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Research Update:

Shopping Center Owner NEPI Rockcastle 'BBB' Ratings Affirmed; Outlook Remains Stable

July 15, 2022

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Rating Action Overview

- We expect NEPI Rockcastle S.A. (NEPI) to continue improving rental income in 2022 as pandemic-induced restrictions have been lifted in most of Central and Eastern Europe (CEE). Rising inflation should increase NEPI's rent indexation in 2023, though it may also dent retailers' sales and capacity to afford higher rents.
- Progressive recovery in EBITDA, along with limited portfolio investments, should sustain NEPI's credit metrics in line with the current rating.
- We are therefore affirming our 'BBB' long-term issuer credit rating and senior unsecured debt ratings on NEPI.
- The stable outlook reflects our view that the company's operating performance will continue to improve as economic growth recovers in CEE, hence, we expect its adjusted net debt to EBITDA to be around 5.5x-6.5x, debt to debt plus equity about 35%-37%, and EBITDA interest coverage higher than 5.0x over the next two years, supported by resilient cash flows and conservative financial policy.

Rating Action Rationale

We expect the rebound in retail activity to bolster continued improvement in NEPI's operating performance in 2022. Since pandemic-led restrictions eased across CEE countries in the first quarter (Q1) of 2022, we have seen NEPI's operating performance gradually improve. Tenants' sales increased by 53% in Q1 2022 from Q1 2021 and footfall by 35%. NEPI's occupancy remains stable at around 96% in Q1 2022. As of mid-May 2022, the collection rate was 99% of reported revenues for 2021 (adjusted for concessions) and 96% for Q1 2022. NEPI signed 297 leases in Q1 2022, of which 38% are new, with international tenants accounting for 40% of total new leases signed.

Rising inflation should increase NEPI's rent indexation in 2023, though it may also dent retailers' sales. We expect NEPI's revenue to benefit from the current high inflation for 2022-2023, since most of its leases are index linked. As such, we forecast annual like-for-like rental income growth of 5%-6% over the next 12-24 months, including some post-pandemic recovery and a stable occupancy rate. In addition, we understand that the effects of higher energy and labor costs should be limited, given the triple-net structure of most of NEPI's leases, which allows it to charge these costs to its tenants. Furthermore, euro-based contracts should provide some hedge against currency volatility. However, high inflation could erode retailers' sales and footfall in NEPI's main operating countries (Romania: 14.2% for 2022, 8.5% for 2023; Poland: 12% in 2022, 10% in 2023). This would limit the company's capacity to negotiate higher rents on lease renewals and could pressure retailers' already squeezed sales and margins. However, NEPI's lower occupancy cost ratios should give it more resilience against these challenges, in our view.

NEPI´s credit metrics may slightly weaken but remain stronger than the market average. We forecast that the company's leverage may increase due to planned capital expenditure (capex) or pursuing opportunistic acquisitions. We therefore forecast S&P Global Ratings-adjusted debt to debt plus equity will increase to 37%-38% over the next two years from 33.1% as of Dec. 31,2021 and 33.5% as of Dec. 31, 2020. In our updated base case, we expect flat valuation in 2022, given some signs of value stabilization for NEPI's assets. The company reported an asset revaluation gain of €34.7 million (+0.6% of total portfolio value) during the full year 2021. NEPI's debt to EBITDA should rise to around 6.0x-6.5x in 2022-23 from 5.6x in2021 and 6.1x in 2020. As a result, we have lowered our assessment of NEPI's financial risk profile to intermediate from modest to reflect potentially higher debt to debt plus equity in next two years, which indicates slighter higher leverage. That said, we view NEPI's credit ratios as stronger than peers with an intermediate financial risk profile, positioning it at the higher end of that category. We reflect this by applying one notch of uplift as a result of our comparable rating analysis, to derive the 'BBB' rating.

Higher interest rates should have limited impact on NEPI's credit metrics in 2022-2023 due to nominal refinancing needs in the next two years. The weakened perception of real estate players in the bond markets in recent months, along with the rise in the risk-free rate, are increasing European real estate companies' cost of refinancing. However, NEPI has low exposure to variable rates and its debt maturing over the coming years is limited, currently only €8.6 million by end-Q1 2023 and €64.5 million by end-Q1 2024. NEPI had a good liquidity position as of March 31, 2022, underpinned by sound access to funding, including €620 million of available credit lines and €396.9 million of cash and cash equivalent available with limited debt maturities. This is a comfortable cushion to protect against the capital markets narrowing. Furthermore, NEPI has a long average debt duration of 4.9 years. It also enjoys solid hedging security, with 100% of gross debt hedged as of March 31, 2022, with average cost of debt staying around 2.3% as of Q1 2022, which further limits the pressure from rising interest costs.

Outlook

The stable outlook on NEPI reflects our view that the company's operating performance will continue to improve despite weakening consumer sentiment, thanks to the quality of NEPI's assets and limited new competition. This is in the context of recovering economic activity in CEE, particularly in Romania and Poland.

Downside scenario

We could consider taking a negative rating action if:

- NEPI fails to maintain its adjusted debt to debt plus equity below 40% on a sustained basis , for instance as a result of unexpected asset devaluations;

- Debt to EBITDA rises significantly above 7.5x; or
- EBITDA interest coverage falls below 3.8x for a sustained period due to weaker operating performance.

We could also take a negative rating action on NEPI if Romania experiences economic slowdown and its monetary policy flexibility weakens, leading S&P Global Ratings to downgrade the sovereign.

Upside scenario

An upgrade would hinge on NEPI materially improving its portfolio in terms of size and geographic and segment diversification, rendering it more comparable with that of peers with stronger business risk profiles. An upgrade would depend on NEPI's ability to continue generating positive like-for-like rental income growth and showing positive portfolio revaluations.

In addition, a positive rating action on NEPI would be contingent on Romania's credit quality improving or a significant dilution of the company's exposure to Romania--to less than 25% of its portfolio--and improving it debt to debt plus equity below 35%.

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 and Rockcastle Global Real Estate Co. Ltd. The company's property portfolio is valued at €5.9 billion, with a strong focus on retail, alongside additional activities in offices and industrial. It operates in nine countries in CEE, particularly the Romanian and Polish markets.

Our Base-Case Scenario

Assumptions

- Eurozone GDP growth of 2.7% in 2022 and 2.2% in 2023 (Romania: 5.1% in 2022, 3.0% in 2023; Poland: 4.5% in 2022, 2.1% in 2023), with unemployment being stable or slightly declining at around 6%-7% over the next 12-24 months; we consider consumer confidence, household consumption, and shopping center density (that is, the number of stores or square meter per inhabitants) among the most important factors for retail property investors.
- Consumer price inflation growth in the eurozone reaching 6.4% in 2022 and about 3.0% in 2023. (Romania: 14.2% for 2022, 8.5% for 2023; Poland: 12% in 2022, 10% in 2023.)
- Like-for-like rental growth of 5%-6% in 2022-2023 capturing the gradual recovery from the COVID-19 pandemic fallout, alongside a steady occupancy rate of around 96.0%. A positive impact from indexation might be partly offset by some negative reversion.
- Flat portfolio valuation for next 12-24 months.
- Some asset acquisitions in 2022-2023 of €20 million-€30 million, modest asset disposals (about €10 million), and the ongoing sale of the Vulcan residential project.

- Development capex of €150 million-€170 million in 2022 and €300 million-€350 million in 2023, in line with the company's current development plans. We understand that most of it is not committed.
- Cash dividend around €200 million-€220 million in 2022.

Key metrics

- Adjusted EBITDA interest coverage of about 5.5x-6.0x in FY2022 and about 6.0x-6.5x in FY2023.
- A debt-to-debt-plus-equity ratio of about 35%-37% over the next two years, with the company being disciplined around funding any acquisitions or development expenditure.
- Adjusted debt to EBITDA of about 5.5x-6.0x in FY2022, and close to or below 6.5x in FY2023.

Liquidity

We anticipate that liquidity sources will cover liquidity uses by over 1.2x for the next 12 months. Debt covenant headroom is adequate, in our view. NEPI has sound relationships with a diverse group of banks and a generally satisfactory standing in capital markets.

Principal liquidity sources:

- As of March 31, 2022, unrestricted cash balances of about €396.5 million;
- Undrawn revolving credit facilities of €620 million maturing in more than 12 months; and
- Our forecast of funds from operations of €280 million-€320 million for the next 12 months.

Principal liquidity uses:

- €8 million-€9 million of contractual short-term debt repayments during the next 12 months;
- Capex needs of €200 million-€230 million in the next 12 months for the development pipeline, although we understand most of it is not committed; and
- Dividend payments of about €220 million-€240 million.

Covenants

We understand that NEPI has financial covenants for its outstanding debt. We estimate that the headroom for these covenants is strong (more than 15%).

Environmental, Social, And Governance (ESG)

ESG credit indicators: E-2, S-2, G-2

We view NEPI's exposure to ESG factors as in line with other CEE peers. The company's overall portfolio certifications stand at 71% of its buildings being Building Research Establishment Environmental Assessment Method certified as "very good" or "excellent" as of Dec. 31, 2021. Over 95% of the properties are accessible by public transport and some shopping centers offer facilities for bikes and charging points for electric cars. NEPI issued €500 million of unsecured green bonds in January 2022 and all the revolving credit facilities are now linked to ESG performance. NEPI has planned a €37 million investment in photovoltaic plants for a shopping center by the end of 2023, minimizing the carbon footprint, further showing its dedication to increasing its sustainability framework.

Rating Above The Sovereign

Given NEPI Rockcastle's high share of revenue from Romania (35% of gross portfolio value), which is currently rated one notch lower than NEPI, we perform an analysis to test NEPI's resilience to a Romanian sovereign default. To do this, we assume a 25% drop of the company's liquidity sources in a stress scenario. Even under this hypothetical stress scenario, we estimate the company would have sufficient cash flow to cover its needs, and liquidity sources would cover uses by more than 1.0x for one year. In addition, the loan-to-value ratio would remain below 80% in line with our rating benchmark. For these reasons, we rate NEPI one notch higher than Romania.

Issue Ratings--Subordination Risk Analysis

Capital structure

As of Dec. 31, 2021, NEPI's capital structure comprised less than 10% secured debt and 90% unsecured debt, spread across bond and bank debt.

Analytical conclusions

We expect that NEPI's secured debt will remain lower than 40% of total assets (less than 10% as of Dec. 31, 2021, the company's target is to remain below 25%). As a result, although unsecured debt issuance is structurally subordinated to other debt obligations, the subordination does not affect the rating on the unsecured debt. We align our ratings on NEPI's senior unsecured debt with the 'BBB' issuer credit rating.

Ratings Score Snapshot

Issuer Credit Rating	**BBB/Stable/--**
Business risk:	Satisfactory
Country risk	Moderately high
Industry risk	Low
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	bbb-
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)

Issuer Credit Rating	**BBB/Stable/--**
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Positive (+1 notch)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 20, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed	
NEPI Rockcastle S.A.	
Issuer Credit Rating	BBB/Stable/--
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)

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