Corporates: Commercial Property Sector Risk Scores
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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Real Estate Investment Trusts and Other Commercial Property Companies, May 2019
GCR's Country Risk Score Report, May 2020
GCR Ratings Scales, Symbols & Definitions, May 2019
GCR's South Africa Corporate Sector Risk Score Report, July 2020
GCR Places South African Commercial Property on Negative Trend as Fragile Economy Continues to Drive High Asset Liquidity and Funding Risk, 09 August 2020
Corporate Sector Risk Assessment Reports: Spain; Namibia; Kenya, 2019-2020

GCR Corporate Sector Risk Assessment

GCR utilises sector risk scores in conjunction with country risk scores, to determine the operating environment risk scores for each individual sector in a selected jurisdiction or region. The following Commercial Property Sector Risk Scores are intended to provide Corporate rating users with an overview of the major factors that impact GCR's assessment of the relative risk of commercial real estate in a specific jurisdiction or regional grouping. The following list is a selection of regions and jurisdictions where mostly South African domiciled funds and other real estate entities in GCR's ratings universe have material exposures. Additional Commercial Property Sector Risk Score jurisdictions will also be introduced going forward as necessary. GCR continues to monitor trends in the jurisdictions contained in this publication, and will update sector risk scores as the underlying factors shift.

Commercial Property Corporate Sector Risk Scores

While most territories covered by GCR's property sector risk assessments have a framework akin to REIT legislation, GCR currently assigns the same sector risk scores to REITs and other real estate entities that can retain sizeable profits (to fund growth or discharge debt). As earnings retention directly impacts the financial profile, GCR instead incorporates any benefits of higher retention demonstrated by non-REITs into their respective liquidity profiles.

Balkan territories, Commercial Property Sector Risk Score, 6.25

All-in real estate returns beyond the 2020 recessionary climate are expected to be strong relative to Western European markets, supported by diverse international and regional capital sources. While sound growth prospects are supported by domestic consumption expenditure, real estate dynamics remain underpinned, and therefore highly vulnerable to changes in factors that are exogenous to the region. The Balkans and Central/Eastern Eurozone territories are the only European regional groupings where yield compression (and by extension, capital appreciation) is expected to be sustained in the medium-term, driven by their positioning along trade routes between Asia and Western Europe. This continues to support demand for logistics rental stock with ready access to main freight thoroughfares. In addition, regional e-commerce and retail penetration is relatively nascent compared to the dynamics in highly-developed Eurozone markets. Accordingly, and taking into account supply-side nuances, defensive retail and other properties still reflected low vacancies well into 2020, with the recession expected to have a fairly short-lived impact on these trends.

Overall, the region's strong commercial real estate prospects are counterbalanced by risks inherent in most of its territories' exclusion from reserve currency advantages, and their high susceptibility to international capital flight. In addition, the region is very vulnerable to adverse changes in supply chain dynamics between China and Western Hemisphere economies, as well as the discrete fiscal limitations of underlying countries. These factors could slow the economic rebound anticipated in 2021, with potentially rapid contagion on planned property investments.

Central & Eastern Europe, Commercial Property Sector Risk Score, 7.25

The region represents the most robust dynamics and performance prospects in Eurozone real estate markets, underpinned by sustained economic growth expectations beyond 2020, enabling legislation, improving development indicators, and diverse international capital inflows. While generally positive, there are nonetheless nuances across different property segments, which indicate diverging medium-term return prospects. Amongst other considerations, the region is expected to sustain real retail growth, versus the contraction or stagnation expected from its Eurozone counterparts, on the back of investments in accessible, modern, consumer-oriented space and a more measured technological impact on consumer behaviour and leasing dynamics.

The compression in logistics yields is also expected to be sustained, in contrast to its highly-developed European peers (barring Germany and Nordic territories). The segment is therefore expected to still see capital appreciation and strong investment inflows in the medium term, supported by its strategic positioning along key global route(s). Despite supply-side advantages, office dynamics have been moderating in recent years, which has seen some investors shifting focus to other segments considered to be more supportive of sustained capital and income growth.

Looking ahead, the risk of constrained returns beyond the 2020 recessionary climate could arise from Central & Eastern Europe's reliance on external stimulus, including the high import underpin to strong consumption expenditure, and impetus from positive supply chain dynamics between key Eastern and Western hemisphere territories. GCR also views the upside to the region's commercial property fundamentals to be counterbalanced by its speculative investment profile relative to much more developed Eurozone markets. This could elevate the risk of intermittent capital flight, including knee-jerk reactions to perceptions of economic uncertainty or moderating real estate returns.

Highly Developed Europe, Commercial Property Sector Risk Score 9.50

Demand for property in the region is impacted by both structural factors and economic productivity expectations, with the former continuing to sustain positive or defensive dynamics in a number of real estate segments despite high economic uncertainty. Fundamentals remain underpinned by global gateway cities, robust international capital and money markets, relatively resilient manufacturing dynamics despite competitive pressure from Asian markets, and demonstrably moderate variability in property values and all-in returns through business cycles. The internationally diversified investor base and high listed counter trades also support efficient capital allocation. While vacancies spiked in the wake of the COVID-19 crisis, this comes off new highs in occupancy rates across many segments. As European real estate encompasses an agglomeration of highly differentiated commercial property segments, which many investors view as separate investment classes/markets, asset selection is typically a key consideration for fund managers. Further fragmentation of the region's property markets, amidst high investment in technology-related rental stock, could reduce office representation (+40% of commercial real estate portfolio values) to 30%-40% in the medium to long term.

The region reflects the most pronounced structural decline of property classes exposed to technological disruptions, with retail and traditional office most impacted by evolving consumer and corporate behaviour. That said, the impact on the region's overall real estate fundamentals is counteracted by strong upside potential for commercial property segments benefitting from globalisation trends, rapid ICT/telecommunications evolution, price asymmetry arising from (amongst others) supply-side limitations in certain cities, and idiosyncratic risks inherent in each underlying market. This is expected to sustain polarised performance amongst different sections of real estate, as capital is reallocated to demonstrably defensive segments and newer/non-conventional asset classes. Capital allocation across segments and cities is also expected to be driven by further entrenchment of ESG and responsible investment mandates in corporate entities' and institutional investor cultures. The risk of contagion from speculative distortions across different property markets is relatively low, although it could be heightened by a deep recession or fundamental monetary policy shift.

As with other property markets, the inherent competitive advantages and upside from conservative average leverage metrics of highly-developed European funds are tempered by global recessionary risks in the short-term. That said, the sector is expected to benefit from investors' need to counterbalance the impact of the low-interest rate environment on fixed income markets with (*inter alia*) permitted real estate exposures to segments with strong or resilient quality and performance expectations.

Looking ahead, changes related to Brexit, including the potential divergence in economic policy and productivity, or regulatory direction (due to changes in applicable legislation and oversight), could impact also real estate dynamics in the region. While sustained capital reallocation is unlikely, there could be flux in demand for rental stock along trade corridors, or for premium office space between London and regional capital market centres. Further trade and market uncertainty in the wake of the COVID-19 crisis could also constrain the development pipeline for telecommunications, logistics, and other technological evolution-oriented real estate until global macroeconomic stability ensues.

Kenya, Commercial Property Sector Risk Score 4.0

GCR considers the Kenyan property sector to evidence moderate risk characteristics, underpinned by below average cyclicality and the presence of fixed assets that generate stable annuity income. Notwithstanding GCR's expectations of sound economic growth in Kenya and other inherent advantages, the property market has evidenced signs of a slowdown which has resulted from oversupply of retail, office and upper-end residential space, coupled with the constrained supply of credit to the private sector.

This has been reflected in the declining growth rates in both property prices and rental escalations in recent years, as well as pressure on vacancies, due to protracted letting of new space and declining competitiveness of space in city centre nodes prone to traffic congestion. This comes after years of rapid growth, which was supported by an influx of multinational corporates using Kenya as the gateway into the broader East African market, as well as a growing middle class and expatriate population. GCR expects the sound economic growth through the cycle to support sound baseline demand and profit margins in the property sector beyond the COVID-19 crisis.

Namibia, Commercial Property Sector Risk Score 5.0

The Namibian Property sector risk score balances below average cyclicality and relatively sound returns against the adverse impact of structural and economic limitations National Government has been grappling with for a number of years. The increasingly fragile operating climate has reduced demand for new developments, while rentals and lease tenors have come under increasing pressure. Subdued business confidence has also seen tenants scale back their space requirements. Vacancies have therefore picked up, as availability of rental stock in key nodes rises, while viability constraints facing many entities in the SMME sector will impact collections and recoveries.

Counterbalancing this somewhat is the much slower pace of new developments compared to regional counterparts such as South Africa and Kenya, which should help to support more resilience in commercial property values when compared to residential assets. Access to capital and liquidity are viewed to be reasonable, although somewhat restricted by the illiquid capital markets, and banks' more cautious approach to managing their property exposures going forward. Looking ahead, GCR expects established players to continue to leverage first mover advantages, especially entrenched relationships with financial institutions and land held in the country's restricted to development areas to grow or diversify investments. That said, there are likely to be more distressed or heavily discounted disposals in certain segments, especially residential and industrial. Overall, margin progression is expected to be constrained by higher municipal rates, as well as sustained pressure on consumers and business, which will be exacerbated by the COVID-19 related slowdown and/or disruptions.

South Africa, Commercial Property Sector Risk Score 6.0

The South African sector risk score represents average to below average cyclicality, a highly formalised and diverse economy relative to its African counterparts, commercial assets that typically generate strong income through the cycle, and sustained demand for well-positioned properties. That said, commercial real estate faces increased funding and liquidity risks, with the potential for material profit shortfalls and longer cash conversion cycles in the short-term. Financial flexibility has also been constrained by higher all-in debt levels, amidst risks from distortions in cross currency swap exposures, underperforming regional assets, out-of-the-money BEE transactions, and declining portfolio values.

Immediate operating risks continue to be alleviated by easing domestic lockdown restrictions, but medium-term pressures continue to be driven by deep structural limitations in the local economy, which even a fundamental fiscal policy shift would not effectively reverse in the next 12-18 months. In the interim, the monetary policy intervention bodes positively, albeit access to capital markets is likely to be restricted to highly-rated funds or portfolios closely-held backed by strong shareholders. This comes as many listed funds are highly vulnerable to reduced institutional investor support, amidst limited financial flexibility and projections of reduced recoveries for secured creditors. The much-needed cash preservation/deleveraging measures adopted by many funds, including short-term profit retention and disinvestments could inadvertently reduce REITs' attractiveness to investors over the outlook period.

While supportive of proactive treasury risk initiatives, financial institutions are re-rating their property portfolios for high operating, liquidity and funding risk assumptions, which could lead to progressively reduced real estate exposures in the medium-long term. Banks are also viewed to be unwilling and unable to cover the interim liquidity gap created by low institutional investor appetite to refinance maturing bond exposures (the latter reflected by disproportionally high spreads associated with new issuances relative to the cost of term facilities). Against the backdrop of low disposals, GCR thus expects liquidity risk to remain elevated in the next 12 months. Accordingly, GCR has placed the sector on Negative Trend, and only expects very few funds with (*inter alia*) low leverage, exposures to strong(er) territories likely to rebound quickly from shallow 2020 recessions, or more saliently, investments in defensive property segments whose momentum is supported by technological and globalisation trends expected to achieve limited or short-lived financial profile variability over the outlook period.

Spain, Commercial Property Sector Risk Score 7.75

Despite expectations of a fairly quick rebound from the projected 2020 recession, the Spanish property score risk score has been reduced to '7.75' to reflect potential loss of income and investment deferrals due to international restrictions related to the crisis. Beyond this, the market is expected to achieve base income growth through the cycle, supported by positive lease dynamics and reasonably strong access to capital. That said, Spain remains a relatively riskier real estate investment proposition compared to its more developed Western European peers. In addition, Spanish real estate is more vulnerable to international travel restrictions than peers with more diversified economies, due to the high tourism underpin to its economic productivity. As such, delayed correction of commercial property fundamentals beyond 2020, or a resurgence of Catalan/other socio-political uncertainties, could see capital reallocation to other economic sectors, or territories in the region.

Spain's relative insulation from significant e-commerce penetration and other technology-related disruptions is also expected to be largely sustained over the outlook period. This will continue to drive occupancies by strong retail brands that are reducing their footprint in other countries, as well as continued investment in logistics rental stock. Office continues to reflect supply-side dynamics and idiosyncratic factors that drive disparities in yields amongst major cities. Looking ahead, current social distancing could drive even broader, far-reaching corporate culture shifts.

Bank support has been largely sustained in response to the ongoing crisis, although funders remain highly selective of the real estate risk exposures they take up in the country. Looking ahead, further participation by regional financial institutions (including development-finance supranationals) in projects aligned to sustainable development goals is likely to provide strong funding for redevelopments and new rental stock. This could underline yield growth beyond speculative distortions to market fundamentals. Overall, occupancy rates in defensive nodes and sub-classes of retail and office in particular, are expected to largely revert to pre-crisis levels beyond 2020.

The legislative framework has insulated lessees from rental payments during the hard lockdown, but landlords have also had recourse to alternative relief mechanisms and opportunities to improve lease tenors. As with many regional territories, collections have rebounded quickly, although sustaining these dynamics is dependent on how COVID-19 restrictions/interventions will be managed going forward.

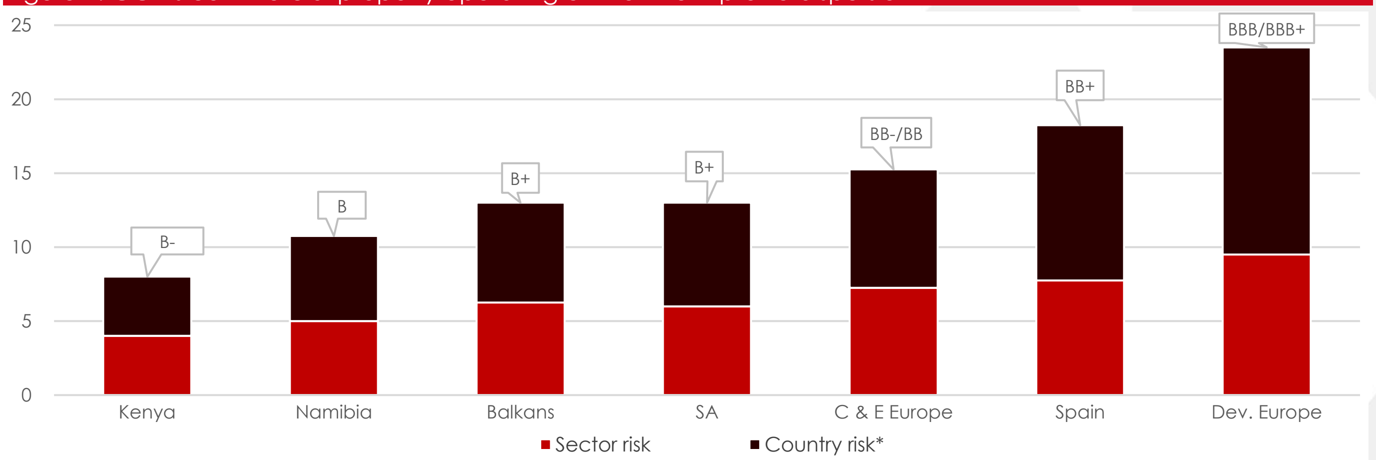
Regional groupings

Regional sector risk score assessments are limited to selected country groupings that represent exposures of South African funds rated by GCR to European real estate. The groupings consist of countries with closely aligned economic fundamentals, monetary systems, policies, and competitiveness (measured by the World Bank's Ease of Doing Business and the World Economic Forum's Competitiveness Indices), amongst other factors. Additional parameters include:

- Highly developed Europe*: GCR's sample is limited to reserve currency territories with diverse, highly evolved economies, typically presenting GDP per capita minima of approximately USD40,000, robust development metrics, high Ease of Doing Business scores, and low inequality indicators.
- Central & Eastern Europe*: GCR's sample comprises Eurozone countries with strong growth dynamics, positive Ease of Doing Business metrics, GDP per capita comfortably above USD10,000, improving equality indices, and typically stronger sovereign risk profiles versus other Central/Eastern European territories.
- Balkan territories: GCR's sample consists of geographically designated Balkan territories that typically fall outside reserve currency zone(s), and present robust medium-term growth dynamics, neutral to marginally positive Ease of Doing Business scores, and GDP per capita below USD10,000.

*GCR remains cognisant of the highly diversified nature of real estate fundamentals in the Eurozone in particular, with investors typically treating each segment as a separate and distinct investment class/market. The fragmented sub-classes and nuanced dynamics in each territory translate to highly polarised fundamentals and performance, but also limit contagion risk across the broader sector or region. Accordingly, the regional sector risk scores assigned capture our high-level view of the potential impact of structural factors and economic growth expectations on broader real estate investment and performance sustainability compared to other sectors. Idiosyncratic risks or defensive features in each segment are typically reflected as differentiating factors in portfolio quality assessment(s) of each issuer.

Figure 1: GCR's commercial property operating environment profile dispersion



*Regional country risks scores are based on a risk-weighted blend of underlying territories' country risk assessments.
NB: The data call-outs show the notional or typical international-scale anchors for each jurisdiction.