

Research Update:

# Shopping Center Owner Citycon Outlook To Negative On Rising Leverage And Tough Market Conditions; Affirmed At 'BBB-/A-3'

September 25, 2019

## Rating Action Overview

- We view the European retail property sector as slightly less resilient and liquid than before, with several rated companies' half-year 2019 results showing devaluations in portfolio value.
- Weaker consumer spending and high retail competition across the Nordics may likely continue to hamper Citycon's like-for-like net rental income growth over the next 24 months.
- Although Citycon's leverage may increase toward 55%, given its reliance on disposals in an uncertain market, we assume Citycon can stabilize its performance and contain leverage growth in line with management's intentions.
- We are revising our outlook on Citycon to negative from stable and affirming our 'BBB-/A-3' ratings on the company.
- The negative outlook indicates that we could lower the ratings over the next 12-24 months if Citycon's leverage increases further, while operating performance weakens.

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## Rating Action Rationale

The outlook revision reflects our view of increasing risks to the company's operating performance and financial risk profile, due to challenging market conditions. We believe Citycon's credit metrics may weaken toward the low end of the range commensurate with the ratings over the next 12-24 months. This is due to ongoing soft trading conditions, increasing yields in the Nordic retail sector, and uncertainties regarding planned asset disposals.

We consider that weakening consumer spending and the increasing share of e-commerce in retail sales across the Nordics may continue to affect Citycon's like-for-like net rental income growth over the next few years. In our view, the gap between different retail properties is increasing. Dominant shopping centers with large catchment areas that are close to city centers are maintain their occupancy rates and rent levels. However, smaller shopping centers outside metropolitan areas lack easy access to public transportation, and suffer from increasing vacancies, falling

retail sales, and negative rent. We understand that about one-third of Citycon's shopping centers display negative sales and visitor numbers. We also see competition is increasing in some Nordic markets (particularly in Finland) as new retail property supply enters the market.

We anticipate these factors may constrain Citycon's overall organic income growth in the next two years. However, this will likely be somewhat compensated by increasing revenue from investments in the current portfolio.

That said, we still regard Citycon's business risk profile as satisfactory and note that leasing spreads are improving, particularly in Sweden and Norway. Also, in our view, Citycon's efforts to strengthen asset management has led to a more diverse client base than several peers'. We continue to believe that Citycon's focus on redeveloping and extending its largest shopping centers (for example, Liljeholms Galleria and Kista Center) should enhance its business risk profile over the medium term. This is because well-located retail assets with high footfall generate more sustainable demand from retailers. Nevertheless, we acknowledge that these investments require higher capital expenditure (capex), which may put pressure on the company's free cash flows.

Citycon's financial risk profile may move to the weaker end of our significant category if leverage increases significantly over the next 12-24 months. At end-June 2019, our adjusted ratio of debt to debt plus equity was 51.3%, and the adjusted loan-to-value (LTV) ratio of 48.9% is higher than Citycon's publically stated target of 40%-45%. We think debt to debt plus equity may approach 54% on the back of ongoing committed capex, cash dividends, possible further negative portfolio revaluations, and uncertainty regarding the execution of asset disposals. A permanent shift to such higher leverage would signal a more aggressive financial policy.

Still, we see as positive Citycon's efforts to strengthen its balance sheet with divestment proceeds. The company intends to continue selling assets it considers noncore. Yet we remain cautious about the amount and timing of disposals because transaction volume in the Nordic retail sector has decreased significantly this year. We understand that Citycon has decided not to lower its cash dividend payments for 2019 or issue new shares, even though its current leverage ratio of 48.9% exceeds its LTV target.

Our assessment of Citycon's business profile remains unchanged, and we consider Citycon to be well funded for the next 12-24 months, with significant headroom under its debt covenants. In addition, Citycon demonstrated good access to low-cost debt capital markets, since it refinanced some of its higher-yielding bonds at midyear 2018.

In our new base-case scenario for the next two years, we forecast:

- Annual flat like-for-like rental income growth for Citycon's shopping centers. This is based on our expectation of intensifying asset-management efforts being partly offset by negative rental reversions at lease renewals.
- A stable occupancy rate of about 96%.
- Negative portfolio revaluations of -2.0% and -3.0%, pressured by weakening tenant demand and an increase of supply in the Finnish market.
- Annual capex of €70 million-€85 million, in line with the company's strategy.
- Average cost of debt of 2.4%-2.5%.

Based on these assumptions, we arrive at the following credit measures over that period:

- An adjusted debt-to-debt-plus-equity ratio of about 54%.

- Adjusted EBITDA interest coverage of 3.3x.
- Adjusted debt to EBITDA of 10x-11x.

## **Outlook**

The negative outlook indicates that we could downgrade Citycon over the next 12-24 months if leverage increases while operating performance continues to weaken.

## **Downside scenario**

We could lower the rating by one notch if the company's debt to debt plus equity rises above 55%. This could happen if asset valuations deteriorated further or the company shifts to a more aggressive financial leverage policy. We could also lower the rating if market conditions worsen and Citycon's operating performance is significantly weaker than we currently expect.

Furthermore, we could consider a downgrade if shareholder Gazit-Globe Ltd. increased its stake and voting rights in Citycon to more than 50%.

## **Upside scenario**

We would revise the outlook to stable if Citycon were able to keep its leverage ratios at around 50%, corresponding to an LTV of around 47%-48%. This could happen if the company completed some of its planned disposals or raises equity, while stabilizing its operating performance.

## **Company Description**

Citycon is the owner, developer, and manager of urban grocery-anchored shopping centers in the Nordic and Baltic region. It managed assets worth approximately €4.4 billion as of June 30, 2019. Citycon is one of the leading shopping center owners in Finland and among the market leaders in Sweden, Estonia, and Norway. Its shopping centers cater to consumers' daily needs and attract approximately 170 million visitors per year. Citycon is listed on the Nasdaq Helsinki. The majority shareholder Gazit-Globe has a 48.6% stake in the company as of June 30, 2019.

## **Liquidity**

We currently assess Citycon's liquidity as adequate. In our opinion, liquidity sources will exceed uses by more than 1.2x over the next 12 months.

Principal liquidity sources:

- Cash available as of June 30, 2019, of €4.1 million.
- Undrawn credit lines maturing beyond 12 months of €530 million.
- Funds from operations of €150 million-€160 million.

Principal liquidity uses:

- Short-term debt repayment of about €219 million.
- Commercial paper maturing in the next 12 months of €135 million.

- Committed development capex and acquisition spending of about €70 million for 2019 and €85 million in 2020-
- Dividend payment of around €115 million.

## **Covenants**

We expect covenant headroom will remain adequate, and the majority of assets to be unencumbered.

## **Issue Ratings--Subordination Risk Analysis**

### **Capital structure**

Citycon has limited secured debt, and bank debt represented 5% of total interest bearing debt as of Sept. 30, 2019.

### **Analytical conclusions**

We align our issue rating on the unsecured notes with the rating on Citycon because we continue to see limited structural subordination for the unsecured noteholders. This is mostly because the proportion of secured debt is significantly lower than 40% of total asset value, which is our threshold for notching down an issue rating under our real estate methodology. As of June 30, 2019, Citycon's secured debt represented only 2% of its total asset value.

### **Ratings Score Snapshot**

Issuer Credit Rating: BBB-/Negative/A-3

Business risk: Satisfactory

Country risk: Very low

- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)

- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

### Ratings Affirmed; Outlook Action

	To	From
<b>Citycon Oyj</b>		
Senior Unsecured	BBB-	BBB-
Issuer Credit Rating	BBB-/Negative/A-3	BBB-/Stable/A-3
<b>Citycon Treasury B.V.</b>		
Senior Unsecured	BBB-	BBB-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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