S&P Global
Ratings

Industry Top Trends 2020

Real Estate

Credit quality remains resilient despite risk of an economic slowdown

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What's changed?

Low interest rates driving lower borrowing costs. A low interest rate environment will help support asset values in most property types into a slower growth period in 2020.

Signs of asset valuation pressure growing. There is growing pressure on retail assets, particularly lower quality shopping centers in the U.S., Asia-Pacific (APAC) and Europe as competitive pressure from e-commerce continues to hurt traditional retailers. We expect store footprint rationalization to remain a theme.

Political risks increasing in key property markets. Increasing political risk from Brexit, policy uncertainty in Latin America, growing sentiment for rent regulation in Germany, and social unrest in Hong Kong is clouding the prospects for landlords.

What to look for in the sector in 2020?

Growing negative ratings bias with more negative actions than positive. Negative rating actions have outpaced positive ones, mainly in the retail real estate sector.

Increased debt issuance and higher M&A activity. We expect access to debt capital to remain generally favorable as interest costs remain low. A recovery in share prices and low cost of debt could drive greater M&A activity in 2020.

Impact from global economic slowdown. While we expect the real estate sector to remain fairly resilient if there's a slowdown in 2020, weaker-positioned assets in the retail or office sector could underperform if tenant risk rises.

What are the key medium-term credit drivers?

Growth strategy and appetite for M&A. As organic growth remains low, real estate companies are looking to enhance growth via M&A or development.

Shifts in financial policy to increase debt leverage. Greater focus on share repurchases could also pressure ratings in 2020, particularly in cases where stock prices trade well below net asset value.

Disruption in the retail sector impacts operating performance. We continue to monitor the retail sector given our ongoing expectation of pressure in occupancy and rent growth in 2020.

Ratings trends and outlook

Global Real Estate

Chart 1

Ratings distribution

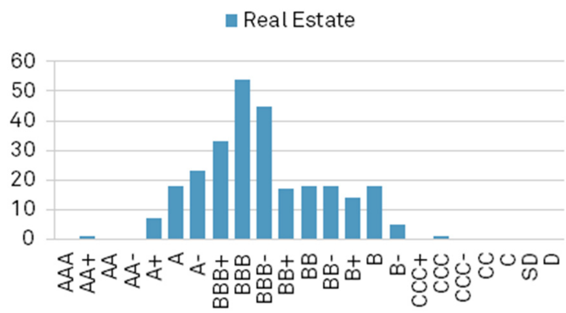


Chart 2

Ratings distribution by region

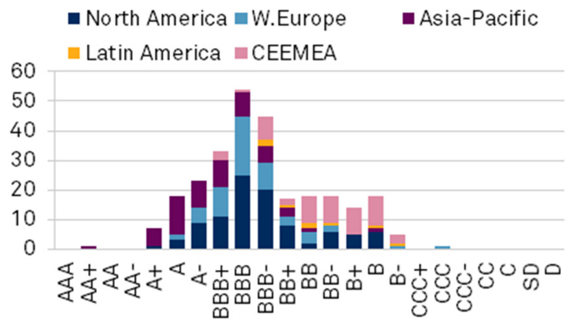


Chart 3

Ratings outlooks

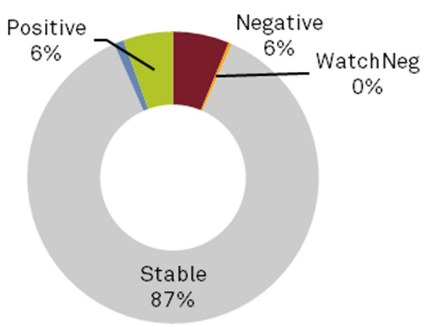


Chart 4

Ratings outlooks by region

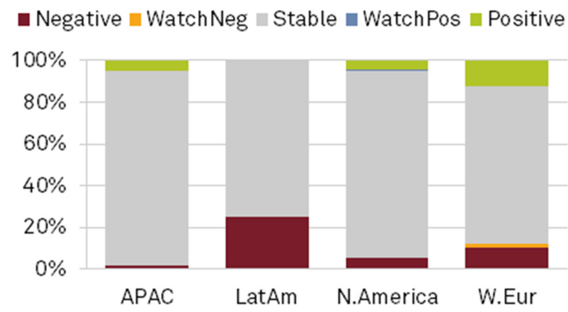


Chart 5

Ratings outlook net bias

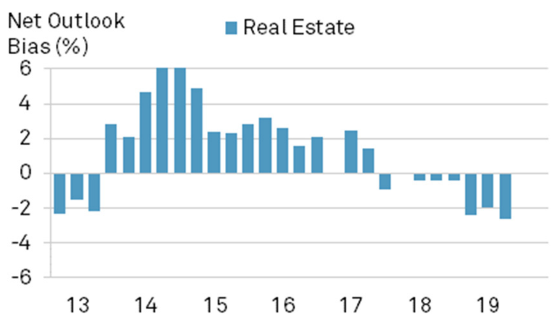
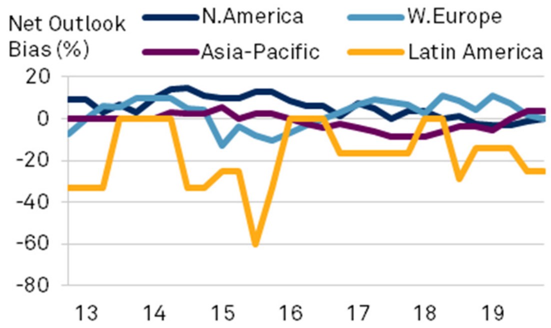


Chart 6

Ratings net outlook bias by region



Source: S&P Global Ratings. Ratings data measured at quarter end. Data for Q4 2019 is end October, 2019

On a global basis, we expect growing negative bias as the number of negative rating actions have outpaced positive ones. While 87% of ratings were stable, ratings with negative outlooks grew to 6% as of Oct. 30, 2019, from 5% a year ago, while the number of ratings with positive outlooks declined to 6% from 7% for the same time period. Credit quality in the sector has peaked in 2019 as we enter the late stages of the cycle and a global economic slowdown. In 2020 we expect negative rating actions to outpace positive ones with more downside risks in the retail, healthcare and office sectors as we think these sectors are likely to be more cyclical than multifamily assets or the industrial sector (which is currently enjoying tailwinds from e-commerce growth) when the next downturn occurs.

In the U.S., 6% of outlooks are positive and 7% are negative, largely reflecting increasingly negative rating trends in the retail sector. APAC is the most stable as more than 90% of ratings have a stable outlook. This reflects the higher portion of ratings in the 'A' category. Rating trends have been slightly more favorable in EMEA compared with the U.S. and APAC, with a somewhat higher portion of positive outlooks. This is the result of companies growing their portfolios through acquisitions and operating with leaner balance sheets. The majority of real estate ratings in Latin America remain speculative grade due to potential volatility in results, and in some cases exposure to sovereign risks. We expect ratings to remain largely stable in 2020 due to an expected recovery in Brazil's economy and steady performance of asset portfolios in Mexico. In Mexico, few ratings are investment grade with stable outlooks.

U.S REITs

Key assumptions

1. Operating performance to remain resilient as economic growth slows

S&P Global economists have raised the odds of a recession in the U.S. to 30-35% in the next 12 months because of the ongoing trade dispute with China. While occupancy and rental growth could face some pressure, we expect U.S. real estate investment trusts (REITs) to achieve relatively stable cash flow given a strong labor and consumer markets, while supply remains constrained.

2. Lower interest rates provide favorable access to capital

The reversal of interest rate trends from rising in 2018 to falling in 2019 contributed to the recovery of equity prices and improved access to debt markets.

3. Capital allocations could shift towards more M&A

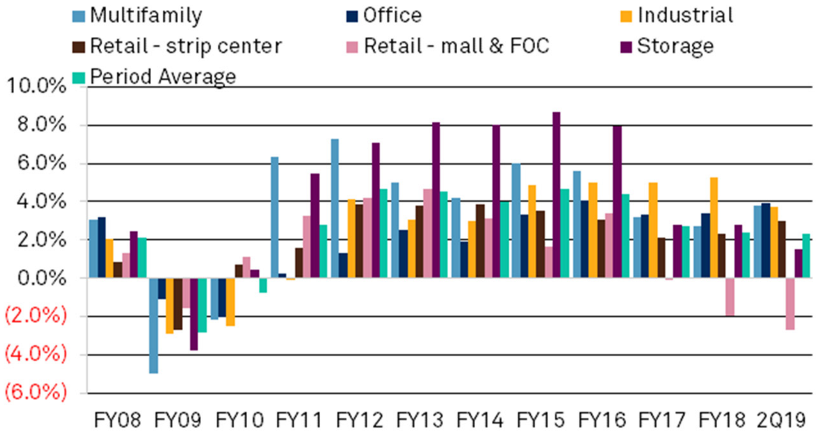
REITs could pursue more M&A in 2020 as the development pipeline slows as we enter an economic slowdown. Share repurchase activities remain modest in most REIT sectors given the recovery of share prices.

Credit quality remains resilient in an economic slowdown

While a recession could put some pressure on occupancy and rent growth, the U.S. labor market remains robust, with solid job gains and wage increases. We expect a solid job market and consumer spending to drive demand for real estate while new supply remains largely constrained. U.S. REITs have been operating at peak occupancy with good rent growth for the past two years and we expect continued deceleration in net operating income (NOI) growth of about 2% in 2020 compared to the mid-2% area in 2019. U.S. REITs have reduced debt leverage over the past few years from portfolio recycling strategies, and most issuers are operating with adequate cushion in credit metrics.

Chart 7

REIT Same-Store NOI By Sector



Source: S&P Global Ratings

A more favorable interest rate environment to fund growth

U.S. REITs' issuance of debt and equity rebounded strongly after a trough in 2018 given a lower interest rate environment. U.S. REITs raised over $55 billion in senior debt as of September 2019, more than doubling the $21.3 billion for the same period in 2018. The Federal Reserve cut interest rate for a third time in October, providing opportunity for REITs to further lower their borrowing costs. In addition, a number of highly rated REITs tapped the commercial paper market in 2019, diversifying their funding sources at an attractive cost of capital. We also expect lower interest rates to support asset values, mitigating risks from slower revenue growth. Still, asset prices could face some modest pressure following frothy levels over the past few years.

Shifting capital allocation from development and share repurchases towards acquisitions

Given the recovery of public equity prices and favorable borrowing costs, we expect an increase in M&A activity in 2020. M&A activity picked up in the latter half of 2019, with Prologis acquiring Liberty Property Trust for $12 billion and Industrial Property Trust for about $4.0 billion; Digital Realty acquiring Interxion for $8 billion, expanding their footprint in Europe; and Hospitality Property Trust acquiring a portfolio of net lease retail assets from Spirit MTA REIT for $2.4 billion.

European REITs

Key assumptions

1. Rising revenues and strong coverage metrics

Steady revenue growth in 2020, in the low-single digits, on the back of lower but positive indexation and rent contribution from investments. EBITDA interest coverage will remain strong, benefiting from the low interest rates and liability management activity in 2019. This should also ease debt-to-EBITDA ratios downward.

2. Fewer asset acquisitions, but possibly more share buybacks and M&A

We foresee lower direct property investments, as prices are getting too high. Given the equity markets, most issuers trade at a big discount to net asset value (NAV), REITs may grow through either M&A or developments. These may be more risky but more cash-flow generative. Another route can be share buybacks in the absence of investment opportunities.

3. Valuations should not rise further, despite tightening interest rates

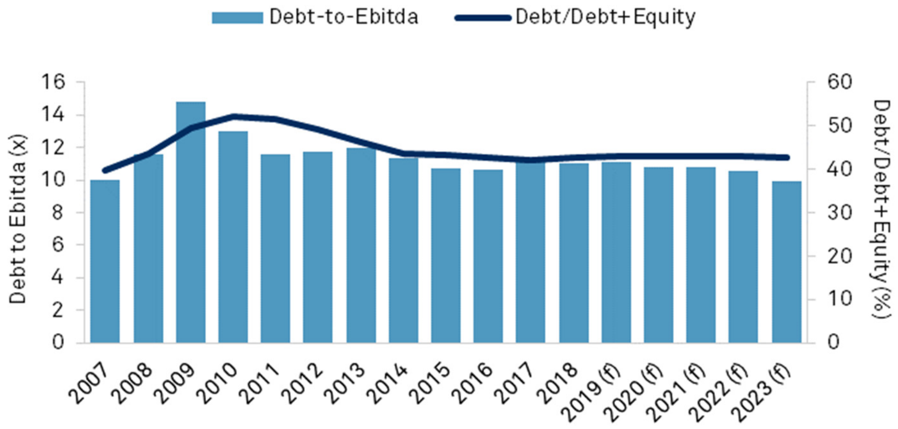
The plateauing of asset valuations should benefit companies' debt-to-debt and equity ratios, despite further decreases in interest rates. This is because most yields in Europe have reached a very low point. We even expect some further decline in the retail segment, due to the negative investor sentiment and growing capitalization rates by appraisers.

Rising revenues and strong coverage metrics

Widespread indexation of rents on various measures of inflation, although lower than previously anticipated, and resilient macroeconomic trends, such as decreasing unemployment rates and still positive GDP, indicate that like-for-like revenue growth for REITs based in continental Europe, especially those operating in the prime office segment, will increase in the low-single digits in 2020. We also foresee rising revenues from portfolios' additions, partly as a result of M&A but also through ongoing development activities (renovations, extensions, and greenfield or pre-let projects). Stronger revenues should also result in better debt-to-EBITDA ratios. At the same time, interest rates have decreased and REITs have been quite active refinancing their maturating debt at significantly lower coupons this year. We therefore expect the cost of debt should strengthen and result in stronger EBITDA interest coverage in 2020.

Chart 8

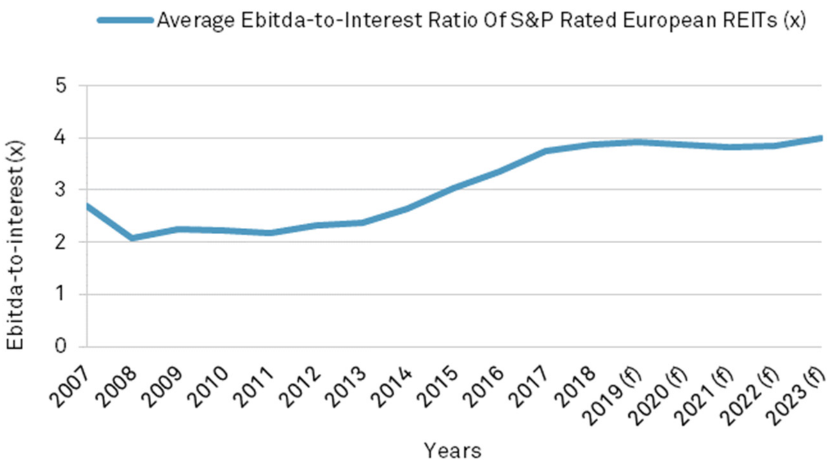
Debt-to-Ebitda Should Decrease, While Debt-To-Debt & Equity Remains Stable



Source: S&P Global Ratings

Chart 9

EBITDA Interest Coverage Is Set To Remain Strong



Source: S&P Global Ratings

Fewer asset acquisitions, but possibly more share buybacks and M&A

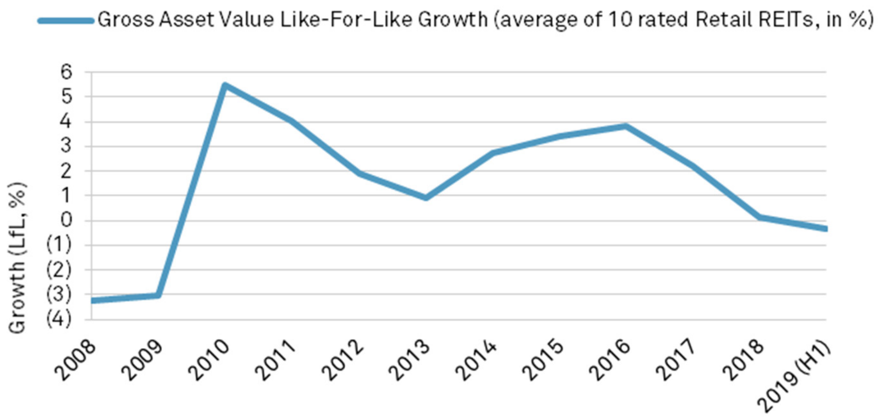
Companies have gained significant financing headroom thanks to the lower interest burden and valuation uplifts in recent years. But external growth is increasingly difficult as assets remain expensive relative to the REITs' cost of capital. Rental yields have reached very low levels across most property segments, especially in the prime office market (around 3% in Paris Central Business District, for example), and therefore acquiring standing properties could be significantly cash flow dilutive. Given the equity markets currently trade their shares at a wide discount to their NAV, REITs may find it more attractive to grow through either M&A or property developments. Although these options generate more returns they present clear operational risks. In the absence of investment opportunities, REITs may be tempted to buy back their shares, which we would view as a credit negative.

While we expect another year of low interest rates, we do not believe it will strongly benefit asset revaluations in 2020. Similar to the interest rates in Europe, the average rental yield has significantly decreased in the past few years, thus generating significant revaluation gains for REITs. Although risk-free rates have decreased more proportionally than rental yields over the same period, leaving risk premiums (rental yields minus risk free rate) significantly higher than before the 2008 crisis, we believe rental yields may have bottomed across most mature property markets. We even expect some further yield expansion in the retail segment, due to negative investor sentiment and cap rate increases by appraisers. As a result, debt-to-debt and equity ratios should not significantly improve, absent deleveraging measures.

Valuations should not rise further, despite tightening interest rate

Chart 10

Asset Valuations Are Turning Negative In The Retail Property Sector



Source: S&P Global Ratings

Asia-Pacific REITs

Key assumptions

1. Landlords will be more accommodative of tenant demands.

Weakening economic conditions will slow rental growth and tenants will be considering cost-competitive real estate options

2. Strong coverage metrics will prevail, as a result of low interest rates.

Debt usage by the sector is currently manageable and debt leverage is being kept in check due to asset prices holding up. Strong demand from institutional investors, who benefit from a low cost of capital, are bolstering asset valuations in spite of the weakening rental outlook.

3. More shares will be bought back.

Fewer asset acquisition opportunities, in combination with robust capital structures, will encourage REIT managers to undertake share buybacks to bolster equity prices.

We expect weaker economic growth compared with last year. This will likely lead to reduced rental growth and heightened vacancy levels. In addition, there could be a contagion effect in neighboring countries if China's economy slows suddenly.

Weakening economic conditions will slow rental growth and tenants will be considering cost-competitive real estate options

Australia

We are forecasting growth of 2.0% in 2019 and 2.4% in 2020. Improving financial conditions, led by monetary easing, should feed through to both firms and households. We assume the housing market bottoms and exerts less of a drag over time. Household spending should pick up, helped by solid real income growth, the benefit of low inflation and reduced mortgage payments. Improving final demand and lower interest rates should lift nonresidential investment spending. However, the risks to growth are still on the downside. Externally, a sharper than expected slowdown in China, especially in the real estate market, could hit commodity prices, especially iron ore, worsening the terms of trade and setting back the recovery in mining investment.

Hong Kong

We have cut our growth forecast to 0.2% for 2019 and about 1.6% for 2020. Political tensions have suppressed economic activity; tourism arrivals and retail sales have fallen sharply, and property prices are declining. The uncertainty is affecting business sentiment and investment plans. Economic activity will likely stabilize gradually, although the effect on business and tourist sentiment could persist.

Japan

We expect growth to be 0.9% in 2019 and then to slow to 0.2% in 2020. Buoyant consumption, both private and public, has helped offset deteriorating exports and a steady falloff in investment growth. Households are benefiting from job creation at about 1%. However, wage growth remains stubbornly low and is failing to keep up with subdued inflation, eroding purchasing power. Most engines of growth will lack power over the next 12-18 months. Most importantly, the looming consumption tax hike is set to hit household spending, albeit by less than previous occasions.

Singapore

We are lowering our growth forecast for 2019 to 1.0% and 1.6% in 2020. Weak external demand led to a sharper than expected slowdown in the second quarter. This is likely to persist through the remainder of the year, and manufacturers are pessimistic about business conditions in the year ahead. Services growth will likely moderate gradually. There have been some job losses in manufacturing and employment gains in services have slowed, but overall labor market conditions remain stable.

With this economic backdrop, we factor slowing rental growth in our APAC forecasts. The retail sector is likely to continue to be buffeted by weakening consumer sentiment. However, the magnitude of the negative rent reversions will depend on whether each landlord has exposure to discretionary or nondiscretionary retailers. Office rentals will continue to rely on employment levels and growth in the services sector. Industrial rentals will benefit from the increasingly sophisticated logistics service centers that are being built or reconfigured to facilitate the growth of e-commerce. Traditional industrial manufacturing will be impacted by local economic activity, particularly in trade-impacted economies. While residential rental will be largely stable, the hotel sector will be susceptible to volatile inbound tourist levels.

Strong coverage metrics will prevail, as a result of low interest rates.

Debt usage by the sector is currently manageable and debt leverage is being kept in check due to asset prices holding up. Strong demand from institutional investors, who benefit from a low cost of capital, are bolstering asset valuations in spite of the weakening rental outlook.

We expect a benign interest rate environment. Low borrowing rates have enabled APAC REITs to bolster their interest coverage metrics and their credit providers have remained supportive of further debt financing. However, for some real estate sectors the favorable impact of low interest rates will not be evenly felt. The cost of funding for industrial landlords, with a logistics exposure, should remain more advantageous due to the growth opportunities that are presented from the e-commerce evolution. As a result, retail landlords whose tenants have a diminishing consumer catchment won't enjoy the same low funding costs. Asset values will hold up for office and logistics but weaken for retail. However, we expect the current buffer in loan-to-value covenants within existing REIT credit agreements will provide sufficient rating headroom.

With institutional investors funding sizable asset acquisitions that benefit from a lower cost of capital than the REIT sector, investor sentiment could turn negative. The inflation driven by competitive capital is driving net asset values to a high point. However, this asset inflation is not uniformly spread and some REIT equity prices are trading at a discount to net asset values. This has prompted debt-funded share buybacks. While this shareholder-friendly development is not pervasive, it could leave rated entities with reduced headroom in their financial profiles, making them more susceptible to an economic shock or sharp negative investor sentiment.

Fewer asset acquisition opportunities, in combination with robust capital structures, will encourage REIT managers to undertake share buybacks to bolster equity prices.

Latin America Real Estate

Key assumptions

1. Mexico's real estate operating performance to remain resilient

Despite Mexico's weak economic growth prospects for the rest of 2019 and 2020 and the fact that the USMCA deal to replace NAFTA is still not finalized, we continue to expect resilient operating indicators for real estate operators. However, given the uncertain business environment, we expect prudent business strategies in the sector, including maximizing asset portfolios and lease structures with limited expansions and development projects.

2. Economic recovery in Brazil should support better business conditions

In line with our expected macroeconomic recovery, we expect Brazilian real estate companies to gradually improve their operating and financial indicators.

Operating performance to remain resilient in Mexico, but policy uncertainty and a weakening macroeconomic environment provide limited visibility for expansions and development projects

Despite Mexico's weak economic growth prospect for the rest of 2019 and 2020 (1.3% GDP growth expected for 2020) and the fact that the USMCA deal to replace NAFTA is still not finalized, we foresee broadly stable occupancy rates of slightly more than 90% on average, and rents to keep increasing in line or above inflation for stabilized properties, supporting our expectation for low- to mid-single-digit organic sales growth. Nonetheless, in light of the uncertain business environment in Mexico, we expect real estate operators to maintain prudent business strategies, including maximizing their current portfolios and lease structures, making no large bolt-on acquisitions, and recycling non-core properties to focus on cash flow retention. We also expect prudent and selective capital deployment strategies to expand existing tenants' GLA (gross leasable area) under build-to-suit contracts. No incremental debt financing is expected. Thus, we expect modestly improved leverage metrics.

In the industrial sector, we believe Mexico remains an attractive and competitive export platform for multinational companies, and demand will continue to surpass current supply dynamics. Moreover, if approved, the USMCA could support additional fixed investments in Mexico and accelerate business opportunities for Mexican real estate companies. In addition, we see some emerging and growing industries gaining traction, such as logistics and distribution driven by e-commerce, but also medical devices, and aerospace manufacturing.

In the retail segment, we anticipate prudent consumer behaviors. A recent slowdown in retail could signal that consumption may be gradually cooling down. In fact, Mexico's nominal same-store sales has been slowing down in 2019 (+3.16% in year-to-date [YTD] September 2019 versus +5.38% during the same period last year), mostly driven by durable goods, and this despite a relatively low unemployment rate and sustained growth in consumer credit. In our view, Mexico's policy uncertainty coupled with a weakening macroeconomic environment could easily extend and accelerate this gradual decline in consumption throughout 2020. Thus, under such an environment, we expect Mexican retailers' same-store sales growth to be broadly flat in 2020 versus 2019. Although we currently do not consider negative growth to be probable next year, we will continue to monitor Mexico's key macroeconomic indicators and external conditions and their effect on consumption trends. In this context, we expect Mexican retailers to adopt prudent strategies towards expansionary capital expenditures (capex), particularly in the opening of new stores.

In the office segment, absorption has been high over the past few years, particularly for first class office space. However, this trend could deteriorate due to the uncertain macroeconomic and business outlooks. Under adverse macroeconomic conditions, demand for office space could slow down, which in turn would put some pressure on rents and occupancy rates in that segment.

Our expected gradual economic recovery in Brazil should support better business conditions for real estate companies

The macro improvements that we expected to come after presidential elections in Brazil in the end of 2018 did not come as fast as we had expected. Still, we have seen improvement from an operating indicator standpoint. Consumer confidence is improving gradually, and should further accelerate thanks to historically low interest rates, which we expect to be 5% for 2020. In addition, GDP should improve to 2.0% in 2020, from 0.8% expected for 2019. Consequently, retail sales are likely to rise in 2020, which will contribute to malls' revenue growth as most rental contracts consider the higher of a fixed amount or a percentage of tenants' sales.

Brazilian retailers continue investing in opening stores to expand their footprint. We expect operators that focus on the more resilient and higher-income segment to keep their high occupancy rates thanks to their active management of tenant mix in order to adapt to shifting consumer preferences. Moreover, in order to mitigate the global industry trend of shopping mall closures, the largest mall operators have been diversifying business lines to a more service-oriented portfolio. Thus, we forecast solid cash flow generation and low leverage during 2020.

On the other hand, the office and industrial segments are still recovering from the recent economic downturn in Brazil. Companies focused on high-quality offices at premium locations are likely to recover faster than the industry average, but this is not a rule. Rated premium office operators are still recovering from significant discounts granted during the financial crisis. Additionally, occupancy levels did not recover at a reasonable rate. We believe companies that are not able to reach sustainable occupancy levels above 90% will have to maintain their discounts to attract new tenants, which would in turn impair profitability and cash flow generation.

Global Real Estate

Key risks and opportunities

1. Retail sector may see more impact from e-commerce competition

Retail properties globally are seeing rent and occupancy pressure from store closures and weak performance of retail tenants resulting from intense e-commerce competition.

2. Political risks are rising across key markets in Europe, Asia, and LatAm

Growing risks from rent control in Berlin, Brexit, tension in Hong Kong, and policy uncertainty in Latin America could hurt prospects for the real estate sector in 2020.

3. Prolonged geopolitical and trade disputes can harm investor sentiment

Uncertainties around the U.S.-China relationship, trade disputes, and geopolitical risks will likely dampen global growth, with the manufacturing sector exhibiting growing weakness.

4. Lower cost of debt could drive M&A activity or other shareholder returns

We expect real estate issuers to shift focus towards growth vs. enhancing credit quality given access to low-cost debt.

5. Growth boosted by tailwind from e-commerce supply chain expansion

We expect industrial assets to outperform other property types in 2020 as the demand for industrial assets remains robust to support retailers' expansion of their supply chain.

Retail property may see more impact from e-commerce competition and some tenants may resort to store closures to survive

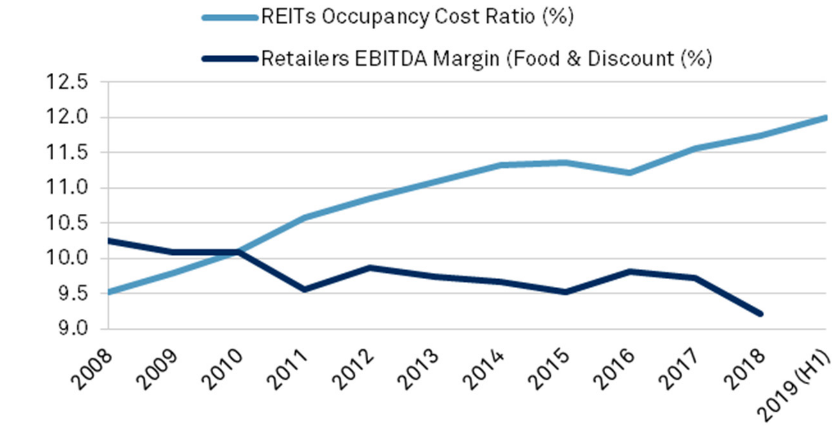
Retailers in the **U.S.** remain under distress from secular changes, including the impact of e-commerce and a shift from larger department store formats. While strip centers and high quality malls achieved relatively stable performance in 2019, lower productivity 'B' malls continue to underperform with negative same-property NOI growth and sequential occupancy declines. We recently lowered the ratings on lower productivity mall REITs CBL Associates to 'B+' and Washington Prime Group to 'BB-' reflecting our expectations for same store NOI growth to remain negative in 2020.

In **Europe**, landlords we rate have been resilient against the gradual increase in e-commerce. We see some signs of market weaknesses that could erode retail landlords' capacity either to generate organic growth or dispose of assets for deleveraging purposes.

As of mid-year, most of the 12 retail landlords we rate still reported positive rental growth on a like-for-like basis. Yet the contribution from rental renegotiations and renewals, on top of the indexation effect, was significantly weaker as of June 30, 2019, than previously. We believe companies will rely more on indexation to generate revenue growth in the coming quarters and potentially generate lower organic growth overall if premises are renewed or re-let at significantly lower rents. In our view, landlords may be affected if retailers' current credit deterioration continues in Europe, with higher bad debt and potentially a negative impact on rent and occupancy. Retailers are carrying more debt leverage (4.26x in 2018 versus 3.99.x in 2013 on average for food and discounters) and achieving thinner margins (9.21% in 2018 versus 9.74% in 2013). Over the same period, the rent burden as measured by the occupancy cost ratio has continuously increased. This will likely hinder their ability to absorb further rent increases.

Chart 10

Rents Are Increasingly Weighting On Retailers Performace

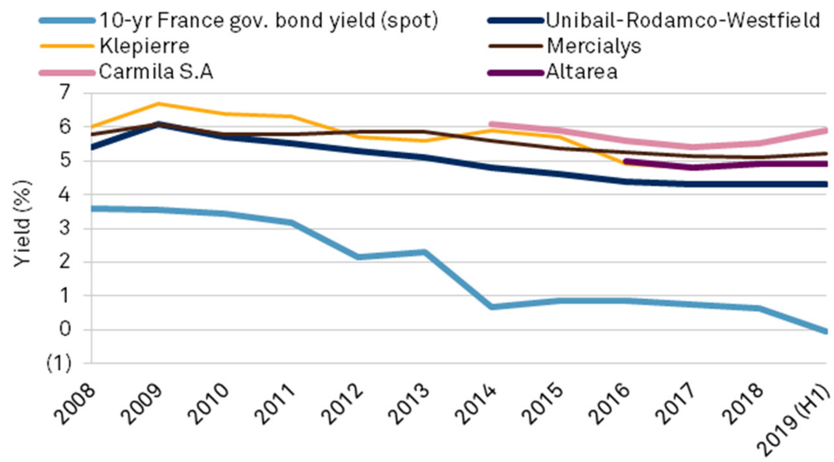


Source: S&P Global Ratings

In terms of asset valuations, the retail property companies we rate reported declines in asset valuations ranging between 0.5% and 1.5% for the last six months. Although the tightest risk premium (Unibail Rodamco Westfield; URW) culminated at 435 basis points (bps), a new all-time high, the devaluations came from an increase in capitalization rates used by independent real estate appraisers. This uplift was largely but not fully offset by rental increases. The percentage of devaluations reported as of June 2019 seem relatively homogeneous across markets, locations, and asset types. Still, the benchmark disposals reported by REITs were achieved with price premiums over book value. The premiums, however, were lower than in the past (5%-8% in 2019 versus 10%-15% in the previous years). We therefore believe retail REITs may be finding it less easy to repay their debt because it is becoming more difficult to sell non-core retail assets above book value and use the proceeds for deleveraging. Moreover, we remain concerned that further yield expansion, if not offset by capex or rental uplifts, may put debt-to-debt plus equity ratios under pressure at a time when debt-to-EBITDA ratios are generally decreasing. For the time being, however, the average cushion under loan-to-value covenants remains adequate (at 15% or more) and manageable, in our view.

Chart 11

Retail Rental Yields Start Increasing, While Interest Rates Continue To Decrease



Source: S&P Global Ratings

In **APAC**, retail landlords are finding it challenging to grow net rental income due to stressed and struggling retailers in combination with changing consumer habits. The landlord would either have to accept lower rents or incur higher vacancies. This is amid an increasing trend across APAC's developed consumer-oriented economies of store closures and retailer defaults. In Japan we expect continued weak consumer sentiment post the consumption tax hike that is likely to harm retailers. We believe weaker-quality retail offerings will be more adversely impacted. It will make it more difficult to access competitive debt financing compared to other retail peers that have demonstrated a robust resilience to changing consumer needs. Managers of retail REITS who are unable to defend their retail catchment areas will likely also pay more for debt-funded capital expenditure to improve their market position, relative to those managers who own flagship retail assets.

Political risk is rising in key property markets across Europe, Asia, and Latin America

In the **U.K.**, Brexit uncertainties continue to affect the commercial and residential real estate markets. In the event of a disruptive Brexit, we expect London office prices to fall by up to 10% over the next 24 months. We believe Brexit will give many companies, especially financial services that are already under pressure, to contain costs, more reason to consider reducing office space in London. We note, however, that supply conditions remain tight in London, with new-build supply forecasted to be limited, which should contain to some extent any potential increase in vacancy rates. As far as residential markets are concerned, we anticipate house prices to remain broadly flat in 2019 across the U.K. with some low-single digit recovery in 2020. We would expect a more significant decline, however, in the event of a disruptive Brexit. Regionalization seems to be more and more pronounced with the Midlands and North of England, as well as in Scotland and Wales, performing well, while the drop in prices is more significant in the South of England, especially in London.

In October 2019 the Berlin senate finalized its draft law for tighter rent regulation with a proposed rent freeze for five years in the **German** capital, which will likely pass the House of Representatives at the beginning of 2020. The law foresees an absolute rent ceiling, linked to the rental mirror (Mietspiegel) of 2013, and based on the construction year and residential asset type where materially higher rents could be adjusted downwards. We believe like-for-like rental income and valuation upside potential would become subdued for landlords in Berlin and, as a result, landlords would lower their investments in the assets, leading to a possible deterioration of the quality of the capital's residential stock. We believe the risk of similar laws in other large German cities is low; however, Berlin's move may encourage further rent regulation discussions.

Increased rent regulation could affect other property markets in EMEA. In **France**, for example, an amendment has been voted in October 2019, to increase by 20% the tax rate on offices located in Prime locations of Paris (such as the Central Business Districts). Although most of this charge will likely be carried by tenants, this may partly subdue interest from potential new tenants and investors and somewhat hinder landlords' capacity to increase rent and generate organic growth.

In Asia, **Hong Kong** has faced substantial social unrest. Despite the substantial disruption to Hong Kong's everyday commerce, we believe the rated real estate companies' diversified and defensive portfolios, coupled with their low leverage, are somewhat resilient. The financial stance of the Hong Kong real estate developers and property leasing and rental companies provides headroom to absorb the financial disruptions. The developers currently have an average ratio of 2.5x debt-to-EBITDA as of year-end 2018, and the landlords have an average funds from operations (FFO)-to-debt ratio of 25%--levels that leave ample headroom at current ratings. The business composition of most property leasing and rental companies is also well balanced across office, retail, hotel, and residential development, with no particular reliance on a single tenant or sector. Rated companies also have a long record of weathering price slumps thanks to their high margins and good flexibility to time and price project launches. However, the adverse impact on tourism, hospitality, and retail will have spillover to our rated portfolio. Among rated companies, IFC, Hysan Development Co. Ltd., Hongkong Land, and Swire are more impacted given their exposure to protest areas or their positioning in the higher end--and more discretionary--retail market. Link Real Estate Investment Trust, SHKP, and Nan Fung International Holdings Ltd. are less exposed given their geographic diversity and focus on mass-market retail.

In **Latin America**, we recently lowered our growth outlook for the major economies for 2019 and 2020. This is mostly due to ongoing weaknesses in domestic demand, unfavorable domestic political dynamics, and volatile external conditions. In Mexico, we expect another year of sluggish economic activity, with GDP growth of 1.3% in 2020 from 0.4% expected for 2019. This reflects falling fixed investment due to delays in public investments, but also due to the lack of private investment amid the absence of policy direction under the current administration. Moreover, external conditions remain challenging with rising trade tensions and geopolitical risks that could further undermine our 2020 growth prospects. The ratification of the USMCA is still at risk, due to political polarization and the 2020 presidential election in the U.S. A significant delay in ratifying the treaty that would replace NAFTA could generate another round of uncertainty over trade and investment relations between the U.S. and Mexico. The ratification of the USMCA has been further complicated by the recent threat by the U.S. to impose tariffs on Mexican goods. In this context, the real estate sector's short and medium-term growth prospects are unclear. However, if the USMCA agreement is approved, the Mexican real estate sector as a whole could benefit. For Mexico's industrial, retail, and office segments, the trade deal could boost investment and support stronger manufacturing and logistics activities, but also improve business confidence and reinforce consumer sentiment.

In **Brazil**, we expect real GDP growth of 2.0% in 2020, stronger than the 0.8% forecasted for 2019, but there are still concerns around the administration’s ability to pass crucial reforms to encourage greater investment in the country. If these uncertainties remain, industrial confidence could decrease in 2020, delaying the expected recovery in the office and industrial segments, because of lower occupancy rates and rent prices than we forecast.

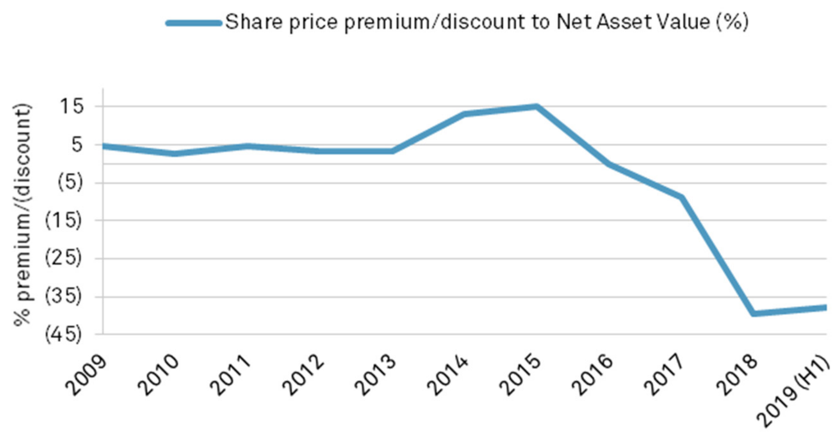
Uncertainties around the U.S.-China relationship, trade disputes, and geopolitical risks will likely dampen global growth, which will impact the APAC real estate markets. This is manifest in subdued consumer spending and a cautious corporate sector. We expect this will continue to impact real estate activity in the gateway cities where our rated portfolio have exposure--particularly in Hong Kong.

Prolonged geopolitical and trade disputes can sour investor sentiment and global growth as real estate reaches the top of the cycle globally

As we reach the top of the real estate cycle, a negative sentiment toward European real estate is prevailing in the capital markets, reflected in their share prices, which are trading below their historical level and below their respective net asset values per shares. This is particularly the case for retail REITs, for which shares prices are strongly discounted. This raises the question regarding whether real estate companies will be able to maintain long-term access to funding and support from equity investors. On the debt side, bond markets remain open and investors are still showing strong appetite. Unibail Rodamco Westfield issued in July 2019 the lowest coupon ever for a 30-year bond. Refinancing risk is currently remote and interest coverage ratios should remain strong in general, if not strengthened, by decreasing interest rates. Liquidity surpluses are still material and higher than their long-term average. But we remain cautious that funding terms may become tighter for REITs over the coming years. A widening credit spread would place pressure on REITs that are most highly exposed to floating rates or facing sizable short-term debt maturities.

Chart 12

Share Prices Of Retail REITS Are Trading At Record High Discounts To NAV



Source: S&P Global Ratings

While valuation remains fairly stable in the U.S., we're seeing limited upside on valuation given expectations for slower growth. Across property types, multifamily and industrial assets continue to see capitalization rate (cap rate) compression, while retail assets, particularly power centers, are seeing cap rates widening modestly.

Lower cost of debt could drive M&A activity or other shareholder returns

Low cost of debt means that REITs are able to debt-fund asset purchases or undertake debt-funded developments. Globally we a seeing speculative-grade issuers' debt spreads widen as the demand for safer, investment-grade debt increases. The risk aversion becomes more pronounced at the lower end of the credit spectrum. It could present opportunities to acquire assets from weaker entities who are stretched to meet debt refinancing commitments. Furthermore, the availability of debt funding for the managers of investment-grade trusts will enable them to make value-accretive acquisitions and undertake developments.

Large institutional investors with considerable funds to deploy are attracted to higher yielding and long-dated investment opportunities when compared with risk-free assets. In addition, the depreciating APAC currencies relative to the US$ have also made asset acquisitions attractive to offshore investors. The rated real estate issuers own assets that provide stable and predictable income streams which are attractive to these funds. These investors have also provided the REIT managers with the opportunity to joint venture large and lumpy asset acquisitions. In addition, they have also been the purchasers of non-core asset disposals undertaken by the managers of our rated portfolio. We are also observing new debt investors participating in debt capital market offerings for our rated portfolio.

In Europe and APAC, net asset values are reaching a high point that, in some cases, is the opposite of REITs' equity prices, which are trading largely discounted. While this may prompt trusts/companies to buy back shares to support their price, the negative market sentiment that currently prevails in the real estate market could affect REITs' ease to raise funding going forward.

In Latin America (LatAm), although financing conditions have improved following the Federal Reserve's monetary easing, we have recently seen various investment-grade real estate players refinancing through the issuance of international bonds at historically low rates. We expect future issuances will remain oriented towards refinancing instead of expansion or acquisition transactions throughout 2020. However, speculative-grade issuers might have difficulties tapping the international market, as investors are more selective and looking for LatAm issuers with more solid fundamentals amid sluggish regional economies and rising geopolitical risks. Moreover, we continue to expect most domestic central banks to maintain their reference rates and, in some cases (like Mexico), to lower them in 2020. In the case of Brazil and Mexico, we expect basic interest rates of 5.0% and 6.5%, respectively, at year-end 2020, which could also support local refinancing. Nonetheless, most of the LatAm real estate companies we rate currently have a well-laddered debt maturity profile, with limited maturities over the next two years. With the exception of only few players in the sector, most have maintained relatively low leverage, ensuring that debt service is not a cash burden during turbulent times. Moreover, most maintain strong or adequate liquidity positions with solid cash balances and undrawn committed credit lines available.

Growth remains healthy in the industrial sector given tailwind from e-commerce supply chain expansion

We expect industrial REITs will continue to outperform other subsectors, supported by strong re-leasing spreads. This is especially true for well-located properties in high-barrier-to-entry markets near major coastal ports, which demand price premiums. These locations benefit from robust demand fuelled by favorable e-commerce tailwinds and "last mile" delivery initiatives. Thus far, industrial demand has largely absorbed the new supply growth in most markets, which bodes well for the leasing up of (predominately speculative) development pipelines. However, land values are increasing and we would expect that our rated managers will continue to exercise financial discipline when bidding for new sites.

Other Regions

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In Israel, the slowdown in the commercial centers segment continues due to structural changes in the retail sector, including growth in e-commerce, overseas shopping, and changes in consumption habits. In addition, the sector continues to suffer from an oversupply of retail space. In all regions, rent growth has slowed or even reversed, and retailer turnover declined in January-March. Average rents in Tel Aviv and the Central District decreased by 1.7% (after a 0.5% decrease in 2017); in the Southern Region rents decreased by 0.7% (after a 0.5% increase in 2017); and in the Northern Districts they increased by 1.3% compared with 2.5% in the previous year. In 2019 we expect the current trends to continue, forcing property owners to lower rents, partake in tenant improvement expenses, or reduce management fees. We expect Amazon's gradual penetration into the Israeli market to exacerbate this trend, especially if it sets up logistic warehouses in Israel or nearby. In addition, anchor retailers that have so far avoided launching an online platform to avoid cannibalization are changing their approach. A notable example is Zara, which, despite its success in Israel, recently opened an online shopping site, which could reduce shopping traffic in malls. The office segment remains stable. This is particularly evident in Tel Aviv and the Central District, where, despite a large supply of new office space, rents increased by about 2% in 2018 (after a 0.6% increase in 2017). Rents in the rest of the country remain stable. We identify increased demand for cooperative workspaces, a model that seems to have become a trend, especially in light of the boom in the local high-tech industry. We also see solid demand from mature high-tech companies that rent entire floors in new buildings in the main business centers.

We expect demand for office space to remain strong and the construction momentum that characterizes a boom to continue, given the Bank of Israel's forecast of 3.9% GDP growth in 2019, the low unemployment rate, and the increase in average wages in the economy.

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In the Gulf Cooperation Council (GCC) region, geopolitical tensions have escalated and dragged on growth in addition to hydrocarbon production quotas and subdued oil and gas prices. Low confidence has moderated key growth sectors, such as real estate, and contained improvements in non-oil private sector growth. We do not expect a direct military conflict in the region; however, political volatility will remain high, which remains a risk to the region’s growth outlook. Still, we expect government incentives to prompt private sector activity will gradually strengthen domestic demand and large government projects will also add to growth; we expect GCC growth will average 2.4% over 2020 to 2022, compared to 1% over 2017 to 2019.

The general trends in rentals in GCC remain negative due to slow business activity and lower consumer spending, albeit each of the countries has a different pace of decline and unique internal pressures. In Dubai there is oversupply across all segments. While we believe Dubai Expo 2020, which could attract about 25 million visitors, will temporarily ease pressures for hotels and retail, it is unlikely to have a material long-term improvement on the real estate sector. Qatar’s real estate market is finally seeing some stabilization after many quarters of rental rate decline following its boycott by neighboring countries. In Saudi Arabia, while new supply isn’t material, downward pressures on rents can be seen as an increasing number of foreign workers leave the country due to expat and dependent taxes. The Saudi government has announced--as part of Vision 2030--a number of reforms intended to grow international tourism, develop an entertainment sector, and add more women to the workforce, which will likely help fuel real estate growth.

Sector developments

The introduction of IFRS 16 in APAC and Europe is progressively being rolled out. It requires lessees to recognise assets and liabilities for most leases. With the present value of future cash outflows by the tenant being discounted at their borrowing rate, this commitment will be recorded on the lessees' financial statements. We expect large retail tenants in APAC, which currently enter into long term leases, may reconsider the term of these leases given the IFRS balance sheet liability that may eventuate. This could introduce more volatility into a landlord's weighted average lease expiry. Whilst long-term leases are common for retail tenants in APAC, and particularly for supermarket operators, it also applies to corporates who lease industrial space on long lease terms. The sizable capital expenditure spent on fit-outs, particularly for distribution centers, and proximity to transport hubs results in agreed leases with a number of option periods. Likewise, corporate tenants whose leases allow for multiple option periods may reconsider the terms of these leases if they are required to recognise an outsized liability on their balance sheet.

Leasing enters a new accounting paradigm, which could result in shorter leases and more instability to landlords

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This report does not constitute a rating action.

Industry forecasts

Global Real Estate

Chart 14

Debt to capital (adjusted)

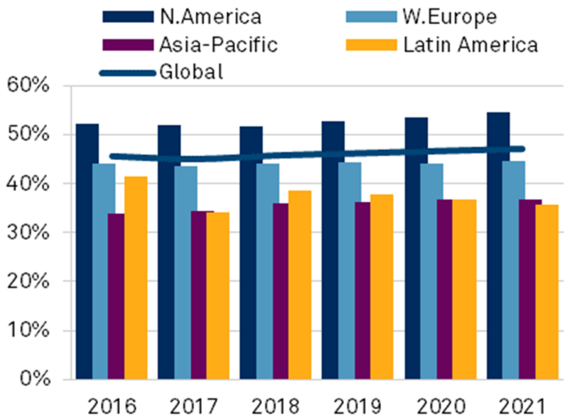


Chart 15

EBITDA interest coverage (adjusted)

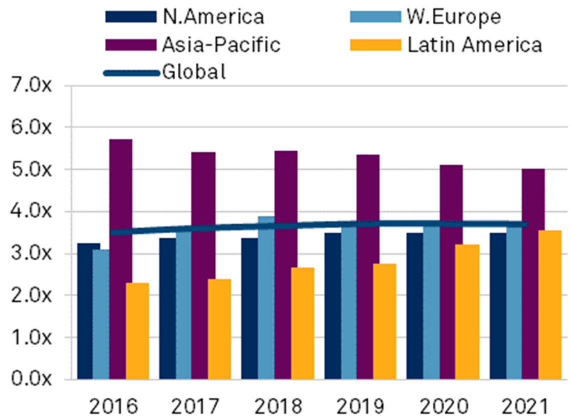


Chart 16

Debt / EBITDA (median, adjusted)

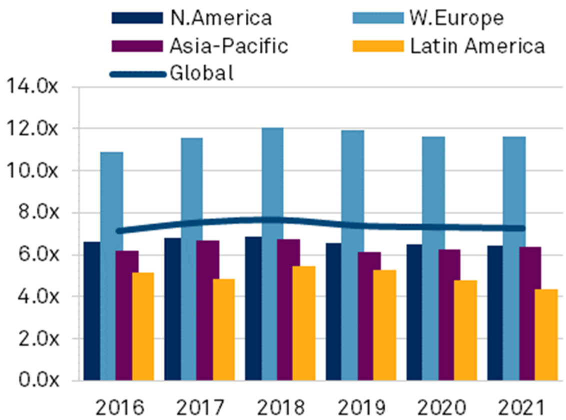
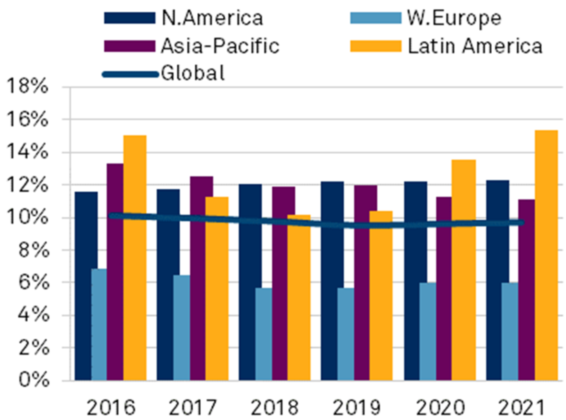


Chart 17

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are 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

Global Real Estate

Chart 18

Rental revenue growth

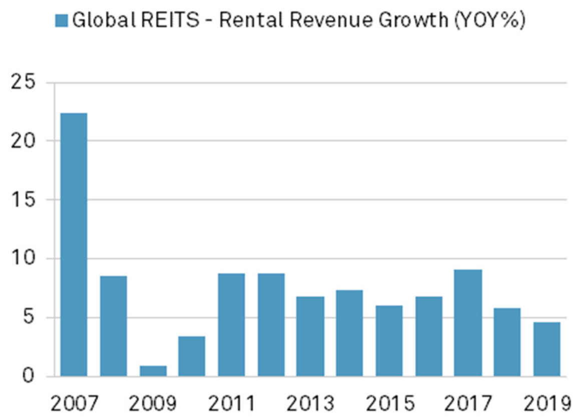


Chart 19

Return on capital employed

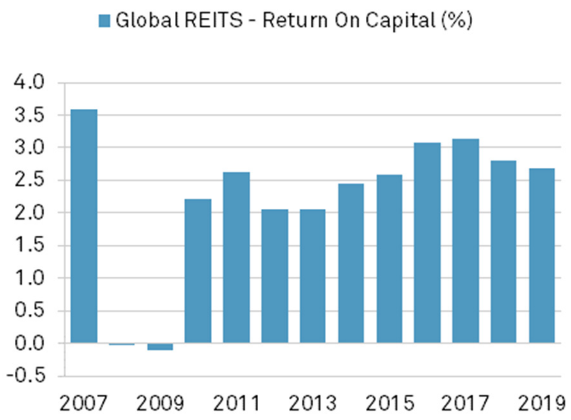


Chart 20

Fixed versus variable rate exposure

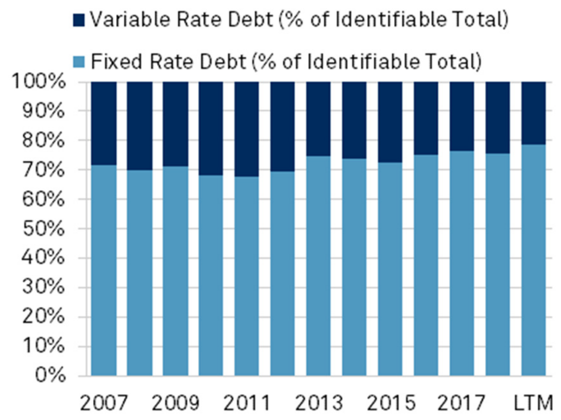


Chart 21

Long term debt term structure

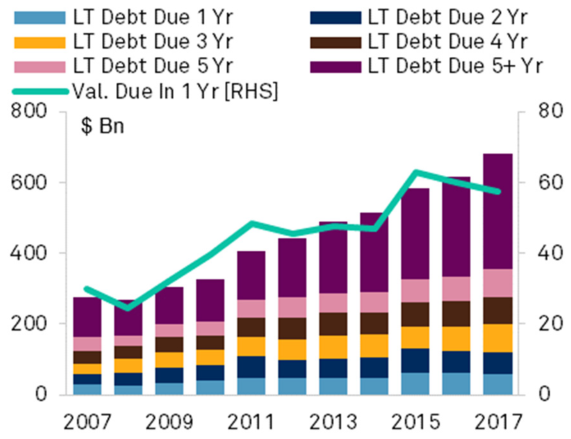


Chart 22

Cash and equivalents / Total assets

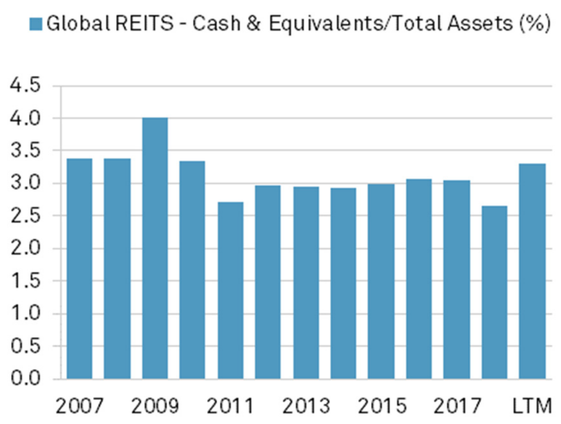
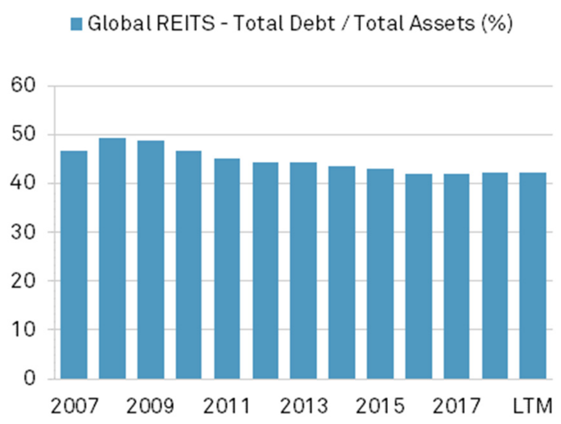


Chart 23

Total debt / Total assets



Source: S&P Global Market Intelligence, S&P Global Ratings calculations

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