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27 October 2020

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CLIENT SERVICES

Retail real estate – Europe

Coronavirus exacerbates difficult operating environment, weighing on credit quality

Summary

» **European retail landlords' credit quality at risk of further deterioration as coronavirus makes difficult operating environment even harder.** We expect a less creditworthy tenant base, with space demand remaining weak and exacerbated by the shift online. Continental companies including Unibail-Rodamco-Westfield SE (Baa1 stable), Corio N.V. (Klépierre S.A., A3 negative), Citycon OYJ (Baa3 negative) and Atrium European Real Estate Limited (Baa3 negative) will grapple with tough operating conditions but should fare better than their UK peers.

» **UK landlords face a combination of credit negative challenges.** These include higher-than-average online sales growth, higher costs for tenants, increasing use of company voluntary arrangements to reduce rents and the government's extension of an evictions moratorium to the end of this year. The operating performance of companies with high exposure to the UK such as Hammerson Plc (Baa3 negative) and intu Properties PLC will remain weak as a result.

» **A shift to more flexible leases will benefit retailers, but reduce landlord's income.** This shift will depress rents and asset values in the short term. However it could lead to a more collaborative approach between tenants and landlords over the longer term, leading to more sustainable rents and a return of investor confidence. This trend will be more widespread in the UK than in continental Europe.

» **Coronavirus has accelerated trends that will boost the credit quality of logistics landlords.** We expect logistics to continue to outperform other sectors such as retail and offices. This will benefit the credit quality of logistics focused companies like Prologis European Logistics Fund FCP-FIS (A3 stable), Goodman European Partnership (Baa1 stable), Tritax Big Box REIT plc (Baa1 stable) CTP B.V. (Baa3 stable), AB Sagax (Baa3 stable) and SEGRO European Logistics Partnership S.a r.l. (Baa2 stable).

» **Key features within CMBS transactions offset the pandemic's effect on deal credit quality.** Prime quality retail assets, amortising structures and sizable liquidity facilities covering interest and scheduled principal payments on the notes provide a buffer to the retail sector's credit deterioration. Lower vacancy rates, positive rent reviews, lease renewals and strong rental collection all support securitised logistics transactions' credit quality.

Credit quality at risk of further deterioration as coronavirus makes difficult operating environment even harder

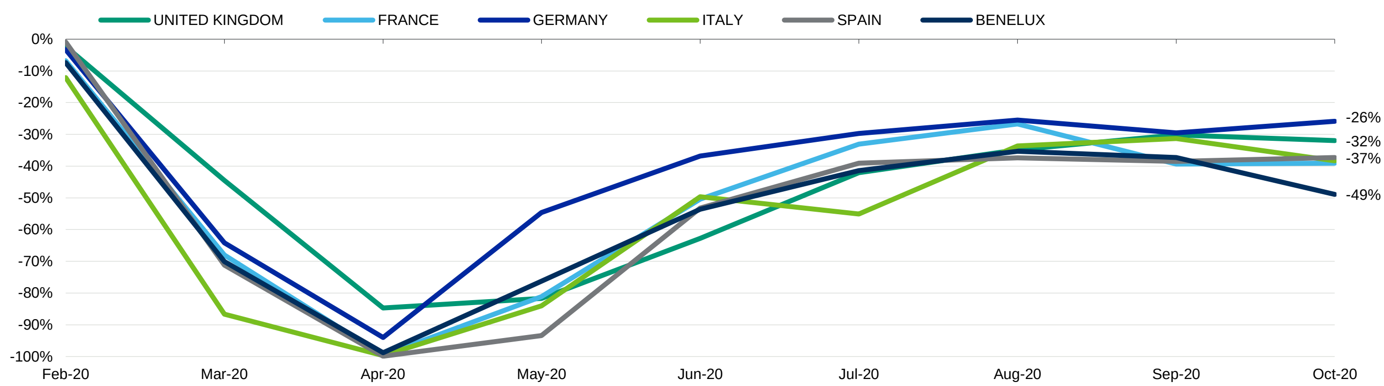
We expect a significant deterioration in retail landlord's rental income for at least the next 18 months as the coronavirus pandemic makes the operating environment even harder. This deterioration will be driven by much weaker demand for retail space, low rent collection rates and higher vacancy rates as landlords struggle to refill vacated stores. As a result we expect higher Moody's adjusted net debt/EBITDA leverage ratios and weaker interest cover. Weakening income and souring investor sentiment will lead to further falls in the value of retail assets. By the end of 2021, we expect retail assets to have fallen 15%-20% in continental Europe, 10%-15% in the Nordics, Poland and Czech Republic and up to 30% in the UK compared with values as of June 2020.

Retail landlords have taken various measures to shore up their income and balance sheets including raising fresh equity, accelerating asset disposals, reducing dividends and curbing capital spending. However, it is too early to know whether these measures and additional steps retail landlords can take will be enough to offset deteriorating credit ratios and avoid further negative rating actions.

An economic recovery is underway, but it remains tenuous and it will be closely tied to containment of the virus.[1] We expect consumers to remain cautious and consumption weak as long as Europe continues to battle the pandemic. In the absence of a reliable vaccine and the continued need to wear face coverings, we expect in-store sales and footfall to remain below pre-pandemic levels.

Footfall ground to a halt during the peak of the pandemic. And while consumers have returned to stores as governments have eased lockdown measures, footfall remains less than 75% what it was before coronavirus (Exhibit 1).

Exhibit 1
Footfall still well below what it was before the pandemic
Year-over-year footfall traffic

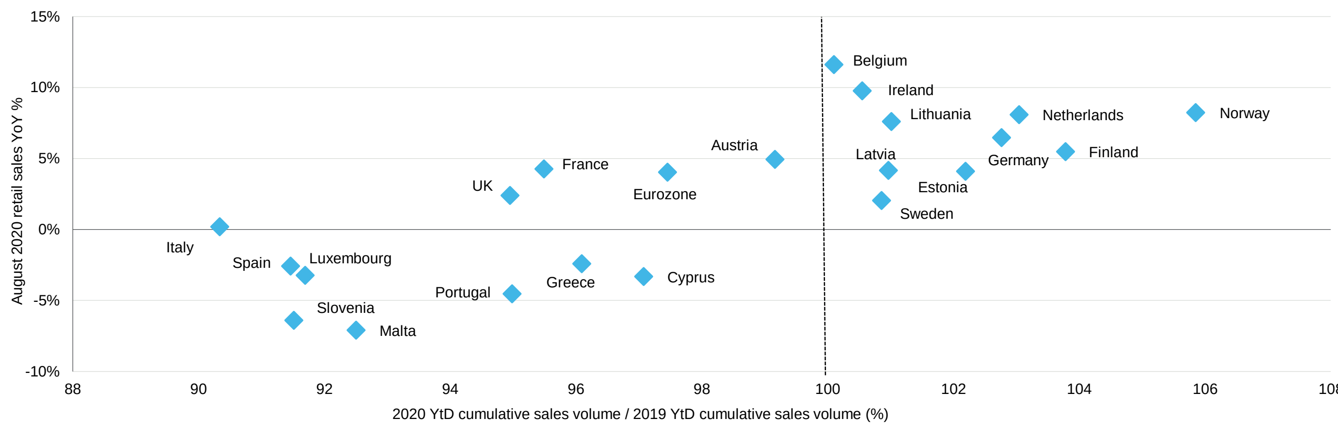


Year-over-year traffic data comes directly from ShopperTrak's 40 billion annual footstep counts. The index takes data from each week or month and compares it to the same period during the previous year
Sources: ShopperTrak, Moody's Investors Service

Footfall recovery also varies by region, with Benelux lagging. This will weigh on the performance of retail landlords such as Wereldhave N.V. (B1 negative), which has more than 70% of its assets in Belgium and the Netherlands.

The retail sales recovery in the summer outpaced footfall. Those customers which did shop in stores had a clear intent to buy and spent more on average than they did before the pandemic. However as Exhibit 2 shows, retail sales also vary considerably by country and are down on 2019 in several markets. Countries in the top right of the quadrant in Exhibit 2 are outperforming, with year-to-date overall retail sales exceeding last year and monthly sales higher than pre-covid levels. Countries toward the bottom left are lagging.

Exhibit 2
EU retail sales vary considerably by country
Retail trade volume (excluding motor vehicles & motorcycle)

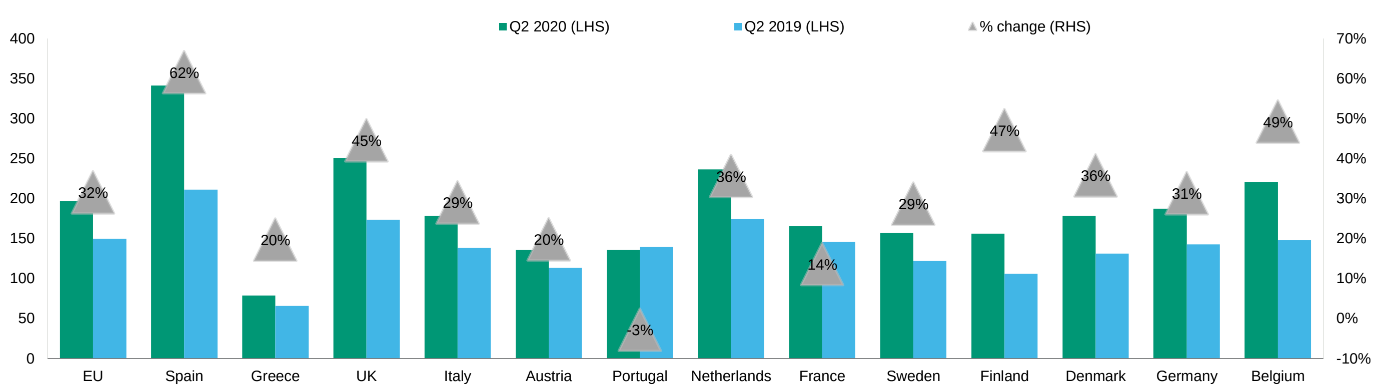


July data is used for Cyprus and Greece due to data availability
Source: Haver Analytics, Moody's Investors Service

Despite recent improvement, year-to-date retail sales through August in the euro area are still 3% below the level during the same period of 2019. For Italy and Spain, year-to-date sales are down around 10% from a year earlier. A weak retail sales recovery in Italy will weigh on the performance of retail landlord Immobiliare Grande Distribuzione SiiQ S.p.A. (Ba2 stable), which has 95% of its assets in Italy. By contrast, the operating environment for retail landlords in the Nordics has held up well compared with most other countries. Lockdowns were less severe and these countries have public sectors which comprise a larger part of their economies than elsewhere. This will support the credit quality of Citycon OYJ (Baa3 negative) and retail-backed CMBS transaction Taurus 2019-4 FIN DAC, both of which have all their assets in the region.

The pandemic has also accelerated the structural move of retail away from physical stores and online. This move online will further reduce retail space demand. As Exhibit 3 shows, European mail order and internet sales rose 32% on the year in the second quarter of 2020, the highest pace on record.

Exhibit 3
Online sales gained momentum in most European countries
Monthly average mail order and internet sales (2015=100)



Sources: Haver Analytics, Moody's Investors Service

However the move online remains uneven: in some countries such as Greece and Portugal, online sales growth remained weak during government-imposed lockdowns, probably hampered by lower than average internet connectivity. While we expect some customers to return to shopping in physical stores and away from online, in-store shopping will not return to pre-pandemic levels. We forecast online sales penetration in Western Europe will reach 15% of total sales during the next three years, up from 10% before the pandemic. [2]

UK landlords face a combination of credit negative challenges

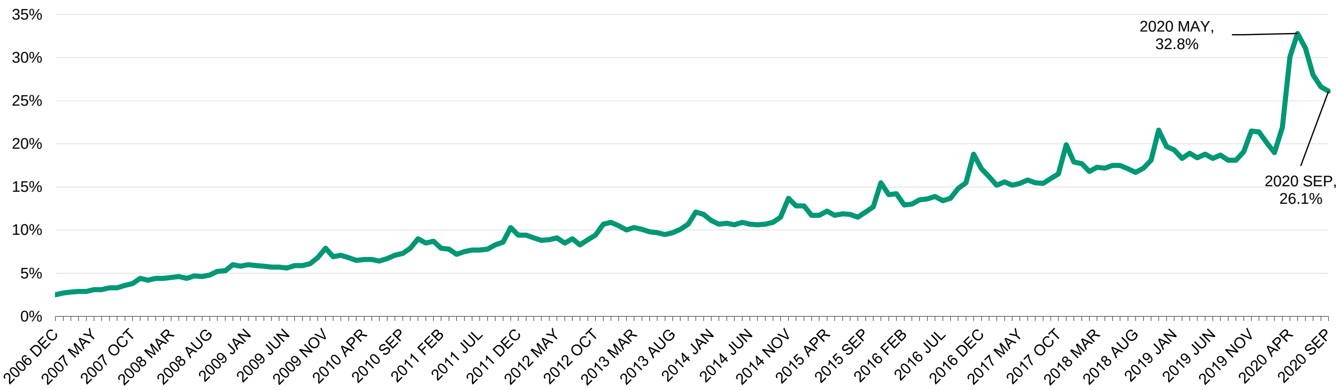
The UK will remain the most difficult operating environment for retail landlords in Europe driven by a combination of factors. This cocktail of challenges will weigh on the credit quality of Hammerson Plc (Baa3 negative). Hammerson has roughly 50% of its assets, including flagship shopping centers and retail parks, in the UK. intu Properties PLC also has high UK exposure, owning or part owning 17 UK shopping centres as well as three in Spain.

Firstly, we expect online retail penetration in the UK will remain the highest in Europe, at well above 25% of total sales during the next few years. As Exhibit 4 shows, online sales peaked at 32.8% of total retail sales in May, before falling back to 26.1% in September.

Exhibit 4

Online penetration in the UK well above 25% in the next five years

Monthly UK internet sales as a percentage of total retail sales (ratio) (%)



Source: UK Office for National Statistics (ONS)

This will reduce demand for bricks-and-mortar selling space. Retail bricks-and-mortar costs remain fixed but online sales are cannibalising those made in stores, prompting rationalisation. And online sales will be margin dilutive for all but a few specialists online retailers in the next 12-18 months. [3]

Secondly, retail occupancy costs in the UK are the highest in Europe. Rent, service charges and property taxes as a percentage of store sales are in the 20%-25% range compared with an average of roughly 15% on the continent. A main contributor to the much higher retail occupancy costs in the UK are property taxes, also called business rates, which typically equate to about 50% of annual rent. As part of the UK government's coronavirus support measures, retail shops and other outlets do not have to pay business rates from 1 April 2020 until 31 March 2021. The end of the business rates holiday, assuming the government does not extend it, will add further credit stress to UK landlords' tenants. The typically much higher retail sales per square foot sales density in the UK compared with the continent does not fully offset the higher occupancy costs for retailers.

Thirdly, we expect retailers to continue their aggressive use of company voluntary arrangements (CVAs) to force lower rents and more relaxed terms on landlords. We expect UK retail rents to fall between 15%-25% in the next few years to make them more affordable for retailers and adjust to weaker demand.

Finally, a moratorium on evicting commercial real estate tenants was recently extended by the UK government to the end of 2020. This acts as a disincentive for retailers to pay their rent, knowing they will not be evicted if they fail to pay.

We expect rents to also decline 8%-15% in continental Europe. However we do not expect the same large drops in rents as in the UK because European rents are more sustainable. The rent model in continental Europe has historically been based more on affordability. By contrast in the UK landlords aim to achieve the highest level of rent on a new lease or at rent review. As a result, the credit quality of some retail landlords with high exposure to the continent, including Unibail-Rodamco-Westfield SE (Baa1 stable) and Corio N.V. (Klépierre, A3 negative) should fare better than their UK peers.

Of the retail-backed commercial mortgage backed securities (CMBS) transactions we rate, the credit quality of The Trafford Centre Finance Limited and Taurus 2019-4 FIN DAC will be marginally weakened by the economic fallout of the underlying sector.

More flexible leases will benefit retailers, but erode landlord's income

An element of turnover rent is a common part of leases, representing on average 5%-8% of retail landlord's overall rent. Since the pandemic flexible leases and a higher proportion of variable rent have become a key demand from retailers as they grapple with lower sales, profit margin erosion and the need to contain costs.

As a result we now expect the proportion of variable rent linked to sales or footfall to increase to 10%-15% during the next few years. This change will be more prevalent in the UK market, where operating conditions are tougher and rent costs are high for retailers. Most leases are very long and rent reviews almost always result in higher rents.

We also expect to see a shift toward shorter leases in the UK paid on a monthly basis, similar to continental peers, rather than quarterly in advance as is the case now. Retail landlords on the continent are under less pressure to accept such concessions because rents are more affordable and the base-plus-turnover rent concept is more prevalent in many continental European markets.

The shift from largely fixed rents to more turnover-based rents will be a short-term credit negative for European retail landlords. We expect rents and asset values to correct lower and this will introduce an element of variability and uncertainty to rental income. This shift will also lower covenant capacity for many retail landlords; a clear credit negative because lenders normally exclude the turnover based element of rent when calculating interest cover. However, in the longer term the shift could be positive for the sector if it leads to a more collaborative relationship between landlords and tenants. This could result in more affordable rents for retailers and sustainable asset values for landlords. Once these new lease formats develop a track record investor confidence will return and retail asset values will stabilise.

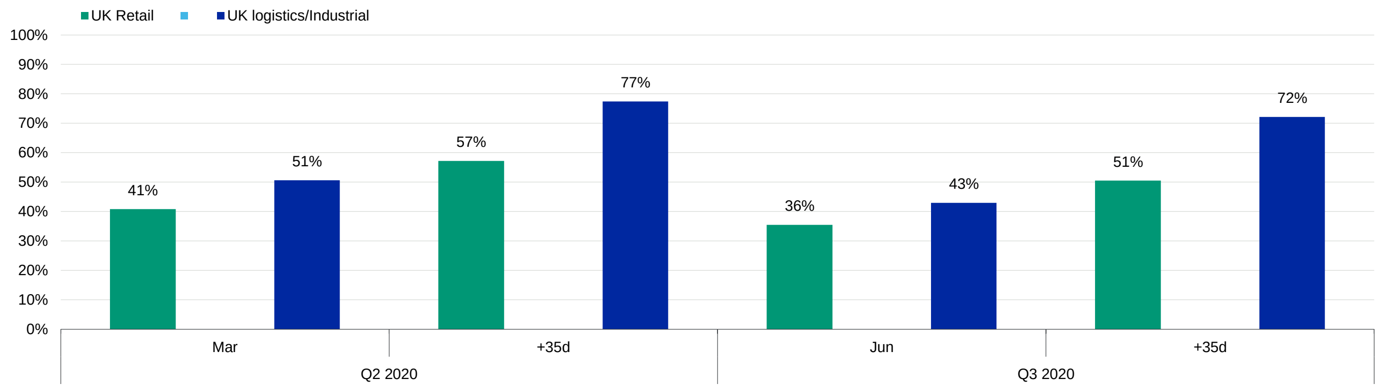
Coronavirus has accelerated trends that will boost logistics landlord's credit quality

We expect logistics landlords to continue outperforming as the rise of online shopping increases demand for warehousing and distribution space. According to data from real estate company Savills, takeup of UK industrial warehousing space in the first three quarters of 2020 was 4% higher than it was for the whole of 2016, the previous record year. Retailers still need to invest substantially in their online platforms and supply chain technology and infrastructure, further boosting demand.

Strong sector fundamentals alongside positive investor sentiment will bolster the credit quality of logistic landlords across Europe. The beneficiaries of this trend include Prologis European Logistics Fund FCP-FIS (A3 stable), Goodman European Partnership (Baa1 stable), Tritax Big Box REIT plc (Baa1 stable) CTP B.V. (Baa3 stable), AB Sagax (Baa3 stable) and SEGRO European Logistics Partnership S.a r.l. (Baa2 stable).

The different rent collection rates for retail landlords and logistics landlords further illustrates the diverging fortunes of the two sectors. UK logistics landlords collected 72% of their quarterly rent in the third quarter of 2020 on average, compared with 51% for retail landlords, as Exhibit 5 shows.

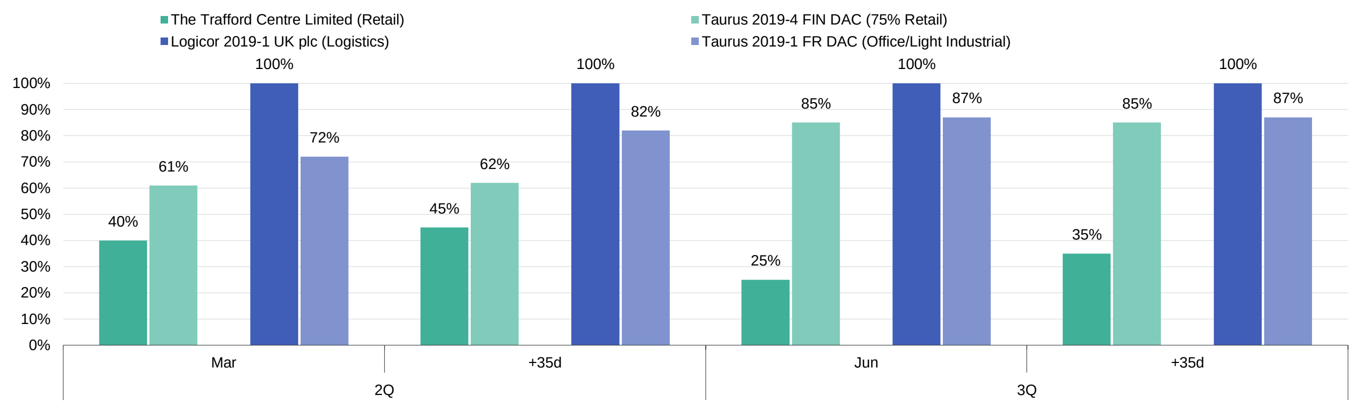
Exhibit 5
UK logistics landlords' collection rates have been stronger during the pandemic
UK quarterly rent collection rates



Source: Remit consulting[4]

Among logistics-backed CMBS, the credit quality of Taurus 2019-1 FR DAC and Logicor 2019-1 UK PLC will benefit from the underlying sector's outperformance (Exhibit 6)

Exhibit 6
Logistics-backed CMBS collection rates have outperformed retail-backed CMBS
Quarterly rent collection rates



Source: Investor reports

Key features within CMBS transactions offset pandemic's effect on deal credit quality

We expect retail and logistics-backed CMBS to offset the fallout from the coronavirus on credit quality. The credit quality of the retail deals we rate are supported by prime quality retail assets, amortising structures and sizable liquidity facilities which cover interest and scheduled principal payments on the notes. The underlying credit quality of the securitised logistics transactions we rate are supported by low vacancy rates, rent increases and lease renewals.

The Trafford Centre Finance Limited and Taurus 2019-4 FIN DAC transactions also have an adequate liquidity facility coverage of the notes of more than a year, even if the properties receive no income. The Trafford Centre Finance Limited's Class D noteholders are limited to £15 million, leading to an expected yearly note interest and principal coverage of 88%. The Trafford Centre Finance Limited's lower leverage at maturity also provides an extra buffer against the secular decline of retail property values.

The Trafford Centre in Manchester is one of the region's prime retail shopping and leisure destinations for the second year in a row, according to consultants GlobalData.[5] It has excellent transport links and a strong record of active asset management. The Ratina Shopping Centre, which represents 75% of the Finnish transaction Taurus 2019-4 FIN DAC, is the city of Tampere's newest shopping destination and benefits from a strong tenant mix. The centre's tenants include two large grocery retailers (Lidl and K-Supermarket) which have had strong sales during the pandemic and a national alcoholic beverage retailer, which has a very limited number of stores in the city.

Taurus 2019-1 FR DAC transaction's underlying portfolio is made up of mostly regional offices or mixed-use properties. Office and adjacent warehouse space is nearly fully let to the majority state-owned Electricité de France (EDF, A3 negative) or its affiliates. We expect the transaction's collection rate level to increase as adjustments are made to the main tenant's rental payment process. The latest vacancy rate of 7.9% in August 2018 is second lowest rate after Logicor 2019-1 UK PLC.

Logicor 2019-1 UK PLC's performance has improved since closing in October 2019, with reported rental income up 3% and vacancy levels falling to 2.6% from 4.5% during the past year. Recent leasing activity reflects an increase in demand for prime logistics space. Reviewed and extended leases were on average 8% under-rented at closing and are now 4% over-rented compared with July 2019's estimated revenue values (ERVs). A new lease was completed by a major UK grocery retailer opening a new national food distribution centre in Milton Keynes. The transaction's strong rental collection rate compares well to light industrial/warehouse portfolios which have been securitised in other transactions that we do not rate, ranging from 59% to 79% in the second quarter of 2020.

Moody's related publications

Sector research:

» Retail - Europe: Outlook stable as demand recovery is balanced by margin dilutive online surge, 20 October 2020

» Office Real Estate – Europe: Risks to credit quality are rising as coronavirus effects deepen, 19 June 2020

» Retail Real Estate – Europe: Credit quality weakens as coronavirus exacerbates sector's structural challenges, 15 April 2020

» Retail – Global: Pandemic is forcing retail to accelerate its transformation, 24 August 2020

» Real estate – Europe: Limited immediate negative credit impact of coronavirus, substantial downside risk, 16 March 2020

Issuer research:

» Unibail-Rodamco-Westfield SE: Update following downgrade to Baa1 stable, 25 September

» Hammerson Plc: Update following downgrade to Baa3, 20 July 2020

» Atrium European Real Estate Limited: Update following ratings confirmation, 17 June 2020

» Citycon OYJ: Update following confirmation of Baa3 rating outlook changed to negative, 17 July 2020

» Prologis European Logistics Fund FCP-FIS; Update to credit analysis, 14 February 2020

» Goodman European Partnership: Update to credit analysis, 15 January 2020

» Tritax Big Box REIT plc: Update to credit analysis, 13 November 2019

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 See Global Macro Outlook 2020-21 (August 2020 Update): Economic recovery remains tenuous as pandemic fears persist, 25 August 2020

2 See Retail – Global: Pandemic is forcing retail to accelerate its transformation, 24 August 2020

3 See Retail - Europe: Outlook stable as demand recovery is balanced by margin dilutive online surge, 20 October 2020

4 REMark 2020: June Quarter Day – 35 Day Analysis

5 GlobalData Consulting - Top 50 UK Shopping Centres (December 2019)

REPORT NUMBER 1242955

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