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Industry Report Card:

After Falling Valuations, Cash Flow Performance Could Pressure Ratings In The European Real Estate Sector

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Industry Credit Outlook

Depressed economic conditions, sliding asset valuations, and scarcity of capital sources continue to challenge the real estate sector.

Standard & Poor's Ratings Services has consequently taken some negative rating actions since the beginning of 2009. General prospects for the sector remain glum. We expect additional pressure on ratings during the coming quarters, and believe financial flexibility and liquidity will be the key negative rating triggers.

We are focusing particularly on asset valuations, which weaken the balance sheets of real estate companies and hamper their financial flexibility, albeit to differing degrees depending on markets and segments.

We also highlight the weaker-than-expected liquidity of real estate products, amid plunging transaction volumes and the significantly reduced availability of debt financing. The difficulties of selling assets in the current sluggish market environment weigh negatively on real estate companies' financial flexibility and are testing their ability to restore their balance sheets through disposals.

We believe that European commercial real estate markets may need to adapt to a new world with a prolonged decrease in the availability of debt financing, a rebalancing of capital structures, and a shift toward equity financing.

Although we think most of the effects of the economic recession are already apparent in asset valuations (and therefore on balance sheets), we emphasize that the strain on real estate companies' operating and cash flow performances will likely increase over the coming quarters, because of falling rents and Europe's depressed economies.

Rating actions and trends: down, down, down

Since our last sector report card in January 2009, real estate markets have continued to deteriorate, on falling asset valuations, rising pressure on rent levels, and the financial market downturn. We continue to believe that most of the companies we rate are well positioned to face the adverse environment thanks to their generally high-quality asset portfolios and manageable balance sheet structures. Most of them benefit from business risk profiles that we view as strong and are rated investment grade, which reflects our views on their credit quality. They are nevertheless not immune to the slowing economy. We have consequently taken some negative rating actions, mostly linked to reduced financial flexibility and liquidity. Interestingly, companies' constrained financial flexibility has resulted more from bad corporate governance practices and an ensuing lack of investor confidence than from pure operating fundamentals or high leverage. All in all, we believe that financial flexibility remains a major rating factor and a key rating trigger given the current scarcity of capital.

For instance, we lowered the rating on Atrium European Real Estate Ltd. to BB/Stable from BB+/CreditWatch

Negative in February 2009 on slow market conditions in Eastern Europe and Russia. We again lowered the rating to BB-/CreditWatch Negative from BB/Stable in May on risks associated with the potential acceleration of one of Atrium's bonds and the ensuing effect on the group's liquidity position. Corporate governance issues and deteriorated investor confidence also contributed to these downgrades.

We also lowered the long-term rating on France-based Gecina to 'BB-' from 'BB+', with a negative outlook, on credit-dilutive corporate governance practices and a perceived weakening in financial flexibility, resulting from a lack of investor confidence.

Still, we affirmed several ratings with stable outlooks on various players, based on solid operating performances, adequate liquidity positions, and a proven ability to raise capital. These include French companies Unibail-Rodamco (A/Stable/A-1) and Klepierre S.A. (BBB+/Stable/A-2), as well as Belgium's Befimmo S.C.A. (BBB/Stable/A-2).

We affirmed the ratings on U.K.-based Derwent London PLC (BBB/Stable/A-2) despite the rapidly deteriorating office real estate market conditions in the U.K. Our view of the group's solid balance sheet and adequate liquidity position underpinned our affirmation.

Our outlook distribution for the sector points to potential further negative rating actions in the coming quarters, which if they take place will be due to continued declines in companies' financial flexibility and liquidity positions. Rating pressure will likely be accentuated, particularly if companies do not successfully access new capital to refinance future debt maturities or if they are unable to sell properties to deleverage their balance sheets. A material deterioration in the economic landscape, beyond current expectations and resulting in depressed operating performances in the real estate sector, could also lead to additional downgrades, although we have already incorporated declining rents in our forecasts for 2009 and 2010. Finally, we will closely monitor merger and acquisition (M&A) activity, as we understand current valuations offer great investment opportunities, given the combination of falling asset valuations and discounts on net asset value (NAV) implied in stock prices. Some companies might be willing to use their fire power??? to benefit from deals that could be considered as once-in-a-lifetime opportunities.

Valuation slide weakens balance sheets and strains ratings

The degree of the fall in valuations so far has become apparent, as have the variations from one market to another, depending on each market's transparency, liquidity, and reactivity. The U.K. market correction has been particularly severe, while continental European markets have suffered less. Although it is difficult to predict when valuations might bottom out, we expect further drops in valuations throughout 2009.

Three factors shape the correction in real estate asset valuations: global asset repricing, capital scarcity, and changing macroeconomic expectations. Asset repricing is ongoing and expected returns are still being defined. These uncertainties weigh negatively on real estate prices, as investors prefer to take a conservative view on valuations. In addition, capital scarcity remains a main issue given the sector's capital-intensive nature. As capital becomes less available and more expensive, companies are cherry picking their investments. Prices are being cut to offer a decent return given higher cost of capital. Lastly, players have scaled down their expectations for future rental performance given the adverse economic conditions, resulting in an increasing focus on operating risks such as vacancy rates, over renting, and potential tenant default. These trends negatively affect cash flow-based valuations and drive prices further down.

That said, we note that some markets have reacted much more rapidly and severely than others. The U.K. market

correction was especially pronounced, with commercial real estate values shedding 30%-40%, whereas values across continental Europe have slipped 10%-20%. We believe U.K. market conditions stem from increased transparency in the country's investment market and the more drastic approach that independent appraisers have taken versus their continental European counterparts. We also underscore another obvious reason: the deeper impact of the financial dislocation on the U.K. economy compared with Germany and France, for instance, given the U.K.'s high exposure to sharply lower financial services activity. Still, we think valuations are more likely to fall further in most markets in 2009, but the rebound could be more rapid for U.K. assets than for those in continental Europe.

Declining valuations are a chief contributor to the weakening of companies' balance sheets and their asset coverage. This is because leverage in the sector is often measured using the loan-to-value ratio. We view asset coverage as a major credit strength for the sector, because it generally provides some financial flexibility and increases recovery prospects for lenders. Companies' lack of control over asset valuations and therefore of the management of their own balance sheets is nevertheless a negative that is placing strain on the ratings on groups that did not maintain a conservative balance sheet during the good years.

Financial flexibility drives ratings in the short term with an emphasis on debt covenant compliance and maturities

We are keeping a strong focus on companies' maintenance of adequate financial flexibility and liquidity, given our opinion that weakening in one or both of these areas could prompt downgrades. Both are crucial in real estate, given the sector's high capital intensity and generally high leverage. In particular, we put a lot of emphasis on a company's ability and flexibility to meet investment and financial commitments over the next 24 months and to avoid short-term liquidity problems or refinancing issues. We also believe that management credibility, visibility on strategy, and high corporate transparency are vital to reassure investors and attract capital.

We also use the existing and projected headroom under financial covenants to measure financial flexibility. We assess, in particular, a company's processes to identify, measure, and manage covenant-breach risks as well as its ability and willingness to reduce its investment pipeline and capital expenditure outflows--to what degree, by when, and with what repercussions on the business profile.

How real estate companies will manage future debt maturities is another hot topic, given the significant refinancing needs in the years ahead for European corporates and the real estate sector in particular. After reviewing all companies that Standard & Poor's publicly rates in the region, we calculate that €329.9 billion of debt will fall due in 2009 and €235.3 billion in 2010 (see "European Corporates Face Significant Refinancing Risk In Extremely Difficult Market Conditions," published March 31, 2009, on RatingsDirect). On the CMBS side, we estimate that 75% of total outstanding debt is due between 2009 and 2014, with the largest maturities occurring from 2011 to 2013. Still, we believe there will be adjustments in commercial real estate finance to avoid meaningful refinancing concentration.

Companies generally achieve financial flexibility through a proactive and early refinancing strategy, by maintaining low financial gearing, diversifying funding, setting up a long-dated and well-staggered debt maturity schedule, and gaining access to adequately sized committed back-up credit facilities. We believe that Klepierre's €2.4 billion debt refinancing with BNP Paribas and the €575 million convertible bond issued by Unibail-Rodamco improved each company's respective financial flexibility. In addition, the ensuing improvement in the respective debt profiles had little or no negative impact on cost of debt, and profitability remained relatively unhindered by these transactions.

Investment markets find the financing doors shut, reducing the liquidity of real estate assets

Increasing moves globally to reprice assets and the resulting imbalance between high prices still asked by sellers and the far lower expectations of potential buyers prompted the steep fall in investment activity in the real estate sector starting in the second half of 2008 and prevailing in the early months of 2009. We observe that the decrease in valuations that began in 2008 and then accelerated toward the end of the year continued in the first half of 2009. Real estate asset prices have now become attractive again, although the correction in valuations has not yet come to an end, for the reasons we outline above. Investors that are still ready and able to invest are looking again at opportunistic investments, which is a positive sign against this gloomy backdrop.

Yet, once the imbalance between expectations of buyers and sellers is resolved, there comes the problematic question of raising funds at a time when banks are struggling to restore their own balance sheets and trying to reduce their exposure, especially to the real estate sector. Highly leveraged financing structures have fuelled property investments in recent years. During these buoyant times, banks were the greatest liquidity provider for the sector by far and their current need to manage their existing loan books and to strengthen their equity has a significant impact on investment activities. Our understanding is that banks are still ready to accept loan extensions (at a much higher price, though) but are less enthusiastic about providing new credit lines. One illustration of this abrupt change is the limited number of banks that are now ready to lend "big-ticket" loans, i.e. loans above €100 million, whereas this amount would have been relatively easy to obtain not more than two years ago.

Another financing option is the financial debt markets. Although the bond market has been very active since the beginning of the year for companies, spreads observed in sectors linked to real estate and construction continued to be very high. Most of the time, spreads have been far too expensive to sustain a business model that is notably based on the spread made between cost of capital and the real estate yield.

Given the still-challenging debt market conditions, transactions are in our view likely to remain limited over the coming quarters. Although we generally consider real estate assets as fairly illiquid, as it takes time to market and complete a disposal, we believe that the real estate investment market is usually an active market with a steady flow of transactions. If the absence of a high volume of transactions--especially large ones--persists, we could reconsider our views on the marketability of real estate assets and on companies' ability to manage disposals and deleverage their balance sheets on a timely basis. This could ultimately have a negative impact on our assessment of the industry risk and business risk profiles of rated companies.

Equity financing therefore appears to us to be an expensive resource but also a key driver for any improvement in the investment market and necessary to restore the financial health of the real estate sector. Equity-rich buyers are more active now, especially pension funds, private funds, and multi-family offices. What we have observed so far is nevertheless mostly limited to small transactions and we will monitor how larger transactions will be structured in the coming quarters. In addition, large corporate capital increases gained importance during first-half 2009, as some real estate companies were unable to keep up with the value correction and their balance sheet deterioration by making an adequate number of disposals. Companies' objectives were to restore balance sheets, avoid any covenant breaches, and to maintain sufficient headroom to make opportunistic acquisitions in the future.

Rents currently benefit from a time lag effect but could squeeze future operating performances and cash flows

We have seen a material drop in asset values over the past 18 months, but cash flows remain resilient so far. The stability of and visibility on revenues from rental activities remain major credit strengths. Still, we believe the sector

is now entering the test phase because rents in Western European capitals have almost all peaked and are now trending down.

This is due especially to much lower demand for new space. Unemployment is on the rise in most markets and uncertainties on future growth prospects remain high. The consequences include much longer decision process--already experienced during 2008--and a clear shift in the negotiation balance from landlords to tenants, along with mounting vacancy rates as space optimization increases and new projects come to completion.

Other increasingly important factors include:

- The rise in tenant defaults-–or at least distressed situations, resulting in delayed rent payments or even bad debt.
- The expanding subletting market in cities where this is permitted, such as London, and which could lead to a distressed rental market. Average sublet prices are generally lower, pressuring the traditional rental market. In addition, landlords usually have little control over sublet prices.

Although the scenario of a marked drop in rental values is increasingly likely for the reasons we outline above, we are only just starting to observe the decline's impact on market face values. We believe this is mainly due to a time lag effect, arising from new lease contract structures and timing in the renegotiation of existing contracts. We understand that new contracts have face values very close to the still-high market prices but include increased incentives, such as significantly longer rent-free periods. We also understand that average lease maturities are shortening. This reduces somewhat the long-term visibility on future cash flows, which we consider is generally a key supporting factor for the sector. Finally, the risk of having an over-rented portfolio increases as market rents fall. We think this could also result in decreasing rental cash flows in the future or a limited ability to pass on positive index-linked rental adjustments.

All in all, we believe that the expected strain on future rental revenues given the above-mentioned reasons, combined with much higher margins on new contracted debt, could lead to reduced profitability and operating cash flows for the sector. This in turn would result in gradual further downward pressure on the ratings. Still, since this could take time, the currently low interest rate environment is likely to favor an improvement in cash flow metrics in the short term.

Chart 1

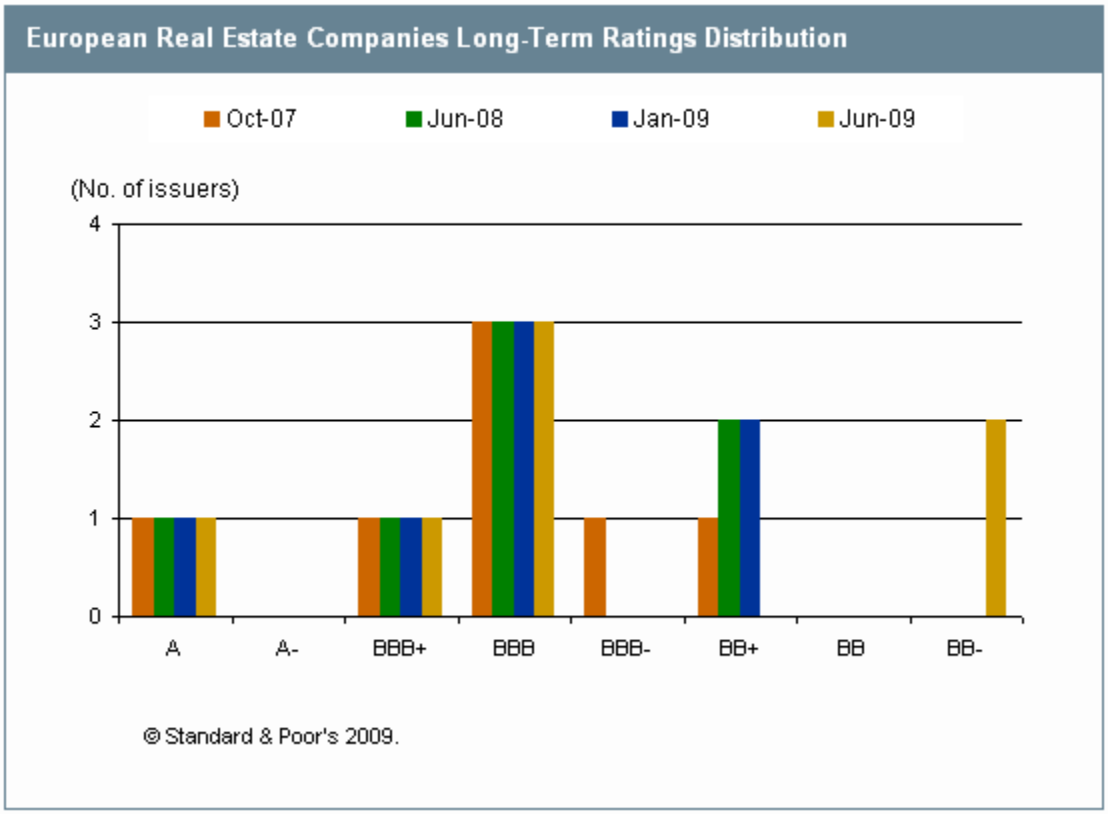
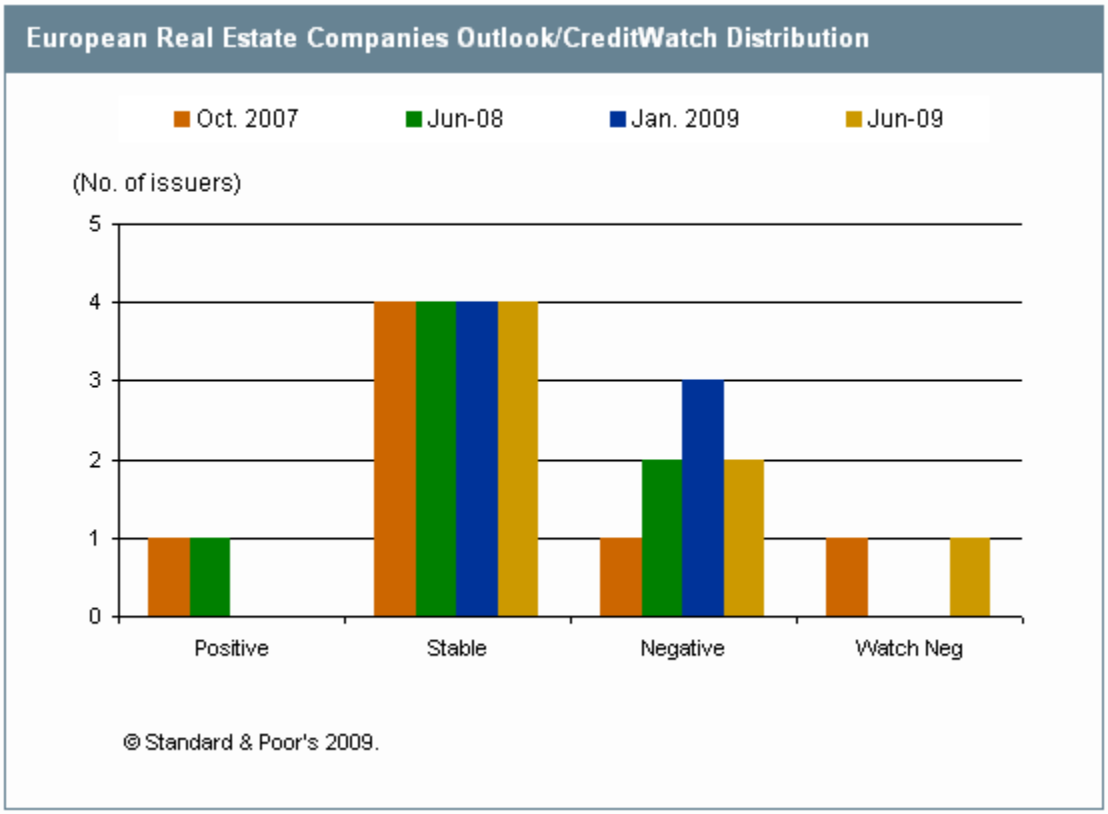


Chart 2



Issuer Review

Table 2

Company/Corporate credit rating/Comments	Country	Analyst
Atrium European Real Estate Ltd. (BB-/CreditWatch Neg/B) The ratings were recently lowered and place on CreditWatch, reflecting our perception that bondholders may be willing to seek redemption from Atrium, which we analyze as evidence of reduced access to liquidity. It also reflects the potential negative impact on the group's hitherto solid liquidity position in case of an acceleration of its bond due in 2016.	Jersey/Austria	Pierre Georges
Befimmo S.C.A. (BBB/Stable/A-2) Befimmo's recent capital increase has strengthened the group's balance sheet and provides greater headroom to operate in a more challenging environment. We believe this deleveraging action also currently provides additional stability in the BBB rating.	Belgium	Pierre Georges
Cofinimmo S.A./N.V. (BBB/Negative/A-3) The negative outlook reflects the pressure on Cofinimmo's credit profile stemming from the company's current high leverage and the increasingly tough conditions in the real estate and capital markets. We believe the group is nevertheless taking steps to reduce leverage, notably by selling assets and treasury shares.	Belgium	Pierre Georges
Derwent London PLC (BBB/Stable/A-2) The stable outlook reflects our expectation that Derwent London is well positioned to face increasingly challenging market conditions. We may revise the outlook to negative if conditions on the real estate or capital markets deteriorate more than expected, notably if the real estate transaction market maintains its current illiquidity or if tenant defaults sharply increase.	U.K.	Pierre Georges

Gecina (BB-/Negative/B) We recently lowered the rating, reflecting our negative opinion of Gecina's corporate governance and the resulting risk we perceive of significantly reduced financial flexibility. We believe that several unexpected related-party transactions reflected heavily credit dilutive corporate governance practices that may weaken the company's access to financing	France	Pierre Georges
Klépierre S.A. (BBB+/Stable/A-2) We believe the recent restructuring of the group's three syndicated credit lines provides additional financial flexibility to the group, which supports current ratings despite the increasingly tough real estate market. This will notably remove potential short-term pressure linked to previously reduced headroom under the financial covenants.	France	Pierre Georges
Unibail-Rodamco (A/Stable/A-1) The stable outlook reflects our expectation that Unibail-Rodamco will maintain an intermediate financial profile, with funds from operations (FFO) to debt at close to 10%, LTV below 45%, and EBITDA interest cover of more than 3x. The mix of large, dominant retail centers, geographic diversity, low vacancies, and indexation clauses in the group's rental contracts should continue to contribute to resilient rental income over the cycle and we believe these positive factors will allow the group to continue weather the depressed macroeconomic environment.	France	Pierre Georges

Ratings as at July 27, 2009.

Quarterly Rating Activity

Table 3

European Real Estate Recent Rating/Outlook/CreditWatch Actions*

Issuer	To	From	Date	Reason
Atrium	BB/Stable/B	BB+/Watch Neg/B	20 February 2009	Increasingly challenging market conditions in the Central and Eastern European markets, as well as Russia, where the company operates.
	BB-/Watch Neg/B	BB/Stable/B	09 June 2009	Atrium announced acceleration risk on its €600 million bond due 2013.
Gecina	BB-/Negative/B	BB+/Watch Neg/B	15 May 2009	The rating actions reflect our negative opinion of Gecina's corporate governance and the resulting risk we perceive of significantly reduced financial flexibility.

Contact Information

Table 4

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Related Research

European Corporates Face Significant Refinancing Risk In Extremely Difficult Market Conditions, March 31, 2009

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