FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Emirates REIT to 'B+'; Negative Outlook

Tue 08 Sep, 2020 - 2:51 PM ET

Fitch Ratings - London - 08 Sep 2020: Fitch Ratings has downgraded Emirates REIT's Long-Term Issuer Default Rating (IDR) to 'B+' from 'BB'. The Outlook is Negative. Fitch has also downgraded the senior unsecured sukuk trust certificates, issued through Emirates REIT Sukuk Limited, to 'BB-'/RR3/57% from 'BB'. All ratings have been removed from Rating Watch Negative (RWN), where they were placed on 2 July 2020.

The rating actions reflect Emirates REIT's limited ability to reduce high cash flow leverage. The Dubai real estate market is suffering from a supply and demand imbalance and an economy weakened by the effects of the pandemic and low oil prices. Increasing Emirate REIT's occupancy to improve its cash flow in this environment will be challenging. To do so, the company will likely have to make rent concessions to re-sign, retain or attract new tenants. The office portfolio's occupancy rate remains low and only two of the company's four schools are currently generating rents.

Net debt to EBITDA (YE19) remained high at 13.8x and with Fitch forecasting in excess of 18x by YE20 based on expected cash rent receipts, FY20's net interest cover is expected to fall below 1.0x.

KEY RATING DRIVERS

Weak Real Estate Market: An oversupply of office space in Dubai has been pushing down average rental rates for several years and the effects of COVID-19 as well as low oil prices have stressed the economy and real estate market further. The economy may contract in 2020, which could force many businesses, especially SMEs, to cut costs, consolidate space, or possibly close. In addition, if many expatriate residents - representing 90% of the Dubai population - cannot find work, they may return to their home countries, further weakening the consumer base.

Rental Income Stressed: Most of Emirate REIT's office tenants remained open during the lockdown and continued to pay rent, although the retail portfolio, which generates around 10% of rental income, was largely closed. In 1H20, the company re-signed large office leases with key tenants, but the group's average rent per square metre fell about 4.2% yoy. To alleviate pressure on some tenants, the company extended some leases early, lengthening maturities, and provided rent-free concessions. Given the stress in the economy and local real estate market affecting the ability to increase rental income, reducing existing high leverage will be challenging during 2021.

Education Sector Weakness: Private education in Dubai has overcapacity and a limited ability to increase revenues since the authorities froze school fees in 2018. There are also indications that expatriates are leaving Dubai, reducing the student base. Jebel Ali School, which generates about 11% of the company's rent, ceased paying rent in 2019, but remains operational.

The company has provisioned for lost rent and begun litigation. Efforts continue to sign a tenant for the School in DIP, which is vacant following a 2018 operator payment default. The company's other schools, GEMS and Lycée Français Jean Mermoz, continue to pay their full rents.

Occupancy Remains Low: Occupancy marginally declined to 73% from 75% in 2018 at YE19, which is the lowest among rated EMEA real estate companies. The occupancy rates of a number of properties, including the company's largest assets, the 80-storey Index Tower (occupancy 50%), have been affected by external infrastructure projects or asset re-configurement. While most of these works have or will shortly be completed, the weak market and economy will complicate signing new tenants and will likely require rent concessions, further weakening cash flows.

High Leverage Forecast to Persist: EBITDA grew only 2.5% in 2019, weakened by nearly USD7 million of expected tenant-related credit losses. This increased net debt/EBITDA to 13.8x in 2019 (2018: 13.1x). In the current stressed environment, Fitch forecasts leverage to exceed 18.0x by YE20, well outside Fitch's previous negative rating sensitivity of 12.0x. Materially reducing this high leverage will be arduous, given the economic and market uncertainties.

YE19 interest coverage also is tight at 1.2x. We forecast it will fall below 1.0x by YE20, before increasing above 1.2x in 2021. Emirates REIT has taken measures to preserve cash flows, such as suspending 2020's cash dividends and committed capex is only about 2% of the investment portfolio. REIT manager fees, which at 1.5% of gross asset value appear in line with peers, are based on independent third-party value of properties by CBRE and Atesco, so they remain high relative to lower cash rents received.

Looming Refinancing Risk: The company issued a five-year USD400 million sukuk in December 2017. While its repayment is still more than two years away, the weak economy and real estate market, which may persist, heighten refinancing risk. Compounding this, management is dealing with a number of issues, including potentially de-listing from Nasdaq Dubai, appointing Houlihan Lokey to advise on the strategic options for the company, an ongoing DFSA investigation and the Jebel Ali litigation.

Emirates REIT has an ESG Relevance Score of '4' for governance structure reflecting concerns on the management structure as management fees, which are based on the REIT's asset values, irrespective of lower cash rents received, which together with rent non-recoverables, create a financial burden and an EBITDA margin that is lower than peers. In addition, the company is experiencing several shareholder issues as detailed above. Our concerns about governance have a moderate influence on the company's rating.

DERIVATION SUMMARY

Emirates REIT's occupancy, size and EBITDA margins are lower than other rated EMEA peers, which are reflected in the company's non-investment grade rating. The company's high cash flow leverage of 13.8x at end-2019 is also among the highest in EMEA real estate. Turkish retail real estate company Ronesans Gayrimenkul Yatirim A.S. (RGY; B+/RWN) had net debt/EBITDA of 11.3x at end-2019, but has significant foreign currency exposure as debt is denominated in US dollars or euros, while rents are in Turkish lira, which is highly volatile.

With 11 assets all in Dubai, Emirates REIT also has geographic concentration. Arabian Centres Company (ACC; BB+/Stable), a retail real estate company based in Saudi Arabia, operates only within its home country, but with 25 assets spread across multiple cities, its geographic concentration is lower. ACC also has net debt/EBITDA of 5.0x (YE2019) and occupancy above 90%. However, ACC operates in the less mature and unpredictable Saudi retail market.

The effects of the pandemic have been more substantial on retail real estate companies such as RGY and ACC, as their shopping centres were closed during government-imposed lockdowns, during which the companies collected no rent. Nearly all of Emirates REIT's office and school tenants (apart from the School at DIP and Jebel Ali) continued to pay rent during the lockdown with only the retail tenants (about 10% of rent) temporarily stopping rental payments.

KEY ASSUMPTIONS

A lower rate of occupancy growth across portfolio compared with management's expectations.

The Jebel Ali School resuming payments in 2021.

The School at DIP starting operations in 2021 with a slow ramp up of operations.

No cash dividends distribution assumed for 2020, but partially resuming thereafter

No acquisitions within our forecast period.

RECOVERY ASSUMPTIONS

In a distressed scenario, Fitch believes Emirates REIT would likely be liquidated given that the value of the business lies in the company's investment property portfolio and would likely provide the largest return to investors.

We have excluded all secured debt, as well as any mortgaged assets.

We have applied a 45% discount to reflect a potential decline in the property values.

After deducting 10% for administrative claims, our analysis generates a recovery in the 'RR3' band for the USD400 million senior unsecured sukuk, reflecting a senior unsecured debt rating of 'BB-'. The waterfall analysis output percentage is 57%.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Total occupancy rates consistently exceeding 85%.

Net debt/EBITDA ratio consistently below 10.0x.

EBITDA interest coverage ratio above than 1.25x.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Further deterioration of occupancy rates.

An inability to reduce net debt/EBITDA.

EBITDA interest coverage ratio of less than 1.10x for a sustained period.

A lack of resolution on Jebel Ali School paying rent in 2021.

Within 24 months, lack of visibility on December 2022 refinancing risk.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

In 2018, Emirates REIT borrowed USD121.7 million to fund acquisitions through two secured Islamic bank facilities. At YE19, 10% of the debt was still undrawn. The facilities are mortgaged against USD289.3 million of investment properties, which has reduced the company's unencumbered asset ratio to 1.56x. The loans, which have a weighted average cost of 5.75%, have maturities of seven and eight years and amortise in equal instalments. The company's other debt is a USD400 million, 5.125% Sukuk maturing in 2022.

Available cash end-2019 was USD48 million, which combined with the remaining USD11 million from the Islamic credit facilities, is sufficient to cover short-term debt of USD13 million and Fitch forecast of negative free cash flow of USD18.8 million for 2020.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Emirates REIT: Management Strategy: 4, Group Structure: 3 Governance Structure: 3, Financial Transparency: 4

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING	RECOVERY	PRIOR

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Emirates REIT	LT IDR	B+ Rating Outlook Negative	Downgrade		BB Rating Watch Negative
Emirates REIT Sukuk					
• senior unsecured	LT	BB- Rating Watch Negative	Downgrade	RR3	BB Rating Watch Negative

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APPLICABLE CRITERIA

Sukuk Rating Criteria (pub. 22 Jul 2019)

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Country-Specific Treatment of Recovery Ratings Rating Criteria (pub. 27 Feb 2020)

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub. 26 Jun 2020)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Emirates REIT	EU Issued
Emirates REIT Sukuk	EU Issued

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Corporate Finance: Leveraged Finance Middle East Asia-Pacific United Arab Emirates