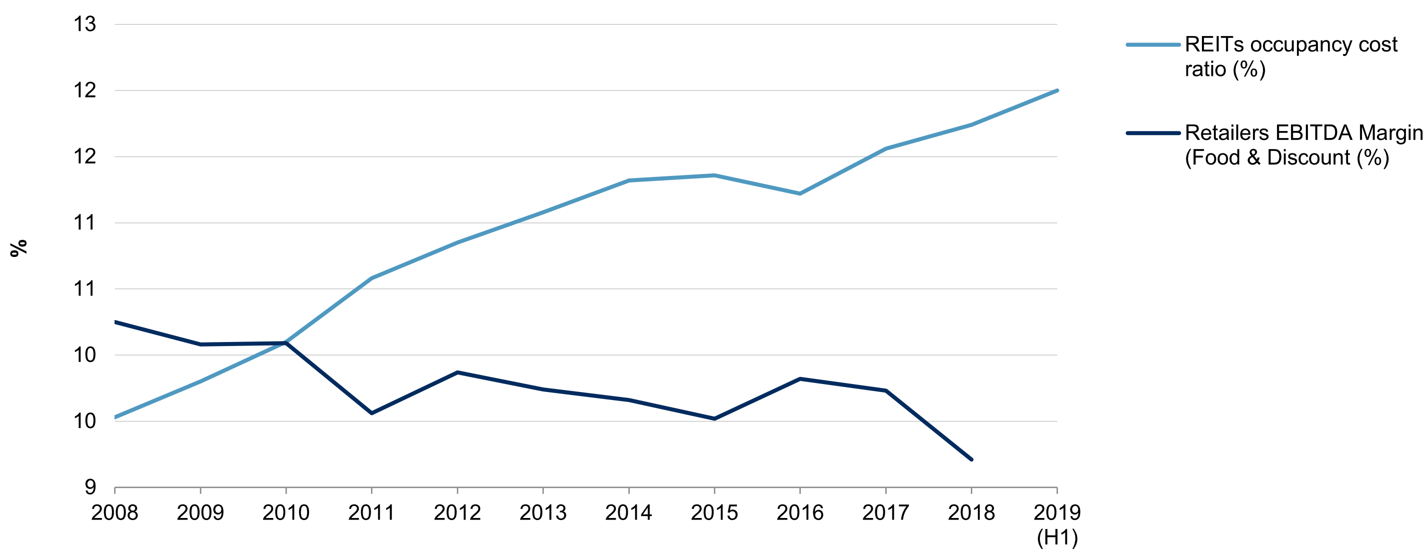
Vacancy On The Rise
Average vacancy levels of Six Rates REITs



Source: S&P Global Ratings.

Chart 3

Rents Are Increasingly Weighing On Retailers' Performance
REITs occupancy cost ratio versus retailers EBITDA margins



Source: S&P Global Ratings.

U.K., Nordic, And French Markets Face Different Degrees Of Pressure

In the U.K., a combination of Brexit uncertainties and stronger-than-average incursion of e-commerce has forced a number of retailers into bankruptcy and deterred new market entrants. The situation has prompted major retail landlords to accept compulsory voluntary arrangement insolvencies.

In the Nordics, the heavy competition between large shopping centers, as well as weakening demand, is now putting retailers' sales under pressure, leading to some negative rental reversions--meaning that new tenants are paying less than older tenants. Moreover, the retail property investment market has dropped substantially in Sweden, causing concerns about future valuations.

In France, the situation is more mixed. Non-food hypermarkets, which are prominent in France, are struggling. But the retailers that typically surround them in shopping galleries reported a rebound in the second quarter of this year. Nevertheless, large retailers such as Casino are facing difficulties.

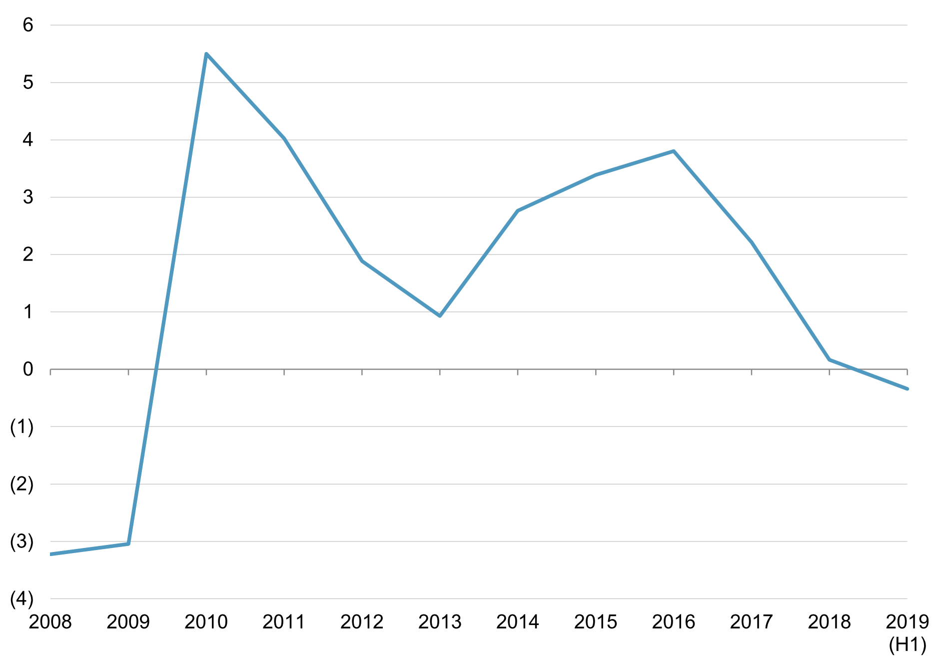
We will continue to scrutinize developments for property companies that are reporting high or increasing occupancy cost ratios and bad debt. While both indicators remain relatively low on average (below 12% and 3%, respectively), they clearly are on an upward trend.

Valuations Are Declining, Yields Rising

As of June 30, 2019, the retail property companies we rate reported declines in asset valuations ranging between 0.5% and 1.5% for the last six months. Although the tightest risk premium (Unibail Rodamco Westfield; URW) culminated at 435 basis points (bps), a new all-time high, the devaluations came from an increase in capitalization rates used by independent real estate appraisers (see chart 4). This uplift was largely, but not fully offset by rental increases. The percentage of devaluations reported as of June 2019 seem relatively homogeneous across markets, locations, and asset types. Still, the benchmark disposals reported by real estate investment trusts (REITs) were achieved with price premiums over book value. The premiums, however, were lower than in the past (5%-8% in 2019 versus 10%-15% in the previous years). We therefore believe that retail REITs may be finding it less easy to repay their debt because it is becoming more difficult to sell non-core retail assets above book value and use the proceeds for deleveraging. Moreover, we remain concerned that further yield expansion, if not offset by capex or rental uplifts, may put debt-to-debt plus equity ratios under pressure at a time when debt-to-EBITDA ratios are generally decreasing. For the time being, however, the average cushion under loan-to-value covenants remains adequate (at 15% or more) and manageable, in our view.

Chart 4

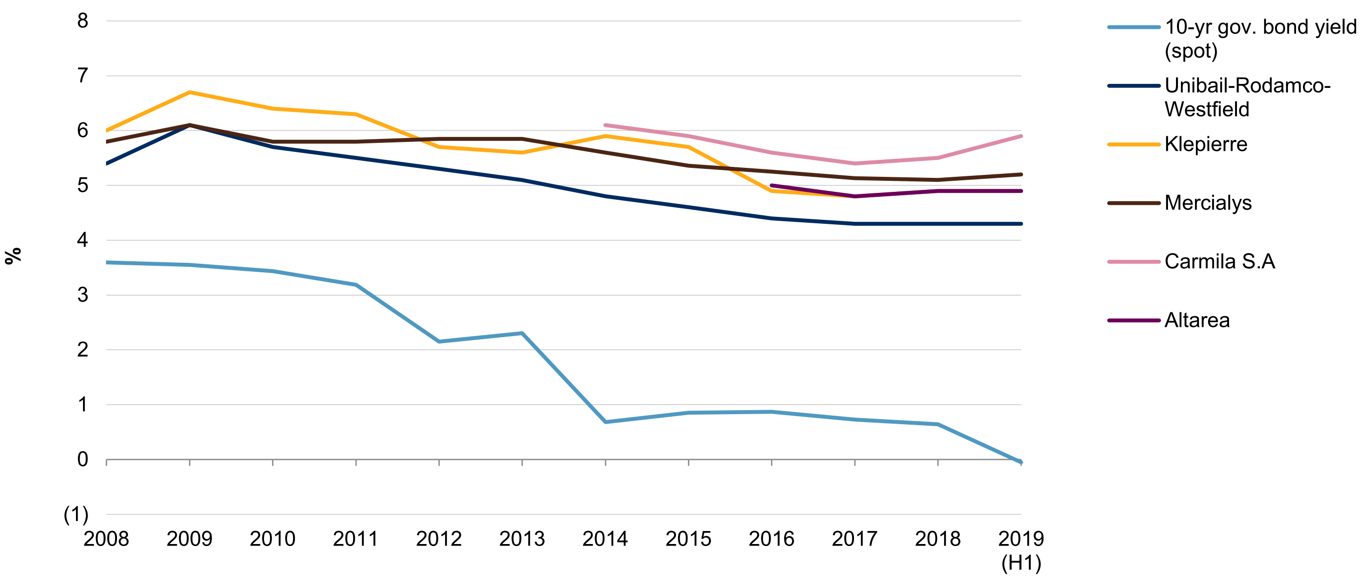
Yields: A Point Of Inflexion?
Gross asset value like-for-like variation*



*Average of 10 rated REITs. Source: S&P Global Ratings.

Chart 5

Yields Increase Despite Risk Widening Premiums
Rental yields versus risk free rate (%)



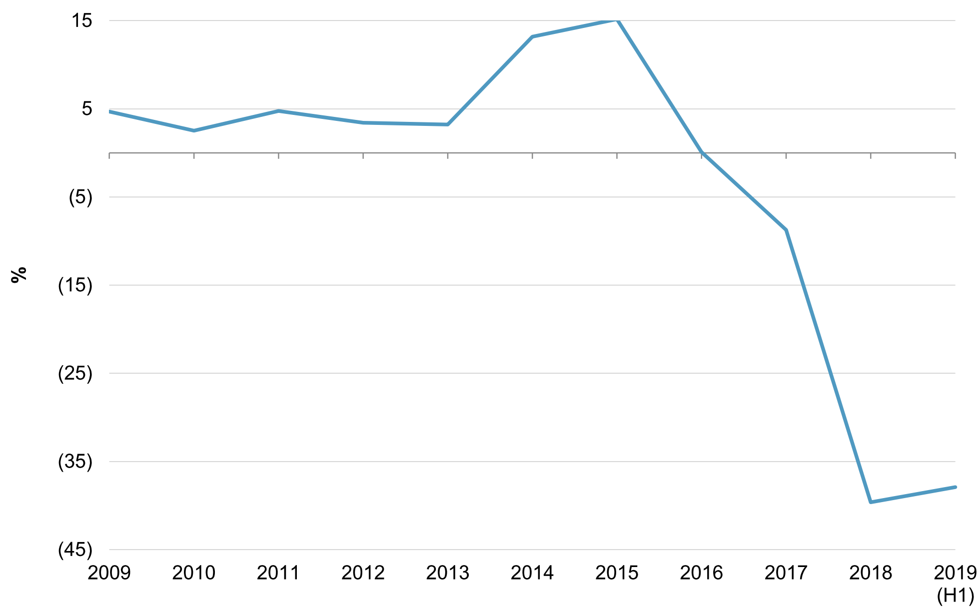
Source: S&P Global Ratings.

Negative Market Sentiment Prevails

The negative sentiment toward European retail REITs that currently prevails in the capital markets is reflected in their share prices, which are trading well below 2015 level. This raises the question whether they will be able to maintain long-term access to funding and support from equity investors. On the debt side, liquidity surpluses are still material and higher than the long-term average. We estimate that current liquidity sources (unrestricted cash and available committed credit lines) of the 12 rated REITs could cover by about 1.7x the debt that is maturing in the next 12 months on average. Debt capital markets remain open. URW in July 2019 issued the lowest coupon ever for a 30-year bond. Refinancing risk is currently remote and interest coverage ratios should remain strong in general, if not strengthened, by decreasing interest rates. But we remain cautious that funding terms may become tighter over the coming years. REITs share prices currently trade at a wide discount to their respective net asset values (see chart 6). We believe this could tempt some REITs to buy back shares in the absence of investment opportunities, which we would consider credit negative.

Chart 6

Prices Trade At a Discount To Net Asset Values
Share price premium/discount to net asset value*



*Average of four rated retail property companies. Source: S&P Global Ratings.

Structural Challenge May Lead Us To Recalibrate A Few Ratings

While we do not believe shopping centers will disappear, e-commerce represents a serious alternative option to physical shopping that is here to stay and is likely to intensify the competition between traditional retailers over time. The negative sentiment has not only reached retail tenants, but also property investors, financial investors, and real estate appraisers. We therefore see the retail asset class in Europe as slightly less resilient, less liquid, and more replaceable than in the past, as it is now facing a structural challenge.

While all 12 retail companies we rate in Europe are facing the same challenges, we yesterday took a number of actions on six issuers because we currently see them as more weakly positioned in their current rating. We revised our outlook to negative on URW, Mercialys, Citycon, and to stable from positive on Carmila. We also tightened our ratio guidance on two issuers (Altarea and Altareit).

We may reassess these ratings downward over the next 24 months should performance weaken or should we see them too weakly anchored in their business or financial risk categories, partly reflecting our revised long-term view of the sector.

Related Research

- Shopping Center Owner Unibail-Rodamco-Westfield Outlook Revised To Negative; 'A/A-1' Ratings Affirmed, Sept. 25, 2019
- France-Based Mercialys Outlook Revised To Negative; 'BBB/A-2' Ratings Affirmed, Sept. 25, 2019
- French Property Owner And Developer Altarea Affirmed At 'BBB'; Outlook Stable, Sept. 25, 2019
- French Property Developer Altareit Affirmed At 'BBB'; Outlook Stable, Sept. 25, 2019
- Carmila S.A. Outlook Revised To Stable From Positive; 'BBB/A-2' Ratings Affirmed, Sept. 25, 2019
- Shopping Center Owner Citycon Outlook To Negative On Rising Leverage And Tough Market Conditions; Affirmed At 'BBB-/A-3', Sept. 25, 2019

This report does not constitute a rating action.