S&P Global
Ratings

Industry Top Trends 2022

Real Estate

REITs' Fragile Recovery Is Underway As Several Threats Hover

This report does not constitute a ratings action

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Authors

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

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

Alexandre Michel
Mexico City
+52 1 55 5081 4520
alexandre.michel
@spglobal.com

Esther Liu
Hong Kong
+ 852 2533 3556
esther.liu@spglobal.com

Sapna Jagtiani
Dubai
+ 97143727122
sapna.jagtiani
@spglobal.com

Hila Perelmuter
Tel Aviv
+ 97237539727
hila.perelmuter
@spglobal.com

What's changed?

Economic growth is driving REIT recovery, thanks to a robust GDP rebound and some government measures to limit financial distress. Improving business sentiment and lower unemployment are revitalizing the need for real estate space.

Inflation is higher, raising rent indexation and development costs. Global inflation means higher rent expectations for CPI-indexed leases. But rising construction costs and labor shortages also weigh on REIT development projects.

Secular change is fueling demand for industrial and data centers. Booming e-commerce and working from home have underpinned the need for goods and data storage space globally. Supply is also soaring, but demand continues to outpace it.

What are the key assumptions for 2022?

Retail rents should bottom out, but recovery will be fragile. Landlords should see rent reversions and vacancy stabilize as restrictions ease. But they may face disruptions again and will likely not recover their 2019 NOI level before 2023.

Working from home will harm offices. Office landlords may face higher vacancies and tougher leasing prospects as tenants revisit space needs. However, job and economic growth globally should bolster demand.

Growing costs could squeeze REITs' returns on investments. Higher building materials and labor costs, as well as U.S. property taxes, will affect yields on property developments this year.

What are the key risks around the baseline?

Further COVID-19 restrictions would delay recovery. A new round of government-imposed restrictions, such as shopping center closures, could harm rent payments.

High interest rates and lasting inflation would likely affect capitalization rates and reduce headroom under LTV covenants.

M&A and shifting financial policies could limit improvements to key ratios. M&A and aggressive acquisitions could increase, exacerbated by better capital markets access, low cost of debt, and depressed share prices for some REITs.

Ratings trends and outlook

Global Real Estate

Chart 1

Ratings distribution

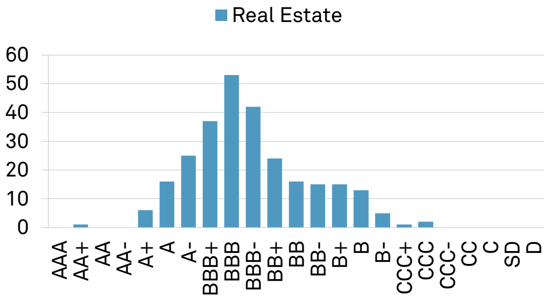


Chart 2

Ratings distribution by region

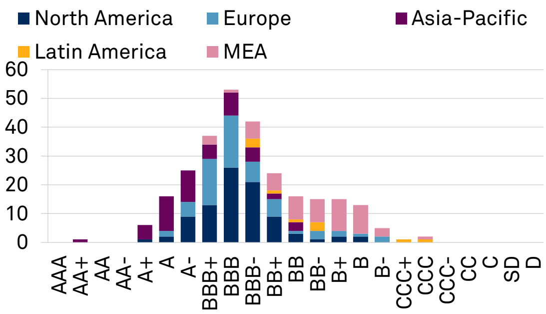


Chart 3

Ratings outlooks

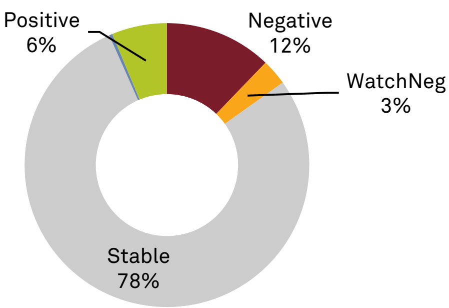


Chart 4

Ratings outlooks by region

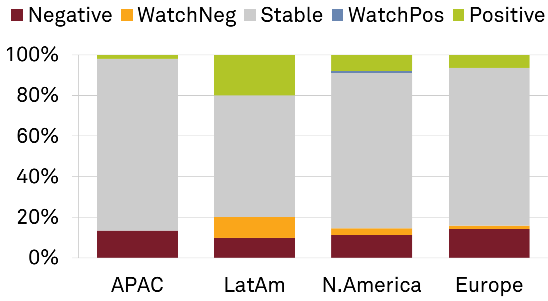


Chart 5

Ratings outlook net bias

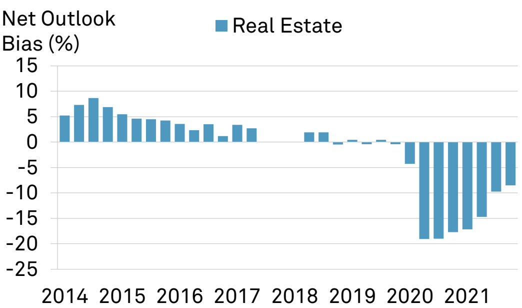
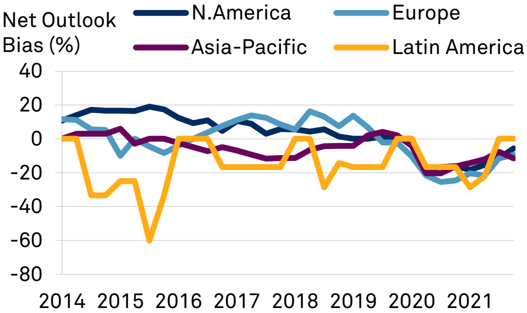


Chart 6

Ratings net outlook bias by region



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

U.S. REITs

Ratings trends and outlook

The number of negative rating actions for U.S. REITs are easing as operating performance stabilizes and credit metrics recover. The negative rating bias has eased, and about 14% of REITs currently have negative outlooks. The upgrade-to-downgrade ratio improved in 2021, with six upgrades to seven downgrades in 2021, with some upgrades due to acquisitions by higher-rated REITs. We expect recovering operating performance to support relatively stable credit quality in 2022, though a faster pace of acquisition activity or shift to more aggressive financial policies could delay the recovery and pressure some ratings.

Main assumptions about 2022 and beyond

1. Economic growth and a healthy job market will drive demand

Economic expansion, robust consumer demand, and healthy job growth should feed demand for real estate. Rent collection should stay at pre-pandemic levels, with occupancy and rental rates rising for most property types.

2. Higher costs and taxes could hinder margin recovery

Rising labor costs will hinder margin recovery, particularly for health care REITs as operators face lower occupancy and rising costs, while rising building costs could constrain yields for development projects. In other REITs sectors like multifamily, higher property taxes will mute growth somewhat, although rapidly increasing rents should more than offset this headwind.

3. Higher M&A or development activity limit recovery of credit metrics

After pausing acquisitions and development projects during the pandemic, REITs are positioned to grow in 2022 given a more stable operating landscape and good access to the capital markets.

Healthy economic growth and a robust job market in the U.S. will support demand for real estate in 2022. We forecast U.S. GDP to grow at a healthy clip of 5.5% in 2021 and 3.9% in 2022 despite supply chain disruptions. Job gains continue to be robust, reaching 199,000 in December, while the unemployment rate fell 3 basis points (bps) to 3.9%, near its pre-crisis low of 3.5%. Across the real estate sector, we expect operating metrics to continue rebounding with improving occupancy and rent growth for most property types. We expect demand for rental housing, industrial assets, storage, and data centers to remain robust. Demand for office assets remains muted and we expect occupancy and rents to be pressured.

For rental housing, we expect multifamily REITs with exposure to urban markets (such as New York and San Francisco) to improve in 2022 driven by a rebound in leasing and higher rents as renters return to cities. Multifamily REITs in the Sun Belt performed better than their urban peers, with modestly positive net operating income (NOI) growth through the pandemic. Across most markets, we expect material improvement in 2022 with low-double-digit NOI growth as housing demand remains healthy driven by limited supply and a lack of affordable housing due to a spike in home prices nationwide. Single-family rental and manufactured home REITs continue to outperform their multifamily peers given robust demand, with above-average NOI growth.

Operating performance for retail REITs largely normalized in 2021 and we expect metrics to continue improving in 2022, with NOI growth in the low- to mid-single-digits after a year of robust recovery in 2021 for most rated retail REITs. Rent collection has recovered and is at pre-pandemic levels. Retail REITs have also made significant progress collecting deferred rent granted last year, pointing to a more stable tenant base. We expect leasing spreads to remain positive for strip centers but re-leasing spreads for malls will likely be pressured. Despite continued threats from new COVID variants and the potential for retailers and restaurants to face further social-distancing restrictions, retail sales are steadily rebounding given robust consumer spending supported by solid personal balance sheets.

Office REIT performance is relatively stable, though leasing activity remains below pre-pandemic levels despite recent improvement. We expect recovery for office REITs to be slow as the pandemic will continue to weigh on vacancy and rent growth in 2022 given the slow return to offices and tenants still evaluating space needs as hybrid work becomes a new normal. Since the pandemic began, occupancy and rental rates have gradually declined due to muted demand and higher concessions to encourage leasing. Still, we expect a flight to quality as tenants become more selective, benefiting the high-quality assets REITs typically own. Life science and tech companies underpin most demand across the office space segment and some REITs such as Boston Properties and Kilroy Realty are trying to expand their life science portfolios. We'll continue to monitor leasing activity and its impact on occupancy and rents to gauge the potential fallout from remote working on the office sector.

Rising labor costs are having an outsized impact on health care REITs, particularly those focused on senior housing and skilled nursing facilities. For triple-net leased assets, this is pressuring coverage at the operator level, which may force landlords to restructure leases to keep operators solvent. For senior housing operating property (SHOP) assets, rapidly rising labor costs are directly affecting margins. As a result, we think occupancy rates will have to rise well above pre-pandemic levels (which were in the mid-80% area) to restore profit margins to pre-pandemic levels. In other REIT sub-industries like multifamily, higher property taxes (often rising in the high-single-digit percent area) will mute growth somewhat, although rapidly increasing rents should more than offset this headwind.

REITs are positioning themselves for growth again in 2022 and have resumed their external growth strategies, with more acquisitions. Improving operating fundamentals and low borrowing costs have driven more mergers and acquisitions (M&A) and this could continue for the next several quarters. Asset values remain steady, and capitalization rates have compressed further for some property types, including industrials and multifamily. Although valuation for office assets have declined modestly, we expect cap rates to remain relatively steady, particularly for well-leased and high-quality assets.

Credit metrics and financial policy

We expect credit metrics to recover to pre-pandemic levels by 2022 along with operating metrics, though the path to recovery could be bumpy given if any new COVID variants require more social-distancing restrictions. Given the slow recovery and significant development exposure in the office sector, credit metrics for office REITs will likely remain elevated.

M&A activity steadily increased in 2021 and we expect acquisitions and development to increase in 2022 given still-low borrowing costs and stabilizing operating fundamentals. Increased appetite for M&A and development could limit improvement in credit metrics or prompt negative rating actions. We placed the ratings on CyrusOne on Credit Watch with negative implications following the announced acquisition by private equity firms KKR and GIP. REITs issued a record amount of unsecured bonds in 2021 and we expect debt issuance to remain robust to fund acquisitions or extend debt maturities.

Key risks or opportunities around the baseline

1. Spike in COVID could delay recovery

Although not our base case, another round of pandemic-driven restrictions and property closures in 2022 could delay the recovery of a few asset classes, such as retail and hospitality in some markets.

2. Rising rates and persistent inflation could threaten real estate values

A tight job market and rising wages are driving inflation and we now expect three rate hikes in 2022, with the first hike expected as early as May. A spike in rates could pressure real estate values.

3. Secular changes will drive sustained demand for industrial and data centers

Secular changes such as e-commerce and remote working, which were accelerated by the pandemic, will remain strong tailwinds, bolstering operating performance by industrial and data center REITs.

The course of the pandemic is difficult to predict and new COVID variants could bring additional operating disruptions to the real estate sector, particularly property types that are more exposed such as retail, office, and lodging. While the delta and omicron variants threaten recovery, we still expect improvement in 2022 as operating performance stabilizes for most REITs we rate. Under our base case, we don't expect widespread shutdowns like in 2020 given the progress reopening the economy, vaccinations, and lessons learned while operating in pandemic conditions. In our view, any mandated closures would be more targeted to not derail recovery.

Rising inflation is a growing concern for real estate, particularly if it pushes interest rates significantly higher, pressuring property values. Tight job market conditions and rising wages are driving inflation and we now expect three rate hikes in 2022, with the first hike expected in May. However, real estate landlords such as REITs are somewhat protected from rising inflation as most leases are either triple-net or have built-in rent escalators tied to inflation indices. Assets with shorter-term leases (i.e. residential) could feel more impact if rent cannot be adjusted due to weak demand, but longer-term leases are more insulated, providing stable cash flow. As the landscape for real estate stabilizes, property values have largely recovered from a dip in valuation, though values for retail, lodging, and office remain below pre-pandemic levels. Secular changes will continue to affect retail and office assets, while lodging will take longer to recover given travel restrictions and an uncertain rebound for business travel. Across property types, we expect industrial and residential assets to outperform due to strong demand vs supply.

Industrial REITs and data centers continue to benefit the most from e-commerce and remote working, with demand surging. While supply is also rising rapidly, rated industrial REITs have outsized exposure to high-barrier markets that are better insulated from new supply. These REITs are generally reporting occupancy rates in the high-90% area, with net effective rental rate growth above 25%. While new supply curtailed operating performance at data centers in 2021, we think this sub-industry will benefit from accelerating IT infrastructure needs and connectivity from remote working.

Amid a tight job market, accelerated inflation over the past few months, and increasingly hawkish forward guidance from the Fed, we now expect three rate hikes in 2022, with the first expected at its May 3-4 Federal Open Market Committee meeting (we previously expected one rate hike in September).

European REITs

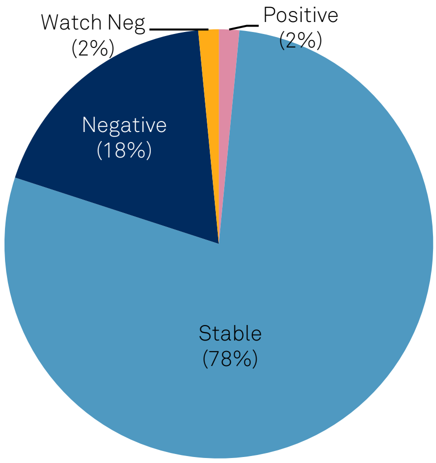
Rating trends and outlook

In 2022, European REITs' organic growth should be stronger, thanks to fewer disruptions from the pandemic and high inflation-linked rent indexations. Moreover, solid job creation in Europe, lower corporate default rates, and improving consumer confidence should support tenants' capacity to pay higher rent. Therefore, REITs' revenue and EBITDA-based ratios should reach or outperform 2019 pre-pandemic levels by year-end, on average, with the retail and hotel segments recovering later in 2023. M&A should be an important rating consideration in 2022 given several issuers are still in the takeover process and most REITs' share prices are still trading below book values.

European REIT rating trends are improving. Some 20% of our outlooks/CreditWatch placements are now negative (versus 32% last year) and 2% are positive (versus 3%) indicating moderate downgrade potential over the next 12-24 months (see chart 7).

Chart 7

Negative Ratings Outlooks And CreditWatch Decreased To 20% Of EMEA REITs



S&P Ratings Outlook distribution for EMEA REITs, as of Jan. 7, 2022. Source: S&P Global Ratings.

Main assumptions about 2022 and beyond

1. Retail REITs' revenue should grow more rapidly in 2022 (5%-15%) and 2023 (5%-10%)

Revenue should rebound this year assuming no more mandatory closures and limited tenant bankruptcies. We assume values stabilize in 2022-23 after two to three years of decline, given low interest rates and yield stabilization.

2. Office REITs' revenue should grow 0%-5% in 2022-2023, supported by job creation, higher indexation, and still-low vacancies

While tenant demand gradually recovers, we think improving corporate sentiment and the scarcity of good-quality office space should support rent stability in 2022-2023 and partly offset the need for less office space due to working from home. In addition, inflation-linked rent indexation should kick in and benefit revenues. We assume stable values in 2022-2023 assuming interest rates remain low.

3. Residential and logistic REITs should post 0%-5% rent growth in 2022-23 as tenant demand outpaces supply

Residential REITs should continue to generate solid revenue growth, thanks to low supply and high collection rates. But rising environmental standards and cost of construction should require higher capital expenditure going forward. Logistic rents should continue to expand amid booming e-commerce orders, despite higher supply.

Most European countries currently face a new wave of COVID-19 cases. This may slow the recovery in consumption, especially for consumer-facing services. However, we believe that this wave will not derail the economy, as businesses and consumers have learned to live with the virus and governments can easily extend or reactivate support measures. We currently expect the eurozone economy to expand 4.4% in 2022 and 2.4% in 2023, from 5.1% in 2021 and -6.5% in 2020. We forecast unemployment to drop to 7.5% in 2022 and 7.3% in 2023, from 7.9% in 2021 and 2020.

Retail REITs' revenue should vigorously rebound in 2022 and 2023, after a flat performance in 2021 due to lasting COVID-19-related restrictions, late collection of retailers' subsidies, and losses on deferred rents. This is because we assume that COVID-19-related closures and tenant bankruptcies will not disrupt rent collection this year. We think that vacancy and negative rent reversion probably bottomed out at the end of 2021, leaving only limited downside risk. We observed that leases remained largely fixed during the pandemic and do not expect a significant shift toward more variable leases. Still, we expect retail sales to be affected by restrictions in some countries in first-quarter 2022 (e.g., The Netherlands, Austria) that required health passes, which may somewhat constrain foot traffic. However, we expect normalization in the following quarters.

Office rental growth should increase 0%-5% in 2022-23 for prime assets, and potentially decrease in the low-single-digits in secondary locations where vacancy is more likely at lease break. We continue to think that the sector faces weaker demand due to work-from-home adoption as corporations are still revisiting their needs for office space. But European office REITs' share of revenue at risk of vacancy or negative reversion remains modest at about 10%-13% per year, and we do not expect tenants to break their contractual obligations before lease maturity. We continue to think that demand will increasingly concentrate on centrally located grade-A assets, with a higher proportion of collaborative spaces and green credentials, such as BREAAM, LEEDS, or HQE. Despite currently low yields, we assume stable asset revaluations for prime assets in 2022-2023, given continued low interest rates and disposals that still trade at or above last appraisal values.

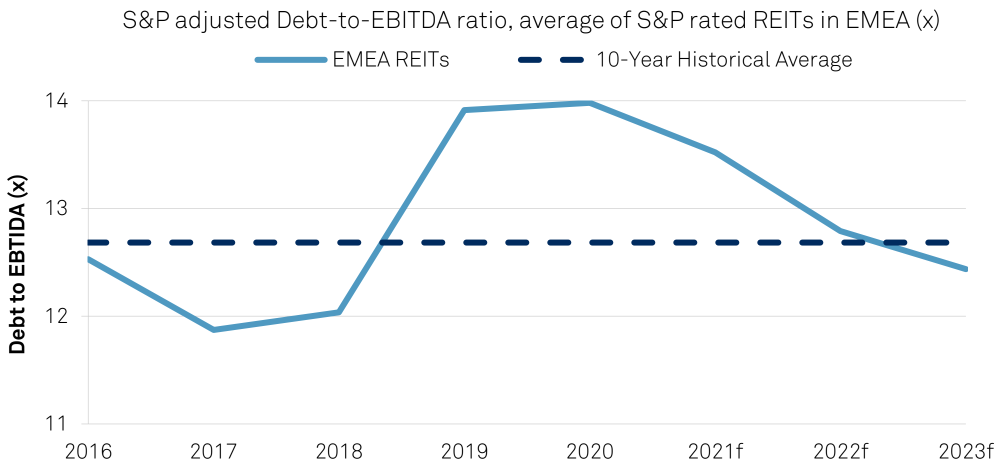
German and Nordic residential markets continue to exhibit high rent collection rates and low tenant defaults. We do not see this changing in 2022-2023, although rising environmental standards and construction costs will likely require higher capital expenditures. Low property yields could constrain direct acquisitions and favor development as the growth engine for REITs. Still, M&A remains likely, as share prices continue to trade at or below net asset values (NAV) despite positive market fundamentals. The logistics property segment has gained new supply across Europe. But demand remains stronger so net absorption is still comfortably positive. Urban localization and "last-mile delivery" type of assets should be in high demand to address the need for faster deliveries. Vacancy should remain at historically low levels in Europe, close to 4%.

Credit metrics and financial policy

Debt to EBITDA should continue to decrease and drop below the 10-year historical average by the end of 2022, mainly because of lower investment and growing revenues (see chart 8).

Chart 8

Debt-to-EBITDA Should Decrease Below Historical Average By 2022

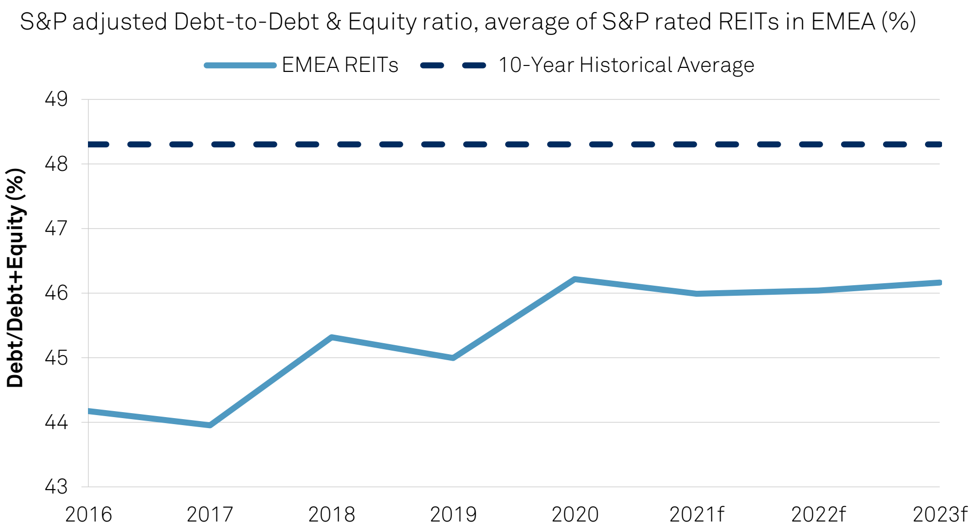


f—Forecast. EMEA REITs: average of S&P rated REITs in Europe. Source: S&P Global Ratings.

Debt to debt and equity ratios should be slightly higher than in 2019 due to neutral to negative asset revaluations (see chart 9). However, this would remain below the 10-year historical average.

Chart 9

Debt-to-Debt And Equity Should See Limited Decline Potential In 2022-2023

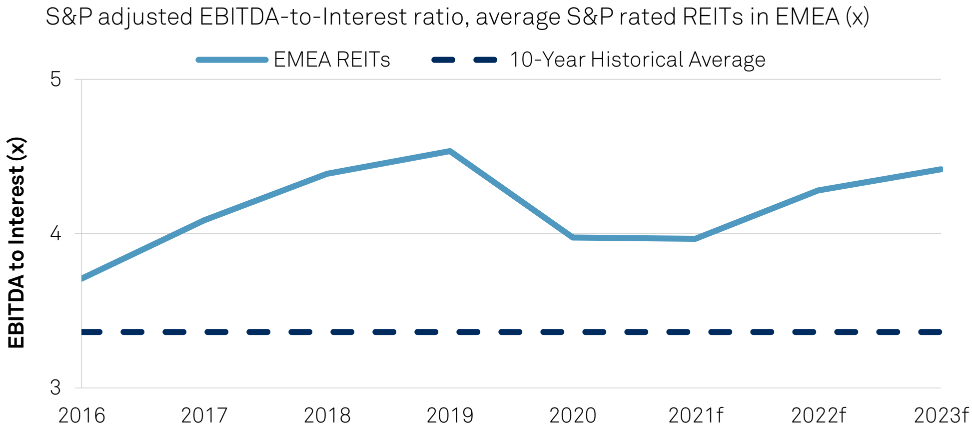


f—Forecast. EMEA REITs: average of S&P rated REITs in Europe. Source: S&P Global Ratings.

EBITDA to interest will likely remain strong in 2022-2023, recovering from a temporary drop in 2020-2021, thanks to rent growth and low interest rates (see chart 10).

Chart 10

EBITDA To Interest Will Likely Remain Strong



f—Forecast. EMEA REITs: average of S&P rated REITs in Europe. Source: S&P Global Ratings

We expect most European real estate companies to maintain prudent financial policies in 2022, especially in the retail and office property segments in which investments and sometimes dividends have been cut.

Key risks or opportunities around the baseline

1. Renewed restrictions on shopping centers and lasting work from home

A longer-term return of social-distancing measures would likely hamper tenants' capacity or willingness to pay rent and affect rent collection or occupancy.

2. Inflation pushing interest and real estate cap rates up

Higher and more prolonged inflation, combined with higher interest rates, could result in a correction to valuations. This would likely affect leverage ratios and reduce headroom under loan-to-value (LTV) covenants and debt to debt and equity ratings requirements.

3. More aggressive financial policies

With many REIT share prices trading at discounts to book value, along with still-low cost of debt, issuers could be tempted to relax their financial discipline via share buybacks, debt-funded acquisitions, or dividend increases.

The return of social-distancing measures, as result of a more aggressive COVID-19 variant for example, would likely affect sales and rent collection for retail landlords. Companies may also reassess their real estate footprints, as working from home could expand more widely than anticipated.

M&A, share buybacks, and dividend increases are likely, especially in segments with solid fundamentals, such as residential, logistics, data centers, and diversified REITs. This would likely affect leverage and reduce financial headroom.

Higher interest rates due to inflation would likely affect valuations more than we currently expect. Most of our ratings can absorb a 5% value decline annually, but over 10% would likely trigger downgrades. However, this is not our current base-case scenario. The European Central Bank and the Bank of England should start normalizing their monetary policies but not to pre-pandemic conditions.

Asia-Pacific REITs

Ratings trends and outlook

We expect retail landlords to gradually recover from the worst effects of social-distancing measures. However, if uncertainties from COVID linger, foot traffic will likely remain pressured. Over the longer term, office demand will gradually be dampened by more permanent work-from-home arrangements.

Main assumptions about 2022 and beyond

1. Lower rentals and higher vacancies in the office sector

Vacancies could rise in some major office markets across the APAC region compared to 2020 as some landlords that compete with subleasing tenants are prepared to be more flexible with both rental incentives and lease terms to secure and retain tenants. That said, it will take some time for rising vacancies in the office sector to affect credit metrics given long weighted average lease profiles and landlords' capacity to repair their balance sheets through other means.

2. Negative rental reversion pressure for retail malls will ease

We expect retail rents to recover quickly from improved cash rent collection and occupancy gains, but the acceleration in new COVID cases could lead to government-imposed lockdowns or tighter social distancing policies, threatening the recovery somewhat. Regardless, online shopping is forcing retail landlords to rethink their business strategies, tenant mix, and lease structure to stay relevant.

3. Lower asset values could hurt refinancing

Weaker rents and cash flows will further cut asset values. Retail may continue to be subdued for longer than pre-pandemic levels even though they have recovered significantly from the trough. Office properties will likely experience shifts in structural demand, although this will depend on individual cities' supply and demand dynamics, economic outlooks and working culture.

Credit metrics and financial policy

Pacific: Our rated REITs have better asset quality and solid market positions relative to the broader market. Shopping center landlords have benefitted from a faster recovery in tenant cash collection and occupancy rates as Australia recovered from the pandemic. Therefore, we are forecasting better key credit metrics. However, the lockdowns in NSW and Victoria in the latter part of calendar 2021 hurt retail sales, and this will need to be offset by consistent consumer demand and visitation levels in the first half of calendar 2022. Against the backdrop of rising vacancies in major office markets, landlords that compete with subleasing tenants are prepared to be more flexible with rental incentives and lease terms to secure and retain tenants. Employees have also adapted to working from home, with many in Melbourne and Sydney's larger central business districts not yet returning to offices. Companies are progressing return to office initiatives at different rates, noting that employees have already largely adapted to working from home during the pandemic and some prefer to continue working from home. The adverse impact of lower rental rates and higher vacancies in the office sector will take time to materialize in key credit metrics, given long weighted average lease profiles and landlords' capacity to fix their balance sheets. Industrial landlords should improve credit metrics beyond pre-COVID levels given their favorable locations that are sought after by logistics tenants. The long-term boost from online tailwinds will likely give rated industrial landlords moderate headroom in our credit metrics relative to the ratings.

Hong Kong: Rated REITs are expected to ride the economic rebound and keep their credit profiles steady, supported by their strong balance sheets and prudent financial management. Retail properties could grow the swiftest among the property types because spot rents could gradually recover when travel restriction ease. Residential prices will likely remain resilient although volume growth may slow. Office vacancy appears to be peaking, but we expect spot rents to linger at low levels due to new supply.

China: We expect credit metrics for rated REITs to improve in 2022 given mild economic growth, with domestic consumption as the key driver. We expect growth to be slower than it was in the previous cycle.

Japan: We expect credit metrics of our rated issuers to remain similar to pre-COVID levels in 2022. Occupancy and rent growth will likely remain hampered in the office sector as leasing activity remains soft due to remote working. Vacancies for some rated issuers have increased as the pandemic continues. However, credit metrics should remain resilient thanks to their large and diversified portfolios and prudent financial management. Also, office landlords will likely continue selectively investing in new properties, but fundraising will occur through both debt and equity (or funds from asset divestments) so we do not expect their balance sheets to deteriorate materially. For retail REITs, we continue to expect long-term fixed-rate leasing contracts with high-credit-profile tenants to support credit metrics even amid the changing environment.

Singapore: We anticipate that negative rental reversion for retail malls will ease over the year. This will be supported by Singapore's strategy of living with COVID-19 and limited supply of new retail space. Online shopping will force retail landlords to rethink their business strategies, tenant mix, and lease structures to stay relevant. We believe the impact on suburban malls should be milder since they're closer to residential areas and have more service-based and nondiscretionary tenants. Overall, office rental reversion will be constrained by structural changes as employers recalibrate their space needs. Furthermore, demand from growing sectors such as technology, health care, and wealth management will partially offset declining demand from financial institutions. We expect logistics and industrial landlords to continue to benefit from the effects of growing e-commerce, a trend that we view as unlikely to fade.

Key risks or opportunities around the baseline

1. Credit metrics will rebound

Credit metrics for most rated REITs should improve modestly through 2022 backed by gradual economic recovery and reduced rental subsidy compared to the past two years. However, credit metrics in 2022 are unlikely to return to pre-pandemic levels due to debt-funded acquisitions undertaken by Singapore and Hong Kong REITs over the past two years and while sales remain low.

2. Secular changes for offices will continue

We do not expect office demand to recover to pre-COVID levels before 2022. The pandemic has prompted international firms to reduce office footprint across APAC as employees adopt work-from-home measures, which will likely persist post-COVID. This is somewhat mitigated by tight office supply, particularly in Tokyo and Hong Kong.

3. Online sales become an opportunity for industrial REITs

We expect logistics services to support growing online consumption. The specter of rising speculative development creating an oversupply of good-quality industrial space will determine the pace of rental income growth for rated industrial landlords.

Pacific: The key risk to the landlords are the continued effects of COVID containment measures and their impact on consumer confidence and business expectations for earnings recovery. In the short term, less foot traffic at shopping centers could harm near-term rental collection. For nongovernment businesses, confidence that earnings will rebound and be sustained will dictate whether their tenancy requirements require more flexible leases as they reconfigure their space requirements. As a result, we expect office landlords to exhibit reduced occupancy and weaker rental growth over the medium term. Longer term, consumer preference for online shopping and the prevalence of remote working will remain a key rating focus for retail and office landlords. However, industries supporting the transition to online shopping are thriving. Industrial landlords are riding the wave of demand for logistics services to support growing online consumption. The specter of rising speculative development creating an oversupply of good-quality industrial space will determine the pace of rental income growth for rated industrial landlords.

Hong Kong: We expect that a full recovery of Hong Kong's economy to the previous peak will still take more time, despite its return to growth in the first half of 2021. Negative rental reversions for retail could persist in 2022, given that tourist spending accounted for 30%-40% of overall retail sales before the pandemic. The missing piece to a full recovery is a full relaxation of Hong Kong-China border controls and sustained containment of the pandemic--uncertain given the latest COVID outbreak in Hong Kong. Nonetheless, rental concessions should further subside as retail sales and business confidence have improved from depressed levels. Retail spot rents could begin to recover in 2023 if the border fully reopens and the pandemic remains under control. The pandemic will continue hitting the hotel segment hard as travel recovery hinges on more widespread vaccination, but we expect local demand as staycations continue to boost occupancy levels. We believe the tide has turned for Hong Kong office properties with negative rental reversion to start hitting in 2022 amid an uncertain economic outlook. However, we think this will affect key credit ratios gradually, as it will take time to filter through large and generally stable portfolios.

China: We expect rent growth of 0%-5% in 2022. Consumption rebounded in 2021after hitting a trough in 2021. However, we do not expect this trend to continue given tight liquidity could hurt consumer confidence.

Japan: Risks are slightly skewed to the downside for both office and retail landlords, in our view. For office space in Tokyo, however, a supporting factor for 2022 is limited new supply. New floor space is expected to be only about 500,000 sq. meters for the year, counting only large-scale buildings, which would be one of the smallest increases in the past 20 years. Moreover, the volume is only about 30%-50% compared to the past few years. We continue to expect ongoing structural changes in leasing markets to weigh on office landlords' rental revenues, but market conditions may slowly improve into 2022 along with the economic recovery. Our base-case scenario for vacancy rates in the Tokyo central business district office market is 7.5%-8% at year-end 2022, up slightly from 6.3% in December 2021, with rent levels down at a low- to mid-single-digit rate year over year. In the meantime, we expect rated issuers to continue performing better than the general market thanks to their higher asset quality. Retail will continue to be affected by changing consumer behavior, including working from home and increased ecommerce spending.

Singapore: Credit metrics of rated Singapore REITs are expected to improve modestly through 2022 backed by a gradual economic recovery and reduced rental subsidy compared to the past two years. However, credit metrics in 2022 are unlikely return to pre-pandemic levels due to debt-funded acquisitions that occurred over the past two years. Improvement in credit metrics for rated commercial REITs will be driven by EBITDA contributions from newly completed assets. Furthermore, a “flight to quality” sentiment will continue to benefit operating performance at rated commercial REITs as the portfolio consists of strategically located Grade A office buildings that are all green certified.

Latin America Real Estate

Ratings trends and outlook

As of January 2022, 60% of our real estate rated portfolio in Latin America has a stable outlook, while 20% has a positive outlook and the remaining 20% is negative. This indicates the possibility of positive and negative rating actions on about 40% of the portfolio over the next 12-18 months. As expected, sub-sector recovery trends have been uneven since the pandemic broke out and we still expect mixed results in 2022 and 2023 depending on property type. On one hand, industrial assets have emerged stronger than before the pandemic in 2021 due to the acceleration of e-commerce activity and need for more and improved logistics platforms across the region. We expect this positive momentum to continue for at least the next two years. In Mexico, industrial asset growth prospects and leasing activity will also continue to benefit from the solid U.S. economic recovery and nearshoring trends given global supply chain disruptions. On the other hand, we believe that retail and office properties will continue to recover more slowly, likely by the end of 2022 or beyond, with significant downside risks given the recent resurgence of COVID-19 variant cases that could trigger additional mobility restrictions and continue delaying return to office and consistent recovery in mall traffic. In addition, downside risks remain elevated in the region, particularly because we anticipate higher inflation rates and tighter financing conditions, with most countries returning to traditionally low GDP growth. On top of that, some LatAm countries will face general election cycles, while others still face uncertain policy directions that will likely keep private investments subdued.

Main assumptions about 2022 and beyond

1. Industrial assets will ride positive momentum

We think that the acceleration of e-commerce growth and global supply chain disruptions will support strong long-term growth prospects for the industrial sector in the region.

2. Retail assets face a bumpy recovery path

We foresee that nondiscretionary retail will remain stable, while discretionary retail will continue to face a bumpy recovery path. Tougher macroeconomic conditions and political uncertainties could hamper consumer spending.

3. Office assets are still suffering from remote working

The office space sector is still transitioning, with a slow and fragile recovery path, as new variants continue to delay return to office.

We expect the recovery path for LatAm's real estate sector to be mixed and segmented, not only by property type, but also geography. The industrial real estate sector has emerged faster and stronger in 2021 from the pandemic than other sub-sectors like office and retail assets, for which we expect a lengthy recovery path to pre-pandemic levels by year-end 2022 or beyond.

We think that industrial assets will continue to benefit from strong tailwinds given the acceleration of e-commerce growth and the need for larger warehouse space in LatAm. Disruptions in the global supply chain and trade tensions between the U.S. and China should also benefit the manufacturing activities in the region as manufacturers take advantage of a lower-cost and skilled labor force with increased productivity and efficiency. Given its proximity with the U.S., Mexico should further benefit from the swift U.S. economic recovery, coupled with the need of international manufacturers to reshore some operations to mitigate supply chain risks. In our view, this will continue to drive demand for premium industrial real estate assets, predominantly in northern and central Mexico. We also expect Brazilian industrial assets, a younger sector than Mexico's, will continue to post high growth, mostly concentrated in logistics, distribution, and e-commerce within the Sao Paulo metropolitan area. As a result, we still expect real estate industrial portfolios to achieve healthy occupancy and renewal rates from existing tenants. We also foresee a significant number of strategic development expansion projects to continue through 2022, as companies are expanding and increasing their footprint, predominantly on a pre-leased basis. Overall, we believe this trend bodes well for industrials portfolios long-term growth prospect in terms of rental income and NOI, as most lease agreements are adjusted at consumer price index (CPI) levels.

In many LatAm countries, same-store-sales are already above or close to pre-pandemic levels in 2021, but 2022 will remain a challenging year for real estate companies focused on retail assets. We still expect retail assets focused on nondiscretionary products to remain more stable, while we anticipate discretionary retail activities will remain exposed to relevant downside risks in 2022. In LatAm, we forecast softer economic growth, a higher inflationary environment with rising interest rates, less social aid from governments, and unemployment higher than pre-pandemic levels, although gradually recovering. We believe that those macroeconomic conditions could slow retail consumption activities in 2022 versus 2021 because they will likely weight on consumers' disposable incomes and spending. Moreover, the recent surge of new variants and COVID cases expose the sector to potential mobility restrictions. In 2022, the region will also be exposed to political uncertainties given upcoming general elections in countries like Brazil and Colombia, and the still-uncertain policy directions in other markets such as Peru and Chile following recent elections that could also harm consumption trends. We also anticipate that the adoption of e-commerce will continue to accelerate in 2022 and 2023, which will require brick-and-mortar retailers to update their strategies, resulting in a gradual and lengthy recovery in demand for shopping mall space. Thus, we expect a bumpy recovery path for retail portfolios throughout 2022.

The office space sector is still transitioning, with a slow and fragile recovery path, as new variants continue to delay the return to office. Like in other regions, the pandemic has disrupted ways of working and therefore the office market in Latin America. With the appearance of new COVID-19 variants and rising cases, some companies are still fully working from home while others have partially returned to office through flexible working schemes. We think it's highly likely that over the medium to longer term, companies in those markets will switch to new hybrid operating models (a mix of working from home and physical office presence), pressuring office landlords. In that context, we expect office space owners will need to adapt their product offerings to retain and attract new tenants. As a result, we believe the office market in key Latin American cities will continue to face downward pressure over the medium term. We foresee office utilization, space needs, occupancy rates, and rent prices will still be well below pre-pandemic levels in 2022 given the uncertainty on when the pandemic will become endemic. Therefore, we expect many companies to renegotiate their leases and, in some cases, reduce their space needs. Office spaces may need to be rethought, considering safe distance requirements, while flexible working policies will continue to expand. On the other hand, office portfolio developments have been delayed and current conditions do not provide any near-term visibility on when they could be reactivated. Thus, we anticipate developers to proceed more cautiously on greenfield projects, reducing financing needs.

Credit metrics and financial policy

Our updated base-case scenario suggests that most real estate operators should return to pre-pandemic credit metrics by the end of 2022, or even beyond in some cases. We expect retail and office assets to take longer to recover, as they are subject to several downside risks, while industrial assets have remained resilient and are poised to benefit from longer-term secular tailwinds. In most cases, we expect real estate operators to sustain their prudent financial policies, particularly toward the use of debt, dividend payouts, or share buybacks, and to focus on maintaining healthy liquidity positions. Except for a small group of issuers, LatAm real estate operators are not exposed to significant refinancing risks in 2022 although we may see some banking debt refinancing throughout the year. Specifically, we anticipate industrial asset operators will continue leveraging their prudent balance sheets to perform selective strategic land acquisitions, deploy capital, and recycle nonstrategic assets when necessary to capture demand for additional and larger spaces. On the other hand, we expect retail and office landlords to remain more cautious in terms of expansions because risks from the pandemic have not yet subsided and those asset types are more exposed to potential future COVID-19 variants and related mobility restrictions. Moreover, their occupancy rates have not yet recovered to pre-pandemic levels and space absorption in the market remains negative in several countries. Overall, for 2022, we expect LatAm rated real estate entities to maintain solid credit metrics, with debt to capital of 35%-40%, EBITDA interest coverage ratio of 2.5x-3.0x, net debt to EBITDA within of 4.5x-5.5x, and funds from operations (FFO) to debt around 14%.

Key risks or opportunities around the baseline

1. Weaker macroeconomic fundamentals and persistent political risks

Slow economic growth will weigh on the sector's growth prospects, while political uncertainty will likely keep investments subdued, except for manufacturing activities. We believe that prolonged high inflation and rising interest rates could undermine real estate companies' cash flows and credit metrics beyond our current estimate.

2. Emergence of new COVID-19 variants and cases could delay recovery

The resurgence of COVID-19 cases and emergence of new variants will continue to delay the return to office and could pose further downside risk to other property types if local governments impose new mobility restrictions. Those risks could have significant implications on our forecast, particularly for retail and office assets.

3. Expansion projects will vary depending on property type

We expect real estate companies focused on industrial assets to keep growing their portfolios prudently amid favorable supply/demand market dynamics, but office and retail space expansions will likely remain on hold until there is more visibility on the evolution of the pandemic.

Weaker macroeconomic fundamentals and persistent political risks will weigh on real estate companies' growth prospects, with the potential to undermine credit quality. First, we expect most LatAm countries to return to their traditionally low GDP growth rates in 2022 and to face the same structural economic challenges as before the pandemic. As a reference, we expect LatAm's six largest economies to only grow 2% in 2022 and 2.3% in 2023, down from 6.6% in 2021 (and a 6.8% contraction in 2020). As a result, we expect real estate companies to face slow growth (low- to mid-digit-single rate, on average), while election cycles and uncertain policy directions could subdue investments outside of the industrial sub-industry. Second, we think that the risk of prolonged high inflation has risen. Historically, real estate companies have proven their ability to pass on most rising costs because lease agreements are usually adjusted to inflation. However, we believe that in cases where rents could not be reset rapidly, this could affect profit margins and cash flows beyond our expectations. Third, financing conditions are also tightening, domestically and abroad, posing downside risks for the sector. Most, central banks in LatAm are hiking their reference rates. For instance, in Mexico and Brazil, policy rates increased to 5.5% and 9.25%, respectively, at the end of 2021, from 4.25% and 2.0% at year-end 2020, and we expect them to keep increasing toward 6% and 11.25%, respectively, by year-end 2022. Although most rated LatAm real estate companies have limited exposure to variable-rate debt, and generally have well-laddered debt maturity profiles, higher borrowing costs could pressure cash flows and undermine issuers' credit metrics beyond our current expectations. Thus, lower-rated credits will remain more vulnerable to either higher borrowing rates or losing access to credit markets under potential new waves of COVID-19 cases.

Resurgence of new COVID cases remains a downside risk for real estate operators. We think that a resurgence of COVID-19 poses a material risk, since vaccination rates remain relatively low in many LatAm countries. The emergence of new variants, including omicron, increases downside risk to our baseline growth scenario for the sector, especially if widespread mobility restrictions are implemented. This could continue to delay the return to office and put additional pressure on shopping malls (retail), specifically those exposed to discretionary retailers, and therefore delaying the sector's recovery path to pre-pandemic levels.

Expansion projects will vary depending on property types. In 2022, we anticipate that most new developments will remain related to industrial assets, specifically facilities designed for tenants in the logistics, distribution, health, and e-commerce sectors. We expect real estate companies focused on industrial assets to keep growing their portfolios prudently amid favorable supply/demand market dynamics. As seen in recent years, we project management teams will remain committed to prudent and disciplined financial policies over the next couple of years, with an opportunistic approach to potential developments, acquisitions, or asset recycling activities, without compromising their credit profiles. However, we expect expansions and investments to remain on hold for other property types such as office and retail, at least until there is more visibility on the evolution of the pandemic.

Other Regions

Gulf Cooperation Council

Sapna Jagtiani, Dubai

Retail: Foot traffic at malls has yet to recover to pre-pandemic levels, while rental rates demonstrate persistent weakness across the region. Most major cities also have substantial new supply scheduled to deliver over the next two years, which may lead to further rental rate declines. On a more positive note, retailers in prime malls are operating at a healthy sales level given some improvement in tourism, especially in Dubai during the holiday season. Mall operators' profitability, however, is unlikely to rebound to previous levels over the short term due to the competitive pressure and increasing adoption of e-commerce. We expect the cost reduction efforts completed during the pandemic will continue to support margins in the near term.

Offices: High vaccination rates in the region supported a return to the office at the end of 2021 despite new COVID-19 variants and travel restrictions. We believe that Dubai remains an attractive place for businesses, especially considering the minimal COVID-19-related disruptions and recent relaxation in rules regarding foreign ownership (which we see as a stimulus). Across the GCC region however, corporations will likely revisit their real estate needs over the coming years, since COVID-19 triggered changes in work patterns and normalized remote work. Offices in prime locations have only experienced low-single-digit rental or demand declines, unlike offices in secondary locations, which suffered worse.

Israel

Hila Perelmuter, Tel Aviv

Offices: We estimate office rents decreased about 1.9% for 2021. In 2022 we see improved business certainty, good demand for office spaces, and increased rents, mainly related to large tenants, and especially tech companies. On the other hand, for smaller spaces or tenants, we expect renewals to be shorter in length, providing tenants increased flexibility. Overall, we continue to see the office segment as stable despite remote working.

Israeli rated companies are characterized by having a diverse mix of solid credit quality tenants. They usually have full ownership of their properties and solid financial flexibility, making them relatively resilient to economic downturns. On the one hand, working from home continues to challenge landlords and change new development plans. On the other, we estimate that the booming technology sector will boost the office segment in 2022. There is a shortage of thousands of engineers in Israel, which will continue to support demand for office space even though the per capita area will be reduced due to remote working. We estimate that interest rates will remain low. Therefore, capital investments in technology companies will continue to attract investors, which will strengthen the Israeli economy in general and support the office segment.

Retail: The effects of online shopping, “shopping abroad,” and the excess supply of commercial spaces continue to challenge the retail segment. Inflationary pressures could affect the free income of Israeli consumers and retailer turnover. However, rent contracts are index-linked and provide a neutral hedging for shopping center landlords.

As worldwide travel increases to pre-pandemic levels, challenges for local retailers will increase due to “shopping abroad,” especially as the shekel remains strong. Overall, we do not think shopping centers will be redundant; they will continue to generate solid cash flows for rated companies. However, we expect to see changes in traditional models of shopping centers, for example pop-up stores, collaborations with online retailers, and more mixed-use shopping centers, for example co-working complexes.

Industry forecasts

Global Real Estate

Chart 11

Debt to capital (adjusted)

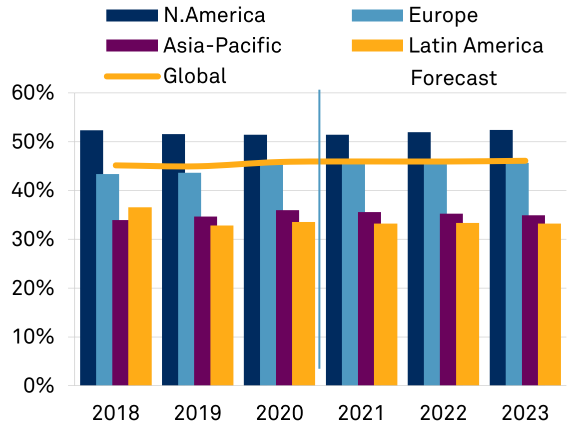


Chart 12

EBITDA interest coverage (adjusted)

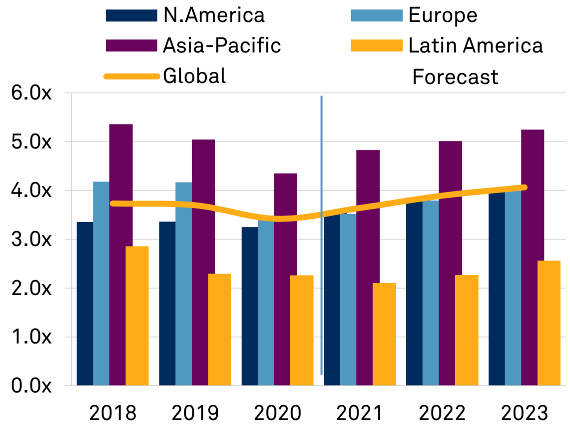


Chart 13

Debt/EBITDA (median, adjusted)

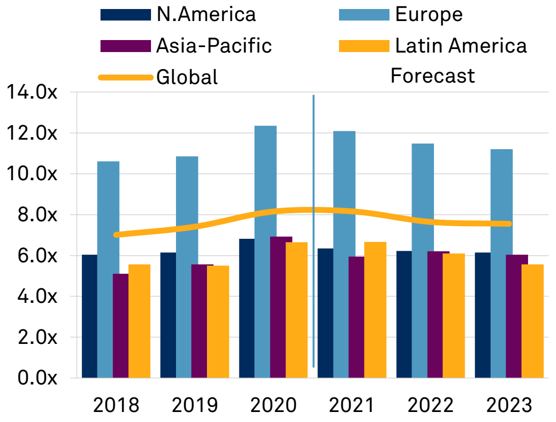
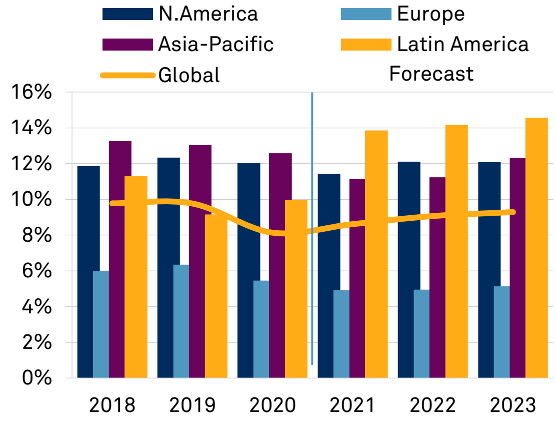


Chart 14

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 historical 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 15

Rental revenue growth

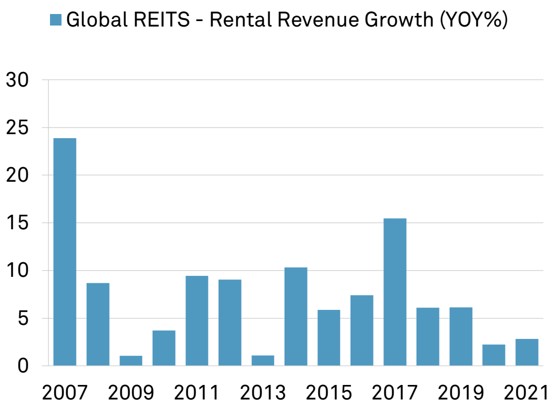


Chart 16

Return on capital employed

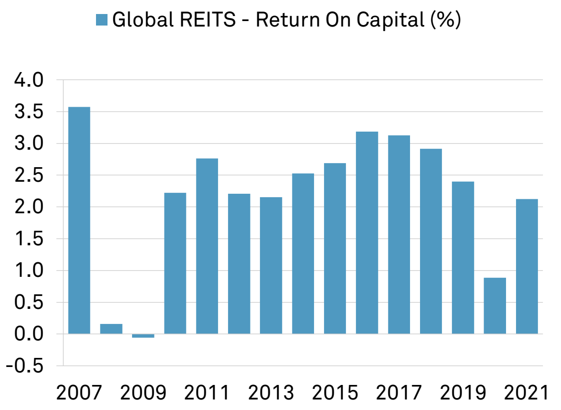


Chart 17

Fixed versus variable rate exposure

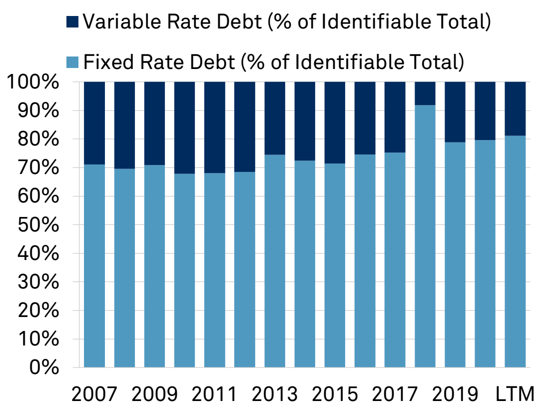


Chart 18

Long-term debt term structure

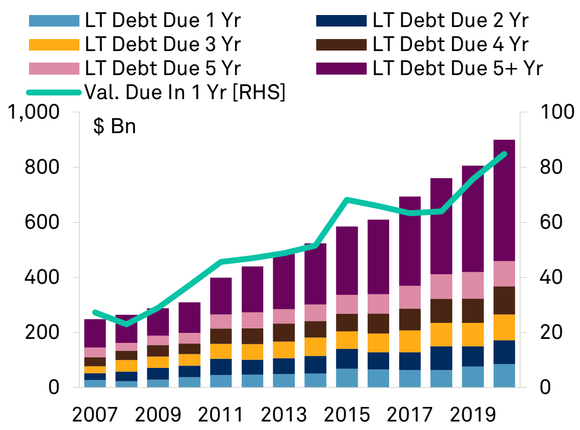


Chart 19

Cash and equivalents/total assets

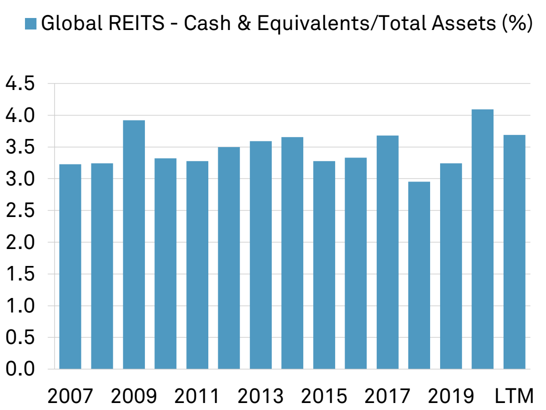
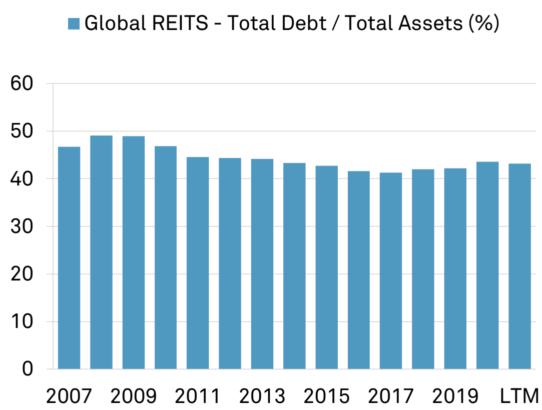


Chart 20

Total debt/total assets



Sources: S&P Global Market Intelligence, S&P Global Ratings calculations. Most recent (2021) figures are using last-12-months data.

spglobal.com/ratings