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Credit Opinion: New Europe Property Investments plc

Global Credit Research - 19 Nov 2014

Isle of Man

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Ba1

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Key Indicators

[1]**New Europe Property Investments plc**

	6/30/2014(L)	12/31/2013	12/31/2012	12/31/2011
FFO Payout	15.7%	10.7%	33.0%	100.8%
Amount of Unencumbered Assets	28.3%	31.5%	4.4%	6.0%
Debt / Gross Assets	21.5%	22.9%	30.5%	38.7%
Net Debt / EBITDA	2.3x	4.4x	2.9x	4.1x
Secured Debt / Gross Assets	21.5%	22.9%	30.5%	38.7%
Gross Assets (USD Million)	$1,611.4	$1,430.1	$821.6	$550.7
Development Pipeline	22.0%	37.2%	28.7%	N/A
EBITDA Margin (YTD)	109.9%	99.8%	122.0%	101.8%
EBITDA Margin Volatility	11.4%	11.4%	N/A	N/A
EBITDA / Fixed Charges (YTD)	10.5x	4.7x	4.1x	3.3x
Joint Venture Exposure (YTD)	7.5%	10.6%	13.8%	N/A

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Small scale relative to rated peers and limited geographic diversification

- Although development pipeline is large relative to income-earning properties, most are in late stages of development

- Robust financial metrics

- Important franchise value in Romanian retail property market

- Knowledgeable and supportive shareholders

Corporate Profile

New Europe Property Investments plc ("NEPI") is an Isle of Man incorporated real estate investment company that acquires, develops and manages retail and office property investments located in Romania, with a foothold in Slovakia. NEPI is listed on the main board of the Johannesburg Stock Exchange (JSE), the Alternative Investment Market (AIM) of the London Stock Exchange and the regulated market of the Bucharest Stock Exchange; however, more than 90% of the shares are listed on the JSE. NEPI's three largest shareholders are South African property-focussed investment funds: Resilient Property Income Fund, with an 10.5% stake in the business, Fortress Income Fund with 9.6%, and Capital Property Fund (rated A3.za - stable) with 7.6%. The company had a market capitalisation of EUR1.84 billion as of 20 August 2014.

As of 30 June (H1) 2014, NEPI's balance sheet assets totalled EUR1.18 billion and reported net rental and related income for the last 12 months was EUR52.4million.

SUMMARY RATING RATIONALE

NEPI's Ba1 rating factors in the company's relatively small scale of operations compared with investment-grade rated peers in EMEA and fairly large development pipeline relative to the size of the company's income producing assets. However, the rating also takes into account NEPI's (1) important franchise value as the largest retail space owner in Romania; (2) robust financial metrics; (3) good quality, modern assets with high (>96%) occupancy rates; (4) steady cash flow from contractual rental income with no tenant base concentration risks, but with a moderate average lease length of 4.6 years and geographical concentration in Romania; and (5) knowledgeable and supportive major shareholders.

DETAILED RATING CONSIDERATIONS

ROMANIAN RETAIL PROPERTY - NATIONAL SHOPPING CENTRE PIPELINE REMAINS LOW IN 2014

In Romania, there is a growing trend towards modern retailing from traditional retailing, including market stalls and small shops, and there is little competition thus far from online shopping. The bulk of shopping centre space in Romania is located in Bucharest. Tenant demand for retail space continues to be focussed on the more populous cities in Romania, those with more than 150,000 inhabitants. NEPI reports that the catchment areas for its centres are more than double that number. The shopping centre pipeline in Romania remains low and there were only two retail centres delivered in 2014, both of which were developed by NEPI. In addition there are two major retail projects being developed for delivery beyond 2014, one of which is NEPI's (Mega Mall). However, DIY stores and hypermarkets are reported to have significant expansion plans.

GOOD QUALITY BUILDINGS, MANY IN REGIONAL LOCATIONS OUTSIDE OF BUCHAREST

NEPI's real estate portfolio contains predominantly retail properties (66%), 31% offices and 3% industrial. The portfolio comprises 52 properties as of 30 June 2014, but total balance sheet assets, at EUR1.18 billion ($1.61 billion), are relatively small in scale compared with rated peers in EMEA. NEPI's retail properties comprise a mix of shopping centres, value retail centres and strip malls in diverse locations across Romania, with one in Slovakia. All of its retail properties have land available for extension with the exception of its shopping centre in Zilina, Slovakia, where the company is negotiating the acquisition of an adjacent property. NEPI's two largest office buildings are situated in good office locations in Bucharest with two other office buildings located around the country.

NEPI's retail and office properties are young, modern facilities that range from good- to high-quality. Many of its retail properties are situated in regional locations across Romania, but the company invests only where it can achieve dominance within each of its catchment areas.

While property markets in Romania outside of Bucharest are less developed than those in Western Europe, occupier demand from well-known international retailers remains similar. These tenants prefer operating from efficient, modern accommodation that attracts shoppers; the type of property that NEPI invests in. Therefore, the company enjoys high occupancy rates, which as of 30 June 2014, was 98.6% for both its retail and office portfolios. (As of 31 December 2013 the occupancy rate for retail was 98.5% and offices 98.8%).

NEPI's property portfolio is valued on an annual basis by external, independent valuation firms and based on discounted cash flows and open market comparables, where available. In its financial accounts, NEPI reports land to be used in developments at fair value and buildings under construction at cost until the development is complete or its fair value can be reliably determined. There are few market comparables for prime retail assets in Romania. We understand that while there is investor demand, current owners are not willing to sell. We believe, however, that investor appetite for acquiring Romanian property assets, including the modern stock owned by NEPI, is likely to exhibit greater volatility over the course of an economic cycle compared to that for very large, prime shopping centres in Western Europe such as those owned by the large French and UK REITs.

COMMITTED DEVELOPMENT PIPELINE IS LARGE RELATIVE TO ITS SIZE

NEPI has a fairly large committed development pipeline (amounts spent to date plus the costs to complete committed developments) relative to the size of its income producing property portfolio. While three of its four current developments were completed in Q3 2014, we expect the company to begin new projects shortly thereafter, causing the ratio of committed developments/total assets to remain at around 15% through 2015. NEPI has a well-defined approach to development: in addition to having overcome the usual hurdles of design, planning permission, building regulations and arranging finance, each development project must also be sufficiently "anchored" with pre-lettings to appropriate tenants prior to commencing construction works. NEPI's developments are phased according to the capacity of its in-house teams that manage the process.

We expect that developments under construction as a percentage of total assets will decrease over time as the company's income producing portfolio grows. At present, however, NEPI's six Baa3-rated peers in EMEA all have substantially smaller committed development pipelines that are less than 8% of their respective balance sheets. While we believe the larger development programme increases NEPI's business risk, many of its developments are either extensions of existing successful shopping centres or are low-rise buildings on easily accessible sites. In addition, we recognise that the company's development pipeline is largely equity funded, given that its leverage is very low.

CASHFLOW IS UNDERPINNED BY HIGH OCCUPANCY RATES, TENANT QUALITY AND DIVERSITY

NEPI's cashflow is underpinned by the quality of its top tenants. The top three retail tenants are well-known retailers: Carrefour (Baa2 stable), Auchan (unrated) and Brico Depot (owned by Kingfisher plc, Baa2 stable). Together they account for 12.4% of NEPI's total rental income. The top three office tenants represent 5.9% of total rental income; they are PricewaterhouseCoopers (unrated) and Royal Bank of Scotland plc (Baa1 stable) and Huawei Technologies (unrated, the world's largest telecommunications equipment maker). Tenant concentration risk overall is modest. The top 10 tenants represent 25.7% of NEPI's total rental income and the top 20 represent 33.6%.

NEPI's weighted average lease expiry is moderate at 4.6 years. The company has a dedicated in-house leasing team that has demonstrated its ability to renew leases and re-let space. In addition, management takes care to choose creditworthy tenants, as indicated by the negligible level of rental arrears.

FINANCIAL METRICS ARE STRONG

NEPI has strong financial metrics. Leverage for the last 12 months to 30 June 2014, as measured by net debt/EBITDA, was 2.3x, indicating that the company's earnings can easily support its current level of debt. Over the same 12-month period, fixed charge coverage, as measured by EBITDA/interest expense + capitalised interest + ground rents, was high at 10.5x. In addition, "effective" leverage, as measured by adjusted debt/total assets, at 21.5% indicated generous asset cover for its debt as of 30 June 2014. The company's financial policy is to maintain its loan-to-value ratio (defined as interest-bearing debt less cash/investment property and listed property securities) at around 30% with a ceiling of 35%. We therefore expect that NEPI's financial metrics will continue at conservative levels, in line with the company's financial policies.

Liquidity Profile

CASH RESOURCES COVER CASH OUTGOINGS FOR THE NEXT 12 - 18 MONTHS

NEPI exhibits an adequate liquidity profile. Internal cash flow generation plus cash and cash equivalents are sufficient to cover its cash requirements over the next 12 - 18 months, including maintenance capex, dividends and debt repayments. In addition to cash balances, NEPI has a secured, undrawn EUR9.5 million revolving facility. External sources of funding are required for the company's development pipeline and the related funding commitment is obtained in advance of the development's commencement. In early August 2014, the company raised EUR100 million through a rights issue and EUR52.5 million of the proceeds are being used to repay bank debt.

NEPI has more flexibility over the disposition of its cash resources than some of its industry peers because it is not a real estate investment trust (REIT); cash can be used to manage leverage and capex rather than pay obligatory dividends according to REIT tax rules.

Despite most of its properties being located in Romania, NEPI's functional currency is Euros. The majority of the company's transactions, assets and liabilities are denominated in Euros and its interest rates swaps are based on Euro borrowings.

As of 31 December 2013, all of NEPI's debt was hedged; 51% by interest rate caps and 49% by interest rate swaps.

At 30 June 2014, NEPI's property portfolio was largely secured with around 35% of its assets unencumbered. Therefore, its properties provide only a very limited potential source of alternate liquidity. However, we expect this will improve as the company plans to refinance its secured borrowings with unsecured debt. The company is currently in compliance with its bank covenants.

NEPI has demonstrated good access to capital. In addition to its banking relationships, the company has raised equity totalling EUR839 million, including the latest equity raise in early August 2014 of EUR100 million. In addition, it has retained earnings of EUR74 million through the issuance of scrip dividends over the past two years, as an alternative to paying out the entire dividend in cash.

Rating Outlook

The stable outlook reflects our forecast for continued positive GDP growth in Romania, which will support retail expenditure and, by extension, tenant demand for retail property. The stable outlook also reflects our belief that NEPI will continue managing its business to maintain lease renewals and high occupancy rates, similar levels of operational profitability and will not significantly increase its exposure to development risk above current levels.

What Could Change the Rating - Up

Upside pressure on the rating could build as the company continues to expand carefully, while at the same time, decreasing the size of its committed development pipeline relative to its total assets to a range of around 10%-12%, and maintaining an adequate liquidity profile at all times. Quantitatively, given NEPI's scale of operations, we would expect adjusted debt/total assets to be maintained at around 30% and fixed charge coverage of at least 4.0x.

What Could Change the Rating - Down

Downward pressure on the rating could arise from (1) operational difficulties that negatively affect NEPI's profitability or cashflow; (2) an increase in its exposure to development risk such that the committed development pipeline relative to its investment property portfolio rose sustainably above 25%; (3) a change in NEPI's capital structure such that leverage in terms of adjusted debt/total assets trends up towards 35% or fixed charge coverage falls below 3.0x; or (4) a failure to maintain an adequate liquidity profile.

Other Considerations

GRID INDICATED RATING

The principal methodology used in rating NEPI was Moody's Global Methodology for REITs and Other Commercial Property Firms, published July 2010. The Ba1 final rating is three notches lower than the Baa1 grid outcome because more weight was placed upon the company's modest scale, the fact that its assets are primarily located in a developing property market where asset values could prove volatile given the limited number of market comparables for prime retail assets, and its exposure to increased business risk from having a large committed development pipeline relative to the size of its income-earning property portfolio.

Rating Factors

New Europe Property Investments plc

REITs and Other Commercial Property Firms Industry Grid [1][2]	**Current LTM 6/30/2014**			[3]**Moody's 12-18 Month Forward ViewAs of 10/21/2014**	

Factor 1: Liquidity and Funding (24.5%)	Measure	Score	Measure	Score
a) Liquidity Coverage	Ba	Ba	Ba	Ba
b) Debt Maturities	Baa	Baa	A	A
c) FFO Payout	15.7%	Aa	40% - 50%	Aa
d) Amount of Unencumbered Assets	28.3%	B	90% - 98%	A
Factor 2: Leverage and Capital Structure (30.5%)				
a) Debt / Gross Assets	21.5%	A	25% - 30%	A
b) Net Debt / EBITDA	2.3x	Aa	3x - 4x	A
c) Secured Debt / Gross Assets	21.5%	Ba	2% - 5%	A
d) Access to Capital	Baa	Baa	Baa	Baa
Factor 3: Market Position and Asset Quality (22%)				
a) Franchise / Brand Name	Baa	Baa	Baa	Baa
b) Gross Assets(USD Million)	$1,611.4	Ba	$1600 - $1900	Ba
c) Diversity: Location / Tenant / Industry / Economic	Ba	Ba	Ba	Ba
d) Development Pipeline	22.0%	B	15%	B
e) Asset Quality	Baa	Baa	Baa	Baa
Factor 4: Cash Flows and Earnings (23%)				
a) EBITDA Margin (YTD)	109.9%	Aa	100% - 110%	Aa
b) EBITDA Margin Volatility	11.4%	B	8% - 10%	Ba
c) EBITDA / Fixed Charges (YTD)	10.5x	Aa	4x - 5x	Aa
d) Joint Venture Exposure (YTD)	7.5%	A	5% - 10%	A
Rating:				
a) Indicated Rating from Grid		Baa1		A3
b) Actual Rating Assigned		Ba1		Ba1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 6/30/2014(L); Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

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