FitchRatings

EMEA Real Estate – The Adverse Effects of Rising Interest Rates

Existing Long-Term Debt Delays Adverse Effects

Higher interest rates will increase the cost of debt, which will tighten property companies' interest coverage ratios and have a negative effect on real estate values. For many Fitch-rated property companies with long-dated debt and rate-fixing, rising interest costs will reduce profits only gradually as existing low coupon debt matures and is refinanced.

Most of the property sector has benefitted from a long period of decent rental growth and historically low funding costs, which have inflated values. In the new inflationary environment, to preserve property values, rents will need to rise to compensate for the additional funding costs. Lower operational profitability and stricter funding conditions will prompt property companies to reassess dividend payouts as profits decline.

Reflecting the September Global Economic Outlook, Fitch Ratings' updated rating cases (the 'interest rate case') include higher variable rates of interest and refinancing assumptions for fixed-rate debt (see *Cost of Debt Assumptions* page 2).

Effect Upon Sectors and Rated Companies

Under the interest rate case, no ratings will be affected by: a near-term debt maturity schedule that causes a marked refinancing risk; a resultant sudden adverse change in interest coverage ratios; or, from an increased average cost of debt. This analysis has not included the effect of company-specific interest rate derivatives fixing floating- to fixed-rate debt, which will soften the impact further.

Residential-for-rent companies are particularly affected as rising policy rates creep closer to their property income yields (for example, an all-in euro cost of 3.0%-4.0% versus the same rental or tighter EBITDA yields for prime assets). Heimstaden Bostad AB's 'BBB' was put on Negative Outlook by Fitch as the prospect of rising interest rates constraisnipns the group's deleveraging capacity. Similarly, for logistics companies' which acquired assets at recent 3.0%-3.5% income yields, with high net debt/EBITDA leverage, their interest coverage ratios will tighten.

The list of rated companies covered in this report ranks entities by the proportion of debt due to be refinanced soon, also indicating the risk of higher interest costs on refinanced debt. Often, 2025 and 2026 interest cover ratios, when a higher proportion of debt will be at new rates, remain consistent with the existing rating. Company-specific debt analysis is on the following pages.

List of Rated Companies in this Report

Company	IDR/Outlook, Unsecured Rating	% of debt refinanced 2022-2023	Company Profile
1. Peach Property Group AG	BB/Stable, BB	30%-35%[a]	p.27
2. IGD SIIQ S.p.A.	BBB-/Stable, BBB-	25%-30%[a]	p.21
3. Sirius Real Estate Limited	BBB/Stable, BBB	25%-30%[a]	p.33
4. Akelius Residential Property AB	BBB/Stable, BBB+	25%-30%[a]	p.5
5. SELP Finance SARL	BBB/Stable, BBB+	25%-30%[a]	p.32
6. NEPI Rockcastle N.V.	BBB+/Stable, BBB+	25%-30%[a]	p.25
7. SBB – Samhallsbyggnadsbolaget i Norden AB	BBB-/Positive, BBB-	20%-25%[a]	p.29
8. Global Switch Holdings Limited	BBB/Stable, BBB	15%-20%[a]	p.15
9. Globalworth Real Estate Investment Limited	BBB-/Stable, BBB-	15%-20%[a]	p.16
10. VGP N.V.	BBB-/Stable, BBB-	15%-20%[a]	p.37
		% of debt refinanced 2022-2025	
11. Pinewood Group Limited	BBB-/Stable, SS BBB	60%-65%	p.28
12. Civitas Social Housing PLC	A-/Stable, SS A	60%-65%	p.12
13. Canary Wharf Group Investment Holdings plc	BB+/Stable, SS BBB-	35%-40%	p.11
14. Hammerson plc	BBB/Stable, BBB+	35%-40%[a]	p.19
15. Heimstaden Bostad AB	BBB/Negative, BBB	30%-35%[a]	p.20
16. British Land Company PLC (The)	A-/Stable, A	30%-35%[a]	p.10
17. Annington Limited	BBB/Stable, BBB	25%-30%[a]	p.7
18. AKROPOLIS GROUP, UAB	BB+/Stable, BB+	20%-30%	p.6
19. Globe Trade Centre S.A.	BBB-/Stable, BBB-	20%-30%	p.17
20. MAS PLC	BB/Positive, BB	20%-30%	p.24

Others	Rating	Others	
21. NewRiver REIT plc	BBB/Stable, BBB+	29. AXA Logistics Europe Master S.C.A.	BBB+/Stable, A-
22. Derwent London plc	BBB+/Stable, A-	30. VIA Outlets B.V.	BBB+/Stable, BBB+
23. Land Securities PLC	S/T IDR: F1	31. D.V.I. Deutsche Vermogens- und Immobilienverwaltungs GmbH	BBB-/Stable, BBB-
24. Triple Point Social Housing REIT plc	A-/Stable, SS A	32. SCI LAMARTINE	BBB+/Stable, A-
25. Grainger plc	BBB-/Stable, SS BBB	33. Tritax EuroBox plc	BBB-/Stable, BBB
26. SEGRO PLC	A-/Stable, A		
27. Lar Espana Real Estate SOCIMI, S.A.	BBB/Stable, BBB		
28. Assura plc	A-/Stable, A-		

[a] This ranking is based on respective companies' year-end data. See company-specific commentaries on post-year-end events, or cash resource mitigants to these debt maturity profiles.
Fitch has excluded rated entities with no bond debt (Castellana, Supermarket Income REIT and M&G European Property Fund). SS = senior secured rating.
Source: Fitch Ratings

John Hatton
+ 44 20 350 1061
john.hatton@fitchratings.com

Robert Jeeves
+ 44 20 350 1305
robert.jeeves@fitchratings.com

The New Normal – The Interest Rate Case

Given property companies' interest cover ratios were typically around 2x during the last 'normal' interest rate environment, before the global financial crisis in 2009, we may return to a world when these costs accounted for around half of their profits. Current interest coverage ratios, reflecting a historically low cost of debt, are typically above 5x.

Since 2012, investment-grade EMEA property companies have refinanced and raised new debt at rates that, together with central banks' participations in bond markets, have resulted in an average cost of typically 1.0%-1.5% for their euro-denominated debt, with Swedish krona and Swiss franc lower, and 3.0%-3.5% for sterling. These averages are set to increase.

The average cost will rise if a property company's debt is variable (typically bank debt using Euribor or Sonia), or, if fixed rate, debt due to be refinanced whether to higher fixed or variable rates. From existing low rates, and given long-dated maturities, the adverse effect will permeate slowly.

For many Fitch-rated property companies that recently raised unsecured debt (in some cases refinancing all secured debt), locking into low coupons, the cost benefit will flow to shareholders and credit profiles for at least four to five years. For companies set to expand with acquisitions or development, they will raise debt at contemporary interest rates, and metrics will transition to a new normal earlier. Some investment-grade companies have tested the market and raised debt at new interest rates in July and August 2022 (GBP: Annington Limited at equivalent 5%; EUR: SCI LAMARTINE at a headline 3.625%; SELP Finance SARL at 3.75%).

Given that interest coverage ratios are typically above 5x, however unpalatable these rising costs are, they are not jeopardising many Fitch-rated property companies' ratings.

Certainly, REITs' distributable profits for dividends are set to decrease. From a creditor's perspective, lower dividends will help mitigate higher interest costs on companies' credit profiles.

Real Estate Valuations

As an asset class and closely connected to the cost of debt, real estate valuations will decline due to the interest rate component within property yields. Property companies with assets bought at past years' low yields (potentially overpriced), unjustified by imminent rental growth, will need to re-assess their balance sheet leverage. Rental growth, even if aided by leases having contractual CPI-linked indexation, will be contested by tenants facing inflationary cost pressures and more cautious (retail tenant) consumers.

It is difficult to calculate the future spread between a currency regime's risk-free rates (policy rates) and property yields since 2011. The market had largely kept a disciplined yield gap of 300bp-350bp for quality assets. As policy rates rise, some of that gap (or property premium) may absorb some policy rate rise, some asset classes may not maintain their popularity from investors, yet Fitch believes assets like UK retail are unlikely to fall far from existing lows. Given that much real estate is debt-funded, comparative evidence of market transactions will feed through to valuers reducing real estate values.

Fitch does not have a crystal ball on the extent of the valuation decline – and neither do property companies - hence our ratings have concentrated on cashflow leverage (net debt/EBITDA). This is a ratio we can forecast with greater visibility, where longevity of rental-derived EBITDA is measured relative to long-dated debt and interest rate protection. This is a more meaningful ratio for a long-term bond investor riding through the cycle, rather than a short-term loan-to-value (LTV) where 'V' is unforecastable. All of Fitch's rating sensitivities for upgrade and downgrade quote cashflow leverage metrics rather than balance sheet LTVs. Where breach of LTV covenants can precipitate a debt refinancing, these ratios are important to monitor.

Interest Rate Case - Cost of Debt Assumptions

	2022	2023	2024	2025	2026
Increase in EUR policy rates (%) to	2.00	2.00	1.75	1.75	1.75
Increase in GBP policy rates (%) to	4.25	5.00	4.00	4.00	4.00
Incremental rise in a company's margin payable, in addition to the above policy rate for investment-grade entities	Additional +50bp				
Interest rating case's new debt (expansion) at new variable rate or new fixed-rate debt for 'A' rated entity	100bp above policy rate				
Interest rating case's new debt (expansion) at new variable rate or new fixed-rate debt for 'BBB' rated entity	200bp above policy rate				

Source: Fitch Ratings, September 2022 Global Economic Outlook for EUR policy rates; September 2022 UK GEO for GBP policy rates.

Illustrative Examples

	2022	2023 onwards
Existing RCF at 80bp margin refinanced in 2022 EUR	80bp+50bp+200bp	80bp+50bp+200bp
Existing BBB 3.5% bond refinanced in 2022 EUR	200bp+200bp	
Existing BBB 3.5% bond refinanced in 2023 EUR		200bp+200bp
Existing BBB 6.0% bond refinanced in 2024 EUR		175bp+200bp

Source: Fitch Ratings

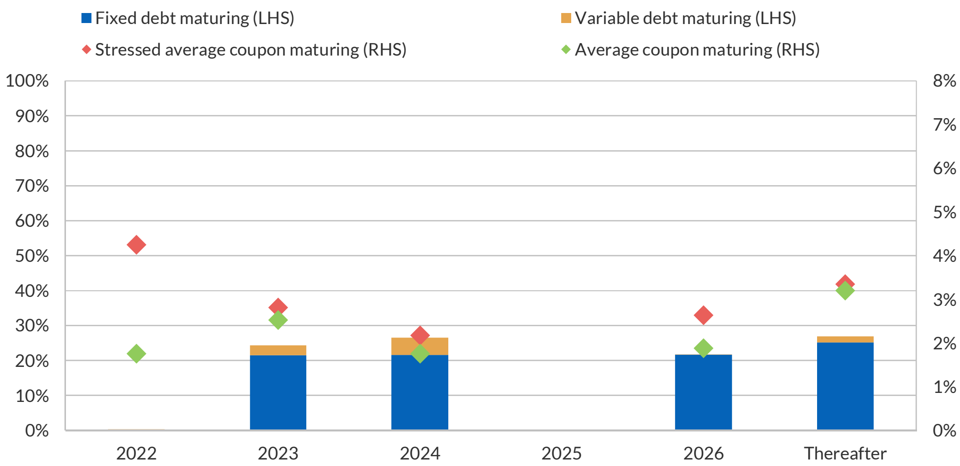
Explanation of the Interest Rate Case Charts

Fitch has put its rated companies' debt structures through a rising interest rate environment (the 'interest rate case') to quantify the effect on their future financial profiles. The following pages show these main charts for each company. Without replicating companies' specific and detailed derivative hedging, they show the long-term debt structure and limited exposure to rising rates.

Chart 1: Debt Maturity Chart and Average Coupon of Maturing Debt

This first chart's bars show the debt maturity of the rated entity, illustrating the extent of debt refinancing and longevity of interest-rate fixing. The green diamond denotes the rating case's weighted average coupon of the fixed- and variable-rate debt maturing in that year. The red diamond shows the same but under the new interest rate case's assumptions: where there is maturing variable rate debt, the red dot (if shown) is higher than the green diamond (which was probably fixed interest-rate weighted).

Maturities as Percentage of Maturing Debt/Average Coupon of Maturing Debt



Source: Fitch Ratings, NEPI used for illustration

In most cases, there will be a rise in the average cost of debt as, say, 2012-2015 10-year or 2017-2018 five-year bond maturities are refinanced. Where companies are refinancing legacy higher-coupon debt interest, costs may decrease (see Derwent and Hammerson).

Chart 2: Interest Rate Effect on Interest Coverage Ratios

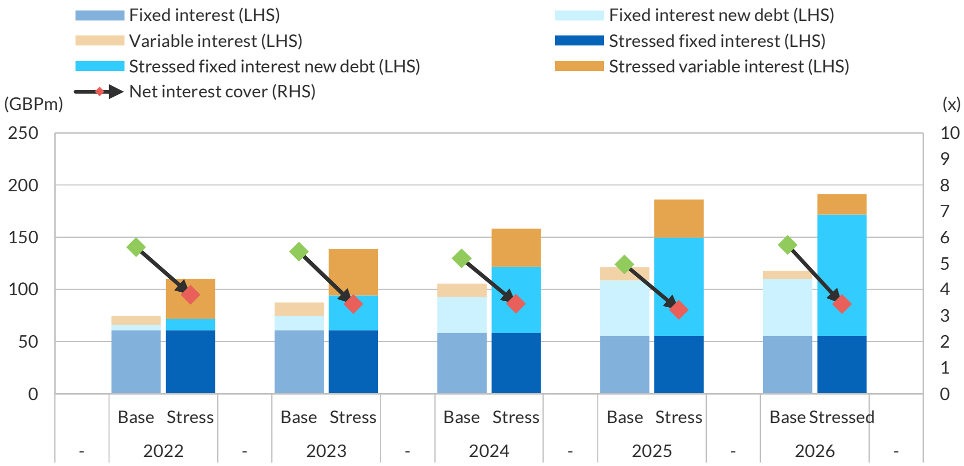
Using existing rating cases' recurring rental-derived EBITDA and the higher cost of debt assumptions:

- Variable policy rates increase the cost of variable-rate debt (orange bar);
- A refinanced debt credit spread (margin) increases the cost of variable-rate debt (orange bar);
- Maturing fixed-rate debt is refinanced at a higher cost of debt (dark blue bar).

Fitch's rating case may have had further issuance of debt for expansion plans, which are now at new policy rates and higher margins. This new (more expensive) debt could be at variable or the same equivalent fixed rate (brighter blue).

This second chart compares the original Fitch rating case with the interest rate case, often projecting a decrease in the interest cover ratio.

Interest Paid and Interest Coverage Ratio



Source: Fitch Ratings, SEGRO used for illustration

Rating Case: First Bar: Light blue – existing rating case fixed-rate debt;
Orange – existing rating case variable-rate debt
Interest Rate Case: Second Bar: Dark blue – unaffected interest rate case fixed-rate debt;
Bright Blue – further issuance of debt at new cost of debt (whether variable plus increased margin or the equivalent all-in fixed coupon);
Orange – refinanced variable -rate debt at higher cost
Line: Denotes the change in interest coverage ratio between the two cases (RHS axis).

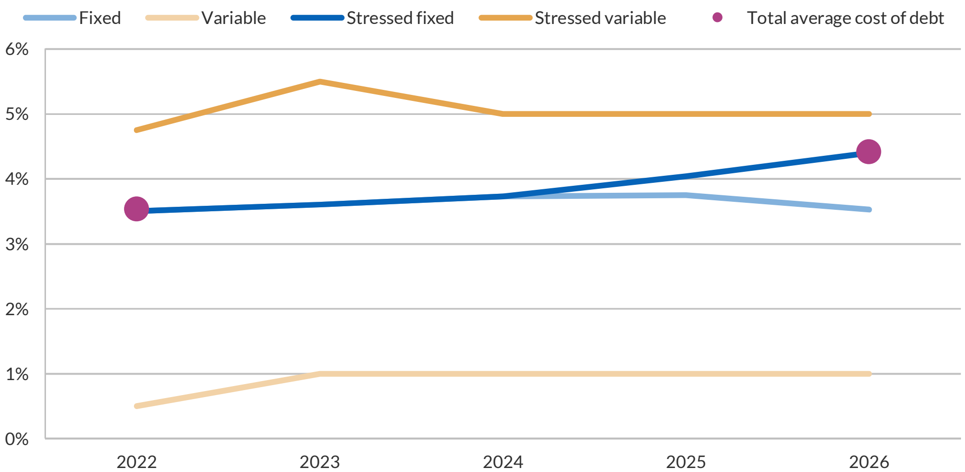
For some companies, interest costs increase because the rating case includes a rise in debt (and EBITDA). Other companies' rating cases do not have an expansionary portfolio with only the opening amount of debt refinanced.

Chart 3: Average Cost of Debt

This third chart shows the annual change in the cost of debt due to increasing rates. Where companies are refinancing legacy expensive debt, the average cost may improve.

In this chart, using the above assumptions, by FY26 this illustrative company's average cost of mainly GBP debt increases to 4.4% from 2022's 3.5%. In the original rating case, its variable rate debt had an average cost of, say, 0.5% which the rating case had assumed at slightly higher policy rates from 2023. Under the interest rate case of higher interest rates, the underlying policy rate changes to 5% in 2023 and 4% in 2024, to which we add the same margin for the unchanged revolving credit facility (RCF). In the fixed-interest cost line, legacy and refinanced debt is included. The blend of the two proportions of variable- and fixed-rate debt results in an average cost of debt of around 4.4% at 2026.

Average Cost of Debt: Ratings Case versus Stressed Case



Source: Fitch Ratings, Hammerson used for illustration

VGP N.V.

Long-Term IDR: BBB-/Stable Outlook

Interest Rate Environment: EUR

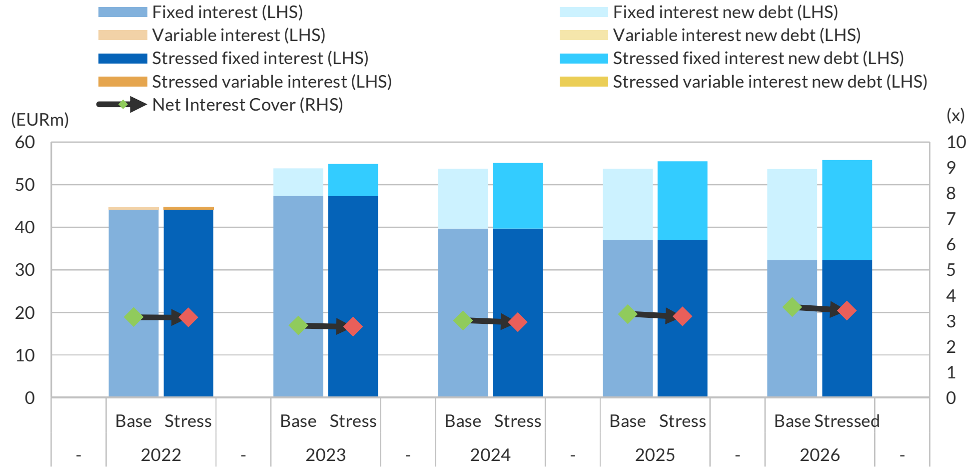
Financial Year-End: End-Dec 2021	Actual YE21	Interest Rate Case YE26
Debt maturing between FYE21 and FYE26 (%)	32	
Average cost of debt (%)	2.3	2.4
Net interest coverage ratio (x)	2.8	3.4

Source: Fitch Ratings, VGP N.V.

VGP has been migrating from small, shorter-dated, Belgian retail bonds to longer-dated, unsecured, international fixed-rate bonds. In January 2022, it issued EUR1 billion of bonds at a blended 2%, providing ample liquidity for its capex programme and scheduled bond maturities in 2022 (1H22: EUR23 million, 2023: EUR375 million). VGP reports that 97% of debt is fixed rate. The joint ventures' non-recourse funding (with 2026–2029 debt maturities) are not included in these charts.

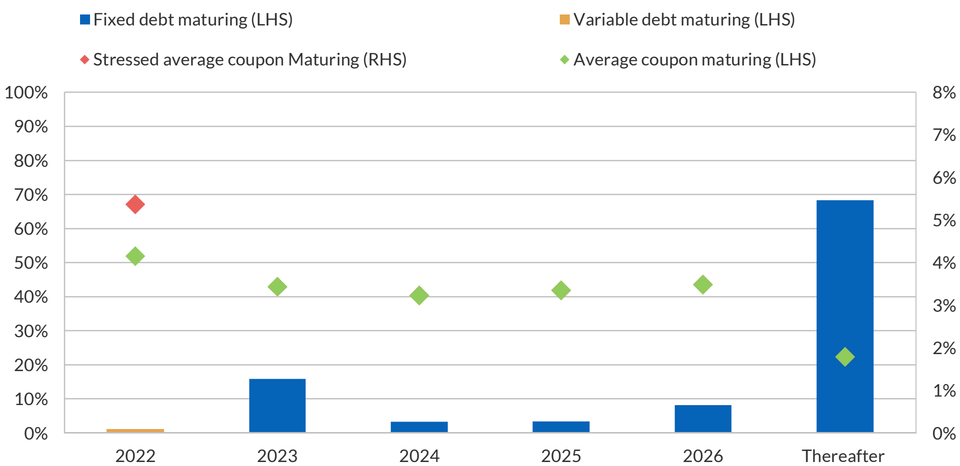
The rating case and above figures are based on the "VGP as HoldCo" analytical approach (see rating report). The interest rate case assumes that 2023 maturities (blended 3.4%) are refinanced at 3.75%.

Interest Paid and Interest Coverage Ratio



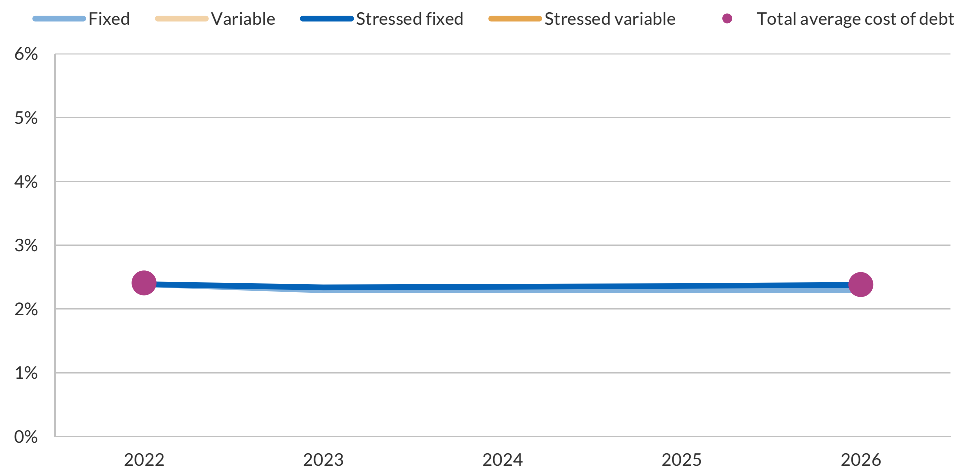
Source: Fitch Ratings, VGP N.V.

Maturities as Percentage of Maturing Debt/Average Coupon of Maturing Debt



Source: Fitch Ratings, VGP N.V.

Average Cost of Debt: Ratings Case versus Stressed Case



Source: Fitch Ratings, VGP N.V.