Real Estate

Tide has turned amid higher rates and weaker growth

January 23, 2023

This report does not constitute a rating action

What's changed?

The negative rating bias is growing. 18% of ratings in Europe are on negative outlook, compared to 10%-12% of ratings in the U.S., Asia-Pacific, and Latin America.

Higher cost of debt will hamper growth. Wider bond yields and tighter credit market conditions will curtail acquisition and development plans.

Growing valuation pressure could increase refinancing risk. As financing conditions worsen and earnings outlooks weaken, we expect cap rates to widen and valuations to decline.

What are the key assumptions for 2023?

Slowing revenue growth. We expect lower rent growth and occupancy due to weaker job growth and consumer spending, and office assets will face further pressure from remote working.

More cautious approach to growth. We expect a pull-back in acquisition and development as issuers reset yield expectations due to higher cost of capital.

Increased borrowing costs will pressure credit metrics. Refinancing of debt at higher rates will pressure interest coverage and debt to capital metrics.

What are the key risks around the baseline?

Persistent inflation could extend downturn. Persistently high inflation could lead to elevated rates for a longer period, further curtailing demand for real estate amid a prolonged recession.

Office demand is still evolving. We expect remote working to pressure demand on top of lower cyclical demand.

Tighter access to funding could increase refinancing risk. Property valuations could be pressured across asset classes if rates remain elevated, increasing refinancing risk.

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Ratings Trends: Real Estate

Chart 1
Ratings distribution

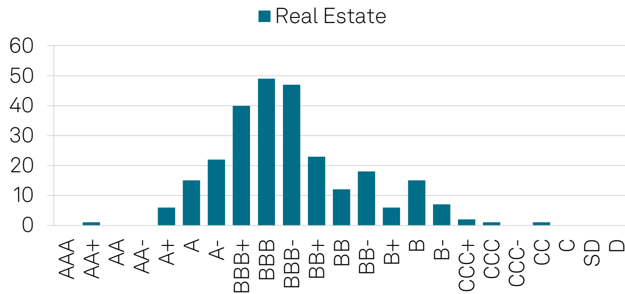


Chart 2
Ratings distribution by region

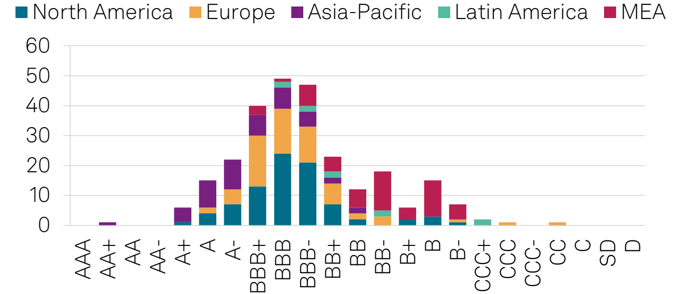


Chart 3
Ratings outlooks

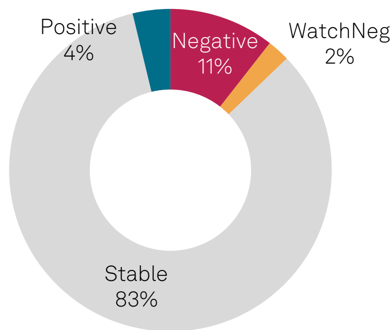


Chart 4
Ratings outlooks by region

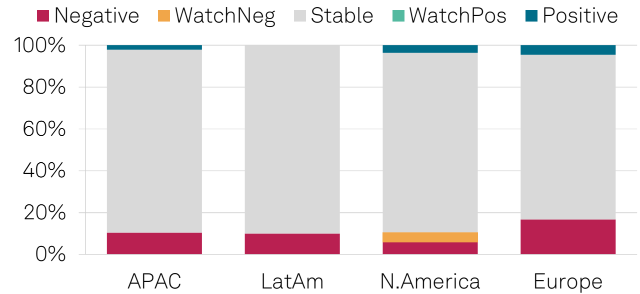


Chart 5
Ratings outlook net bias

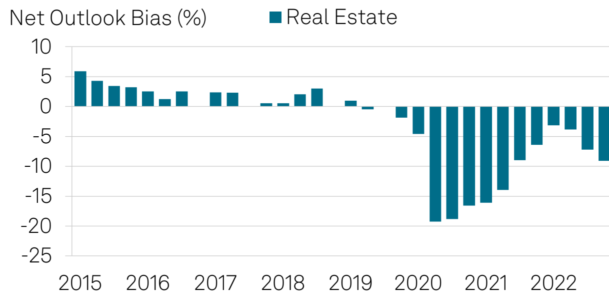
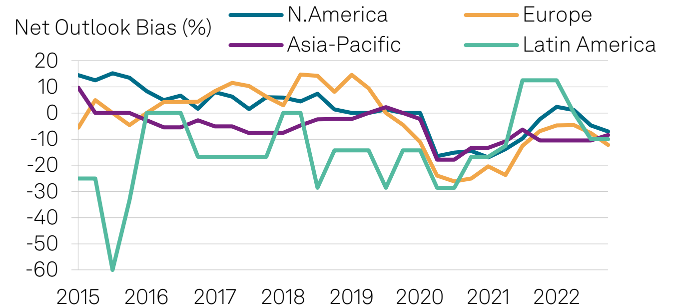


Chart 6
Ratings net outlook bias by region



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

Industry Outlook: U.S. REITs

Ratings trends and outlook

The tide has turned for the real estate sector after a prolonged period of low interest rates. The sharp increases in rates along with a looming recession in the U.S. will likely pressure the credit quality of real estate issuers in 2023. We expect conditions for North American real estate companies to become increasingly challenging over the next year, but there is potential for the landscape to improve in the second half of 2023 if the interest rate environment stabilizes and inflationary pressures continue to wane. We expect a growing negative rating bias for the sector given our expectations for slowing growth and higher funding costs. Currently about 11% of ratings have negative outlooks or are on CreditWatch with negative implications, while only 4% have positive outlooks. The downgrade to upgrade ratio worsened in recent months with 5 upgrades to 4 downgrades in 2022, and we expect the negative rating trend to continue in 2023.

We are closely monitoring office REITs and expect them to remain under pressure given their higher debt leverage relative to other REIT subsectors. In addition, we expect muted growth for this property type amid declining demand due to the shift toward remote work and a weaker job outlook. While retail REITs have achieved a solid recovery, with most operating metrics returning to pre-COVID levels, retail landlords may face increased risk as they deal with weaker consumer spending and inflationary pressures. We expect rental housing and industrial REITs to remain resilient, despite decelerating growth in rental rates, given their lower debt leverage and more-favorable growth prospects relative to other property types.

Main assumptions about 2023 and beyond

1. Revenue growth will slow due to expected recession

We expect revenue growth to decelerate in 2023 with lower rental growth and pressure on occupancy levels. We expect same-property net operating income (NOI) growth to decelerate across most property types, and believe the office subindustry will likely underperform as the shift to remote work dampens demand.

2. Higher cost of capital will limit acquisition and development activity

We expect most rated issuers to take a cautious approach to development and acquisition activity in 2023 given the higher cost of funding, with many re-underwriting projects and resetting yield expectations.

3. Higher borrowing costs will pressure credit metrics

We expect interest coverage ratios to weaken because maturing debt will need to be refinanced at much higher rates. Issuers with higher exposure to variable-rate debt or sizable debt maturities could find refinancing options somewhat limited in light of declining asset values and ongoing volatility in the capital markets.

S&P Global economists expect the U.S. economy will enter a shallow recession in the first half of 2023, leading to a mild contraction (-0.1%) in U.S. GDP for the year. We project the unemployment rate will peak at 5.6% in the fourth quarter of 2023, then slowly decline below 5.0% in 2025. We forecast interest rates remain elevated because the U.S. Federal Reserve (the Fed) will likely keep monetary policy tight until inflation begins to moderate in late 2023. We also expect the federal funds rate will peak at 5.00%-5.25% by the second quarter of 2023 before the Fed implements modest rate cuts in late 2023.

Weakening consumer spending and higher unemployment will likely pressure occupancy levels and rental rates across most property types in the next year. Still, we expect the fundamentals for rental housing and industrial assets to remain more resilient despite a moderation in revenue growth, supported by favorable demand trends. We expect the office sector to remain under pressure as the weakening job picture, as well as lower demand due to the adoption of remote working, slows leasing activity. Still, we expect that the flight to quality, because tenants prefer high-quality office space with rich amenities, will support better demand for class A assets (the asset quality typically held by rated REITs). We expect retail landlords to face increasing, yet manageable, risks given the more challenging operating environment for their retail tenants as consumer spending slows (S&P forecasts 0.80% growth in 2023 compared to 2.75% in 2022) and tenant bankruptcies increase. Logistics, labor, and supplier cost inflation continues to pressure lower-rated retailers.

Real estate is capital-intensive and the sudden sharp increase in interest rates will likely dampen external growth as the much higher cost of funding leads to the re-underwriting of development projects and a pause in activity on projects that no longer meet desired yields. We expect a general pull back in acquisition and development activity given challenging capital market conditions, at least until the interest rate environment stabilizes later in 2023. Bond yields have widened significantly, with the debt of 'BBB'-rated corporate issuers trading at over 7% in December 2022 compared to below 3% in January 2022. Capital offerings also declined significantly in 2022, with the debt issuance of public REITs down about 65% compared to 2021, while common equity issuance declined by about 50% in 2022. Accessing the equity market also remains difficult because the REIT sector (in aggregate) continues to trade at a significant discount to net asset value (NAV). Publicly listed U.S. equity REITs traded at a median of a 21% discount to their consensus S&P Capital IQ NAV per-share estimates as of Dec. 30, 2022, with the office sector trading with the widest discount to NAV at 48%, and health care REITs trading with the narrowest discount to NAV at 1.2%. Given their significantly higher cost of capital, most REITs are largely choosing to sit on the sidelines.

Credit metrics and financial policy

We expect credit metrics to weaken moderately in 2023 given the impact of higher rates and lower earnings. Issuers more exposed to floating-rate debt or near-term maturities will face higher borrowing costs, thereby impairing their debt coverage ratios. Given the tighter access to credit, we see increasing refinancing risk, particularly for lower-rated issuers. Rated REITs benefit from largely unencumbered balance sheets, and issuers have the flexibility to resort to alternatives to the unsecured bond market, such as term loans or private or secured debt (including commercial mortgage-backed securities), to refinance maturing debt and manage their borrowing costs. Increased use of secured debt could put unsecured debtholders at a relative disadvantage. Additionally, issuers rated in the speculative-grade category could face recovery ratings pressure.

Most rated REITs have proactively refinanced higher-coupon debt with lower-coupon issues over the past few years and built a good cushion in their debt coverage metrics, limiting downside risk. We believe most rated U.S. REITs can absorb these interest rate increases, given that they hold a limited amount of floating-rate debt and have well-staggered maturities. There are only a few issuers whose proportion of variable-rate debt exceeds 25% of their total debt.

Exposure to a sizable development pipeline could also pressure issuers' cash flow given the potential for slower lease-ups, which would delay the cash flow contributions from these new assets. Given recent capital markets volatility, the transaction market for real estate assets remains muted and planned asset sales could take longer to execute, delaying the receipt of

proceeds earmarked for debt reduction. Still, real estate issuers benefit from long-term leases that provide good cash flow, thus any deterioration will likely be modest and gradual.

While credit metrics have largely recovered from COVID-19-related headwinds, we expect further improvement to be muted, and anticipate the credit metrics of more leveraged or weaker-positioned issuers will deteriorate given their slowing growth and weaker earnings.

We expect financial policies to remain largely unchanged, and for most rated issuers to pull back on development and acquisition activity in 2023. That said, issuers with stronger balance sheets and cost-of-capital advantages may more aggressively pursue opportunistic acquisitions given the reduced number of bidders. We expect share repurchases and dividends will stay at current levels.

Key risks or opportunities around the baseline

1. A prolonged recession could further weaken performance

Persistently high inflation could lead to higher rates for longer, curtailing demand for real estate in a prolonged recession, with office and retail assets facing higher risks.

2. Elevated interest rates could drive steeper valuation declines

We expect property valuations could face greater pressure across asset classes if rates remain elevated, increasing refinancing risk.

3. Housing cooldown supports rental demand

Worsening affordability exacerbated by steep mortgage rate increases could further support the demand for rental housing despite a looming recession.

The economic landscape remains uncertain and the timing and pace of further rate increases is unclear. While our economists forecast a shallow recession in 2023, a possible downside scenario could involve inflation remaining elevated on continued supply chain disruptions and the Fed maintaining an aggressive rate stance. Our current base-case estimate for the federal funds rate is that it peaks at 5.00%-5.25% by the second quarter of 2023. If high inflation persists, the Fed may need to raise rates higher than we expect and maintain them for longer than anticipated. A steeper recession with higher unemployment will pressure rental growth and occupancy levels, with retail and office assets more severely affected by weaker consumer spending and slower job growth. Office real estate experienced the steepest decline in rents during the Great Recession and took longer to recover than other industry sectors. In this high interest rate environment, access to capital will remain constrained and external growth will likely slow further.

Steep rate increases could drive a more significant drop in asset values. We expect capitalization rates to widen more for assets with weaker growth prospects, such as retail and office. In this scenario, issuers with near-term debt maturities will face increasing refinancing challenges.

Home ownership in the U.S. has become more expensive. According to S&P Global economists, housing affordability is the weakest it's been since 2006 because rising borrowing costs have limited home affordability, while elevated inflation has lessened household savings. We expect the fundamentals for rental housing to remain solid over the next one to two years. We also anticipate that REITs who own portfolios concentrated in markets featuring the most unaffordable housing are well positioned to benefit from these dynamics. We expect housing landlords will likely be able to increase rents (albeit to a lesser degree than in the past 18 months) for at least the next several quarters as renting continues to be a more affordable option for most Americans.

Industry Outlook: European REITs

Ratings trends and outlook

European REITs will continue to confront rising funding costs and valuation headwinds in 2023, particularly for low-yielding assets and leveraged capital structures, because interest rates will likely continue to rise, leading to tightening EBITDA-to-interest and growing debt-to-debt and equity ratios. While inflation will likely progressively ease in 2023, we expect rent indexation, which will be mostly based on the 2022 inflation rate, will support rising revenue and declining debt-to-EBITDA ratios this year. However, tenants' capacity to afford higher rents on new leases may be undermined by weaker economic sentiment and purchasing power, particularly in the retail and residential segments. We think that the U.K. market, in particular, could be more vulnerable because of its weaker economic prospects, higher rates, and slower return to office. Nordic REITs will also likely face more headwinds relative to mainland European REITs given their weaker balance sheets (namely higher leverage, elevated exposure to floating-rate debt, and shorter debt maturity profiles).

European real estate companies, particularly in the Nordic countries, have issued significant levels of subordinated hybrid capital instruments in recent years. Many companies will need to make refinancing decisions in 2023 because numerous first call options will fall this year amid less-supportive financial markets. Real estate companies' ability to issue new hybrid capital instruments was already affected by market volatility throughout 2022, making the replacement of existing hybrid instruments more expensive or more difficult than some may have anticipated. We understand that this situation is exacerbating existing concerns among debt investors.

We expect most issuers will take actions to address these challenges and comply with their long-term loan-to-value (LTV) and interest coverage ratio targets, including by making disposals, cutting their dividend and/or capital expenditure (capex), and possibly undertaking equity raises. Still, we have negative outlooks on 18% of the REITs that we rate, which follows the 13 downgrades we undertook in 2022 (out of 68 companies; 19% of the rated portfolio), highlighting the risk for further downgrades in the next 12-24 months.

Main assumptions about 2023 and beyond

1. Rising interest rates will increase cost of refinancing

European REITs will likely continue to refinance their upcoming debt maturities through a mix of cash, private debt, and public debt, the latter of which still appears to be the least attractive from a pricing perspective.

2. Valuations will likely decline sharply and affect most property segments

We currently assume valuations decline by 10%, on average, from their peak in June 2022 to the end of 2023 or mid-2024. We believe office (particularly non-prime), logistics, and other low-yielding assets could fare worse than other subsectors because their yields have contracted the most in recent years and might move closer to risk-free rates.

3. Rents will likely increase, albeit at a slower pace as economic conditions weaken

We assume revenue rises by the low- to mid-single digit percent area on a like-for-like basis. This assumes that weaker economic prospects in 2023 hamper rental uplift and soften indexation effects. We think retail and non-prime office assets could see the most limited uplift in their rental renewals.

We expect European central banks to continue hiking interest rates in 2023, implying that new refinancing, either from banks or capital market, will remain significantly more expensive than in 2010-2020. Because most European REITs enjoy long debt maturity profiles and have low exposure to variable-rate debt, we think the impact on their cost of funding will be gradual.

Property appraisers will likely apply significantly higher cap rates to their upcoming property valuations as interest rates rise sharply. Appraisals are generally performed and adjusted to REIT's reported fair value annually (with some partially updated on a semiannual or quarterly basis). Revenue growth expectations, boosted by inflation-linked rent indexation, may soften the impact, though likely not enough to fully offset the effect of the material cap rate increase. Therefore, we assume valuations decline for most property segments.

Rental income will likely continue to increase, supported by the limited supply of new builds and inflation-linked rent indexation, which often effects rents with a time-lag. However, tenants' capacity to afford higher rents may be undermined by weakening consumer confidence, lower employment, and higher energy bills, particularly in the residential and retail segments. In the office segment, lower job creation or job cuts, combined with still-low utilization, could also erode corporations' willingness to pay higher rents and impact landlords' occupancy rates. Vacancy rates have remained resilient but may creep up over 2023-2024 if the economic situation deteriorates.

Credit metrics and financial policy

EBITDA-to-interest and debt-to-debt and equity ratios will remain pressured because of the rising cost of debt and valuation declines. In the next two years, we expect EBITDA to interest will decline by about 0.50x-0.75x and debt to debt and equity will increase by 1-3 percentage points, absent deleveraging measures. Most companies use these two ratios to indicate their long-term financial policies, therefore we expect them to take the necessary actions to remain within their stated guidance.

Debt to EBITDA, one of our core ratios, will likely improve by 1.0x-1.5x by 2024, on average, because we expect most companies to cut their investment and expand their EBITDA on a like-for-like basis.

Free operating cash flow generation will likely become more positive, especially in 2024, as material capex cuts likely exceed the additional interest burden. Issuers are aiming to be net sellers and use the proceeds for deleveraging, although disposing assets could prove challenging in the current volatile environment.

Key risks or opportunities around the baseline

1. Limited access to funding is a key concern

As the bond market remains volatile, REITs can use alternative sources to cover debt maturities and build up liquidity cushions, such as bank lending, private placements, and asset disposals. Therefore, refinancing risks for 2023 are remote. However, debt maturities will remain elevated in 2024-2025 and could cause issuers to start selling assets at distressed levels in case of more-restrained access to funding. Investors will also likely discriminate further between REITs based, for instance, on their own views about governance or the long-term quality of the underlying real estate assets.

2. Higher rates or a harsher-than-expected economic recession

Higher interest rate hikes or weaker-than-expected economic prospects would likely lead to more pressure on asset valuations and revenue.

3. Rates stabilization could revive investments and stabilize valuations

More clarity on terminal rates by central banks would likely help buyers and sellers agree on a price. A revival of transactions would also stabilize private valuation assumptions.

Bond market conditions strongly deteriorated in 2022, particularly for capital-intensive REITs, pushing them to refinance debt maturities with either existing cash or alternative funding, such as mortgage-secured loans. Bond issuances by S&P Global Ratings-rated European REITs fell to €16 billion in 2022, from €45 billion in 2021 and €30 billion in 2020. While investment-grade REITs exhibit sufficient liquidity to tackle their 2023 (and most of 2024) debt maturities, we think more restrained access to funding (from banks, for example) could further raise the refinancing risk for 2024-2025 maturities (which is already elevated for the sector). We believe REITs with ESG credentials and a pipeline of eligible assets will likely be better positioned to obtain new funding.

We believe a weaker economic environment could affect tenant demand for real estate. Shrinking corporate sentiment and job destruction could lead corporates to cut office space beyond what is necessitated for remote working. Reduced purchasing power would also likely impact retailers' sales and households' disposable income, ultimately reducing their capacity to pay higher rents.

Rapidly increased borrowing costs affected investment prices and volumes in the second half of 2022, especially in the residential and office segments, despite a very strong start to the year. We understand most market participants expect a repricing, which remains uncertain absent clarity around the final extent of rate increases. Therefore, we think a stabilization in rates could unlock investments and ultimately help appraisers provide more accurate valuations.

Industry Outlook: Asia-Pacific REITs

Ratings trends and outlook

The improvement in Asia-Pacific REITs' credit metrics likely peaked in 2022 (for most countries) and we expect their metrics will stabilize in 2023. Higher interest rates and operating costs will likely erode ongoing rental income improvements. The negative rating bias was relatively stable through 2022 but eased late last year to about 10%. Rated REITs' portfolios of high-quality assets and prudent financial management will continue to support their relatively stable credit quality. Most REITs and landlords will feel the impact of a full year of interest rate hikes in 2023. However, their limited amount of floating-rate debt and modest upcoming debt maturities will reduce the strain. We also expect REITs to take a more measured approach to acquisitions and speculative development activities considering higher financing costs and economic headwinds.

Main assumptions about 2023 and beyond

1. Hong Kong and Japan office landlords face downward rental pressure

Significant new office supply in Hong Kong and Japan will depress rents and occupancy rates. We expect Hong Kong's overall office vacancy rate to remain above 10%, which is materially higher than 4.5% during 2015-2019. Similarly, we expect Japan's new office supply will surge by over 100% in 2023 relative to 2021, widening the vacancy rate to 7.0%-7.5% as of the end of 2023 from 6.0%-6.5% as of the end of 2022.

2. Retail malls focusing on consumer non-discretionary stores will see stable occupancy and rental rates

Retail malls with a high proportion of non-discretionary stores that serve as points of convenience for local consumers will maintain stable occupancy rates and a mild positive rental reversion. Downtown malls will likely benefit from the surge in tourist arrivals, but discretionary spending could decline due to inflation and higher interest rates.

3. Covenant headroom remains sufficient and acquisition pace slows amid rising interest rates

The pace of the expansion in the cap rate for rated REITs and landlords has been gradual. This is due to their ownership of high-quality assets and the limited sales transaction volumes to guide their property valuations. The covenant headroom of most rated REITs will provide them with a buffer against lower asset valuations. Higher financing costs and economic headwinds will also likely slow acquisition and development activities for REITs and landlords.

Credit metrics and financial policy

Pacific: We expect the credit metrics of our rated REITs to remain resilient in 2023, supported by strong market positions and tenant demand for quality assets. The transition toward a post-COVID normal began in earnest during 2022 as government progressively eased lockdown restrictions. Although this led to an uptick in trading performance, the improvement was stymied by the quick succession of interest rate hikes.

The credit metrics of our rated retail REITs will depend on the composition of their asset portfolio and their susceptibility to declines in discretionary retail sales. Despite the strong performances

of both discretionary and non-discretionary retail sales and rising foot traffic in 2022, we expect interest rate hikes and inflationary pressures will have a more severe effect on consumer spending in 2023. Retail shopping centers underpinned by non-discretionary stores and regional malls that serve as points of convenience for local consumers will likely continue to perform even if household savings and discretionary income levels decline.

We expect the credit metrics of our rated office REITs to remain moderate relative to the demands of their development pipelines. Office physical occupancy levels are improving, although they remain below pre-pandemic levels. With hybrid and flexible working arrangements here to stay, we expect an overall decline in office space requirements. However, the impact on our rated REITs will likely be relatively muted as new and existing tenants seek out prime office space offered by rated REITs with quality assets. Rental income growth will continue to be supported by inflationary pressure on prime-grade net face rents, although this will be partially offset by persistently high incentives.

We expect our rated industrial landlords to maintain adequate headroom in their credit metrics. The demand for industrial properties remains elevated, supported by the ongoing expansion of e-commerce retailers and distributors and the localization of supply chains. Rising interest rates will likely soften industrial capitalization rates, while also limiting supply as speculative development moderates.

Hong Kong: We expect our rated REITs will maintain their credit profiles despite softening economic conditions and higher interest rates, supported by their prudent financial management. Retail properties will remain broadly stable and likely benefit from the reopening of the city's borders. Those with high exposure to non-discretionary retail will face limited rental pressure over the next 12 months, supported by domestic consumption. Office landlords will face downward pressure on rents in 2023 amid economic headwinds and substantial new supply, while vacancy rates remain high. New grade-A office supply is set to reach more than five million square feet (sq.-ft.) over 2022-2023, which compares with about one million sq.-ft. over 2020-2021.

For Hong Kong landlords, while we expect the office segment to face constraints over the next 12 months, retail may provide some upside following the reopening of the border. Moreover, landlords with rental portfolios exposed to other countries could offer some cushion to the downcycle in Hong Kong. However, if the economic downturn persists, it could undermine the credit strength of Hong Kong property companies.

Overall, we believe Hong Kong landlords are better positioned for a downcycle than their mainland peers. This is due to their stronger credit metrics and better access to funding.

China: For landlords in China, the lingering effects of COVID-19 and the related economic slowdown could weigh on their near-term operational performance. We expect retail rent and occupancy to mildly improve in the second half of 2023, which will support the credit metrics of retail REITs. This is due, in part, to the relaxation of COVID-related travel restrictions, though domestic consumption remains the key driver. We expect office rents to be soft and negatively affected by high vacancy. We do not expect Chinese REITs to increase their capex and instead believe they will adopt more of a wait-and-see strategy.

Japan: We expect the credit metrics of rated REITs will remain stable in 2023, thanks to their high-quality assets and prudent financial management. Central Tokyo's office vacancy ratio will somewhat widen to 7.0%-7.5% as of the end of 2023, from 6.0%-6.5% as of the end of 2022, due to the spread of remote work and the massive supply of new offices. The supply of large-scale offices in Tokyo’s 23 wards will surge by over 100% in 2023 compared with 2021. However, the performance of rated REITs will be resilient, supported by their high-quality and well-located

portfolios. As for the retail property segment, store sales will mostly recover to pre-pandemic levels, while hotels will see a gradual recovery in 2023. Condominium sales will remain resilient as solid demand continues to outstrip limited supply. Landlords will likely continue selectively investing in new properties with both debt and equity (or funds from asset divestments). In addition, the strong interest-coverage ratios, long average debt durations, diverse maturity profiles, and high fixed-rate debt of rated issuers will provide them with ample room to absorb some increase in interest rates.

Singapore: We expect the credit metrics of rated Singaporean REITs (SREITs) will remain steady in 2023. This is underpinned by their high-quality asset bases and prudent financial management. We expect more upside in the rebound for downtown retail assets, which suffered the greatest declines through the pandemic. Rated office landlords, who mainly hold high-quality assets, continue to benefit from the flight to quality. Amid the tougher funding environment, we believe rated SREITs have sufficient headroom to tolerate rising rates. This is supported by their relatively high proportion of fixed-rate debt--between 70% and 80% as of September 2022. Rising interest rates, culminating in a higher cost of capital, could cause rated SREITs to become more judicious in pursuing acquisitions.

Key risks or opportunities around the baseline

1. Office demand is still evolving

Remote and hybrid working trends have persisted, giving companies more flexibility on their leasing footprint upon lease expiry. This continues to create uncertainty around leasing demand. The flight to quality will continue to see tenants leaving older office buildings in favor of newer and more-sustainable buildings. Tougher economic conditions in 2023 and the large volume of office supply in countries like Hong Kong and Japan tilt risks toward the downside for office landlords.

2. The lifting of China's COVID restrictions could boost tourism and regional retail spending

The easing of COVID restrictions in China and opening of cross border travel could see higher mobility domestically and the resumption of travel to key gateway cities in Asia-Pacific. This would support stronger retail spending and hotel demand. On the other hand, significantly larger or longer-than-expected waves of COVID-19 infection could lead to voluntary social distancing and more stringent tourist arrival requirements.

3. Interest rates rise higher for longer

This could lead to further cap rate expansion, declining asset valuations, and an erosion in covenant headroom. REITs will also face higher refinancing costs. S&P Global Ratings' downside scenario assumes the Fed raises rates to least 6% by mid-2023, which compares with 5% in our baseline, and we believe rates could remain higher for longer.

Pacific: The key risks to the rated landlords across all sectors are the macroeconomic impacts of rising interest rates (recent and future) on consumers and businesses. The impact of interest rate hikes and inflationary pressures on household disposable income will influence retail sales and shopping center foot traffic. Businesses with maturing leases will decide if the current economic environment supports ongoing commercial viability and further lease renewals. Structural changes to e-commerce and the importance of supply chain timing and certainty will likely support the demand for storage and distribution facilities. Customer expectations around order fulfillment and delivery timing will drive the demand for strategically located urban infill locations to manage inventory levels and order fulfillment. Widespread hybrid and remote

working will likely lead to an overall reduction in office space requirements as businesses determine longer-term floorplate utilization patterns. We expect existing and new tenants will look for newer office space with improved facilities, instead of maintaining larger existing floorplates with lesser facilities, to attract employees back into the office.

Hong Kong: Hong Kong is on track for more COVID-related relaxations after it dropped the mandatory quarantine requirement for inbound travelers at the start of October 2022 and reopened its borders with China on Jan. 8, 2023. Retail landlords could benefit from greater demand for rentals, while the faster-than-expected uptick in tourism will boost retail sales and business confidence.

More persistent office decentralization could further narrow the difference in spot rents between central and other districts, pressuring the rent and occupancy levels of rated entities that are highly exposed to central Hong Kong. High-quality office premises located outside central Hong Kong will continue to attract tenants due to their more-attractive rents.

China: In the face of spiking new COVID cases and strained hospital capacity, reduced consumer mobility and retail mall footfall will weaken rental demand through the first quarter of 2023. We expect landlords' rent and occupancy will mildly improve in the second half of 2023. On the other hand, a significantly higher-than-expected level of COVID infections could prolong the negative impact on consumer spending and the economic recovery.

Japan: In our view, the key risk for Japan is a larger-than-expected domestic interest rate hike due to changes in the Bank of Japan's policy rate, which would undermine rated REITs' portfolio asset values and financial flexibility. In addition, risks are skewed to the downside due to increased office supply, which has created an imbalance in leasing supply and demand, as well as the possibility that remote working levels will remain elevated.

Singapore: SREITS could face tougher leasing conditions in 2023, especially for older office buildings. This is due to the uncertain macroeconomic conditions and higher-than-historical average new office supply. This could slow spot rent growth this year. Grade-A office spot rents surged last year and recovered above pre-pandemic levels. On the retail front, inflationary pressures could dent consumer sentiment, particularly discretionary spending. This may limit retailers' capacity to stomach higher rental increases.

Industry Outlook: Latin America Real Estate

Ratings trends and outlook

As of January 2023, we have stable outlooks on 90% of our rated Latin America (LatAm) real estate portfolio, with negative outlooks on the remaining 10%. This indicates our expectation for rating stability in the next 12-18 months, with a mild potential for negative rating actions. In our view, most of our rated LatAm real estate entities will maintain resilient credit metrics in 2023, despite our expectation for a shallow recession in the U.S. and in other large economies. Industrial portfolios will likely continue to perform well because we believe the current nearshoring and e-commerce trends in LatAm will continue despite our view that Mexico's manufacturing output will likely contract due to lower U.S. demand in 2023. We expect retail portfolios will enjoy a second year of restriction-free operations, which--coupled with some divestments and liability management carried out in the past year--will likely provide some buffer against an expected slowdown in consumption, particularly for discretionary products. Additionally, we estimate that office properties will continue to post a weak performance because these assets have suffered from the adoption of hybrid work models. Although vacancy rates have stabilized in key markets, we expect continued pressure through 2023 due to a worsening business environment, which may lead to further expense cuts (such as real estate leases). Nonetheless, the impact on our rated LatAm real estate portfolio will likely be mild because the office segment represents a small share of rated portfolios. Lastly, the political landscape in the region has worsened business conditions, in addition to recession risks and tight financing conditions, which may pose downside risks for the sector throughout 2023.

Main assumptions about 2023 and beyond

1. The performance of industrial assets will remain resilient

Global supply chain disruptions have increased the pressure on companies to shorten and strengthen their supply chains, while the demand for e-commerce continues to grow. Therefore, the demand for premium industrial assets in LatAm has increased since 2022. We expect these tailwinds will partly offset a mild recession in the world's largest economies and anticipate a significant economic slowdown in LatAm.

2. Office properties have stabilized but are vulnerable to worsening business conditions

Operating indicators seem to have stabilized. Nonetheless, a deteriorating economic environment in 2023 may further pressure landlords, who are already contending with higher vacancy rates, lower rents, and reduced valuations since the outbreak of the pandemic.

3. Recovery in retail properties is underway but may slow due to persistent high inflation

We assume retail assets will continue to recover absent major lockdowns or curfew measures. However, we estimate persistent high inflation in 2023 will undermine discretionary spending, which will negatively affect some retail tenants, tempering their occupancy rates and lease spreads.

We expect LatAm's real estate sector will have a broadly stable performance in 2023, though slightly skewed to the downside depending on property type, location, debt leverage, and available liquidity. In our view, the anticipated recession in the U.S., along with persistent high inflation, may impact some of these companies' tenants, which could ultimately reduce their occupancy rates and rents. However, we consider the rated entities to be relatively well

positioned to weather another challenging year. On average, we expect a rise in revenue and EBITDA of near 5%-10% for these entities with limited funding needs, which will be reflected in decreasing leverage metrics and stable coverage ratios despite higher financing costs. In most cases, our rated entities maintain well-extended debt maturity profiles, which alleviate their risk from tight financing conditions. Moreover, there are some planned asset recyclings and divestments for this year, though worsening business conditions could delay some of these plans.

Our rated industrial players are concentrated in northern Mexico, where they enjoy tailwinds from the shift to nearshoring and benefit from a wider range of tenants, such as manufacturers of auto parts, health devices, electronics, logistics, and e-commerce tenants. We expect stable occupancy rates on a country-wide basis, which have been close to 95%, indicating already tight supply and positive lease spreads above inflation growth. We currently estimate a shallow U.S. recession, which will slightly decrease the demand for manufactured goods from Mexico and affect some industrial tenants. Nonetheless, most of these entities are multinational companies with sound credit profiles and long-term investment horizons. On the other hand, our rated Brazilian players with industrial assets are largely geared toward e-commerce and logistics, rather than manufacturing facilities. Due to the increasing adoption of e-commerce by Brazilian consumers and retailers, we expect these entities to post double-digit percent increases in their revenue, fueled by developments that are already underway and some which will be finalized in 2023 and are already pre-leased.

We estimate a relatively stable performance in retail portfolios for 2023. Last year, the recovery in retail real estate continued to progress, benefitting from a surge in consumption from the reopening of malls and pent-up demand where retailers were able to increase their selling prices to pass-through higher costs and operating expenditure. Furthermore, occupancy rates continued to recover from the pandemic, although at an uneven rate depending on each asset's qualities. We expect that softer economic growth and still high inflation levels in 2023 will lead to continued elevated interest rates, undermining households' disposable income. In our view, this will likely pressure retail tenants' sales and, in turn, undermine landlords' variable rent collection. However, for our rated entities, a vast majority of their rental income comes from fixed rents, usually representing close to 90%. Although these lease agreements tend to be pegged to inflation, the decline in occupancy rates from greater e-commerce adoption has pressured asking rent; hence, flat or negative lease spreads for some properties is not off the table. Moreover, we expect occupancy rates to continue improving in 2023 in Mexico. Meanwhile, in Brazil, the vacancy rates of premium players have remained relatively low. In the next two to three years, we expect that e-commerce penetration in the region will continue increasing, reducing the need for traditional brick-and-mortar retailers. Therefore, real estate operators may need to adapt their properties to entertainment, leisure, and other services. We do not anticipate retail gross leasable area (GLA) will significantly increase in 2023; on the contrary, some rated entities have sold assets to repay debt and improve their profitability in the last year. We expect a few issuers will continue this strategy in 2023. However, persistent high inflation and interest rates may delay some transactions.

Although offices account for a smaller proportion of the portfolios of our rated real estate entities, we expect that these assets will continue to perform weakly in 2023 and not recover to pre-pandemic levels. In our view, a vast supply of offices in metropolitan areas, like Mexico City or Sao Paulo, and high vacancy rates above 20% will lead to stiff contention among landlords to attract tenants by lowering rents and refurbishing office spaces. In addition, worsening business conditions have prompted major corporations to cut their operating expenditure, such as lease agreements, which may continue throughout 2023 and further pressure office landlords.

Therefore, the value of these properties has been undermined and we expect that developers will proceed cautiously on greenfield projects, which will reduce the need for financing.

Credit metrics and financial policy

Our updated base-case scenario assumes most real estate operators will improve their leverage metrics by the end of 2023. In the case of industrial portfolios, we expect a mix of rental income and EBITDA growth, given strong operating indicators and an active pipeline, but not necessarily debt repayment. For retail and office portfolios, we also expect an improvement in rental income and EBITDA, in a few cases from asset sales and debt repayment. In most cases, we expect real estate operators to sustain their prudent financial policies, particularly regarding 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 2023, although there may be some refinancing of bank debt 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 the demand for larger spaces. On the other hand, we expect retail and office landlords to remain more cautious in terms of expansions because their portfolios haven't recovered from the pandemic and, in our view, are more vulnerable to the current business environment. On average, we expect rated LatAm real estate entities to maintain solid credit metrics for 2023, with debt to capital of 30%-35%, EBITDA interest coverage of about 3x, net debt to EBITDA in the 5.0x-6.0x range, and funds from operations (FFO) to debt of about 15%.

Key risks or opportunities around the baseline

1. Economic and political risks in LatAm may further weaken business conditions

A deeper and longer-lasting economic recession in the U.S. could impact several LatAm economies, negatively affecting tenants' financial performance and undermining real estate operators' credit quality beyond our current expectations. Additionally, political shifts in major LatAm economies may discourage investment in real estate.

2. Secular trends will continue to undermine retail and office portfolios

In our view, e-commerce still has room to grow in the region in the coming years. A faster pace of adoption could lead to a stiffer challenge for retail portfolios. While office portfolios have shown signs of recovery, with vacancy rates stabilizing, further corporate expenditure cuts and deteriorating investor sentiment may lower occupancy rates.

3. There is uncertainty surrounding the nearshoring trend

The surging demand for nearshoring could be more transitory than expected now that global supply chains seem to have normalized. Moreover, political shifts in the region may discourage foreign investment. On the contrary, geopolitical tensions may continue to increase companies' need to re-locate their operations closer to key markets.

The economic and political environment poses downside risks to our forecast for 2023. We currently estimate a 0.1% GDP contraction in the U.S. trickling down to LatAm economies, which slows the pace of GDP growth to between 0%-1% for Argentina, Brazil, Colombia, and Mexico, and leads to a 0.4% contraction in Chile. In our view, the Fed could continue to hike interest rates into mid-2023, damaging household purchasing power, until inflation yields. Nonetheless, there's a risk this won't reduce the pace of economic activity as expected, deepening or extending the

economic slowdown. Coupled with tight financing conditions, this could further reduce investment and consumption trends and undermine tenants across the three real estate subsegments we follow. For industrial portfolios, it could decrease foreign demand for goods manufactured in LatAm, slowing the need for nearshoring or affecting the terms and conditions for renewals. For retail assets, tenants' sales may stagnate because we expect a low single-digit percent rise in consumption in most LatAm economies, while high inflation in 2022 and 2023 will likely shift household demand away from discretionary goods and leisure. This scenario could discourage renewals and pressure lease spreads. In our view, the impact on rated retail portfolios will likely be mild and lead to more of a slowdown in the recovery to pre-pandemic levels, rather than a contraction. On the other hand, if corporates struggle with the economic slowdown and inflationary pressures on their costs and expenses, this will weigh on the demand for office space in 2023. However, the magnitude of the pressures is relatively unclear, given the already weakened level of demand since the outbreak of the coronavirus pandemic.

We anticipate that e-commerce adoption will increase in the region in the coming years, although at a slower pace than in 2020-2021. The region continues to represent an opportunity for further digitalization of e-commerce in several sectors, such as retail, which have pushed retailers to reevaluate their growth strategies, although we expect net store openings will likely remain positive. In the case of Mexico and Argentina, it is estimated that e-commerce represents close to 10%-12% of total retail. This is behind Brazil, which is estimated to be closer to the U.S. at 15%-20%. However, other economies' e-commerce penetration is below 10%. In our view, these levels suggest further expansion of e-commerce, reallocating capital to logistics and distribution and away from store openings. We expect retail landlords to increase their investment in mall refurbishments, rather than greenfield projects, to adapt to new demands from tenants and increase their spaces dedicated for services, such as entertainment and leisure. Additionally, occupancy growth will likely slow because we anticipate stagnant consumption in 2023, which will affect the return of small retailers that struggled the most during the pandemic and were forced to close stores. On the other hand, we consider the adoption of hybrid work models will gradually expand in most sectors in the coming years after surging amid the lockdowns during the pandemic. We estimate vacancy rates in key markets, such as Mexico City or Sao Paulo, of between 20%-25%, which about 10% higher than pre-pandemic levels. Although we expect a mild decline in occupancy rates in 2023 of about 0%-2%, there are some downside risks if corporates cut their expenditure more aggressively than we assume.

Our base case is that nearshoring demand will continue throughout 2023. Although this phenomenon has existed for a few decades in countries like Mexico, the current surge in this trend is largely due to the global supply chain disruptions experienced during the pandemic. We expect global supply chains will normalize in 2023, similar to what we saw in the second half of 2022, which will reduce the urgency of global manufacturers to re-shore next to key markets, like the U.S. This could slow the industrial real estate momentum in the region. Moreover, weaker demand from the U.S., suggested by the 0.1% GDP contraction in 2023, could somewhat impact industrial tenants, although we estimate the impact on landlords will be fairly contained. On the other hand, there's a risk that the local features of LatAm countries, such as the uncertainty in public policies, like energy policy, the rule of law and security, and countries' environmental strategies to deal with water scarcity, may start to weigh more on reallocation decisions depending on the tenants' intensity.

Industry Outlook: Other Regions

Gulf Cooperation Council

Retail: The broader GCC region's retail sector was supported by the Qatar World Cup held in November-December 2022 that reportedly attracted 1.4 million sports fans, with positive ramifications spilling into neighboring countries, predominantly Dubai. The World Expo (in the first quarter of 2022) in Dubai led to increased spending from international visitors, while local residents also stepped up their spending amid relatively less-prohibitive inflationary pressures compared with many other regions. Occupancy levels in malls rebounded to close to pre-COVID level as footfall also approached historic levels. We think that the upside from such global events will be short lived, but the economic rebound, supportive oil prices in this hydrocarbon-reliant region, population growth, and increased tourism will support steady operations. However, considering the recent deliveries of malls, as well as the pipeline of new projects, we think that rental pressures will linger despite some recent improvement. Therefore, we expect mall operators will remain focused on cost control and reconsider future investments because funding costs have increased.

Offices: Office landlords have benefitted from the economic rebound in the region, which has supported the demand for higher-grade offices, reducing the vacancy rate and increasing rental rates particularly in Dubai and Riyadh, the two biggest business hubs in the region. New business license issuance is on the rise as the region become more attractive to foreign investors. Riyadh endeavors to emerge as a new business center and requires international companies to establish their regional headquarters in the city, thereby competing principally against Dubai. We believe Dubai will remain an attractive destination despite the introduction of a 9% corporate tax starting in June 2023. The broader trends related to coworking and remote work may gradually shift companies' preferences, but we do not expect this to disrupt the market in the near term.

Israel

Offices: Continued economic changes may affect the demand for office space. S&P Global Ratings' latest forecasts include slower but positive growth in Israel's economy in 2023, which will likely support the demand for office space. However, we expect pressure on rents and occupancies amid the trend toward downsizing among high-tech companies. We also expect the supply of new high-quality office space entering the market in the coming years may lead to negative pressure on rental rates and occupancy, especially in areas already suffering from excess supply.

Retail: Lower retailer profitability will pressure rents. Continued inflationary pressures due to supply chain disruptions, as well as slower growth and higher interest rates, are weighing on retailers' profitability. Retailers may find it difficult to pass on the full increase in their costs to consumers, which will further reduce their profitability and, consequently, pressure rents.

Continuously higher interest rate pressure could lead to growing risk of asset devaluations. However, higher rents due to consumer price inflation will act as a moderating factor. We note that in the first nine months of 2022, most income-producing real estate companies presented positive estimates, due to both indexation and a real increase in rents. At the same time, amid the uncertainty in the global economy, we see a higher risk of moderate single-digit percent asset devaluation in 2023, mainly for office properties.

Related Research

- Nordic Real Estate Outlook 2023: Refinancing Cliffs And Valuation Falls Ahead, Dec. 12, 2022
- Real Estate Monitor: Negative Rating Bias Grows In The U.S. Real Estate Sector, Sept. 19, 2022
- SLIDES: When Rates Rise: Most Asia-Pacific REITs And Landlords Have Maneuvering Room, Sept. 18, 2022
- Property In Transition: Slowing Economies And Shrinking Demand Pressure The Credit Outlook For Office Landlords, Sept. 12, 2022
- When Rates Rise: European REITs' Funding Costs And Cap Rates Climb, So Does Revenue, June 16, 2022
- Credit FAQ: World Cup Will Give An Additional Near-Term Boost To GCC, Nov. 7, 2022
- Saudi Arabia's Vision 2030: Some Likely Winners, Dec. 5, 2022
- Credit FAQ: How The Rising Cost Of Debt Will Affect AREITs, July 25, 2022

Industry Forecasts: Real Estate

Chart 7

Debt to capital (adjusted)

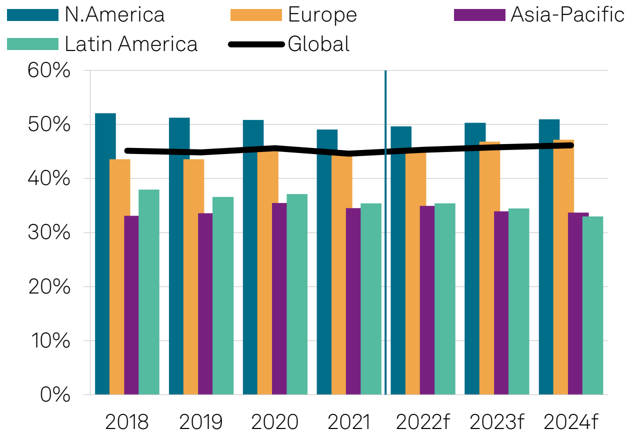


Chart 8

EBITDA interest coverage (adjusted)

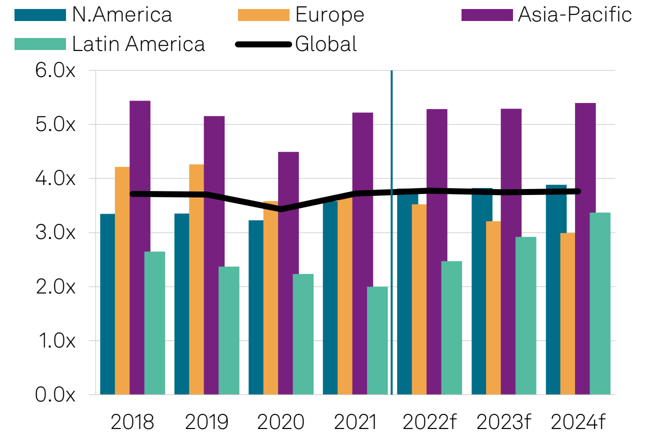


Chart 9

Debt / EBITDA (median, adjusted

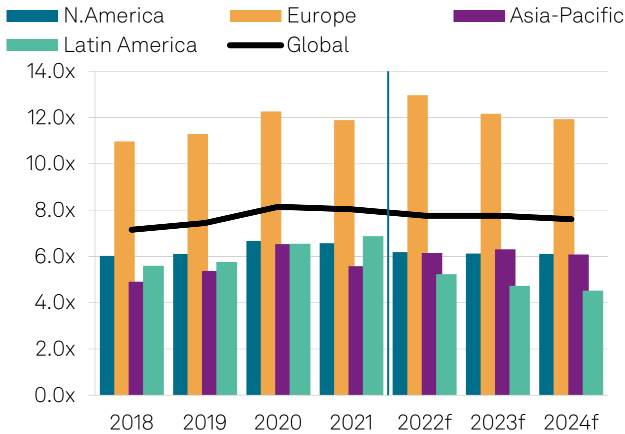
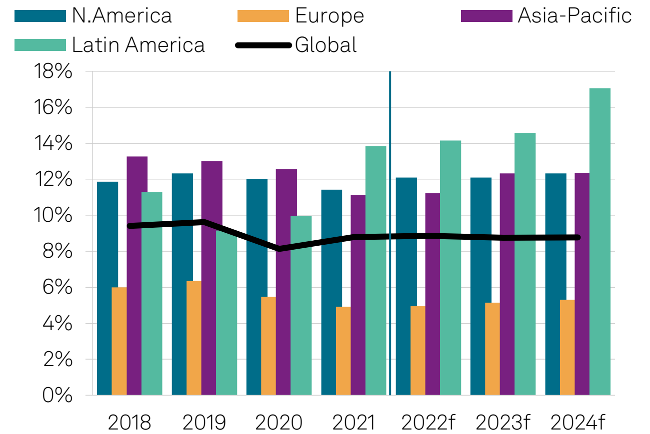


Chart 10

FFO / Debt (median, adjusted)



Source: S&P Global Ratings. f = Forecast.
All data 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: Real Estate

Chart 11

Rental revenue growth

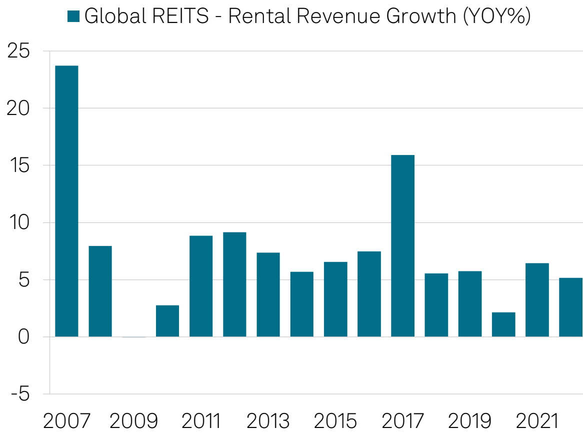


Chart 12

Return on capital employed

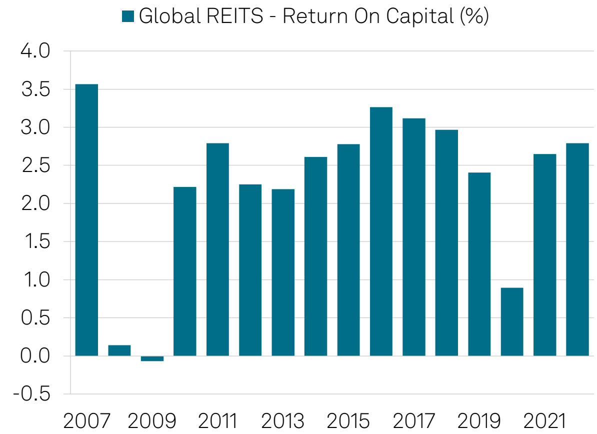


Chart 13

Fixed- versus variable-rate exposure

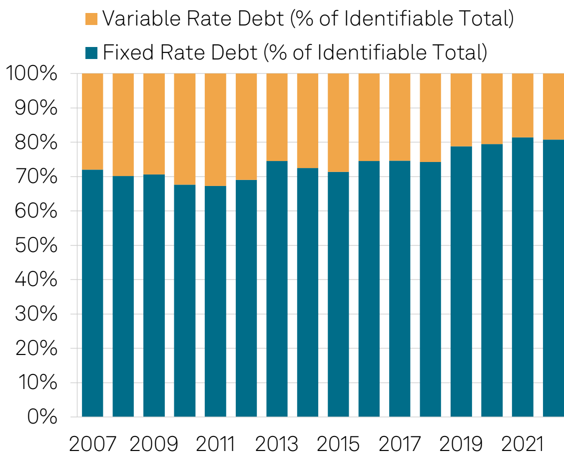


Chart 14

Long-term debt term structure

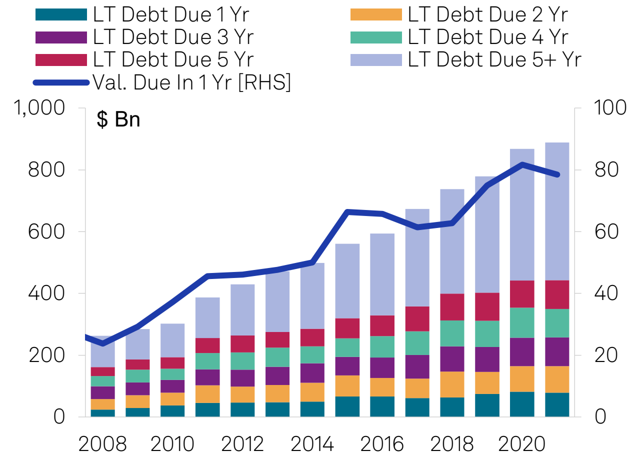


Chart 15

Cash and equivalents / Total assets

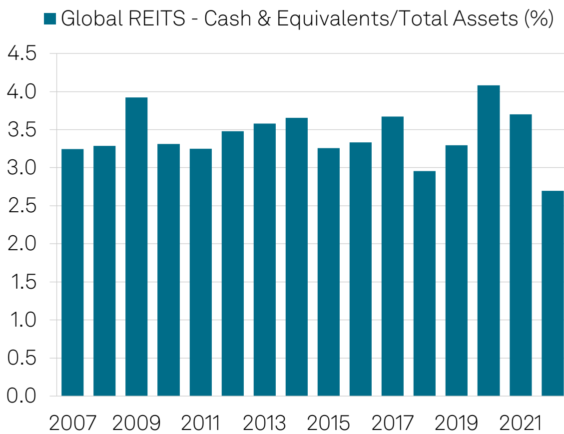
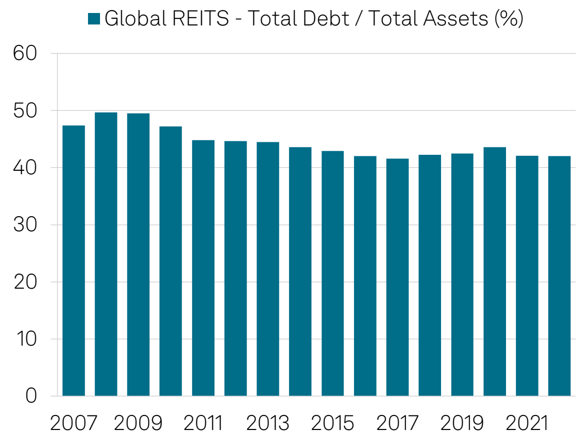


Chart 16

Total debt / Total assets



Source: S&P Capital IQ, S&P Global Ratings calculations. Most recent (2022) figures use the last 12 months' data.

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