FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Arabian Centre's Outlook to Negative; Affirms at 'BB+'; Assigns 'A-(sau)' National Rtg

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Fitch Ratings - London - 02 Dec 2020: Fitch Ratings has revised the Outlook on Saudi Arabia-based real estate company Arabian Centres Company's (ACC) Long-Term Issuer Default Rating (IDR) to Negative from Stable and affirmed the IDR at 'BB+. Fitch has also affirmed the 'BB+' unsecured rating and 'BB+' rating of the sukuk trust certificates issued through Arabian Centres Sukuk Limited (ACSL).

Fitch has assigned ACC a new National Long-Term Rating of 'A-(sau)' with a Stable Outlook. Fitch has used Saudi Arabia's National Rating Correspondence Table and relativities with national peers to determine the national scale rating in accordance with Fitch's National Scale Rating Criteria. Fitch also assigned ACC a Long-Term Local-Currency IDR of 'BB+' with a Negative Outlook

The ratings reflect the company's competitive position as the largest retail real estate company in Saudi Arabia (KSA), owning and operating a portfolio of 21 retail malls in the most populous cities of the country, while also considering asset concentration, a front-loaded lease maturity profile and a high exposure to related-party tenants and transactions.

The Negative Outlook reflects exposure to the nascent KSA retail market, which continues to be affected by an economic slowdown, a tripling of VAT, which may impact consumer spending, and most recently, COVID-19. In addition, the company's rental income is vulnerable due to a short-term lease profile and potential downward pressure from related-parties.

KEY RATING DRIVERS

Challenging Operating Environment: Low oil prices and COVID-19 have affected the KSA economy and retail markets. GDP is expected to contract more than 4% this year. While the retail market has positive dynamics, such as low mall penetration, a young, growing population, and limited e-commerce, it was negatively affected by a six-week government-imposed lockdown of malls beginning in March 2020.

The border closures have meant some tenants have captured higher consumer spending, as few residents are travelling and KSA has limited non-religious tourism.

COVID-19 Operational Performance: Footfall in ACC's malls reached 17 million in 2Q21 (July to September 2020), but this is 39% below 1Q20. This improved to -23% in October 2020 compared with October 2019. Tenant sales were down 5% in 1HFY21 compared with 1HFY20, indicating increased consumer spend.

Concentrated Portfolio, Strong Market Position: ACC has a market share of 14%, more than double its nearest competitor. ACC's portfolio comprises 21 malls across 10 cities with a gross leaseable area of 1.2 million sq m. The portfolio is concentrated, as the top10 assets are around three-quarters of this.

This concentration will decrease as ACC expands, although the pandemic has delayed development. Management is focused on creating destination malls, particularly by increasing food and entertainment, especially cinemas. ACC launched four cineplexes in 2QFY21.

Tenant Support Affecting Rental Income: To support tenants, ACC waived rents during the lockdown and suspended lease escalations until 2021. Post-lockdown, it has provided support on a case-by-case basis. The company estimates one-off, COVID-19-related rent discounts to be SAR536 million (around 25% of FY20 rents). ACC is no longer granting COVID-19-related discounts. ACC has renewed around 75% of leases due to expire in FY21 but at lower rental rates.

Occupancy declined to 90.5% at 2Q21 (FY20: 93.1%), mainly due to re-allocation of space for cinemas. Management expects to approach 93% by FY21, but this may be challenging. Fitch expects rents to recover to pre-pandemic levels by FY23, reflecting the difficult operating environment.

Material Leaseholds: About two-thirds of ACC's portfolio by sq m is on land leased from third-parties. These head leases, which have a weighted average life of 12 years, typically do not include a right of renewal. If ACC cannot renew a lease, building ownership transfers to the landlord with no compensation. Fitch believes ACC should be able to renew these leases as there is a mutual benefit to do so, but the cost is likely to rise.

For example, ACC renewed the lease for Aziz Mall for 30 years in 2019, but at double the cost to 16% of the asset's rent (fixed thereafter). The impact of this sharp increase will fall as mall rents increase. In FY20, ACC's leasehold cost was 10% of group revenue. Due to the pandemic, ACC has negotiated discounts with landlords of SAR73.0 million (24% of the annual cost) in 1HFY21.

Tenant and Related-party Concentration. With more than 4,100 stores, tenant diversity is good. There is a concentration of key accounts, which are large retail companies that generate about 45% of rent. While these tenants support occupancy and pre-lettings, they benefit from substantial rental discounts.

This concentration is characteristic of the KSA retail market, given the high degree of franchise companies. Key accounts include related-parties, such as Alhokair Fashion Retail, which generates around 25% of ACC's rent. Company policies include measures to control related-party activity, but the risk of rental forebearance remains.

Lease Expirations Front-loaded: ACC renewed 1,343 leases in 1HFY21, which is 75% of leases maturing in FY21. The maturity schedule remains short, with 22% of rents expiring in FY21 and 31% in FY22. While many of these leases have been extended on a short-term basis to allow ACC to manage space, it limits cash flow visibility, particularly given the downward pressure on rents.

Financial Metrics Pressured: Financial metrics have weakened, but remain conservative. Fitch forecasts FY21 net debt/EBITDA to increase to 5.6x (FY20:4.9x) and we do not expect deleveraging as the economic recovery may be protracted and the development programme is likely to resume. ACC's portfolio generates high net income yields of around 8.5% (based on independent valuation), reflecting the nascent retail market in KSA. Interest cover remains healthy at 3.7x at FY20.

DERIVATION SUMMARY

Within the GCC, ACC's most comparable peer is Majid Al Futtaim Holding LLC (MAF, BBB/Stable), a Dubai-based conglomerate whose food retail business includes operations in KSA. MAF's real estate portfolio includes 27 shopping centres and 13 hotels valued at USD9.0 billion, compared with ACC's portfolio of 21 malls with a value of USD4.8 billion. Both companies have asset and geographic concentration. ACC only operates in KSA, while MAF's portfolio is focused on Dubai with some exposure to four other countries in the region.

Both operate in challenging retail markets. UAE is marked by an oversupply of assets, a reliance on tourism and a population that is nearly 90% expats. The KSA retail market is fairly immature and vulnerable to external factors, such as oil prices, government policies and geopolitical factors. The key difference is, however, is that MAF owns and benefits from the operation of a portfolio of more than 300 Carrefour super- and hyper-markets spread across 15 countries, which provides defensive revenue and EBITDA to the group.

Romania-based NEPI Rockcastle (BBB/Stable) owns and operates a larger portfolio of retail assets valued at around USD6.9 billion, but has good geographic diversity with assets spread across nine countries in Central and Eastern Europe. NEPI also has low asset concentration and operates in relatively stable operating environments. NEPI's net debt to EBITDA is expected to fall to 6.0x in FY21 and remain below 6.0x in FY22, which is similar to Fitch's expectation for ACC.

ACC varies from most rated EMEA real estate companies in having leaseholds over about two-thirds of its operating assets. The cost of these leases means that its EBITDA margins are about 10% lower than most other EMEA real estate companies. There is also long-term renewal risk, as the leases do not have an automatic right of renewal. ACC has more related-party activity, with nearly all malls being built by group company FARE, while the largest single tenant is Alhokair Fashion Retail, whose various retail companies generate nearly a quarter of rental income.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Double-digit reduction in FY21 revenues, followed by modest single-digit growth after 2022 provided that rent discounts are less prevalent.

- EBITDA margin slightly lower than past performances at 62% for the forecast period

- High capex intensity ratio above 25% of revenue on average for FY21 to FY23

- Increase in leverage commensurate with rating at 6x on average

- Dividends of around SAR475 million in FY21 and then increasing with company policy of at least 60% of FFO

- Working capital outflow due to receivables from related-parties.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Occupancy rates consistently above 95%

FFO adjusted leverage consistently below 4.5x

A sustained improvement of the operating environment

A material reduction in asset concentration

A smoother lease maturity profile

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Deterioration in the operating environment

FFO adjusted leverage exceeding 7.0x on a sustained basis

FFO fixed charge coverage of under 1.75x

Occupancy rates below 90%

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

In November 2019, ACC issued debut USD500 million (SAR1.875 billion) 5.375% sukuk trust certificates (due in 2024), as well as USD1.2 billion (SAR4.5 billion) of new secured bank loans. The proceeds were used to refinance debt. The company also issued a USD200 million (SAR750 million) committed revolving credit facility (RCF).

The refinancing significantly improved the company's liquidity score, which now exceeds 2x. As of 30 September 2020 (1HFY21), the company had SAR879 million of cash having fully drawn on its RCF as a precaution against the effects of COVID-19. Despite the reduction in capex, Fitch forecasts ACC to have a free cash flow outflow of more than SAR350 million in FY21, mainly owing to working capital and dividend pressure. With only SAR45 million of debt amortisations due in FY21 and SAR119 million in FY22, cash comfortably covers these obligations. The first significant debt repayment will be the sukuk in FY25.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Arabian Centres Company: Group Structure: '4'

Fitch has assigned a an ESG credit relevance score of '4' for Group Structure, reflecting a high degree of related-party transactions that generate more than 25% of group rental income.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Arabian Centres Company	LT IDR	BB+ Rating Outlook Negative	Affirmed	BB+ Rating Outlook Stable
	LC LT IDR	BB+ Rating Outlook Negative	New Rating	
	Natl LT	A-(sau) Rating Outlook Stable	New Rating	
• senior unsecured	LT	BB+	Affirmed	BB+
Arabian Centres Sukuk Limited				

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Sukuk Rating Criteria (pub. 22 Jul 2019)

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

National Scale Rating Criteria (pub. 08 Jun 2020)

Sector Navigators - Addendum to the Corporate Rating Criteria (pub. 26 Jun 2020)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Arabian Centres Company	EU Issued
Arabian Centres Sukuk Limited	EU Issued

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