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Research Update:

NEPI Rockcastle PLC Assigned 'BBB' Prelim Rating; Outlook Stable

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Table Of Contents

1860913 | 300978387

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Overview

- Retail property investment company NEPI Rockcastle should emerge as a leading real estate investment group in Central and Eastern Europe (CEE) following the merger of New Europe Property Investments PLC (NEPI) and Rockcastle Global Real Estate Company Ltd. (Rockcastle).
- Upon completion of the transaction, the company will own and manage a large asset portfolio of about €3.9 billion, mostly comprising prime quality shopping centers in Romania and Poland, and a €1 billion portfolio of listed securities. NEPI Rockcastle will also exhibit very low debt leverage and enough liquidity resources to absorb an economic stress scenario in Romania.
- We are therefore assigning our 'BBB' preliminary long-term corporate credit rating to NEPI Rockcastle.
- The stable outlook reflects our view that the company will generate resilient cash flows over the next 24 months and maintain a conservative financial policy, with ratios of EBITDA to interest and debt to debt and equity of more than 3.5x and less than 35%, respectively.

Rating Action

On June 2, 2017, S&P Global Ratings assigned its 'BBB' preliminary long-term corporate credit rating to NEPI Rockcastle PLC. The outlook is stable.

The final rating will depend on our receipt and satisfactory review of all final documentation and confirmation of the irrevocability of the merger. Accordingly, the preliminary rating should not be construed as evidence of final rating. If S&P Global Ratings does not receive final documentation within a reasonable timeframe, or if final documentation departs from materials reviewed, we reserve the right to withdraw or revise our rating.

Rationale

NEPI Rockcastle is a real estate investment company focused on acquiring, developing, and managing retail real estate assets in the CEE region, with a primary focus on Romania (48% of total asset value, pro forma as of March 31, 2017) and Poland (30%). At the closing of the transaction, the company will own and manage 50 standing assets in six countries, for a total value of €3.9 billion (pro forma, as of March 31, 2017), and seven additional assets under development (one currently in construction, six in permitting and leasing process).

1860913 | 300978387

The group's business risk profile is underpinned by its position as the largest retail property owner in Romania, the fourth-largest in Poland and second-largest in Slovakia. It manages a portfolio of prime quality retail assets, mostly located in densely populated areas with good macroeconomic dynamics, higher-than-average consumption and low competition. The company enjoys a very high occupancy ratio of 96.4%. Most of the company's tenants are creditworthy multinational companies or regional leaders with triple-net lease contracts fixed in euros. NEPI Rockcastle's portfolio includes 42 shopping centers, mainly large ones (35 assets have more than 35,000 square meters of gross lettable area; 3 million-14 million visitors per year), representing 90% of NEPI Rockcastle's total rental income, six prime quality office buildings, and two logistic warehouses. Another seven assets are currently under construction or permitting and preleasing, while 14 small noncore assets are up for disposal.

We see limited development risk in the portfolio, because a large share of development is the extension of existing projects, mostly pre-let. Moreover, the share of assets under development should remain moderate, at around 5% of the portfolio value. We believe that NEPI Rockcastle's rent stability should be supported by the good asset quality of its portfolio, with prime positions in most of its locations, and a sound lease maturity profile with an average weighted lease maturity of about five years. NEPI Rockcastle's tenants have a relatively modest occupancy cost (or rent-to-sales) ratio below 15%, which somewhat mitigates the risk of increasing rent burden from currency movements (rents are contracted in euros, while tenants' revenues are in local currencies, mostly Romanian lei and Polish zloty). NEPI's two largest tenants, Carrefour (BBB+/Stable/A-2) and Auchan (BBB+/Stable/A-2), represent 18% of its total rental income, which is in line with rated peers in the same business risk category.

The business risk profile is constrained by modest geographic diversification, with Romania and Poland representing 78% of asset value, and the company's exposure to developing economies such as Romania. However, we understand that tenant demand for retail and office space is increasing quickly in this market, and current economic prospects are favorable. Under our base case, we assume that the company's EBITDA will reach €220 million-€280 million by 2017-2018, on the back of full-year contributions of previous acquisitions, new acquisitions, completed developments, and value-enhancing renovations and project extensions. We assess NEPI Rockcastle's profitability as average, and, in our base-case scenario, we forecast its adjusted EBITDA margin to be in the range of 73%-78% in 2017-2018. At the same time, we note that the company's revenue includes significant costs that are passed on to tenants and, if measured without those costs, the company's profitability would exceed 90%. Our operating base-case scenario for 2017-2018 includes like-for-like rental income growth of 2%-3% and stable occupancy.

Our assessment of NEPI Rockcastle's financial risk profile is underpinned by the company's prudent financial policy, centered on a loan-to-value (LTV) ratio of less than 35%, which is low for the industry. Under our base-case scenario, we forecast a debt-to-debt plus equity ratio of about 29%-31% in 2017-2018. We also anticipate that the EBITDA interest coverage ratio will be strong, at about 4.4x-4.7x in 2017-2018. We expect total dividend distribution to shareholders to remain stable, although NEPI Rockcastle is not legally required to distribute dividends.

NEPI Rockcastle also holds a €1 billion significant portfolio of listed securities, mostly of large real estate companies operating in the U.S., U.K., and Continental Europe. We believe this portfolio could be recycled into higher yielding new direct property acquisitions. We also understand that the company has good access to equity capital markets, as shown by its track record of issuing equity (€2.5 billion of equity raised over the past 10 years) to fund its retail-assets acquisition pipeline.

We expect that the level of NEPI's rental income generated by unencumbered assets will remain higher than 50%. This results in a capital structure where unsecured debt issuance is not structurally subordinated to other debt obligations to the extent that it would affect the rating on this debt.

To test NEPI Rockcastle's resiliency to a Romanian sovereign default, we stressed our forecast of the company's liquidity position using the following assumptions for 2017:

- A GDP contraction and a doubling of inflation in Romania, which would reduce Romanian funds from operations by about 25%, assuming much lower occupancy rates in shopping malls, discounts in rental contracts, and an increase the company's costs and Selling, general, and administrative expenses;
- A doubling of the base interest rate, although this would have a minor impact on the company's interest expenses, given that it has a 100% fixed interest rate either through fixed coupons or hedging;
- A haircut of 35% in the company's cash holdings and the withdrawal of undrawn revolver lines;
- Reduction of capital expenditure to the committed amount only; and
- No dividend, since company is not obliged to pay dividends.

Even under this hypothetical scenario, we estimate the company would have sufficient cash flow generation to cover its needs and would maintain liquidity sources over uses of more than 1x for one year. For this reason, we believe NEPI Rockcastle can be rated higher than our sovereign rating on Romania, but by no more than one notch.

Although the current trend for Romanian and Polish retail markets is positive, we see these markets as more volatile and cyclical than those of peers in the same business risk category, such as French retail for Mercialys and German residential markets for Around Town Properties. Moreover, we believe NEPI Rockcastle's credit ratios are weaker than those of peers that we assess in the same financial risk category, such as GlobalSwitch and Hispania. We apply a one-notch negative adjustment to take into account this comparable ratings analysis.

Liquidity

We assess NEPI Rockcastle's liquidity position as adequate under our criteria for real estate companies. We anticipate that liquidity sources will likely cover liquidity uses for 2017-2018 by more than 1.2x. We assess debt covenant headroom as adequate. NEPI Rockcastle has sound relationships with a diversified group of banks, and a generally satisfactory standing in capital markets.

Principal liquidity sources on March 31, 2017:

- Unrestricted cash balances of about €80 million;
- Undrawn revolver facilities of €230 million;
- An undrawn term loan of €10 million;
- Funds from operations of about €190 million for next 12 months.

Principal liquidity uses as of the same date:

- About €20 million of contractual debt repayments for the next 12 months;
- Capital expenditure needs of approximately €315 million in the next 12 months for the development pipeline.

Outlook

The stable outlook on NEPI Rockcastle reflects our view that the company should continue to benefit from the healthy economic trends in Romania and Poland, thanks to its good quality assets. We also believe its debt to debt and equity and EBITDA interest coverage ratios will be less than 35% and higher than 3.8x, respectively, over the next two years, supported by the company's resilient cash flows and conservative financial policy. We expect NEPI Rockcastle will maintain a large liquidity buffer.

Downside scenario

We could consider taking a negative rating action if, in particular, NEPI Rockcastle's debt to debt plus equity increased above 35% as a result of unexpected asset devaluations or if its EBITDA interest coverage fell below 3.8x. Downward rating pressure might also materialize if we see negative dynamics in its operating performance. We could also take a negative rating action on NEPI Rockcastle if Romania experienced economic, monetary, or political turbulence, leading to a sovereign downgrade.

Upside scenario

An upgrade would hinge on NEPI Rockcastle materially improving its portfolio in terms of size and diversification, while generating positive like-for-like rental income growth and showing positive portfolio revaluation. It would require that the newly formed company establishes a track record of keeping robust credit ratios. A positive rating action on NEPI Rockcastle would also be conditioned on an improvement of Romania's credit quality or on a significant dilution of the company's exposure to Romania to less than 25% of its assets.

Ratings Score Snapshot

Corporate Credit Rating: BBB(prelim)/Stable/--

Business risk: Satisfactory
- Country risk: Moderately high
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: bbb+

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

Stand-alone credit profile: bbb

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

New Rating

NEPI Rockcastle PLC	
Corporate Credit Rating	BBB(prelim)/Stable/--

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