

Research Update:

Shopping Center Owner NEPI Rockcastle PLC Outlook Revised To Negative From Stable; 'BBB' Ratings Affirmed

April 1, 2020

Rating Action Overview

- Since mid-March, 2020, in response to the COVID-19 pandemic, most Central and Eastern Europe (CEE) governments have restricted nonessential retail, businesses, and hotels.
- NEPI Rockcastle PLC's shopping centers, which represent about 93% of the company's overall portfolio value, have been largely closed since then, and we do not know when they will reopen. This will jeopardize retailers' ability to pay rents and could result in rent negotiations or rent-free periods for affected tenants. We have revised our base-case scenarios for retail property owners, and now anticipate a significant decline in net rental income and valuation in 2020, with only a slow recovery in 2021.
- At this stage, we believe NEPI Rockcastle will sustain its credit metrics within our rating threshold, although with less headroom than before. Therefore, we are revising our outlook to negative from stable, and affirming our 'BBB' long-term issuer credit rating and senior unsecured debt ratings on the company.
- The negative outlook reflects our view that due to COVID-19-related disruption, the company's operating performance may be more adversely affected than we previously anticipated, leading to a more material deterioration of credit ratios over the next 12-24 months.

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Rating Action Rationale

The closure of all nonessential stores would have a significant impact on NEPI Rockcastle's operations. CEE countries are less affected at this stage by the COVID-19 pandemic, in terms of reported cases, than Western European countries. However, as a precautionary measure, their governments have opted to limit social interaction, forcing companies to temporarily close all nonessential retail and other businesses. We believe such measures will likely lead to a drop in NEPI Rockcastle's shopping centers' footfall, as well as retailers' sales.

The company's real estate portfolio of shopping centers (which represents 93% of its overall

portfolio) is therefore severely affected by the closures--with the exception of its properties in Hungary, where cinemas and entertainment operators are closed but shops remain open. Although we understand that there have been no rent losses from NEPI Rockcastle's affected retail tenants so far, we believe the likelihood of rent renegotiations or unpaid rents increases as long as the situation continues, and that tenants' credit quality progressively deteriorates. That said, we believe NEPI Rockcastle can compensate, at least to some extent, for a potential negative impact on rents with its 20% to 25% exposure to food and other essential retail outlets, which for the moment continue to perform without material disruption. The high number of fixed-rent contracts (accounting for about 91.2% of gross rental income as of Dec. 31, 2019) also means that losses linked to variable rent contracts should not be too substantial. In addition, the company has taken measures to cut costs and adjust its investment pipeline. At this stage, we understand that office properties are fully functional, although many businesses have implemented work-from-home policies to limit social interactions. However, offices account for only a limited share of the company's portfolio (7% of total gross portfolio value), and a large part of this share is earmarked for sale.

In this environment, our revised base-case scenario anticipates a 15% to 20% drop in net rental income for 2020 on a like-for-like basis, with only a slow recovery in 2021. We have revised our base case for retail real estate companies, including NEPI Rockcastle, in light of the pandemic. While we previously anticipated low- to mid-single-digit growth in like-for-like net rental income, in line with the company's 2019 figures (+6.2%), we now forecast a drop of 15%-20% for 2020. This encompasses some expected rent discounts or cancellations due to the closures, but also some negative renegotiation and a potential drop in occupancy rates, even after the lockdown measures end. We believe the pandemic could severely and durably affect the retail sector, because we expect there will be a rise in the unemployment rate, and less disposable income in people's hands, once the outbreak is over. Therefore, we anticipate only a slow recovery once lockdown measures end. In our base-case scenario for 2021, we now forecast about 2% growth in rental income compared with 2020 figures.

We expect a slowdown in NEPI Rockcastle's investment pipeline and some declines in valuation. We anticipate that retail property owners, including NEPI Rockcastle, are likely to experience more material declines in asset valuation than we previously forecast, because appraisers are likely to assume a drop in cash flow when looking at portfolios. While we previously expected a flat portfolio valuation growth for 2020 (compared with about 2% increase in 2019 for the entire portfolio), our revised base-case scenario includes a drop of about 10% in 2020, with the valuation being flat in 2021. In addition, before the outbreak, we were assuming about €250 million of annual expenditure, reflecting the company's extensions program. We now anticipate that NEPI Rockcastle will slow its development program, and in our analysis we factored in only the €65 million to €75 million already committed capital expenditure (capex) for 2020, with about €75 million to €100 million in 2021. The company benefits from flexibility in its development pipeline and dividend distributions, and did not rely on any significant disposals plan to reduce its leverage, which somewhat limits the credit metrics' deterioration.

With these new assumptions, we anticipate the company's credit metrics will remain within our rating threshold, but believe there is a one-in-three likelihood that they will deteriorate further if market conditions worsen more than expected. Before the COVID-19 outbreak, we assumed the company's credit metrics over the next 24 months would remain well within our thresholds, with S&P Global Ratings-adjusted debt to debt plus equity, and debt to EBITDA, remaining in the 32%-34% and 4.8x-5.3x ranges, respectively. However, our base-case revision now anticipates that adjusted debt to debt plus equity could weaken to 34%-35% at the end of 2020, which is

close to our outlook downside threshold of 35%. At the same time, we forecast the company's adjusted debt-to-EBITDA ratio to peak at 6.0x-6.5x in 2020 (versus 5.6x in 2019). These credit metrics remain within our rating threshold, but we believe market conditions could worsen more than we anticipate, for example through subdued consumption patterns, retailers' bankruptcies, more downward rental negotiations, or more devaluation. All of these scenarios could lead the company to exceed rating thresholds in the next 24 months.

Our assessment continues to incorporate a one-notch adjustment to reflect that NEPI Rockcastle's credit ratios are weaker than those of peers we assess in the modest financial risk category. This remains a key factor in our rating assessment compared with peers assessed in similar business and financial risk profiles.

NEPI Rockcastle's liquidity profile remains robust. We understand that the company is reassessing its capex and development plans, which should limit future cash outflows. NEPI Rockcastle has no outstanding loans or bonds due in 2020, and only €243 million due in 2021. The company's cash position remains strong (€209 million of cash and cash equivalents, €575 million available under its committed undrawn backup facility, and €77 million in net-listed securities as of Dec. 31, 2019). Therefore, we see limited rating pressure from the company's current liquidity position.

Outlook

The negative outlook on NEPI Rockcastle reflects our view that due to the COVID-19-related disruption, its operating performance may be more adversely affected than we anticipated, leading to a more material deterioration of credit ratios over the next 24 months.

The outlook also captures the company's large operations in Romania, where the sovereign outlook remains negative. Our expectation is that emerging markets could be more affected if the epidemic accelerates, and that it could last for several months, which could depress economic activity and weigh on health systems.

Downside scenario

We could consider taking a negative rating action if NEPI Rockcastle's debt to debt plus equity increased sustainably above 35% as a result of unexpected asset devaluations, or if its debt to EBITDA moved above 7.5x and EBITDA interest coverage fell below 3.8x on a sustained basis due to weaker operating performance. A negative rating action would become increasingly likely if we saw negative dynamics in the company's operating performance due to a prolonged pandemic effect, or a sluggish recovery once the pandemic is over, affecting retailers in the medium term. We could also take a negative rating action on NEPI Rockcastle if Romania experienced an economic slowdown and monetary policy flexibility weakened, leading to a sovereign downgrade.

Upside scenario

We could revise the outlook to stable if NEPI Rockcastle shows resilience against the tough retail conditions and macroenvironment in CEE caused by the COVID-19 pandemic. In addition, we could revise the outlook to stable if NEPI Rockcastle's adjusted debt to debt plus equity remains comfortably below 35%, and its debt to EBITDA below 7.5x.

Company Description

NEPI Rockcastle is a property and development company operating in the CEE region. It was established in 2017 by the merger of New Europe Property Investments PLC (NEPI) and Rockcastle Global Real Estate Co. Ltd. (Rockcastle). The company has a portfolio of €6.3 billion, and a strong focus on retail, with some additional activities in offices and industrial. It operates in nine countries in CEE, particularly the Romanian and Polish markets.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Negative/--

Business risk: Satisfactory

- Country risk: Intermediate
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Modest

- Cash flow/leverage: Modest

Anchor: bbb+

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile : bbb

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings:

Methodology And Assumptions, Nov. 19, 2013

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

	To	From
Ratings Affirmed; Outlook Action		
NEPI Rockcastle PLC		
Issuer Credit Rating	BBB/Negative/--	BBB/Stable/--
Senior Unsecured	BBB	
NE Property B.V.		
Senior Unsecured	BBB	

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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