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. To find out more about GCR sector risk scores please visit our website: http://gcrratings.com/risk-scores/. 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 outside of South Africa and Kenya. 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 portfolio 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

**Balkan territories, Commercial Property Sector Risk Score, 6.25 (previously 6.25)**

Trends in the Balkan property market have followed those of the more developed countries through the pandemic but have been somewhat more exaggerated. Because countries in the region did not have as much financial leeway to provide relief for residents, economic growth fell by 4%-5%. In addition, several countries were negatively impacted by the collapse in the tourism industry. The uncertain economic environment impacted consumer spending patterns, as a result of which retail sales were constrained. As such, activity in the retail property segment was subdued, with few new entrants into the region and a generally weak letting environment. With the shift towards convenience shopping also being evidenced in the region, developers are now focussing more on retail parks. Notwithstanding the COVID-19 disruptions, retail penetration in the region remains well below that of Western or Central Europe, suggesting the sector will continue to expand rapidly once economic growth resumes.

The office segment has also been weak due to work-from home initiatives. Nevertheless, landlords are experiencing renewed interest in leases, as most businesses are expected to return to the office from 2H 2021. Moreover, as employment numbers remain fairly high, little downsizing of space is anticipated. This should lead to recovery in rental rates from the lows experienced in 2020. Whilst e-commerce penetration remains well below that of developed Europe, there has been a clear upward trend through the pandemic. This has spurred strong demand for industrial/logistics...
properties, a trend which is expected to strengthen. Accordingly, there are several new industrial parks being developed across the region to meet this anticipated demand.

Overall, the region’s strong commercial real estate prospects are counterbalanced by risks inherent in most of its territories, as well as its high susceptibility to migration of the younger population and 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 fiscal limitations of underlying countries. These factors could slow the economic rebound anticipated, with potentially rapid contagion on planned property investments.

Central and Eastern Europe, Commercial Property Sector Risk Score, 7.25 (previously 7.25)

Similar to other markets, the Central and Eastern Europe (“CEE”) region has faced various COVID-19 disruption challenges, resulting in a high degree of financial uncertainty and decreased investment levels. Nevertheless, the underlying real estate fundamentals and performance prospects of this region remain compelling to investors, underpinned by sustained long term economic growth expectations beyond the COVID-19 related pullback in 2020. The CEE region still has to mature, particularly in regard to its smaller markets and sectors, and competition within the market is considered less rife than that of the more sought-after developed European markets. These emerging economies are projected to recover to their pre-pandemic GDP levels faster than most Western European countries, even as the speed of the vaccination roll-out is anticipated to be similar, on average, to that in the European Union as a whole.

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. This is a result of continued investments into mixed-use projects and retail parks, which offer accessible, modern, consumer-oriented spaces, and have become more desirable given the changing shopping needs of consumers in the wake of the pandemic. Further, e-commerce impacts on consumer behaviour is much lower relative to other regions. Overall, amidst the pandemic most transactions have seen investors shifting focus to other segments considered to be more supportive of sustained capital and income growth, such as logistics and residential assets. General office market conditions are expected to remain broadly resilient despite current pressures. While a high level of new office supply was earmarked before the pandemic, it is estimated that the disruptions will see less space delivered to the market, which should help to partly manage vacancies in view of new hybrid working requirements, while demand for flexible, greener buildings is anticipated to increase.

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. This is particularly relevant given that the most active investors in the region are internationally based (as opposed to a 50/50 split in Western Europe).

Highly Developed Europe, Commercial Property Sector Risk Score 9.50 (previously 9.50)

Defensive property fundamentals for this regional grouping remain underpinned by global gateway cities, robust international capital, relatively resilient construction and manufacturing dynamics, 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. The speed of economic rebounds in the underlying territories in the second half of 2021 is largely pinned on the successful vaccine distribution rollout, with roughly 60% to 70% of the European population forecast to be inoculated by the end of this year. The ramifications of COVID-19 are expected to sustain a polarised performance amongst different sections of real estate; thus investors remain selective to 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 pandemic has accelerated structural changes, most notably to the office and retail real estate sectors. Traditional shopping centres in certain countries continue to be under significant pressure with online retail sales growing to between 15-25% depending on the country, further promoted by the repeated lockdown measures taken throughout Europe as a result of COVID-19. The retail picture is, however, not uniform, with variation between European cities and assets, such as supermarkets, which continue to benefit from necessity sales, and prime high street retail that will only likely see an improvement once tourism picks up. Retail parks also remain popular given their convenience element and open-air nature, whilst retail sales are in general already benefiting from pent-up demand post-lockdown. Despite the dip in office use, prime CBD offices that are high-quality with solid tenants on long contracts have demonstrated resilience compared to those in secondary locations. As office construction projects have also paused, this has helped to protect rentals to some degree, although prospects in the sector remain uncertain until more concrete plans can be made on occupiers’ space requirements in relation to corporate culture once a more widespread return to the formal workplace can become a reality. The logistics market continues to evidence strong demand and capital values, with growth in the sector expected to remain robust as e-commerce trends in the region remain unrelenting, whilst supply levels are limited. Residential markets have held up well, as broader income support packages have helped tenants meet their obligations.

As with other property markets, accommodative monetary policies are expected to remain in place for longer, which gives support to real estate asset prices where income is robust. Thus, the sector is expected to benefit from investors’ need to generate sound returns with (inter alia) permitted real estate exposures to segments with strong or resilient quality and performance expectations a time of low interest rates. The European debt market continues to display a resilient landscape, due to a combination of low leverage and wide base of funders. Bank lending remains selective with assets priced more cautiously, whilst lenders have demonstrated forbearance on assets where cash flows have temporarily dried up, by allowing covenant testing holidays for up to 12 months to promote financial stability.

Namibia, Commercial Property Sector Risk Score 5.0 (previously 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 that national government has been grappling with for a number of years. The sector was already under pressure prior to the COVID-19 pandemic, with the economy struggling to recover after it fell into recession in 2016. The fragile operating climate has reduced demand for new developments, while rentals and lease tenors have come under increasing pressure, particularly in certain segments (such as retail) that bore the brunt of lockdowns due to the pandemic. While this led to significant rental reduction requests during 2020, collections and recoveries have subsequently improved in line with better trading conditions. Nevertheless, subdued business confidence has also seen, and is likely to continue to see, tenants scale back their space requirements, as evidenced by the recent exit of some large South African corporate brands. Vacancies have therefore picked up, as availability of rental stock in key nodes rises. Nevertheless, the industrial sector has been fairly resilient and points to more warehousing space requirements. As with trends evidenced by its regional neighbour, South Africa, performance by individual properties within an asset class is nuanced by changing demands. 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.

Spain, Commercial Property Sector Risk Score 7.75 (previously 7.75)

GCR anticipates broadly stable trends within the Spanish property sector over the next 12-18 months, as economic activity picks up with the easing of COVID-19 restrictions in line with the rapid rollout of vaccines (herd immunity, being 70% of the population, is anticipated to be reached by end of August 2021). Whilst downside pressure on market rentals and asset values from the economic fallout of the pandemic remain, collection rates have rebounded quickly, with
the sector expected to achieve base income growth through the cycle, supported by positive lease dynamics and reasonably strong access to capital. Bank support has been largely sustained in response to the ongoing crisis, although funders remain highly conservative in respect of their real estate exposures and are more likely to approve funding at 50% loan-to-value ratios than the prior 60-65%. As the low interest-rate environment is likely to continue for longer, keen interest from investors and private equity should continue to give liquidity to the sector. Our assessment, does however, factor in the historical volatility of the Spanish real estate investment market 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.

Whilst the legislative framework insulated lessees from rental payments during the hard lockdown when non-essential businesses were closed (some of the strictest measures in Europe), landlords have had recourse to alternative relief mechanisms and opportunities to improve lease tenors. These trends were evidenced in particular in the retail and hotel segments, as they have been the most strained by the social distancing restrictions and mandatory store closures. Nevertheless, further retail rent concessions are expected to be limited going forward as footfalls and trading densities have improved as restrictions have eased. Further, Spain’s relative insulation from significant e-commerce penetration is also expected to be largely sustained over the outlook period, with greater interest entrenching omnichannel retailing being beneficial to both the retail and logistics segments. Office continues to reflect supply-side dynamics and idiosyncratic factors that drive disparities in yields amongst major cities, whilst senior living housing is viewed as an interesting space given the region’s ageing population demographics.

**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 risk score dispersion

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