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Research Update:

Retail Landlord NEPI Rockcastle 'BBB' Ratings Affirmed On Robust Operating Performance; Outlook Stable

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Rating Action Overview

- NEPI Rockcastle (NEPI), a real estate company based in Central and Eastern Europe (CEE), continued to increase its retail property portfolio to about €7.0 billion as of the first quarter of 2024 from €5.8 billion in the first quarter of 2021 while maintaining its well-diversified geographic portfolio with resilient operating performance. As a result, we now view NEPI's business risk profile assessment to be positioned at the better end of the satisfactory category.
- We expect NEPI's solid operating performance to continue over the next 12-24 months, underpinned by high indexation and robust occupancy rates, evident in the like-for-like net operating income growth of 9.4% in the first quarter of 2024 and the low retail vacancy of 2.2%.
- We anticipate the company will continue to expand the portfolio across its core markets in line with its financial policy, despite a moderate increase in leverage to fund its development pipeline, translating into S&P Global Ratings-adjusted debt to debt plus equity of about 39%-40%, interest coverage ratio of 4.0x-4.5x, and debt to EBITDA of 5.0x-5.5x over the next 12-24 months
- We therefore affirmed the 'BBB' ratings on NEPI Rockcastle N.V. and on the company's senior unsecured debt.
- The stable outlook on NEPI reflects our expectation that the company will maintain its leading market position in CEE, despite intensifying competition, and soundly execute its planned expansion in its region.

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Rating Action Rationale

In our view, NEPI's leading market position in key markets, well-diversified portfolio, and resilient operating performance over the past few years underpin the business risk profile improvement. Over the past few years, NEPI's portfolio has grown to a total property value of €7.0 billion in the first quarter of 2024 compared with €5.8 billion in 2021 while at the same time maintaining a well-located and diversified portfolio of prime assets, spread across nine CEE countries, with its top 10 tenants accounts for 25.2% of total annual rent as of Dec. 31, 2023. During the first quarter of 2024, NEPI reported 9.4% like-for-like growth in net operating income (13.0% in 2023). This is mostly due to indexation (3.7%) and asset management initiatives that have achieved rental uplifts above indexation on new leases and renewals. At the same time, the average standing vacancy rate of the company's retail portfolio (99% of property portfolio) was low at 2.2%, similar to year-end 2023. This, in our view, shows the quality of the assets and the strong position in the CEE market and, we believe, strengthens the overall business risk profile to the better end of satisfactory from low end. We expect the company to continue benefiting from positive like-for-like growth in rental income while maintaining the current low vacancy rate. NEPI's operating performance has remained solid, and it has demonstrated higher resilience than we initially anticipated, evident in the positive like-for-like fair value adjustment of 2.7% in 2023 amid a challenging year for the overall real estate sector following yield expansion when most real estate peers reported negative portfolio revaluation. We believe NEPI's competitive position is at a similar level to that of other retail landlords such as Carmila, or a diversified real estate player such as Merlin Properties.

We expect our key credit metrics to remain in line with the current rating level rating (BBB) over the next 12-24 months. Over the next 12-24 months, we forecast NEPI's S&P Global Ratings-adjusted EBITDA interest coverage to fall to about 4.0x-4.5x (6.3x in 2023) as a result of recent refinancing activities at higher interest rates, for instance, the signed facility by the International Finance Corp. (IFC) of €445 million issued at variable rates and as such, we expect the average cost of debt to increase to 4.0%-4.5% over the next 12-24 months from 2.5% as of year-end 2023. Yet, we expect EBITDA interest coverage to remain well above our 3.8x downside threshold. The company's hedged capital structure (13% of outstanding debt is exposed to variable rates) as well as solid EBITDA generation and completed development projects, should soften the impact from higher refinancing rates. We expect NEPI to maintain its S&P Global Ratings-adjusted debt to EBITDA at 5.0x-5.5x (4.9x in 2023) over the next two years.

NEPI's conservative financial policy is to maintain a long-term target of a net reported loan-to-value (LTV) ratio under 35% (31.5% as of March 31, 2024). As of Dec. 31, 2023, its S&P Global Ratings-adjusted debt to debt plus equity amounted to 34.7% (LTV of 32.2%) compared with 38% in 2022. The improvement in leverage metrics over the past year mainly reflects a positive fair value adjustment as high yield (European Real Estate Association net initial yield at 6.94% as of 2023) and strong cash flow generation have offset the impact from higher interest rate. Additionally, in 2023, NEPI offered scrip dividends to shareholders that resulted in a high average take-up ratio of 80%. This also had a positive effect on leverage metrics. For 2024, we anticipate that S&P Global Ratings-adjusted debt to debt plus equity will slightly deteriorate to 38%-40% considering investment activity over the next 12-24 months. This includes development projects under construction (NEPI's project pipeline amounts to €652 million as of Dec. 31, 2023) and dividend distribution (a 90% payout ratio)--however, this is at the company's discretion since NEPI is not classified as a REIT.

NEPI continues to benefit from adequate liquidity, and we expect the company to address upcoming maturities well in advance. NEPI has some debt maturities over the next two years, including the €500 million senior unsecured bond (coupon: 1.75%) due in November 2024 and the €500 million senior unsecured bond (coupon: 1.875%) due in October 2026, both collectively representing close to one-third of the company's total outstanding debt of about €2.9 billion as of the first quarter of 2024. We understand the company plans to address the debt maturities in a timely manner as evident in the recent extension of the existing revolving credit lines (RCF) and the draw down of the IFC unsecured loan. Combined with liquidity close to €1.4 billion in cash and undrawn committed RCFs maturing beyond 12 months as of March 31, 2024, we recognize that NEPI could fully cover its near-term upcoming maturity.

The one notch rating above the sovereigns reflects our view that NEPI could withstand a hypothetical sovereign default in the next few years without defaulting on its own obligations. NEPI passes our stress test to be rated above our foreign currency rating on Romania, given its current high cash reserves, including its committed RCF, and limited debt maturities for the next 24 months. These factors provide significant headroom on NEPI's liquidity position, which we estimate could remain adequate and endure a hypothetical default of Romania in the next two years. However, we consider that the rating hypothetically could be allowed to rise to two notches above the sovereign rating (BBB-/Stable/A-1) in line with our criteria. This is because its reliance on domestic market has decreased and more than 60% of its revenue is now outside Romania, and we believe this would be sufficient to service foreign debt.

Outlook

The stable outlook on NEPI reflects our view that the company's operating performance should remain solid over the next 24 months, supported by high indexation. We expect the company to maintain S&P Global Ratings-adjusted debt to debt plus equity of about 40%, with debt to EBITDA and EBITDA interest coverage, respectively, remaining below 7.5x and above 3.8x.

Downside scenario

We could consider taking a negative rating action if:

- NEPI failed to maintain its S&P Global Ratings-adjusted debt to debt plus equity below 45%, for instance, as a result of unexpected asset devaluations or debt-funded acquisitions;
- Debt to EBITDA rose above 7.5x; or
- EBITDA interest coverage fell below 3.8x for a sustained period due to weaker operating performance or much elevated financing costs.

We could also take a negative rating action on NEPI if Romania were to experience a material economic slowdown and its monetary policy flexibility significantly weakened, leading S&P Global Ratings to downgrade the sovereign by more than one notch.

Upside scenario

We might consider raising the long-term rating over the next two years in the following scenarios:

- Adjusted debt to debt plus equity decreases below 35% for a prolonged period, or
- Debt to EBITDA decreases toward 4.5x.

In addition, a positive rating action on NEPI would be contingent on Romania's credit quality remaining robust and the company continuing to pass our hypothetical sovereign default.

Company Description

NEPI Rockcastle N.V. is a property 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 was valued at €6.9 billion (pro forma the Serbian disposal announced on July 4) at the end of March 2024, with a strong focus on retail (99% of the portfolio value) and office and industrial assets (1% combined). It operates in nine countries in CEE, particularly the Romanian and Polish markets (38% and 26% of portfolio value, respectively), in addition to Hungary (9%), Slovakia (8%), Bulgaria (8%), Croatia (4%), Czech Republic (3%), Serbia (2%), and Lithuania (2%). NEPI holds a project pipeline of €652 million as of Dec. 31, 2023, representing close to 9.5% of the property value.

Our Base-Case Scenario

Assumptions

- We expect real GDP growth in Romania of 3.0% in 2024 and 3.8% in 2025 and in Poland of about 2.8% in 2024 and 3.1% in 2025. We expect consumer price inflation growth of about 5.9% in 2024 and 4.8% in 2025 in Romania and 5.4% in 2024 and 4.2% in 2025 in Poland.
- Like-for-like net rental income growth of 4%-5% in 2024, slowing down to 2%-3% in 2025 because we expect the elevated level of inflation in 2023 to benefit the indexed fixed leases as well as further asset management initiatives.
- A sustained high occupancy rate at 97%-98% over the forecast horizon given the company's ability to maintain low vacancies with NEPI being a dominant player in the CEE region.
- S&P Global Ratings-adjusted EBITDA margins to remain broadly stable in forthcoming years at about 90%, in line with average historical levels as also expected by the company.
- We anticipate about flat fair value adjustments, given already high yields (6.94% as of year-end 2023) and decreasing inflation.
- Development capital expenditure (capex) of about €170 million-€180 million in 2024 and €260 million-€270 million in 2025, in line with the management guidance and the company's development pipeline.
- We project acquisitions of at least €300 for fiscal 2024, in line with the company's business plan and management's strategy of expanding the scale of its portfolio.
- We include €177 million in disposals as part of the company's announcement to exit from Serbia, with similar levels expected for fiscal 2025.
- Dividends in line with management's guidance.
- Average cost of debt to gradually rise to 4.0% in 2024 and 4.3%-4.5% in 2025 from 2.5% in 2023, considering the upcoming maturities to be refinanced at about 6% in 2025 and 5% thereafter.

Key metrics

- S&P Global Ratings-adjusted debt to EBITDA of 5.0x-5.5x over the next two years.

- S&P Global Ratings-adjusted EBITDA interest coverage of about 4.5x in 2024, further declining to 4.0x in 2025.
- S&P Global Ratings-adjusted debt to debt plus equity increasing to 39%-40% in 2024 and 2025 from 34.7% at year-end 2023.

Liquidity

We assess NEPI's liquidity as adequate. We anticipate that liquidity sources will likely cover uses by more than 1.2x in the 12 months started April 1, 2024.

We estimate principal liquidity sources for the 12 months started April 1, 2024, to include:

- Available unrestricted cash and cash equivalent of €770 million;
- An RCF of €620 million maturing beyond 12 months; and
- Expected cash FFO of about €360 million-€370 million.

We estimate principal liquidity uses for the same period to include:

- Contractual debt amortization payments of €533 million and the repayment of outstanding credit lines;
- Expected maintenance and committed capex of €174 million; and
- A dividend payout in line with management's expectations.

Covenants

Compliance expectations

We understand that NEPI has some covenants for its existing unsecured bond. We estimate that the headroom under these covenants should be adequate, at about 15%-30% until the end of December 2024.

Requirements

The main bond covenants of NEPI are as follows:

- The solvency ratio should not exceed 60% (38% as of Dec. 31, 2023)
- Consolidated coverage ratio (adjusted EBITDA interest coverage) of at least 2.0x (6.06x as of Dec. 31, 2023)
- Unencumbered consolidated total assets/unsecured consolidated total debt of minimum 150% (269% as of Dec. 31, 2023)

Rating Above The Sovereign

Given the high share of NEPI Rockcastle's revenue coming from Romania (38% of gross portfolio value), which is currently rated one notch lower than NEPI (BBB-/Stable/--), we perform an analysis to test NEPI Rockcastle's resilience to a Romanian sovereign default. In order to do that, we stressed our forecast of the company's liquidity position by 25%. Even under this hypothetical stress scenario, we estimate the company would have sufficient cash flow to cover its needs, and liquidity sources would cover more than 1x its uses for one year and as per our criteria requirement, LTV would remain below 80%.

Furthermore, as geographic diversification has increased over the past several years and the reliance on the domestic market has decreased, we see a limited risk of NEPI failing to service foreign debt. This is also supported by the fact that NEPI's functional currency is the euro and most of its operations are in euros. In addition, we believe NEPI would be able to maintain adequate liquidity over the next 12-24 months during a period of sovereign stress given the company already refinanced most of the upcoming maturities in 2024 and 2025 as of March 31, 2024.

For these reasons, we believe NEPI Rockcastle could potentially be rated two notches higher than Romania, compared with one notch previously. As per our Ratings Above the Sovereign criteria, two notches is the maximum rating differential that can be applied to NEPI Rockcastle because it belongs to the real estate sector, which is categorized as highly sensitive to sovereign default.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of Dec. 31, 2023, NEPI's capital structure comprised €533.7 million of secured and unsecured bank loans and a €1.9 billion senior unsecured bond.

Analytical conclusions

We rate the company's senior unsecured bond 'BBB', in line with the issuer credit rating. This is because we do not see significant subordination risk in the company's capital structure, with secured debt representing about 7% of fair market portfolio value, well below our 40% threshold for which we would typically notch the issue down from the issuer credit rating.

Ratings Score Snapshot

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

Issuer Credit Rating	BBB/Stable/--
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	BBB
Related government rating	BBB-
Ratings above the sovereign	+1 notch

Related Criteria

- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- 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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- German Residential REITs Remain Supported By Funding Access And Solid Rent Fundamentals, May 31, 2024
- Industry Credit Outlook 2024: Real Estate, Jan. 9, 2024
- Second Part Opinion: NEPI Rockcastle Sustainability-Linked Financing Framework, Oct. 19, 2023
- Tear Sheet: NEPI Rockcastle N.V., July 20, 2023

Ratings List

Ratings Affirmed	
NEPI Rockcastle N.V.	
Issuer Credit Rating	BBB/Stable/--
NE Property B.V.	
Senior Unsecured	BBB