Real Estate

Heightened refinancing risk pressures credit quality

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This report does not constitute a rating action.

Contacts

Ana Lai, CFA
New York
+1 212 438 6895
ana.lai@spglobal.com

Franck Delage
Paris
+33 1 4420 6778
franck.delage@spglobal.com

Santiago Cajal
Mexico City
+52 1 55 5081 4521
santiago.cajal@spglobal.com

Simon Wong
Singapore
+ 65 65396336
simon.wong@spglobal.com

Tatjana Lescova
Dubai
+ 971 43727151
tatjana.lescova@spglobal.com

Gil Avrahami
Tel Aviv
+ 972 3 7539719
gil.avrahami@spglobal.com

What's changed?

Increasing negative rating bias globally. EMEA has the largest proportion of ratings on negative outlook at 31%, compared to 21% in the U.S. and 20% in APAC. As such, we expect downgrades will outpace upgrades in 2024 as borrowing costs and refinancing risks increase.

Tighter access to capital. Higher borrowing costs and equity price declines are limiting access to capital, and more restrictive bank lending is pushing issuers to alternative sources of funding.

Slower economic growth pressures revenue. Cost-of-living pressures will also likely dent consumer spending and confidence, which could hurt demand for real estate.

What are the key assumptions for 2024?

Significant increase in borrowing costs. We expect higher-for-longer interest rates at least through mid-2024 and expect borrowing costs will remain high.

Slowing demand. Prospects for subpar economic growth, higher unemployment, and weaker job growth are likely to pressure demand, resulting in lower occupancy and slower rental growth.

Asset values remain under pressure. A recovery in office utilization could take several years, particularly in the U.S., as vacancy remains high.

What are the key risks around the baseline?

Refinancing risk. For office REITs, refinancing options are challenging because bond spreads have widened materially, and lenders have tougher underwriting standards.

Asset valuation could dip further. Refinancing struggles could force some asset sales at wider price discounts. Lower-quality assets could see an increase in distress sales.

Downgrades could accelerate if operating fundamentals weaken beyond our expectations. REITs with large exposure to office assets or significant near-term maturities are more at risk.

Ratings Trends: Real Estate

Chart 1

Ratings distribution

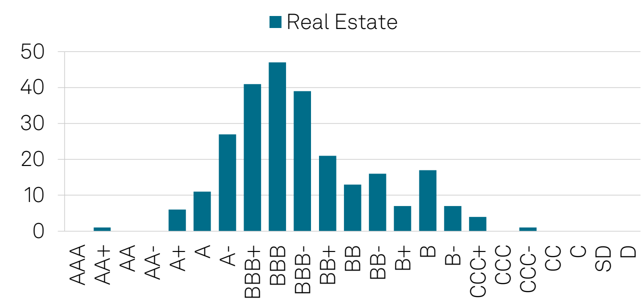


Chart 2

Ratings distribution by region

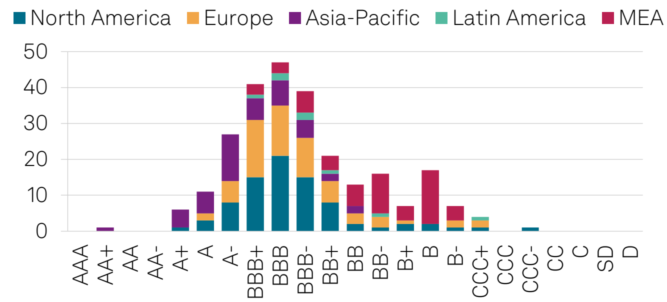


Chart 3

Ratings outlooks

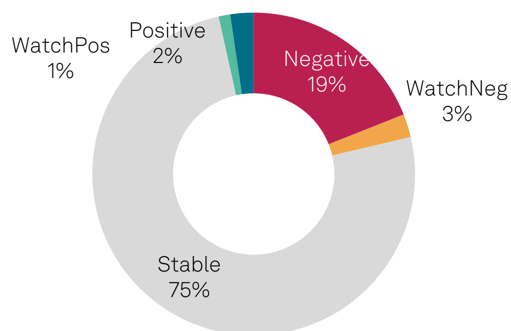


Chart 4

Ratings outlooks by region

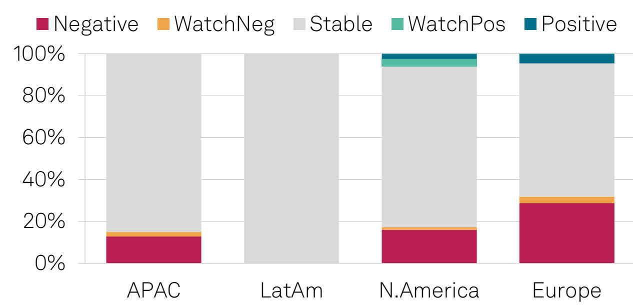


Chart 5

Ratings outlook net bias

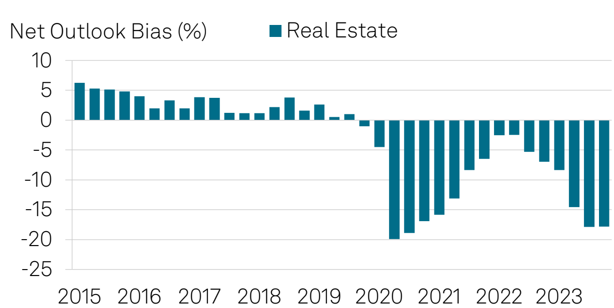
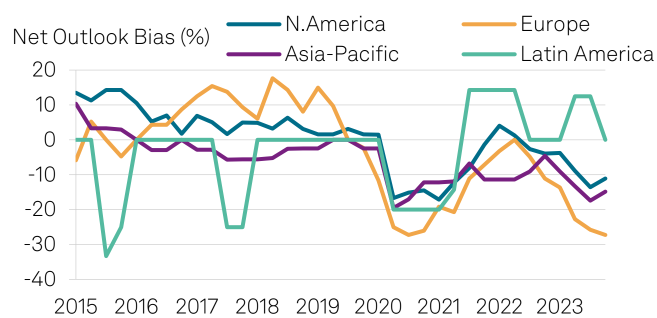


Chart 6

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter-end.

Industry Outlook: U.S. REITs

Ratings trends and outlook

Ratings in the U.S. real estate sector remain under pressure as higher-for-longer interest rates and a restrictive bank lending environment impair credit metrics and limit capital sources. We expect conditions in North America to remain challenging in 2024 given our forecast for slower economic growth and tight financing conditions.

We maintain a negative rating bias for the sector because about 21% of our ratings on North American REITs (U.S. and Canada) have negative outlooks. The downgrade-to-upgrade ratio is overwhelmingly negative, with 14 downgrades to five upgrades in 2023, and we expect this trend to continue in 2024. The downgrades largely centered around the office sector, with seven out of the 14 involving office REITs. Of those seven, four were fallen angels. Heightened refinancing risk has led to a growing number of distressed issuers in the U.S., with about 5% of our ratings in the 'CCC' category.

The U.S. office sector is under intense pressure given a slow return to office, tighter access to capital, and a sharp increase in funding costs. As a result, the credit quality of many office REITs has deteriorated significantly. Currently, about 40% of the rated office REITs are speculative-grade compared to 20% for the broader rated REITs portfolio. We expect rating pressure to persist in 2024 given that about 55% of ratings on the office sector are on negative outlook.

Main assumptions about 2024 and beyond

1. Significantly higher financing costs

Although the 10-year Treasury yield is only about 50 basis points (bps) higher than it was one year ago, many REIT bond spreads have widened materially year over year. Moreover, tighter bank lending (with tougher underwriting) is contributing to significantly higher yields on secured debt as well.

2. Tighter access to capital and limited ability to monetize assets

The capital markets have been less accessible since the bankruptcy of SVB Financial Group in March 2023, and banks are generally trying to reduce exposure to commercial real estate (CRE). Real estate transaction volume remains low and limited price discovery is constraining asset sales.

3. Slowing revenue growth

While the U.S. economy may have averted a recession, S&P Global economists project slow economic growth for the next several years. Except for industrial REITs (which have rents that are well below market) and senior housing-focused REITs (which are benefiting from a sharp recovery from a pandemic-induced trough), we expect low-single-digit revenue growth for most of our rated REITs.

Weaker growth with higher unemployment and consumer spending could further pressure real estate demand, particularly in a prolonged high-interest-rate environment. While our macroeconomic base-case forecast does not call for a recession in 2024, office real estate is highly cyclical, and demand for office space is highly correlated with job growth. Given the slow return to office, declining tenant retention, and weak leasing activity (relative to pre-pandemic levels), along with subpar growth outlook for the next two years, the stress in the office sector will likely be drawn out for several years, because office sector performance generally lags that of economic activity.

Higher-for-longer interest rates remain a key headwind for real estate in 2024. We estimate that refinancing efforts are being executed at rates that are at least 200 bps higher than maturing debt, on average, which is pressuring coverage metrics. Moreover, the transaction market for most property types has slowed to a trickle, as potential sellers and buyers are often far apart on price. For most REITs, access to capital and other funding sources has been more limited as a result. U.S. REITs face a growing debt maturity wall in the next few years, with office and retail sectors facing a significant increase in debt maturities in 2024 and 2025 (see chart 7).

Chart 7

U.S. REIT debt maturities 2023-2027

Data as of Aug. 30, 2023. Source: S&P Global Ratings.

Credit metrics and financial policy

Higher interest rates have reduced debt-service coverage and raised refinancing risk across the sector. Given a sharp increase in borrowing costs, we expect credit metrics will erode further in 2024 (particularly EBITDA interest coverage and fixed-charge coverage) because refinancing will occur at materially higher rates than maturing debt.

Access to capital is constrained. Debt issuance remains subdued as bond spreads remain wide. Although U.S. REITs issued $37 billion of unsecured debt in 2023 compared to $26 billion in 2022, issuance remains well below 2021 levels of about $68 billion. Access to equity remains limited for most companies given the REIT sector is trading at a significant discount to net asset value (NAV) overall. While the discount to NAV has narrowed recently, it remains at about 20% as of Nov. 30, 2023, with the office sector trading at the widest discount (about 37%).

Share repurchases have also been curtailed and M&A remains limited, as REITs have focused on enhancing liquidity and debt repayment over buybacks. We expect acquisition and disposition activity to gradually increase in 2024 but note that a material gap in bid-ask spreads persists, with most potential buyers and sellers remaining on the sidelines. Office REITs that are facing declining cash flows due to weak operating results have cut or suspended dividends. Over the past few months, we have seen an uptick in M&A activity, but these transactions have largely been public-to-public mergers and thus funded with equity rather than debt.

Key risks or opportunities around the baseline

1. Growing refinancing risk

Refinancing risk is one of the key risks we are monitoring. Higher-for-longer interest rates and weaker fundamentals will continue to pressure asset values, increasing refinancing risk across all property types.

2. Further erosion of credit metrics if rates stay higher for longer than expected

Our base case is for interest rates to stay elevated in 2024, with gradual rate cuts beginning in the second half of the year. If interest rates stay elevated or move even higher, the already stressed market for refinancing would certainly worsen and thwart any plans borrowers may have to simply wait conditions out by extending their loans.

3. Resilient demand for housing and industrial assets

Worsening housing affordability and undersupply of housing supports demand for rental housing, albeit at a slower rent-growth pace. Mark-to-market opportunity on upcoming lease expirations for industrial assets will support strong rental growth amid healthy demand.

Financing conditions remain tight as lenders have been pulling back their exposure to real estate assets. For office REITs, refinancing options are even more limited than the broader sector because bond spreads have widened materially, and lenders are enacting tougher underwriting standards. In the meantime, real estate transaction volume remains low and will likely not recover until rates start to decline (or at least stabilize), perhaps toward the end of 2024, thereby limiting REITs' ability to raise capital through asset sales.

Most U.S. REITs have a staggered debt maturity profile and limited exposure to floating-rate debt. There are only a few issuers whose proportion of variable-rate debt exceeds 25% of their total debt. We believe most can absorb rate increases given existing cushion under key interest coverage metrics due to funding at relatively low rates over the last several years. REITs' unencumbered asset pools provide an important source of financial flexibility since rated REITs have a largely unencumbered balance sheet. Still, we expect lenders to reduce loan-to-value (LTV) ratios; in some cases, landlords will be required to inject additional equity to facilitate the refinancing.

Industry Outlook: European REITs

Ratings trends and outlook

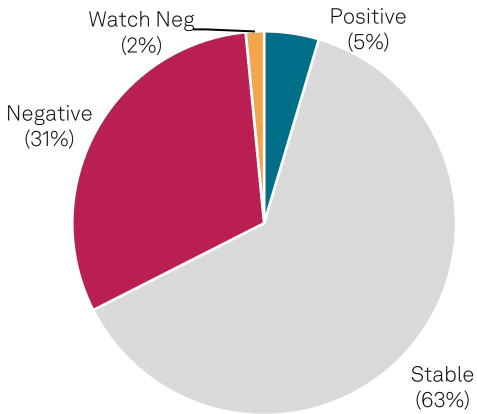
Despite recent improvements in investor sentiment, the rating bias remains negative for European REITs, with 31% of issuers carrying a negative outlook (up from 26% in July 2023), indicating the possibility of further downgrades in 2024 (see chart 8). In 2022 and 2023, we downgraded 16 European companies (25% of rated issuers), including three fallen angels (all from BBB-/Negative), mostly due to rising refinancing risks and credit ratios deviating from our rating expectations (see chart 9).

We believe valuation pressure could ease in the second half of 2024, bond issuances and investments could somewhat revive, but interest coverage will keep ratings on REITs at risk of further downgrades. We believe the situation will stabilize for companies whose capital structure and cash flows are strong enough to refinance at current rates over the long term without breaching our ratio thresholds.

Chart 8

Negative ratings outlooks and CreditWatch represent 33% of EMEA REITs

Ratings outlook distribution for EMEA REITs

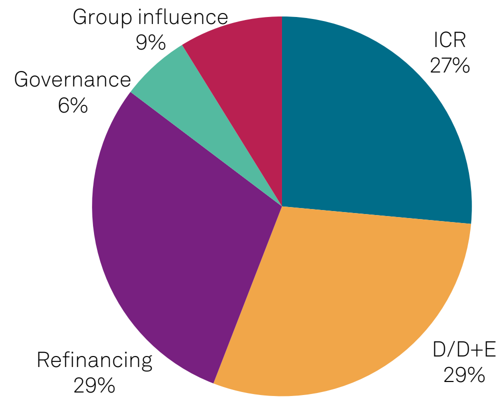


Data as of Dec. 31, 2023. Source: S&P Global Ratings.

Chart 9

Negative outlooks mostly highlight credit ratios deterioration

Main reasons for negative outlooks and CreditWatch on S&P Global-rated REITs in EMEA



Data as of Dec. 31, 2023. Source: S&P Global Ratings.

Main assumptions about 2024 and beyond

1. Higher rates will continue to weigh on refinancing in 2024 and beyond

Despite a stabilization of central rates and the recent tightening in bond yields, we expect REITs will refinance their upcoming debt maturities at materially higher rates than their current average cost of debt (about 1.5%-3.0%). We also believe raising capital from banks could remain difficult given their cautious approach to commercial real estate. We see companies with short-term bulk maturities and Nordic companies as more vulnerable given their refinancing intensity.

2. Real estate valuations could stabilize in the second half of 2024

We think property appraisal values will continue adjusting at least until the first half of 2024 despite a stabilization of central rates, given appraisals' usual lag. However, we do not assume significant value change in 2025, when we anticipate rates will decrease more pronouncedly.

3. Rental growth will likely remain healthy in the first half of 2024, before a progressive normalization

We expect rent will continue to grow throughout most of 2024 despite inflation tempering, thanks to the lagging effect of indexation and significantly lower supply of new assets. We foresee a potential deceleration by the end of 2024 as economies slow and inflation tailwinds progressively fade.

We believe the European Central Bank will maintain its deposit facility rate at the current level of 4% in the first half of 2024, after a 450 bp increase in less than 18 months. Then we expect the ECB will decrease it by a total of 75 bps in the second half of 2024, and by another 125 bps in the first three quarters of 2025, to about 2%.

While this may provide some relief to REITs' funding cost optimization, we believe long-term bond yields could remain elevated, particularly if rate cuts are delayed or if the ECB reduces its balance sheet. We acknowledge that banks are selective with new real estate clients or new transactions. They are attentive to valuations, as demonstrated by low LTV starting points on mortgage secured lending, and could potentially raise margins further. Getting new funding could remain more difficult for companies with limited bank relationships, tight covenant headroom, or limited unencumbered assets. Obtaining bank financing on new property developments, especially speculative ones that are not pre-leased or pre-sold, and riskier by nature, will likely remain a challenge.

Refinancing risks are also higher for Nordic and hybrid capital-intensive REITs. That is due to shorter debt tenors, higher exposure to variable debt, and companies' current difficulty in replacing hybrid instruments once their effective maturity falls below 20 years (for investment-grade entities); this typically occurs at the first optional call dates, most of which will fall in 2025.

Property valuations are slowly adjusting to the new interest rates, as cash flow growth has been largely offset by the high discount rate expansion. S&P Global-rated companies have reported valuation losses between 5%-20% since June 2022 (the peak). However, we expect some more devaluation to be recognized by mid-2024, especially in the nonprime office segment given the large number of assets currently for sale and the wide bid-ask spreads. We have a more favorable view of prime office, though we think they will also be impacted by further repricing given their still low yields.

Lagging indexation from inflation, a relatively strong job market, and scarce supply will support rental growth in most real estate segments in 2024. We foresee a potential deceleration by the end of 2024 as some macroeconomic indicators (like GDP and unemployment) will weaken slightly and inflation fades. We expect eurozone indexation to decrease to 2.9% and 2.0% in 2024 and 2025, respectively, from 5.5% in 2023.

Office vacancy will slowly increase. We think leasing volumes will be hit by low utilization rates and slowing economies. That said, performance between prime and nonprime assets will likely continue to bifurcate, and the scarcity of prime and energy-efficient office assets in central business districts (CBDs) will support rental growth.

Credit metrics and financial policy

Most companies have adopted stricter financial discipline since mid-2022, setting disposal targets and lowering investments and dividends to protect interest coverage and LTV ratios, which are part of their financial policies and covenant packages. Therefore, we expect them to take the necessary actions to remain within their stated guidance. However, the nature and indebtedness of their shareholders may prevent some REITs from more effective deleveraging.

- We anticipate interest coverage will remain under pressure as companies refinance their debt maturities at significantly higher costs, although most will try to repay with cash from disposals. We estimate the ratio will decline by 1.2x from 2021 to 2025, on average (see chart 10).
- LTV will plateau in 2024, at about 5% higher than 2021, based on our assumption of further value corrections (see chart 11). We expect only moderate improvement in 2025, mostly from debt reduction.
- Debt to EBITDA will likely continue to improve, because we expect revenue will grow on a like-for-like basis and most debt-funded investments are halted (see chart 12). We anticipate more free operating cash flow (FOCF) in 2024 than in the past five years.

Chart 10

Higher funding costs will pressure ICR beyond 2024

Average S&P adjusted EBITDA-to-interest ratio for S&P Global-rated REITs in EMEA

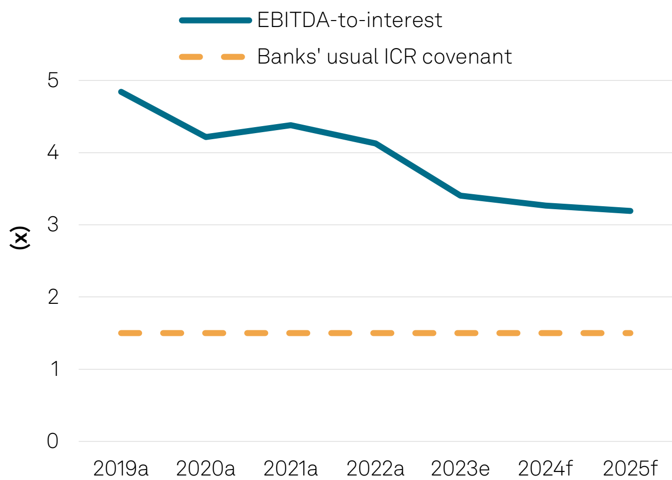


Chart 11

Value corrections could raise debt-to-debt & equity ratio by 5 percentage points from 2021's level

Average S&P adjusted debt-to-debt & equity ratios for S&P Global-rated REITs in EMEA

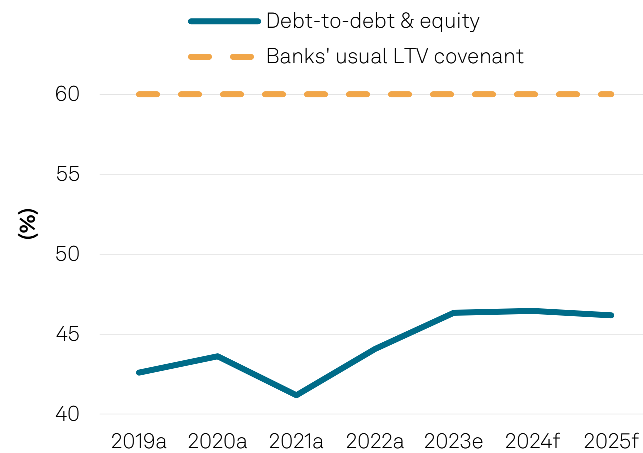
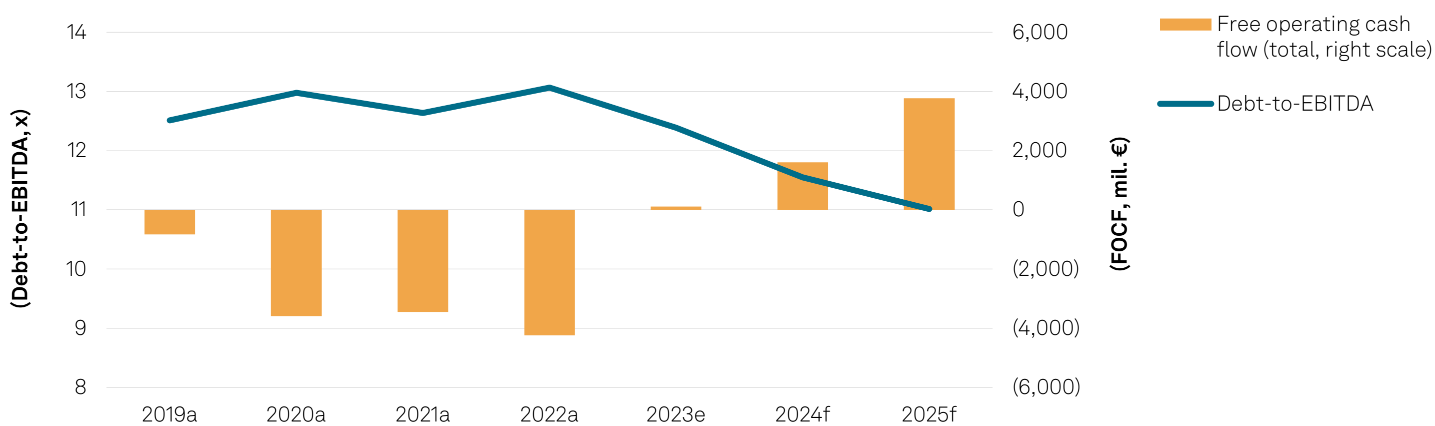


Chart 12

Growing free cash flows will support debt-to-EBITDA improvement

Average S&P adjusted Debt-to-EBITDA ratio for S&P Global-rated REITs in EMEA



a—Actual. e—Estimate. f—Forecast. Data as of Dec. 8, 2023. Source: S&P Global Ratings.

Key risks or opportunities around the baseline

1. Distressed asset sales could accentuate valuations' landing

Transaction activity remains subdued in the absence of clarity on terminal rates. However, refinancing struggles could force some asset sales at wide price discounts in 2024.

2. Weaker access to financing could heighten refinancing risks further

REITs are capital intensive, and they are already facing difficult access to funding. If banks tighten their lending standards further, it would add more stress to the sector.

3. Improving investor sentiment could revive bond issuance and property investments

The real estate sector is capital intensive and sensitive to lender sentiment. Therefore, an improving market sentiment could accelerate a recovery in the sector.

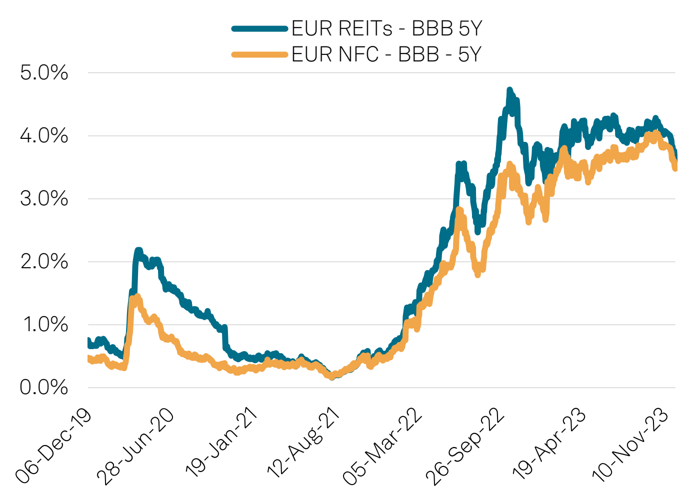
There is a price mismatch between sellers and buyers, with transactions generally on pause. While no major distressed sales have happened yet, large transactions without a price discount are difficult to realize in the current environment. This could have implications for the real estate market. If prices are significantly below market level, the pressures affecting the valuations of CRE assets could be heightened. Although this is not our base-case scenario, banks could become more reluctant to lend to REITs given the deterioration in CRE, which would be detrimental given the capital intensity of the sector.

Investor sentiment is improving slightly as we get more clarity and certainty on interest rate stabilization. This is illustrated by the improving performance of European REITs' bonds and equity prices (see charts 13 and 14). We think further improvement could accelerate a recovery, support direct property disposals, and further revive bond issuance. Moreover, a dilution of the long-standing share price discount to NAV, from the combined effect of the ongoing property value correction and rise in equity prices, could potentially unlock equity transactions.

Chart 13

Real estate bond yields remain elevated, though they recently decreased

5-year bond yields, European nonfinancial corporates versus European REITs

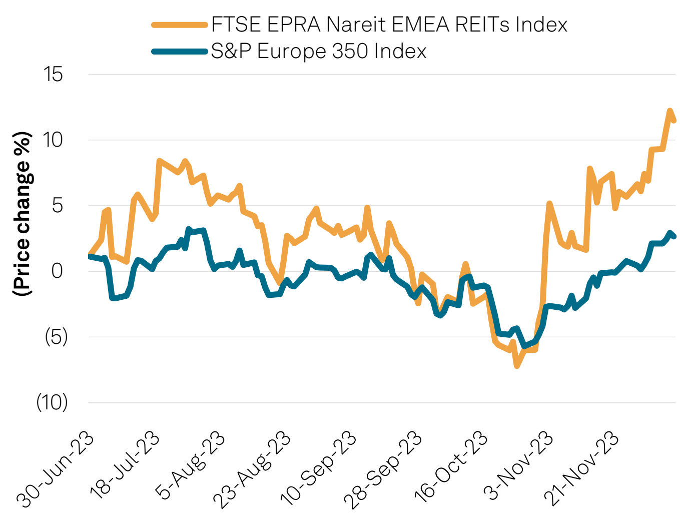


Source: S&P Global Capital IQ Pro. Data as of Dec. 8, 2023.

Chart 14

Price evolution of European REITs equity index (FTSE EPRA) versus S&P Europe 350 Index

Price change (%), from June 30, 2023 to Dec 7, 2023



Sources: S&P Global Ratings, S&P Global Capital IQ Pro.

Industry Outlook: Asia-Pacific REITs

Ratings trends and outlook

Credit metric and covenant headroom diminish as higher interest rates take hold. Heightened interest rates are reducing credit metric headroom for APAC REITs and landlords. Further cost pressures could challenge landlords in the region to maintain earnings margins while accommodating increased cost of capital expenditure (capex). Rising interest rates are translating into higher capitalization rates, resulting in asset devaluations and testing landlords' preferred targeted gearing (debt-to-assets) limits. The negative rating bias has increased to 15% by end 2023 from about 10% at the end of 2022.

The office sector is bearing the brunt of these challenges with a supply-demand mismatch in the central business districts of major Australian cities and Hong Kong. The elevated vacancy rates in office buildings are being accentuated by hybrid working and reduced demand for space.

Continued asset valuation pressure, challenging business conditions, and waning consumer confidence in 2024. Elevated interest rates, the need to repair gearing positions, and wholesale fund redemptions will likely precipitate landlords' decision to sell noncore assets. This will enable greater price discovery.

The office sector is also bearing the brunt of asset valuation declines. Despite inflationary pressures, retail landlords continue to report robust foot traffic volumes, although there are signs that discretionary retail spending is moderating. Business conditions remain challenging, and we expect elevated vacancy rates in the office and discretionary retail sectors. Cost-of-living pressures will also likely dent consumer spending and confidence.

Main assumptions about 2024 and beyond

1. Higher-for-longer interest rates will test credit metrics

Australia, Hong Kong, and Singapore have seen a rapid rise in interest rates, which could erode credit metric headroom more than in other countries. Inflationary pressures will moderate consumer and business spending while the more indebted landlords will be exposed to elevated interest rates, requiring them to shoulder a heavier interest burden.

2. Capex commitments and unitholder redemptions could exacerbate rating pressure

Higher interest rates and historically high vacancy rates in several gateway cities is pressuring earnings, reducing coverage metrics and covenant headroom. Higher-than-expected inflation-adjusted capex commitments are reducing free cash flow. Unitholder redemptions for private unlisted funds could place additional strains on weakened credit metrics and liquidity profiles.

3. We expect rental income trends will diverge between cities

Hong Kong, Japan, and Singapore benefitted from a strong rebound in return-to-office occupancy rates, while increased tourism and retail spending supported retail landlords. We expect more stable and resilient rental income trends across these countries compared to other cities, affected by a lower return-to-office adoption, supply-demand imbalance, and economic headwinds.

Credit metrics and financial policy

Japan: We expect the credit metrics of rated Japan REITs (JREITs) will remain stable in 2024. Central Tokyo's office vacancy ratio will hover around 6.5% in 2024, compared to 6.1%-6.5% in 2023. Although work-from-home habits and an increasing new supply of office space will weigh on office demand over the next two to three years, the average office utilization rate has recovered to about 80%. In our view, new supply of office space will pause in 2024. The performance of JREITs will also be supported by their high-quality, well-located portfolios, which we expect will remain resilient.

We expect retail store sales will grow steadily in a post-pandemic environment. We also predict condominium sales will remain resilient following the recovery of population growth in Tokyo. This is also supported by limited land supply for condominiums.

JREITs will continue to improve assets to enhance portfolio quality and remain selective in their investment of new properties. This will help capitalize on flight-to-quality and improve rental resilience, mitigating the effect of higher interest rates. JREITs will continue to fund investments through debt, equity, and recycled capital from asset divestments to maintain gearing ratios within respective target ranges and financial policies. We expect strong interest-coverage ratios, long average debt durations, diverse maturity profiles, and a high proportion of fixed-rate debt of rated issuers to provide our rated JREITs with ample room to weather further interest rate increases.

Hong Kong: We expect our rated REITs and landlords to maintain steady credit profiles in 2024, despite high interest rates and mild valuation declines. Solid operations and proactive treasury management policies will position our rated issuers to manage market turbulence.

In our view, our rated REITs and landlords have managed rising interest rates well by reducing their debt burdens. Through the course of 2023, the rated REITs have raised funds through various means, such as equity issuance and the sale of noncore assets. Some also embarked on early bond refinancing in mid-2023 for 2024 maturities before further interest rate hikes took place in the second half of the year.

We note a lack of transactions in Hong Kong and the illiquid nature of these assets may mean that property values have not fully reflected interest and capitalization rate movements. That said, most of our landlords have moderate headroom in their gearing-based financial policy limits, borrowing covenants, and rating triggers. The sound asset quality supports valuations and underpins their market position in the city.

Mainland China: For rated landlords in mainland China, we expect retail and office rents to come under further pressure in 2024 due to elevated supply and the uncertainty of the country's economic outlook. Despite the release of pent-up demand in travel and consumption during 2023, consumers remain cautious, especially on large-ticket items. This may constrain the potential rebound of retail rents in 2024. We anticipate office vacancy rates in first-tier cities will remain in the high-teens. In response, we expect Chinese landlords will moderate capital expenditure and acquisitions.

Pacific: Following multiple negative rating actions on our rated office Australian REITs (AREITs) in 2023, we forecast credit metrics for the sector will remain constrained in 2024. Key factors include higher-than-expected debt-funded capex commitments, unitholder redemptions, reduced earnings and covenant headroom, and asset recycling risks. Successive interest rate hikes increased interest and funding costs, reducing covenant headroom. This has challenged managements' adherence to articulated financial policies, and we expect credit metric headroom across the office sector to remain under pressure. This sector was subject to heightened negative rating activity in 2023.

Key performance indicators of our rated retail landlords remain robust, underpinned by strong leasing volumes, positive rental reversion spreads, and robust retail sales. That said, there are signs that tenant sales across some discretionary categories are starting to moderate in the September 2023 quarter. We expect credit metrics of our rated retail AREITs to remain resilient in 2024, underpinned by nondiscretionary stores and core retail categories in strategically positioned assets that will remain resilient in a downturn.

Fundamentals of the logistics sector remain sound, supported by ongoing demand for quality and strategic urban infill sites. The sector is not immune to interest rate increases, which is likely to result in valuation declines and elevated financing costs. That said, we expect low supply volumes, robust rental growth, and a disciplined approach to capital deployment will ensure that our rated industrial AREITs maintain adequate headroom in their credit metrics.

Singapore: We expect leverage for rated Singapore REITs (SREITs) to remain largely stable in 2024. This is supported by resilient earnings and the quality assets that rated SREITs own. Back-to-office momentum reduces the vacancy risks associated with remote working. Rated SREITs with downtown retail and hospitality exposure will see more upside as the recovery in tourism takes shape.

We believe rated SREITs will manage growth plans in line with their prudent financial policies. We expect an increasing focus on asset enhancement initiatives as improving existing assets generally entails less risk. REITs also have other tools to manage leverage, such as asset divestments.

Key risks or opportunities around the baseline

1. Negative office revaluations to increase gearing and reduce covenant headroom

Higher-than-expected vacancy rates, further upward pressure on capitalization rates, and sales of office assets at depressed prices could exert further downward pressure on office valuations. These could further erode covenant headroom, in particular the gearing covenant, for our rated landlords. Another key risk would be higher-than-anticipated interest costs that pressure interest coverage metrics and covenant headroom.

2. Office demand and supply imbalance will persist in 2024

Concentrated completion of new office supply, hybrid working adoption, floorplate reconfiguration, and subletting by existing tenants could contribute to a greater demand and supply mismatch in the office sector. Although increasing return-to-office adoption helped improve physical occupancy rates, we expect vacancy rates will remain high in 2024 due to excess supply that has yet to be absorbed. The risk is that vacancy rates remain sticky, especially for weaker quality assets, pressuring earnings and requiring landlords to lower rent or increase incentives.

3. Nondiscretionary retail, logistics, and hospitality assets remain well supported

Despite inflationary and cost-of-living pressures, retail, logistics, and hospitality assets continue to perform, evidenced by strong rental growth and record-low vacancy rates. Although there are signs that nondiscretionary spending might be moderating, tourism and net migration continue to support consumer and retail spending. In our view, these sectors remain attractive to investors that seek to diversify away from the headwinds facing office assets.

Japan: A larger-than-expected domestic interest rate hike due to changes in the Bank of Japan's policy rate would undermine JREITs' portfolio asset values and impinge on their interest coverage ratios. That said, we believe the low interest rate base and available covenant headroom will position JREITs to shoulder the incremental debt burden. Demand-supply imbalance may be exacerbated with additional new office supply coming to market through 2025.

Hong Kong: Net migration inflow and increasing volume of Chinese shoppers to the city are key opportunities for retail sales growth in 2024. Hong Kong retail sales grew 18.6% year over year during the first nine months of 2023, which we expect will support positive rental reversions in 2024. Retail landlords with high exposure to neighborhood malls are also benefiting from improving retail sales.

Key risks include a slower-than-expected economic recovery, which would continue to suppress office space demand in the city. A protracted pause in capital market activity, such as initial public offerings, is likely to indicate softening demand for new office space in the city. This is likely to pressure rental growth and vacancy levels. We expect average office rent reduction of 0%-5% in 2024, in addition to an estimated 5%-10% decline in 2023. We expect office vacancy rates will remain elevated over the next 12 months amid substantial new supply.

Mainland China: In the office sector, the risks are skewed toward the downside on lease renewals given excess office supply. Amid economic uncertainty, firms with maturing leases must decide if they will maintain their existing floorspace or reduce it. The outlook for retail landlords is more favorable, with retail mall footfall rising amid recovering consumer mobility. Retail leasing demand is highly correlated to business and consumer confidence. Landlords with a strong credit profile and access to local funding lines benefit from lower domestic interest rates.

One opportunity is that recent regulatory developments, such as the launch of domestically listed REITs, may provide exit opportunities for some retail landlords.

Pacific: Inflationary pressures and elevated interest rates are key risks for AREIT landlords. Despite retail malls benefitting from post-pandemic foot traffic and customer visitation levels, there are signs that inflationary pressures are starting to moderate consumer spending across discretionary retail sales categories. Protracted inflation and cost-of-living pressures will further dampen consumer spending and retail sales. Although industrial landlords benefit from strong demand and relatively low supply volumes, weakness in consumer spending is likely to extend to e-commerce sales and crimp demand for industrial storage and distribution sites over the longer term.

Office landlords experiencing higher vacancy rates are more susceptible to increased financing and interest costs. While rental income may benefit from consumer price index (CPI)-adjusted increases, it is insufficient to fully offset vacancies and nonrenewals as tenants conform to smaller floorplate hybrid working arrangements. With upward pressure on capitalization rates and office landlords divesting assets to fund capex commitments, we expect negative office asset revaluations will be more pronounced. Although flight-to-quality may offer some protection for landlords with higher quality assets, we expect gearing targets and credit metrics to come under pressure.

Singapore: Higher-than-expected interest rates will reduce credit buffers. That said, SREITs proactively hedged against rising interest rates. For rated issuers, the proportion of fixed rate debt was between 63%-78% as of Sept. 30, 2023.

Macroeconomic uncertainties may weigh on operating conditions. This may temper rental growth rates or lead to higher vacancy rates. The effect may be exacerbated in the office market, which faces elevated supply in 2024. We expect this will have a disproportionate effect on lower quality office buildings. Growing occupier expectations on sustainability accreditations may require further capital investments to bring the buildings up to a higher standard.

Industry Outlook: Latin America Real Estate

Ratings trends and outlook

All rated Latin American (LatAm) real estate operators have a stable outlook, signaling our expectations for rating stability in 2024. Higher-for-longer interest rates remain a key risk for real estate assets, especially for already distressed assets, such as office properties. However, half of the rated companies are investment-grade, with significant credit buffer to absorb downside risks; the other half are mostly in the 'BB' rating category, with the exception of one rated entity in the 'CCC' category (due to its vulnerability to external events given its unsustainable capital structure).

Industrial portfolios in the region will continue to ride the positive momentum given nearshoring and growing e-commerce tailwinds, particularly in Mexico. We expect retail portfolios will perform well due to resilient consumption trends but with limited upside in terms of expansions. We also believe office properties will remain under pressure due to hybrid work, slowing economic growth, inflation, and the expectation for interest rates to remain high.

We expect stability in our LatAm rated portfolio in 2024. The anticipated slowdown in the U.S. and LatAm economies may affect some of these companies' tenants; however, we estimate the impact in operating indicators will be relatively mild. We consider most of the rated entities to be relatively well positioned to weather a challenging year amid high financing costs. On average, we expect a rise in revenue and for EBITDA to approach 10% for these entities.

Funding needs for industrial operators will increase for growth initiatives, although financing is available and committed in most cases. For retail and office operators, funding needs will be significantly lower, given the absence of gross leasable area (GLA) growth in these asset classes. We estimate relatively stable coverage ratios despite higher financing costs, and for refinancing risks to be limited in 2024. In most cases, our rated entities maintain well-extended debt maturity profiles. Moreover, there are some planned asset recycling and divestments for this year, though pressure on office property valuations could delay some of these plans.

Main assumptions about 2024 and beyond

1. High demand for industrial properties will continue

We expect tight vacancy rates in key markets within Mexico (around 2%), while vacancy rates in Brazil will be below 10%. Despite economic and political headwinds, we expect strong demand for industrial properties near the U.S. will keep occupancy rates high while continuing to push rental rates up, benefitting industrial landlords. Additionally, we also anticipate growth strategies of several players, organic and inorganic, to continue taking place in 2024.

2. Office properties have not bottomed

We expect a gradual decline in vacancy rates during 2024, following the modest improvement from past months. In our view, the full recovery seems elusive in the medium term, and we expect still-high vacancy rates of around 18%-23% in markets such as Mexico City or Sao Paulo. This, coupled with higher-for-longer interest rates, will continue pressuring asset valuations.

3. Retail portfolios will be relatively resilient to softer consumption

Despite strong e-commerce growth since the pandemic broke out, consumers in LatAm continue visiting shopping malls. Occupancy rates at several properties is close to pre-pandemic levels and we anticipate relative stability for 2024, although economic headwinds will likely slow discretionary consumption.

Rated industrial portfolio continues enjoying local tailwinds and is looking to expand GLA. We expect occupancy rates to remain strong at around 97% because rated industrial players are concentrated in northern Mexico, where they enjoy tailwinds from the shift to nearshoring and benefit from a wider range of tenants, such as manufacturers of auto parts, health devices, electronics, logistics, and e-commerce tenants. We estimate net effective rents will be growing around 15%-20% in 2024, similar to 2023, given the very low vacancies in key markets such as Monterrey, Mexico City, and Tijuana.

Despite our expectation for an economic deceleration in 2024 in both the U.S. and Mexico, we estimate little deviation in occupancy rates because most of the tenants are multinational companies that have longer-term investment horizons and sound financial profiles. We expect investment sentiment in this asset class will remain positive, bringing financing options for industrial players to pursue more aggressive growth initiatives. A few entities have raised equity financing, while most have undrawn committed revolving credit facilities, which we expect will be used over the next 12-24 months.

Moreover, growth strategies will continue to vary across companies, depending on the target market. Some of the rated entities are seeking to expand their GLA through their own developments, joint ventures, or acquisitions on stabilized portfolios. On the other hand, our rated Brazilian players with industrial assets are largely geared toward e-commerce and logistics, rather than manufacturing facilities. Due to the increasing adoption of e-commerce by Brazilian consumers and retailers, we expect these entities to post mid-single-digit revenue growth on average.

We expect little growth in retail and office portfolios, and we believe refinancing risks are low. Investment sentiment on both asset classes remains subdued while construction costs are high, limiting growth. Rated retail portfolios are in Mexico, Brazil, and Peru, where we've seen a strong recovery in foot traffic, something we believe will continue during 2024. While these properties have virtually recovered to pre-pandemic operating indicators, such as occupancy rates, we expect limited rental growth in the case of Mexico and Brazil. This is in line with our view of softer consumption trends, especially in discretionary goods and services.

However, as roughly 90% of rental income comes from fixed rent agreements, we don't anticipate a sharp contraction even if consumption drops. The gloomier scenario for Mexico and Brazil contrasts with our view on Peru, where consumption underperformed in 2023, and we expect a soft rebound in 2024; this is in line with our view of more robust economic growth. We expect occupancy rates at Peruvian and Brazilian properties will remain around 95%, reflecting high asset quality and less exposure to discretionary consumption, while in Mexico we expect a gradual improvement toward 90% by year-end 2024.

Similar to last year, the pipeline on retail properties under development is relatively small, and we expect limited funding needs. There are no large debt maturities due in 2024 on these portfolios, so refinancing risks are low. We've seen some proactive refinancing of secured debt on mixed-use properties in 2023, and we expect some more refinancing to materialize in 2024 as well.

Office properties account for the smallest proportion of the portfolios of our rated real estate entities, mostly concentrated in Mexico City and Sao Paulo areas. We anticipate only a modest recovery in occupancy rates in 2024, given large supply in these areas, while business conditions won't significantly improve. This will continue to pressure landlords to refurbish properties and adapt them to demand trends such as plug and play, collaborative spaces, or environmental certifications, in addition to ancillary services within the property.

Credit metrics and financial policy

We expect mixed leverage trends during 2024. In the case of industrial portfolios, we expect greater use of debt and equity proceeds to fund development projects and acquisitions because most rated entities are planning to continue executing a growth strategy to capture the momentum in the sector. Nonetheless, incremental leverage will be relatively moderate, partially offset by rental income and EBITDA growth, given strong operating indicators. Moreover, we expect industrial landlords will fund their strategies with long-term debt financing, as several have committed revolving facilities with maturities within three to five years, while others have raised equity.

For retail and office portfolios, we expect a modest improvement in rental income, and in a few cases asset sales for debt repayment. Moreover, financing needs for this asset class will continue to be limited because our rated portfolio doesn't have material debt maturities in 2024 and expansionary capex, or acquisitions, will be scarce for nonindustrial landlords.

On average, we expect rated LatAm real estate entities to maintain solid credit metrics for 2023, with debt to capital of 30%-35%, EBITDA interest coverage of about 3.5x, net debt to EBITDA in the 5.0x-6.0x range, and funds from operations (FFO) to debt of about 20%.

Key risks or opportunities around the baseline

1. Economic headwinds and strong local currencies could impact operating and credit metrics

Our top-line and cash flow generation expectations could underperform if the U.S. economy enters even a shallow recession in 2024. We estimate it would indirectly impact our rated real estate portfolio, especially where tenants' operations are dependent on U.S. demand. Moreover, strong Mexican-peso (MXN) relative to the U.S. dollar (USD) will likely require extraordinary payout of FIBRAs (Mexican REITs) to certificate holders in 2024, in addition to undermining dollar-denominated rents.

2. Nearshoring remains a key opportunity, particularly for real estate industrial operators based in Mexico

Industrial properties continue being the darling of real estate asset classes in LatAm, and we expect continuity in this positive momentum through 2024, despite local headwinds such as rule of law, energy policies, and security. Several industrial operators and developers are ready to continue expanding their GLA, given record-low vacancy rates, with funds from committed revolving credit facilities (RCFs) and equity financing. Although we anticipate development risk will tick up in 2024, we expect prudent financial policies will continue in our rated portfolio.

3. Political landscape will dictate business conditions, especially for industrial properties

Political risks prevail in 2024, with upcoming election years in both the U.S. and Mexico. A key component of Mexican real estate attractiveness are its economic ties and trade agreements with the U.S. Although we see this as a high-impact, low-probability risk, the entrance of new administrations could deter new investments, fading the momentum away.

Economic headwinds pose a risk to our growth baseline for 2024. The possibility of the U.S. economy entering a shallow recession in 2024 is not off the table, likely dragging other economies, such as those in LatAm. Moreover, a prolonged period of high interest rates would reduce the economic activity beyond our current estimates in several LatAm countries, reducing internal consumption and exporting activities. These would undermine tenants' operations across the three real estate subsegments we follow in the region. However, the bulk of our LatAm rated portfolio have well-laddered debt maturity profiles with low refinancing needs in 2024.

We will also monitor foreign exchange (FX) volatility, given the high number of dollarized rents and debt in the sector, especially in industrial and premium office properties. For Mexican FIBRAs, this represents a particular risk beyond the effect on rental income because they must distribute at least 95% of taxable income to certificate holders to keep their FIBRA status and fiscal benefits.

With current MXN/USD exchange rates and estimated inflation, several FIBRAs will report abnormal income gains for the fiscal year-ended 2023, considering the effect on valuations and dollarized debt, raising distribution requirements by March 15, 2024. We consider the rated FIBRAs relatively well positioned to confront this scenario, given high levels of committed RCF (and in some cases cash reserves from equity financing). Moreover, payment in kind, with certificates, is a less conventional possibility that some companies are evaluating.

Industrial tailwinds will continue, despite local constraints and higher-for-longer interest rates. LatAm has become a more attractive destination for several of value chains considering relocation, given its competitive and skilled labor supply, multiple international trade agreements, and proximity to the U.S., especially Mexico. Demand for Mexican industrial real estate has been at an all-time high over the past couple of years and is showing little signs of slowing in 2024.

Industrial absorption rates were at record highs in 2022 and will likely exceed that record in 2023. We estimate foreign direct investments to be 40% higher in the first half of 2023 compared to the first half of 2022 (excluding extraordinary transactions), while industrial inventory under construction remains strong in several Mexican submarkets.

As a result, our rated industrial portfolio is expanding their GLA and in some cases increasing developments through acquisitions of stabilized assets. Although we consider the development path riskier, low vacancies, secured funding through debt and equity, and leverage headroom lead us to believe the rated entities are well positioned to pursue growth.

Presidential elections in both Mexico and the U.S. could disrupt the trading partnership. Although we consider this a high-impact, low-probability scenario, a reversal from any of the two nations to foster their commercial relationship could significantly reduce demand for industrial properties in Mexico, increasing vacancy rates and pressing asking rents.

The industry may also face longer-term headwinds--or tailwinds--depending on how the political landscape evolves. For example, Mexico's energy policy, electric installed capacity, land and water scarcity in certain regions, and the speed and transparency in dealing with local governments could be headwinds. On the other hand, if policies favor greater infrastructure investments in roads, highways, and ports to improve connectivity and tackle energy-source bottleneck and security issues, the positive momentum in nearshoring trends could be further magnified, directly favoring growth prospects for industrial real estate companies and indirectly affecting the rest of the economy.

Industry Outlook: Other Regions

Gulf Cooperation Council

In the United Arab Emirates, positive traction for hospitality and retail is boosted by a high number of international visitors, population growth, and overall supportive economic environment. Hospitality remains very strong (76% occupancy in the first eight months of 2023), with average daily rates (ADR) at historically high levels ($170), as the country hosts a series of global events, including COP28 in Dubai. Visitor numbers are on track to hit 17 million in 2023, fully recovering to pre-pandemic levels.

The large pipeline of new hotel rooms will preclude further occupancy improvements over the next few years, though. Mall operators benefit from a strong rebound in footfall and solid retail performance, with rental recoveries in prime malls; but secondary retail spaces remain challenging. Continued new GLA supply will limit the extent of improvements, in our view, despite good traction in international tourism and population growth.

Changes in corporate ownership rules allowing 100% foreign ownership as well as active issuance of new regulation for high tech and virtual assets companies have prompted new businesses establishment in the UAE. This resulted in rising office rents and reduced vacancies (10% in Central Business District) over the past couple of years, amid relatively limited new supply.

Saudi Arabia is on a growth path under the framework of its Vision 2030 program. Saudi authorities are taking measures to boost the tourism sector via visa reforms, hosting of high-profile events and developing new tourism destinations. Several international hotel chains have already announced massive investments in the country. We expect a significant rise in hotel rooms in the run-up to 2030, as the country now expects to reach its 100 million visitors target (domestic and international) well ahead of plan.

Office landlords benefit from a strong uptick in international corporations and government-related entities as tenants, which, given limited new supply, led to rental increases and vacancy drops. We expect such a positive dynamic to be sustained as economic growth of non-oil sector is bolstered by large investments in Vision 2030 projects. The retail segment continues to grow, with new GLA additions, and mall operators focus on enhancing their entertainment and omnichannel options.

In Qatar, downward pressure spreads across all real estate subsegments, including hotels, offices, and retail. New capacity delivered for the World Cup in 2022, particularly in the hospitality segment, has significantly increased available inventory. On the positive side, tourism is expanding significantly, while the population increased by about 2% so far in 2023, moderating the downside. We expect pressures to linger for the next two to three years.

Israel

Pressure on office rents and occupancies amid the slowdown in the high-tech industry. Since the second half of 2022 there has been a substantial decrease in the venture capital investments in the high-tech industry, mainly due to global economic challenges with tighter financing conditions, and the domestic political situation regarding the fierce opposition to controversial judicial reform including massive demonstrations and strikes in Israel. It resulted in a growing number of high-tech companies downsizing and a decrease in the number of job vacancies. It has a direct negative effect on demand and correspondingly on the rents of new contracts in the office properties, especially in the Tel Aviv area, which previously enjoyed record prices.

In the short term we do not project any major impact on the occupancies of the rated companies, which operate mainly in areas of high demand with high quality properties. These companies still show growth in rental income mainly due to the linkage to the price index and relatively stable occupancy rates due to the long-term contracts.

Nevertheless, we expect to see increasing pressure on rent level and occupancies, on the back of our weaker updated macroeconomic forecast for Israel due to the war. We also expect the supply of new high-quality office space entering the market in the coming years will put additional negative pressure on rental rates and occupancy, especially in areas already suffering from excess supply.

Increasing risk for lower retailers' profitability could pressure rents. Continued inflationary pressures due to supply chain disruptions, as well as slower growth expectation and higher interest rates, are weighing on retailers' profitability. Retailers may find it difficult to pass on the full increase in their costs to consumers, which will further reduce their profitability and, consequently, pressure rents.

While the economic impact of the war was most notable in October 2023 with the drop in footfall in commercial properties and turnover of tenants, we see increasing risks of the more general slowdown in consumer consumption and weaker macroeconomic performance, mainly impacting rent level growth.

Continuously higher interest rates lead to growing risk of asset devaluations for office and retail properties. However, higher rents due to consumer price inflation will act as a moderating factor. We note that in the first nine months of 2023, most income-producing real estate companies presented positive revaluations, due to both indexation and a real increase in rents.

At the same time, amid the uncertainty in the economy growth prospects, we see a higher risk of moderate single-digit percent asset devaluation, mainly for office properties. Overall, these trends weigh on the credit quality of Israeli real estate, as reflected in the substantial increase in the proportion of negative outlooks compared to 2022.

Related Research

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- Dubai Property Market 2023: Demand Should Hold Up Against Global Economic Pressures, March 10, 2023
- Research Update: Dubai-Based Damac Real Estate Development Ltd. Outlook Revised To Positive On Strong Order Book; Affirmed At 'BB-', Feb. 28, 2023
- Issuer Ranking: Asia-Pacific REITS And Real Estate Operating Companies Ranking--Strongest To Weakest, Feb. 22, 2023
- German Residential REITs Face A Mixed Outlook In 2023, Feb. 20, 2023

Industry Forecasts: Real Estate

Chart 15

Debt to capital (adjusted)

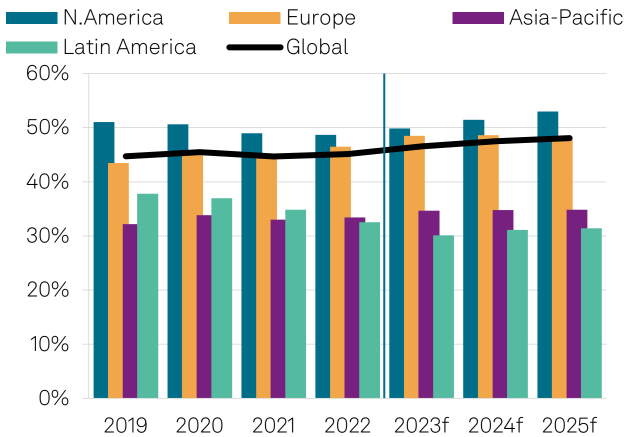


Chart 16

EBITDA interest coverage (adjusted)

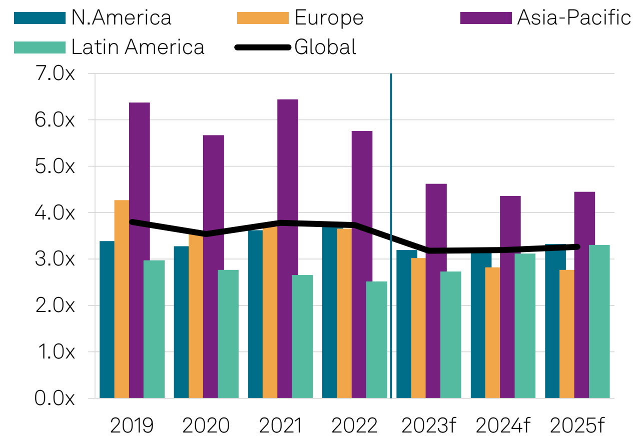


Chart 17

Debt / EBITDA (median, adjusted

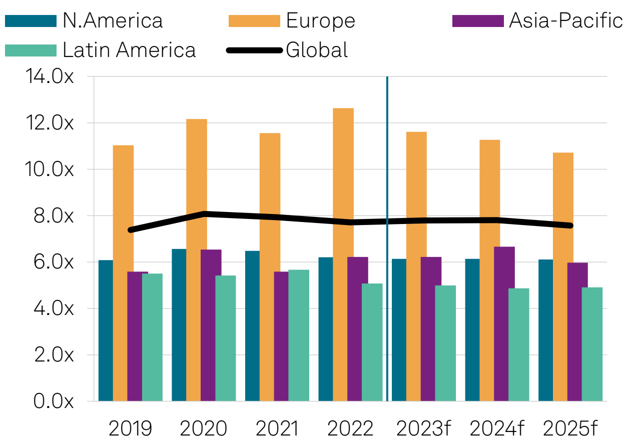
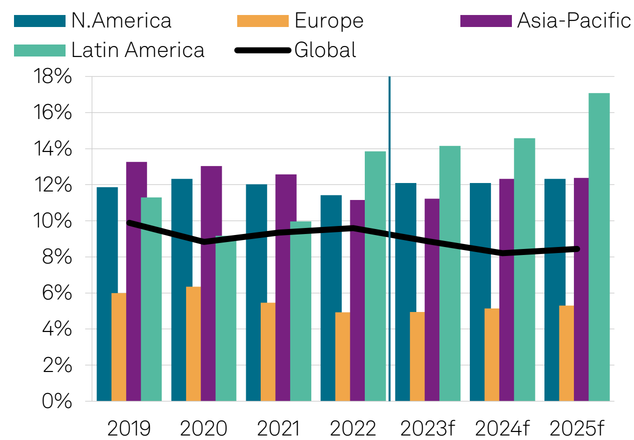


Chart 18

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
All data converted into U.S. dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.

Cash, Debt, And Returns: Real Estate

Chart 19

Rental revenue growth

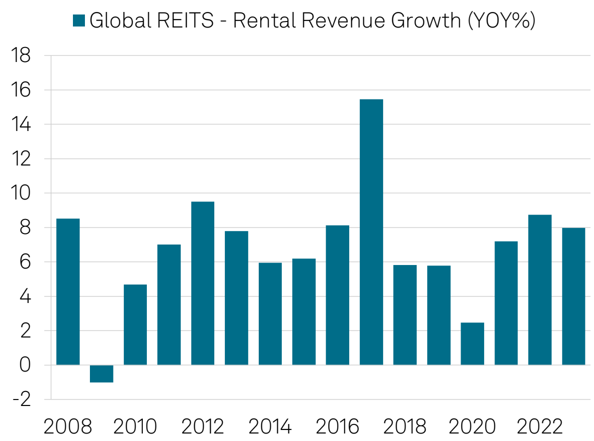


Chart 20

Return on capital employed

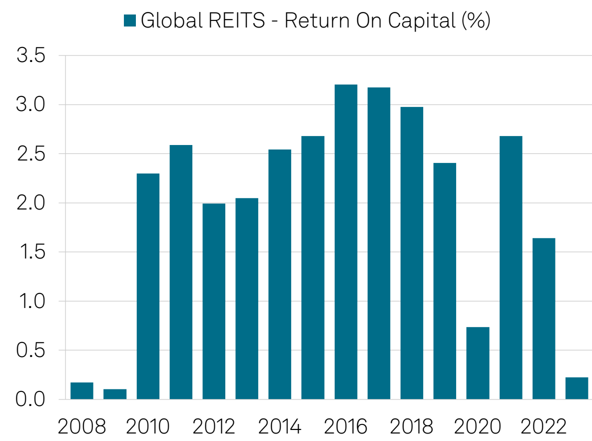


Chart 21

Fixed- versus variable-rate exposure

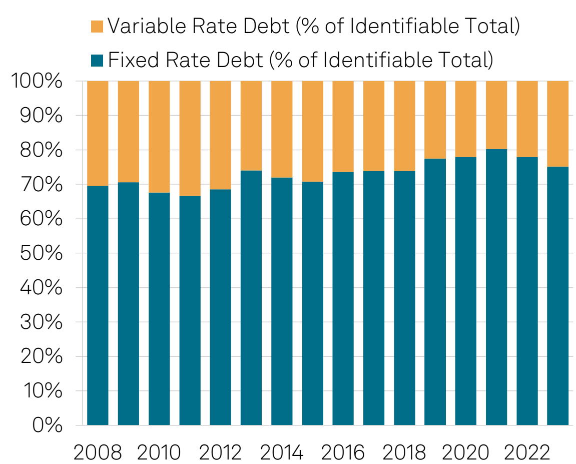


Chart 22

Long-term debt term structure

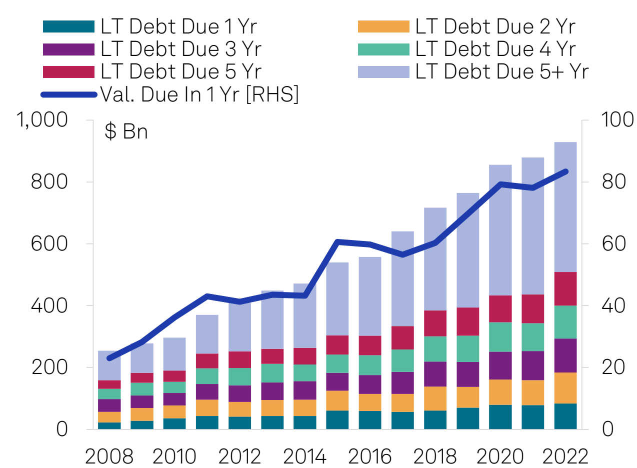


Chart 23

Cash and equivalents / Total assets

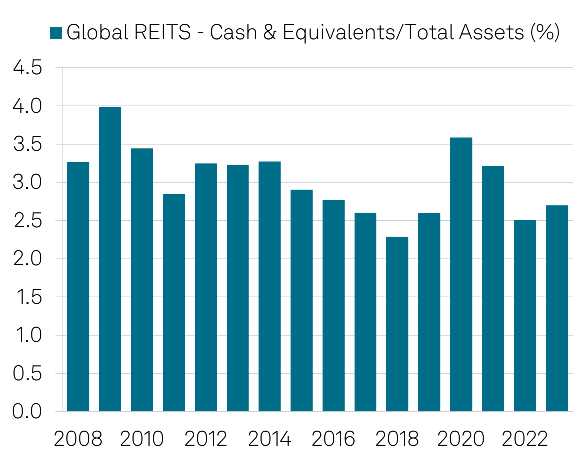
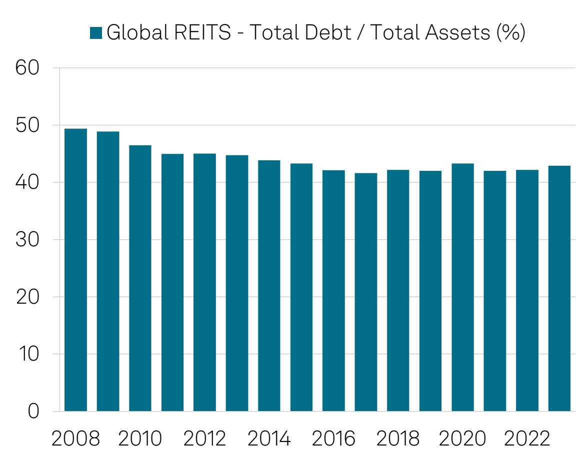


Chart 24

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2023) figures use the last 12 months' data.