Under pressure

CRE uncertainty persists

Commercial real estate companies backed by exposure to retail face difficult months ahead, following renewed downward pressure on rental income and non-prime property values amid the prolonged economic fallout of the Covid-19 crisis. Indeed, as the uncertainty over the sector continues, one question is what sort of approach investors should follow in their attempts to gauge the outlook for the future.

After a roller-coaster 1H20, in which the slump in rental income was not as severe as first expected, the CRE sector is bracing for the winding down of various forms of government support for Europe's economy. The latter contributed to the retail sector recovering faster than expected midyear from the shock of lockdowns and other restrictions in March and April, according to Scope. Footfall fell drastically in the first half, although individual consumers have spent relatively heavily as shops steadily re-opened in recent months and as governments maintained financial support for households and business.

The rating agency notes: "We expect rent collection to improve in the second half after falling to 70%-90% in 1H20, assuming Europe's economies continue to reopen, with no further widespread lockdowns. However, looking at the full year compared to 2019, we expect rental income to come under pressure again as various rent deferrals, waivers and other relief come to an end for retail tenants. This will trigger retailer defaults and put more pressure on property owners as tenants look for rental support in order to stay in business."

Scope expects a 20%-30% shrink in rental income on a comparable basis, despite the positive rent reversion observed in 1H20. However, some real estate companies are still renegotiating important parts of existing leases to deal with the impact of the pandemic on retailers. The full economic impact on businesses is yet to be seen, with tenant protection - such as rent deferrals in Germany and France or suspension of lease contracts in Poland - having ended in 3Q20 in many countries. A combination of lease renegotiations and an increase in vacancies will likely lead to a further decline in rental income for the full year. Furthermore, adverse fair-value adjustments have accelerated, although LTVs reached a peak in June.

The biggest impact was on UK-centric REITs, such as Intu Properties, which reached a peak LTV of 70%. The REITs face shrinking headroom under debt covenants, especially in the UK, where Intu Properties has been in administration since June. The problem appears to be 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.

Scope believes that refinancing risk for properties in the UK is rising sharply, with UK lenders calling for significantly higher risk premiums compared to 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.

As the market evolves over the next year, one question is what approach investors should follow in their efforts to gauge the outlook. Scope's methodology follows a cashflow framework, as opposed to an LTV approach used by other agencies, since commercial property values are cyclical, and investors focus on cashflow returns first.

The approach relies on debt service coverage and debt yield metrics to assess both the term risk and the refinancing risk, since CRE debt is usually rollover debt. The quality of the sponsor is also a key analytical element, given that real estate is an actively managed asset class and exposed to idiosyncratic risks. The agency's expected loss ratings are also not constrained by mechanistic caps and its assumptions are derived from through-the-cycle data.

According to Florent Albert, director at Scope: "We have observed a shift of focus towards cash and debt flow credit metrics from a mainly LTV-based credit risk approach. This is the result of the sharp property value depreciation and the surge of refinancing failures following the 2008 global financial crisis. Real estate is a leveraged income-producing asset class, so whatever you do, you must look at the assets and their cashflow generation. LTVs might be simpler, but it underestimates risks, especially in our low-rate environment."

He adds: "Covid has accelerated some of the well identified structural trends, such as ecommerce weakening brick and mortar retail while supporting the rise of logistics. The pandemic also raises new questions, such as how the hospitality sector will adapt and is the office sector at an inflection point following the working-from-home-experience. Valuers will embed this uncertainty in their property valuations, which will affect LTV metrics and reinforce the focus on cashflows."

Yet not all rating agencies have a cashflow focus. DBRS Morningstar's methodology makes use of debt service coverage ratio (DSCR) and LTVs. From the rating agency's perspective, LTVs are an important metric for European CRE loans since leverage has been historically the main risk in Europe.

Georghios Anker Parson, partner at Brookland, notes: "At the end of the day, there's not much of a difference between a cashflow and an LTV approach. If you take a retail asset that has had no income for an extended period, property values would still be impacted. From a real estate perspective, when loans are given, they are provided on an LTV basis, but the leverage is still a multiple of the rents."

He concludes: "Asset class is fundamentally important in the current environment. If you have light industrial and logistics, you are more comfortable using one with a higher LTV approach. But with retail you might not lend at all or at a much lower LTV."

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