Nordic Credit Rating

RETAIL PROPERTIES UNDER PRESSURE

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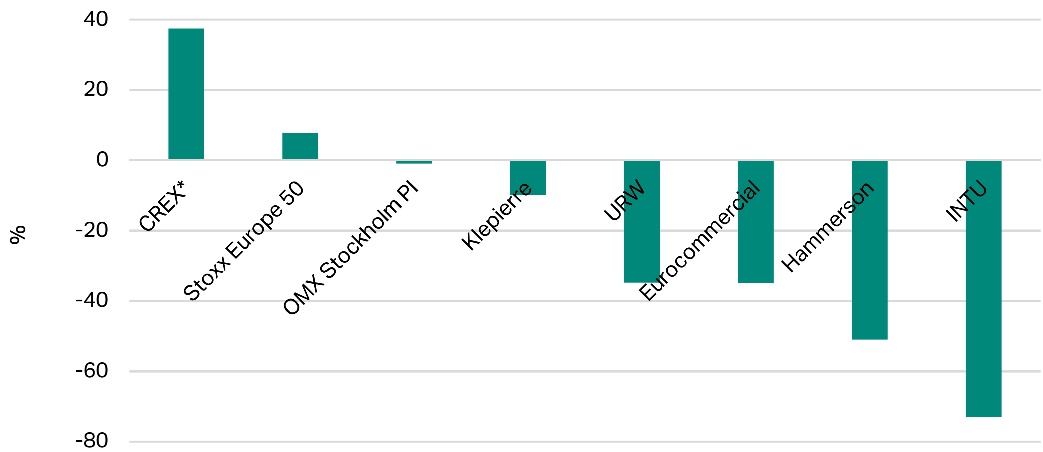
This commentary does not reflect a rating action.

Nordic Credit Rating (NCR) believes that retail property owners in the Nordic region will face challenges in the next few years due to rapid changes in the retail sector and in consumer behaviour. We think that retail property owners will come under pressure to invest more heavily and question what properties can be considered "prime" in their portfolios as a result of e-commerce growth and increasing demand for services and retail "experiences," in addition to the risk of increasing vacancies and pressure on rental rates.

While the wider Nordic property sector has been surging in recent years, large mainland European and UK shopping mall owners (Klepierre, URW, Eurocommercial, Hammerson, and INTU) have seen sharp drops in their share prices due to challenges facing the wider European retail sector, failed takeover attempts and fears over the UK's impending exit from the EU. We have analysed 15 Nordic real estate owners with retail exposure and concluded that the impact on their creditworthiness has so far been limited. However, judging by the experience of the UK, where e-commerce now accounts for about 20% of the retail market, or twice the level found in the Nordic countries, owners of retail property in the region will need to hasten refurbishment to maintain the attractiveness of their portfolios.

Figure 1. Stock market movements in the past 12 months

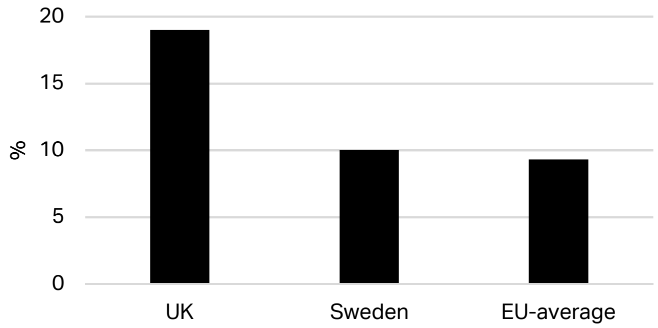


Based on data from Carnegie, Nasdaq OMX, S&P Capital IQ
*CREX: Carnegie Real Estate Index (SEK)

E-COMMERCE, HIGH RENTS AND OVERCAPACITY ARE TAKING THEIR TOLL ON RETAIL

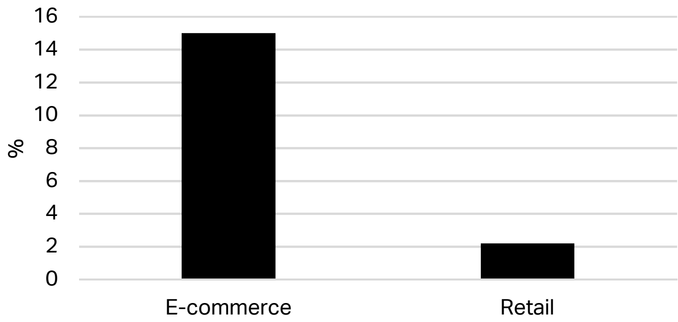
Negative events in the retail sector have been intensifying over the past couple of years. Large- and small-scale bankruptcies have been declared on both sides of the Atlantic, while many Nordic retail chains have been forced to close stores due to rising rental rates and increased competition from e-commerce. The sector has also been hurt by self-inflicted overcapacity. The hardest hit categories include fashion, electronics and toys. Many retail chains are now calling for property owners to reduce rents to avoid financial difficulties and potential bankruptcy. Conversely, the chains themselves have come under criticism for being too slow to adapt to rapidly changing market conditions. In Sweden, total sales via e-commerce grew by 15% in 2018 compared with 2% for the wider retail sector. Moreover, consumers are rapidly changing their behaviour, forcing property owners to provide services and experiences such as hotels, restaurants, cinemas and gyms, rather than traditional retail activities.

Figure 2. Swedish e-commerce share of total retail against UK and EU average, 2018



Source: Eurostat, Swedish Trade Federation, Postnord and Stastics Sweden

Figure 3. Swedish e-commerce growth against total retail, 2018



Source: Swedish Trade Federation, Postnord and Stastics Sweden

If the Nordic retail sector follows the recent pattern seen in the UK, the region's retail chains, and subsequently retail property owners, face several years of pressure. E-commerce in the UK now accounts for about 20% of total retail sales, a proportion about twice as high as that of the Nordic countries and the rest of the EU. This is partly due to the UK's much higher population density, which simplifies logistics and transport. UK shopping mall owners such as Hammerson and INTU have seen their share prices drop sharply in the past year due to fears of weaker future performance.

The weak share price performance has also been driven by failed takeover attempts within the sector and Brexit-related fears. Operational performance and credit metrics are weakening, but not as much as might be adduced from the sharp falls in share prices. The largest shopping mall owners in continental Europe, Unibail-Rodamco-Westfield and Klepierre, continue to show solid operational figures.

Recent reports by Postnord and the Swedish Trade Federation describe the outlook for the Nordic retail sector (and indirectly retail property owners) as challenging. The Swedish retail sector is thought to be 6-8 years behind that in the UK. The Swedish Trade Federation has forecast that about 11,000 stores will have to close in Sweden by 2025, if domestic e-commerce penetration reaches 33%. This would represent a 25% reduction in total stores compared with 2017. The number of grocery stores is forecast to remain stable, despite growing e-commerce in the food segment, albeit from low levels (2% penetration).

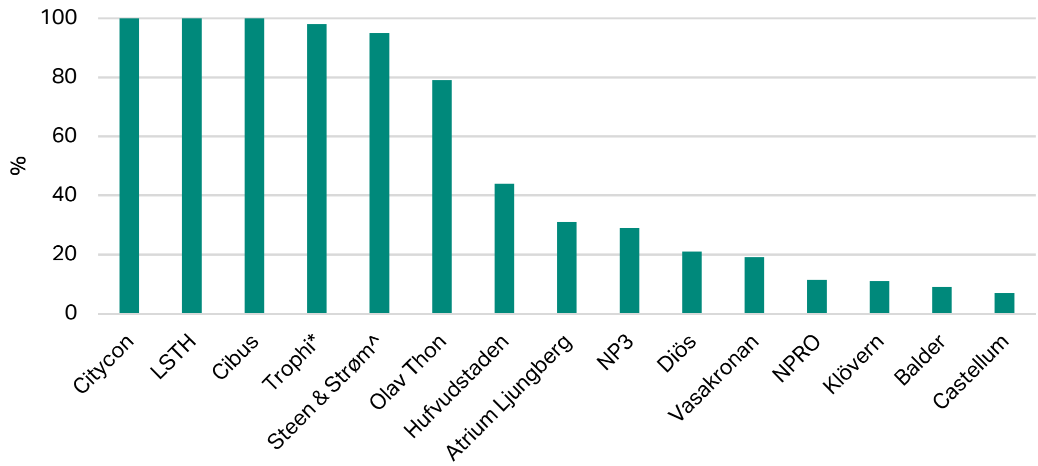
Although these figures appear to be a cause for concern, the decline in traditional retail activity is partly offset by demand for services. Although sales of fashion goods and footwear have declined in city centres and shopping malls, demand for cafes, restaurants, cinemas, gyms and other services is growing. Stores in prime central business district locations and low-cost stores continue to prosper. Increased pressure in the sector will force property owners to reconsider what stores and areas are designated "prime" locations, and will in all likelihood invest heavily in their portfolios as underinvested non-prime properties will see higher vacancy rates, lower rental income, and, eventually, significantly lower values.

Large Swedish property owners such as Atrium Ljungberg and Fabege are taking a holistic approach to specific geographic areas such as Arenastaden and Sickla, both located just outside Stockholm city centre. These locations are being totally redeveloped to include a combination of stores and shopping malls, hotels and restaurants, offices, residential buildings and sport arenas. Both areas are also situated close to public transport hubs.

NEGATIVE PROPERTY VALUATION IS THE ONLY EFFECT ON NORDIC PROPERTY OWNERS SO FAR

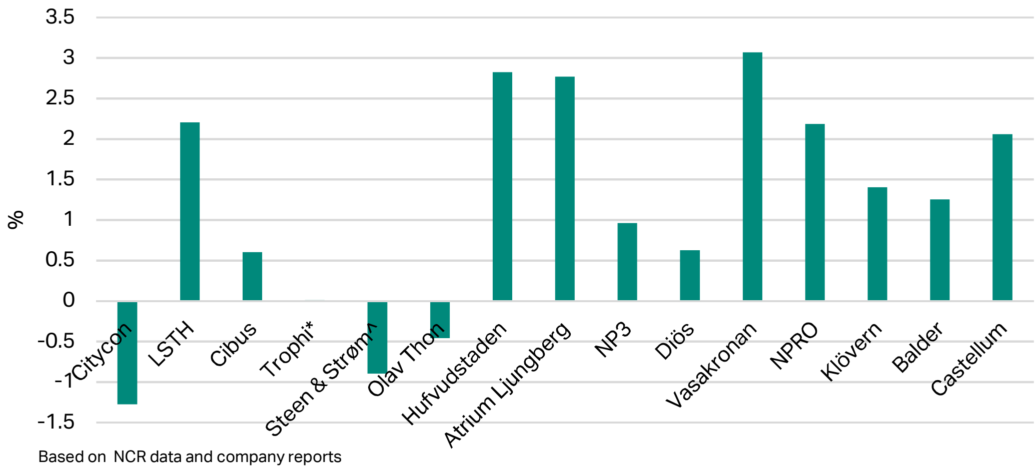
Looking at the latest reports (H1 2019) of the 15 property companies in our sample, there has been little effect on operational and credit metrics so far, despite the overall negative sentiment in the sector. Property valuations are the only financial metric where we can see a clear negative difference for property owners with a retail focus. Olav Thon, Citycon and Steen & Ström owner Klepierre have all made minor negative adjustments to their portfolio valuations, mainly because of lower demand.

Figure 4. Selected Nordic real estate companies' exposure to the retail sector



Based on NCR data and company reports
*Trophi Q1 2019 figures
^Steen & Strøm - Klepierre Scandinavia figures

Figure 5. Change in value as part of total portfolio value, H1 2019



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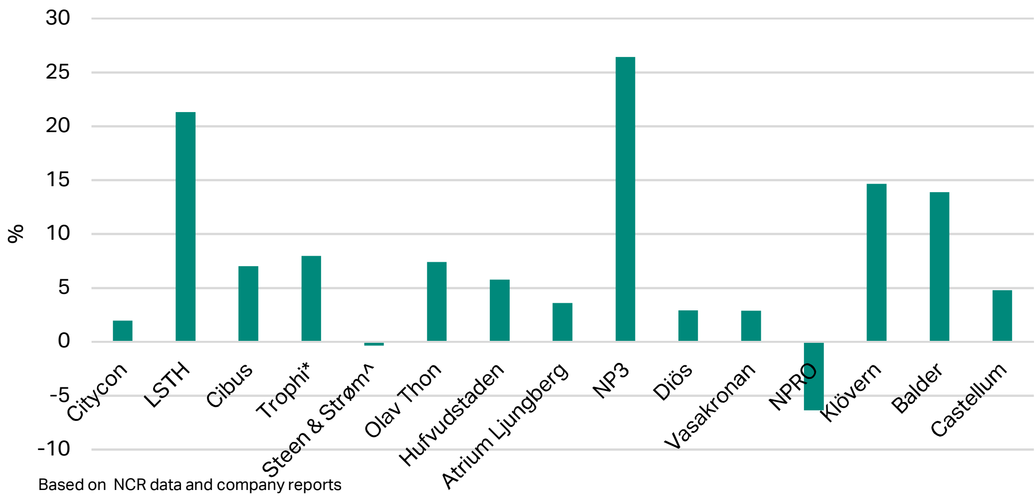
^Steen & Strøm - Klepierre Scandinavia figures

Rental income growth remained positive across our sample as multi-year rental contracts are not immediately affected by poorer performance by tenants. Looking beyond the top-line numbers, like-for-like tenant sales and non-core property rental income are negative in some parts of the Nordic region, typically at underinvested non-prime locations. Many retail companies are now demanding more flexible, revenue-based, rental contracts, as opposed to conventional fixed contacts, which can squeeze profitability when tenant revenues decline. If property owners do not become more flexible, vacancies could rise if stores are forced to close. So far, there have been no changes in vacancy rates across our sample. The vacancy rate remains low, typically below 5% for retail properties, after a decade of strong economic performance throughout the region. By comparison, UK-based mall owners Hammerson and INTU reported declines of 10% in like-for-like rental income and property valuations in the first half of 2019.

Figure 6. Growth in rental income, H1 2019



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*Trophi Q1 2019 figures
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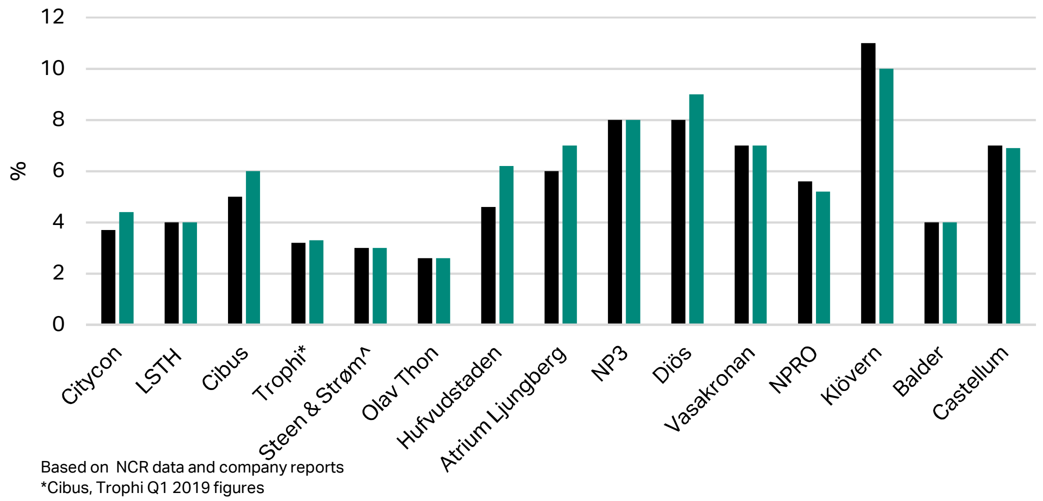
Figure 7. Vacancy rates

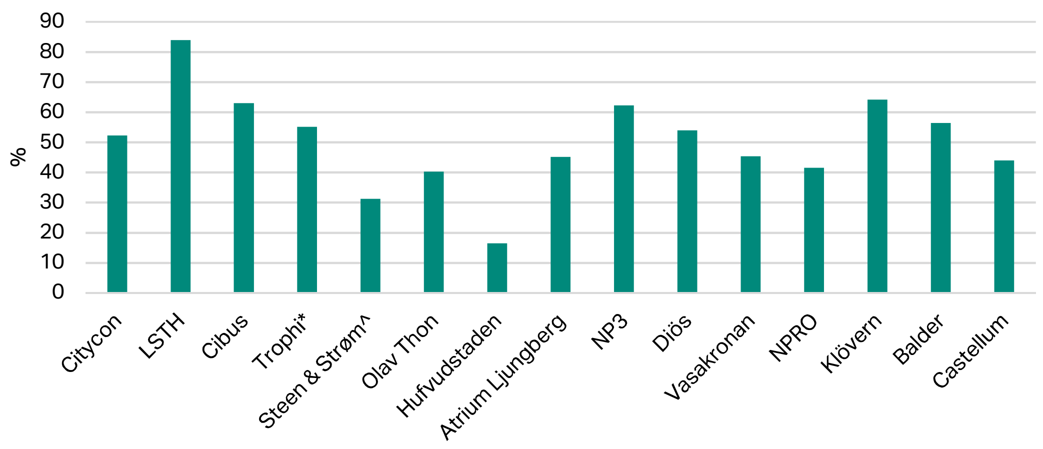


Based on NCR data and company reports
*Cibus, Trophi Q1 2019 figures
^Steen & Strøm - Klepierre Scandinavia figures

CREDIT METRICS REMAIN HEALTHY

Credit metrics remain healthy across our sample as well as the broader Nordic real estate sector. The average loan-to-value (LTV) is currently 50%, with few companies reporting LTV above 60% (on a gross basis), while EBITDA to interest is on average 4x, with few companies reporting below 2x. Although a combination of lower earnings and valuations, in tandem with increased interest rates could easily change the picture, our view is that the sector should have enough financial stamina and headroom to adapt to a tougher retail environment in the years ahead. However, we find it difficult to see a continuation of the rapid increases in rental income, cash flow and valuations seen over the very prosperous past decade.

Figure 8. LTV across our sample, 30 Jun. 2019



Based on NCR data and company reports
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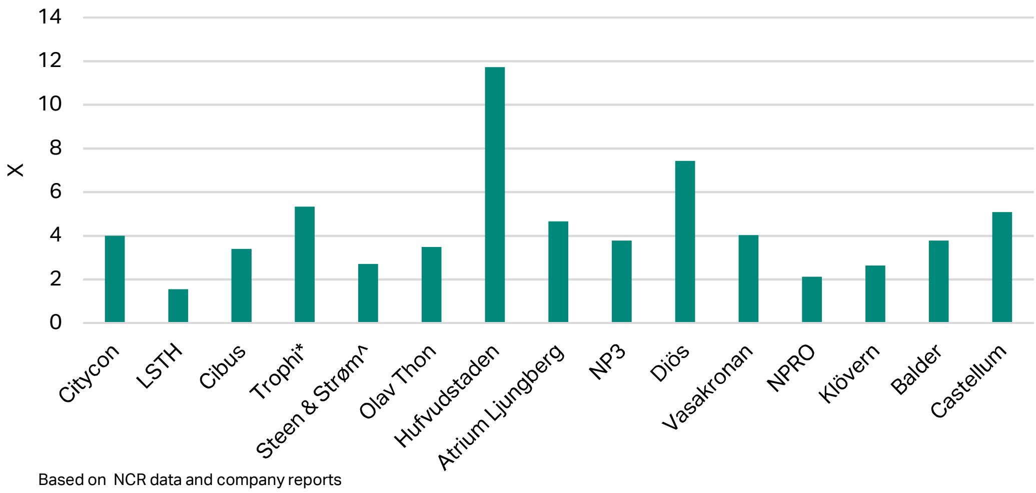
Figure 9. EBITDA/interest across our sample, 30 Jun. 2019



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