04 Dec 2019 | New Rating

Fitch Rates Arabian Centres Company and Sukuk 'BB+

Fitch Ratings-London-04 December 2019:

Fitch Ratings has assigned Arabian Centres Company (ACC), a Saudi Arabia-based real estate company, a final Long-Term Issuer Default Rating (IDR) of 'BB+ with a Stable Outlook, and final senior unsecured rating of 'BB+'. At the same time, Fitch has assigned the sukuk trust certificates issued through Arabian Centres Sukuk Limited (ACSL) a final rating of 'BB+', in line with ACC's IDR.

On 26 November 2019, ACC issued USD500 million, 5.375% sukuk trust certificates due in 2024, which constitutes the company's debut international Islamic bond. The final terms of the sukuk are materially in line with Fitch's base case assumptions. ACC is using the proceeds of the issuance, as well as USD1.2 billion of new secured bank loans, to refinance debt, as well as for general corporate purposes.

The ratings reflect a balance of ACC's strong business position with asset concentration and positive, although uncertain, external factors. ACC is the largest retail real estate company in Saudi Arabia (KSA) in the nascent, but growing, Saudi retail mall sector. Occupancy rates are 93% with a diverse tenant base, although there is a concentration of large key account tenants, many of them related parties.

The lease maturity schedule is lumpy and operating environment factors such as the price of oil, government policy and geopolitics can significantly affect the rate and direction of retail growth, which can influence rents and valuations.

The senior unsecured rating reflects an adequate unencumbered asset pool. Although the trust certificates rank below secured creditors' ring-fenced assets, sukuk holders rank pari passu with all unsecured debt. Unencumbered assets constitute 62% of the investment portfolio value, which equates to a strong 4.1x unencumbered asset ratio.

Key Rating Drivers

Strong Market Position: ACC is the largest shopping mall operator in KSA by total gross leaseable area (GLA), holding a 14% market share in the country's four primary cities (the next largest competitor holds 6%), which provides some economies of scale and competitive advantages. The portfolio comprises 21 malls across 10 cities that cover about 60% of the country's population.

Like-for-like occupancy is 93% with footfall, which has grown 8% per year over the past five years, reaching 109 million in financial year to March 2019.

Cinemas to Bolster Offering: Management is increasing mid- to high-end food and beverage offerings, as well as entertainment, particularly family-oriented activities and cinemas, to ensure that its shopping centres are destination malls. With the government's prohibition on cinemas now lifted, ACC opened its first cinema in the Mall of Arabia (Jeddah) in August 2019 and will open four more by FYE20. In the medium term, ACC expects to open cinemas in 14 more malls, underlining the importance of cinemas to ACC's strategy.

Positive Market Dynamics: Mall penetration is low in KSA, averaging about 0.4 sq m in the four main cities of the country, compared with 1.2 sq m for Dubai and an international benchmark of 1.1 sq m. This should provide ACC with good growth opportunities. The domestic market is benefiting from a young, growing and largely urban population; improved infrastructure and government efforts to diversify the economy; liberalisation of social restrictions; and promotion of tourism, among others. In addition, demand for malls is driven by a cultural inclination towards shopping as entertainment, especially in indoor, air-conditioned shopping centres. E-commerce penetration is also underdeveloped at less than 2%. Nevertheless, oil prices, government policies, and geopolitics can significantly affect the rate and direction of retail growth, which can influence rents and valuations.

Asset Concentration will Reduce: The portfolio is dominated by super-regional malls (more than 74,000 sqm), which generate around one-third of revenue, while the top-10 assets produce around 75% of revenue. This means that an issue in one large asset could cause a material fall in occupancy or footfall, adversely affecting revenue and tenant relationships. This concentration will gradually decrease as ACC expands, having opened two malls in September 2019 and two shopping centres and one extension scheduled to open within the next six months. A further five, including two super-regional malls, are planned in the medium term. ACC has procured the land for these projects but no capex has been committed. While the company has an extensive development pipeline, which will be the main driver of growth, committed capex is low at around 4% of the portfolio value.

Diverse Tenants, but Key Account Concentration: With more than 4,100 stores, 1,100 brands and a balance of international and local retailers, there is good diversity across the malls. However, there is a concentration of key accounts, which are large retail companies leasing multiple retail units across ACC's portfolio. Financial difficulty with a key account could significantly affect rental income. This was evident in 2017 and 2018 when a difficult retail market led to a contraction in like-for-like total revenue despite the objective of rental stability from contractual leases. The concentration of key tenant accounts is characteristic of the Saudi retail market, given the high degree of franchise companies in the retail sector.

Related-Party and Rental Forbearance Risks: ACC maintains long-term relationships with key accounts (averaging seven years), who help maintain good occupancy rates and pre-lettings. In turn, ACC provides material discounts to them. Nevertheless, there is some concentration risk as the top 10 key account tenants generate approximately 45% of rent. Key account tenants include a number of related parties, such as Alhokair Fashion Retail - one of the largest retail companies in the Middle East and ACC's largest tenant - contributing around 25% of revenue. Under company policy, management, audit, board (independent members) and the general assembly must approve and monitor related-party transactions. Nevertheless, the extent of related parties means rental forebearance remains a risk.

Lumpy Lease Maturities: While the weighted average lease term is around five years (1H20), more than 50% of leases expire next year. In FY20, management extended many leases on a short-term basis to improve the tenant mix in many malls and to better allocate space, especially for the new cinemas. Nonetheless, the uneven lease profile with this high level of short-term expiries is a risk and reduces cash flow visibility.

High Level of Leaseholds: Of ACC's 21 malls, 13 operate on land leased through head leases from third-parties. Upon leasehold maturity, ACC has no automatic right of renewal. If ACC is unable to renew the lease, ownership of buildings on the site would transfer to the landowner with no compensation to ACC. The current GLA-weighted average remaining leasehold maturity is 16 years, which implies a long-term risk, although one lease (Nakheel Plaza) expires in December 2019. Fitch views the likelihood of a failure to renew as remote, owing to the mutual benefit of extending the lease for both parties, but ACC's lease expense is likely to increase. For FY19, ACC's leasehold cost was about 10% of total revenues. It recently negotiated the lease renewal of Aziz mall for 30 years but which more than doubled the lease cost to 16% of that mall's current rent. However, the effect of this will diminish over time as ACC's revenue from the mall grows.

Conservative Financial Position: ACC has a fairly conservative financial profile with FY19 net debt/EBITDA of 5.0x, which is expected to fall to 4.6x by FY21. The medium-term development pipeline means this will likely return to current levels. ACC's portfolio generates fairly high net income yields of around 8.5% (based on independent valuation), largely reflecting the developing state of the retail market in Saudi Arabia. The loan-to-value of the total portfolio was 42%. ACC's EBITDA margins are lower than most other rated real estate companies, owing to head lease payments, which account for around 10% of ACC's total rental revenue.

Sukuk Ratings

The Sukuk rating is driven solely by ACC's 'BB+' IDR, as a default of these senior unsecured obligations would reflect a default of ACC in accordance with Fitch's rating definition (for details on the Sukuk issue, see 'Fitch Rates Arabian Centres Company's Sukuk 'BB+(EXP)' dated 13 November 2017 at www.fitchratings.com).

Derivation Summary

ACC's most similar regional peer is Majid Al Futtaim Holding LLC (MAF, BBB/Stable), a Dubai-based retail conglomerate whose food retail business includes operations in Saudi Arabia. MAF's real estate business includes 17 shopping malls (GLA of 1.3 million sq m), benefiting from the diversification of operating in multiple countries in the Middle East. This compares with ACC's 21 malls and GLA of 1.2 million sq m. MAF owns the freehold equivalent of its assets. MAF maintains low net debt/EBITDA of around 4.0x compared with 5.0x for ACC. However, MAF has higher asset concentration with its top five assets contributing more than 80% of EBITDA, while the top 10 assets of ACC generate 75%.

NEPI Rockcastle (BBB/Stable) operates a portfolio of retail assets across eastern Europe, mainly in Romania and Poland. NEPI has slightly higher leverage with net debt/EBITDA of around 6.5x at end-2018 relative to a net initial yield of 6.7%. NEPI is slightly larger with a EUR5.3 billion portfolio, but has better geographic diversity with assets across nine countries in eastern Europe. Its top 10 assets constitute 44% of the income-producing portfolio.

ACC is unusual among rated EMEA real estate companies owing to a high level of leaseholds interests in about two-thirds of its operating assets (with a weighted average remaining maturity of 16 years). The cost of the leases reduces ACC's EBITDA margins by about 10%, an expense most EMEA retail real estate companies do not have, and adds long-term renewal risk, as the leases typically do not have an automatic right of renewal. In addition, ACC has a high degree of related-party activity, with 18 of 21 company malls built by group company FARE, while the largest single tenant, generating nearly 25% of revenue, is the related retail franchise company Alhokair Fashion Retail.

The Saudi Arabian retail market is less developed than most EMEA countries with mall penetration of about 0.4 sq m compared with 1.2 sq m for Dubai and an international benchmark of 1.2 sq m. E-commerce penetration is also low at only around 2% compared with more than 18% in the US and UK. While the early stage of the retail market presents good growth opportunities, the influence of oil prices, government policies and geo-political issues means the Saudi retail market is more volatile than most other EMEA markets' operating environment.

Key Assumptions

-Stable EBITDA margin with three malls added to the portfolio

-Low single-digit growth in revenue as the Saudi retail market shows signs of recovery

-Increased cash outflow from capex and dividend distribution for 2020-2023 resulting in negative free cash flow

-Stable leverage profile

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action:

-Occupancy rates consistently above 95%

-Fitch-adjusted net debt/EBITDA consistently below 4.5x

-Improvement of the operating environment on a sustained basis.

-A material reduction in asset concentration

-A smoother lease maturity profile

Developments That May, Individually or Collectively, Lead to Negative Rating Action:

- Deterioration in the operating environment

-Fitch-adjusted net debt/EBITDA exceeding 7.0x on a sustained basis

-Fitch-adjusted EBITDA interest cover of 1.75x

-Occupancy rates below 90%

Liquidity and Debt Structure

Under the refinancing, ACC repaid an existing SAR7.2 billion loan facility with a secured bank loan of SAR4.5 billion and the SAR1.875 billion sukuk trust certificates. This improved the liquidity profile by significantly reducing scheduled amortisations with no material repayments until 2024. ACC still has fairly high cash levels on its balance sheet with SAR458 million at FYE19 (1H FY20: SAR423 million), mainly owing to remaining proceeds from the original loan. We expect the company to maintain comfortable cash levels. ACC also taken out an unsecured USD200 million committed revolving credit facility to enhance liquidity.

Dividends are expected to be paid semi-annually, in line with ACC's financial policy of a minimum of 60% of funds from operations, subject to adherence to debt covenants.

Date of Relevant Committee
11 November 2019

ESG Considerations

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 to the way in which they are being managed by ACC.

Arabian Centres Company; Long Term Issuer Default Rating; New Rating; BB+; RO:Sta
----senior unsecured; Long Term Rating; New Rating; BB+
Arabian Centres Sukuk Limited
----senior unsecured; Long Term Rating; New Rating; BB+

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Applicable Criteria
Corporate Rating Criteria (pub. 19 Feb 2019)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019)
Sukuk Rating Criteria (pub. 22 Jul 2019)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

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