

CREDIT OPINION

13 November 2019

New Issue

✓ Rate this Research

RATINGS

Arabian Centres Company

Domicile	Saudi Arabia
Long Term Rating	Ba1
Type	LT Corporate Family Ratings
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Arabian Centres Company

New issuer

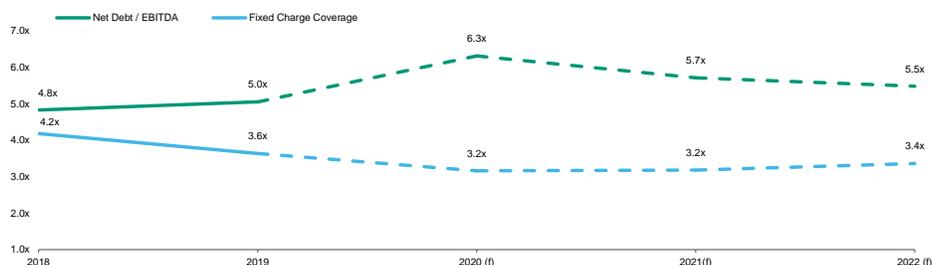
Summary

[Arabian Centres Company's](#) (Arabian Centres or the company) Ba1 corporate family rating takes into account (1) the company's strong market position as the largest retail mall operator in Saudi Arabia with good growth opportunities; (2) its high-quality retail property portfolio, with stable portfolio occupancy rates of around 93% as of 30 September 2019; (3) a diversified tenant base representing local and international brands; and (4) a diversified asset base made up of three super-regional, twelve regional and six community malls in the largest cities of Saudi Arabia with a market value of SAR21.9 billion (\$5.8 billion). The company has a moderate level of leverage, with net debt/EBITDA of 6.3x by the fiscal year ending 31 March 2020 (fiscal 2020), which is likely to fall towards 5.0x over the next 18 months supported by full-year earnings contribution from the recently completed developments.

The rating also factors in (1) the company's concentration in a single country, [Saudi Arabia](#) (A1 stable), and thus its exposure to a single economy in which the commercial real estate market is developing and retail sales have been weak over the past two years; (2) renewal risk on land leases, with the Mall of Dhahran's land lease due in five years and representing 15% of revenue; (3) a high portion of tenant leases expiring over the next two years; (4) the moderate development risk associated with greenfield projects; and (5) a high level of secured debt of 70% of total debt under the proposed debt structure.

Exhibit 1

Credit metrics to improve due to full-year earnings contribution from the recently completed malls



All figures and ratios are calculated using Moody's estimates and standard adjustments. Forecasts represent Moody's forward view, not the view of the issuer, and unless noted in the text, do not incorporate significant acquisitions and divestitures. In addition, forecasts capture the IFRS 16 implementation. Periods are fiscal year-end ending 31 March.

Source: Moody's Financial Metrics™

Credit strengths

- » Strong market position and franchise name
- » Good-quality retail portfolio with moderate occupancy rates
- » Low mall penetration per capita and supportive long-term retail fundamentals

Credit challenges

- » Concentration of assets in a single country
- » Significant related-party exposure
- » Renewal risk from its short rental lease profile and land leases
- » Moderate development risk

Rating outlook

The stable outlook reflects our expectation of a stable macroeconomic environment and that the company will continue to demonstrate stable occupancies and cash flow. The stable outlook further assumes management will pursue its growth strategy within its stated financial policies and ensure that the approaching land leases are renegotiated well ahead of time.

Factors that could lead to an upgrade

We could upgrade the rating if:

- » the company builds a track record of executing its business plan;
- » the weighted average lease term improves substantially with limited risk of leasehold renewals;
- » credit metrics improve such that its net debt/EBITDA is less than 4.0x and fixed-charge cover remains above 4.0x on a sustained basis; and
- » most of the property portfolio is unencumbered.

Factors that could lead to a downgrade

We could downgrade the rating if:

- » material leasehold properties are not renewed well in advance;
- » net debt/EBITDA is above 7.0x and fixed-charge cover falls below 3.0x, on a sustained basis; and
- » liquidity deteriorates.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Key indicators

Exhibit 2

Arabian Centres Company

	2018	2019	2020 (f)	2021 (f)	2022 (f)
Gross Assets (USD Billion)	\$3.8	\$4.2	\$4.9	\$4.9	\$5.0
Unencumbered Assets / Gross Assets	45.5%	46.2%	50.6%	52.3%	54.4%
Total Debt + Preferred Stock / Gross Assets	54.1%	58.1%	63.3%	64.5%	65.8%
Net Debt / EBITDA	4.8x	5.0x	6.3x	5.7x	5.5x
Secured Debt / Gross Assets	40.4%	43.2%	24.6%	26.5%	28.9%
Fixed Charge Coverage	4.2x	3.6x	3.2x	3.2x	3.4x

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Source: Moody's Financial Metrics™

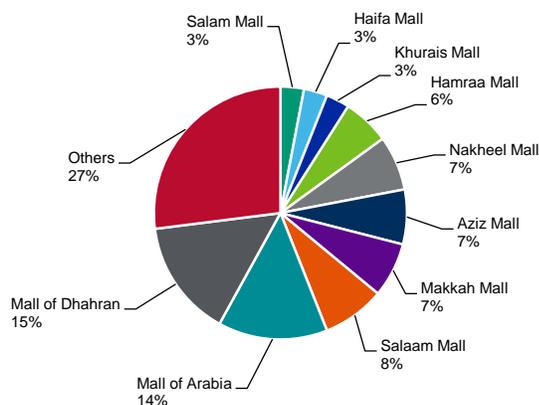
Profile

Arabian Centres, listed on the Tadawul Stock Exchange, is the largest owner and operator of retail malls in Saudi Arabia with a total of 21 existing malls that cover a total gross leasable area (GLA) of over 1.2 million square metres (sqm). The portfolio value had an estimated fair value of SAR21.9 billion as of 31 March 2019. The company has a development pipeline that will see the completion of two new malls and a major extension to one of its existing malls in the next six months, which together will add a further 196,000 sqm of GLA.

As of fiscal 2019, reported revenue was SAR2.2 billion (\$580 million) with a net income of SAR804 million (\$214 million).

Exhibit 3

Revenue split per mall

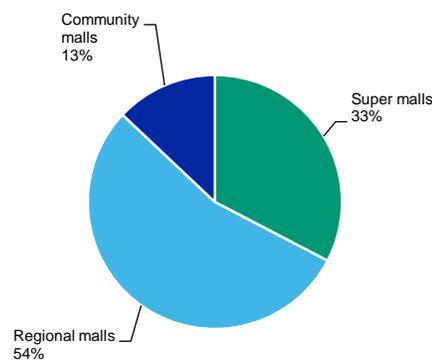


As of 30 September 2019.

Source: Company data

Exhibit 4

GLA split per mall size



As of 30 September 2019.

Source: Company data

Transaction

On 8 November 2019, Arabian Centres announced the refinancing of its current capital structure. The company plans to raise a combined \$1.7 billion in the form of a proposed \$1.2 billion equivalent secured Islamic finance facility and \$500 million equivalent unsecured sukuk trust certificates. The proceeds will be used to refinance all the existing indebtedness of the company. A new \$200 million revolving credit facility (RCF) due 2022 complements the new capital structure and will be undrawn at the closing of the transaction.

Exhibit 5

Indicative sources and uses

Sources of funds	\$ million	Uses of funds	\$ million
New secured Islamic finance facilities due 2027 and 2031	\$1,200	Repayment of Murabaha / Ijara facility	\$1,655
New unsecured Sukuk Trust Certificates due 2024	\$500	Cash on balance sheet	\$25
		Transaction fees	\$20
Total sources of funds	\$1,700	Total uses of funds	\$1,700

Source: Offering memorandum

Detailed credit considerations

Leading mall operator in Saudi Arabia with a good-quality retail property portfolio

Arabian Centres has a strong market position in Saudi Arabia, where it is the largest dedicated retail mall developer and operator, with an estimated 14% market share (per a third-party market study in 2018) by GLA. Arabian Centres benefits from its good-quality shopping malls that are located in prime locations in the top cities in Saudi Arabia. Although the portfolio is concentrated in a single economic region, Saudi Arabia, it does have broad exposure across 10 cities. These cities contribute most of the Kingdom of Saudi Arabia's GDP and benefit from a growing and relatively young population with high disposable incomes.

The company has grown the number of malls to 21, split into three super-regional, twelve regional and six community malls; however, there is some property concentration in the top five largest properties, which contribute 52% of total revenue and represent 40% of the total portfolio GLA. The largest property is the Mall of Dhahran in Dammam, which contributed 15% of total revenue and represents 13.2% of total GLA as of 30 September 2019.

The overall strategy of the company is to make its malls the leading leisure destination for tenants and customers. In the context of Saudi Arabia, retail malls are becoming increasingly popular because of the climate-controlled, secure shopping environment in a generally hot climate. Its malls comprise predominantly fashion outlets but also include important food and entertainment names. The company is enhancing its entertainment offering and has partnered with Muvi (local movie brand and a related group company) to roll out cinemas into most malls (17 out of 21) over the next 18 months, with its first cinemas opened in the Mall of Arabia (Jeddah) in August 2019. This is likely to boost the appeal of these malls, enhancing visitor experience and improving footfall.

With a 2% share of retail revenue, online retail is currently a low risk alternative to the traditional brick and mortar in Saudi Arabia. Arabian Centres' focus as a leisure destination and integration of online retail solutions lessens the longer-term threat of online retail.

Exposure to a single market with supportive long-term growth prospects

Saudi Arabia is the largest and wealthiest economy within the Gulf Cooperation Council (GCC) region, given its significant global oil reserves (18% of global oil reserves). The country benefits from favourable demographics. It has the largest (and relatively young) population in the GCC, which provides retailers with a sizeable consumer base with growing disposable income. Unlike Dubai, which has a large expat population, the majority of the Saudi Arabian population are locals (62%), which provides a more stable consumer base. Furthermore, the government's focus on diversifying non-oil revenue, specifically investments in infrastructure and entertainment sectors, will provide supportive long-term growth prospects to the retail sector.

In addition, the Kingdom has one of the lowest retail GLA per capita of 0.4 sqm compared with the average international benchmark of 1.1 sqm and Dubai at 1.2 sqm, which provides for good long-term growth opportunities for shopping mall operators. Shopping malls are likely to benefit from the structural shift from street shops to shopping centres with a healthy pipeline of retail supply that will be

added over the next three years. The total retail mall GLA in the four main cities was 6 million sqm as of 2018, with a further 1.5 million sqm of GLA planned to be added by 2021, of which Arabian Centres is planning to build 300,000 sqm. The new supply will, however, depend on the continued recovery of the retail environment.

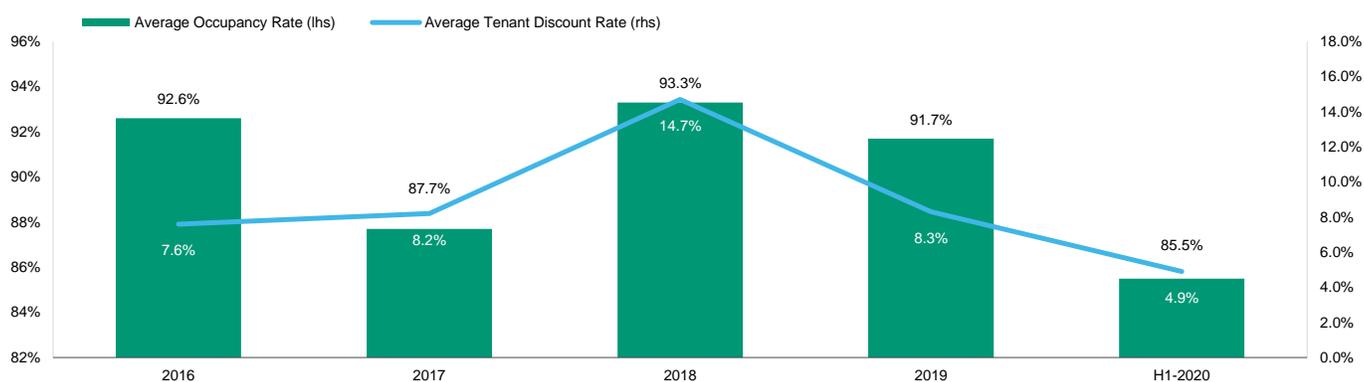
The retail environment over the past two years has been weak, with negative non-grocery retail sales growth of -1.0% and -0.1% in 2017 and 2018, respectively. This weakness has been because of lower oil prices and also as a result of a number of government policies that have been introduced, which have increased the cost of living and reduced disposable incomes (introduction of 5% VAT, expat levy and reduced subsidies to public employees). With signs of economic recovery in 2019, retail sales are slowly recovering and are likely to show moderate growth of around 2% to 3% per year with the potential to grow faster as government policy reforms take effect. According to Euromonitor, non-grocery retail sales are projected to increase to around SAR260 billion (\$69 billion) by 2021 from SAR225 billion (\$60 billion) in 2018, at a compound annual growth rate of around 5%.

Moderate occupancy rates, supported by the discounting of rents

Occupancies have historically been relatively stable; however, because of the weaker retail environment in 2017 and 2018, the company supported its tenants through the discounting of rents. Average discounts of 8.2% and 14.7% during fiscal 2017 and fiscal 2018 resulted in like-for-like revenue declines of 2.2% and 6.7%, respectively. Because of the recovery of the retail market in 2019, the company has reduced the average rental discounts to below 5%, which will help increase the company's rental revenue for fiscal 2020. Revenue for fiscal 2020 will also be boosted by two new malls that opened during the first half of fiscal 2020, which was the reason why the average occupancy rate fell to 85.5%. The period ending occupancy rate was 93.2% as at the end of 30 September 2019 and we expect average occupancy rates to revert above 90% over the next 12 months as these new malls ramp up.

Exhibit 6

Improving retail environment translating into lower tenant discounting



As of 30 September 2019.

Source: Offering memorandum

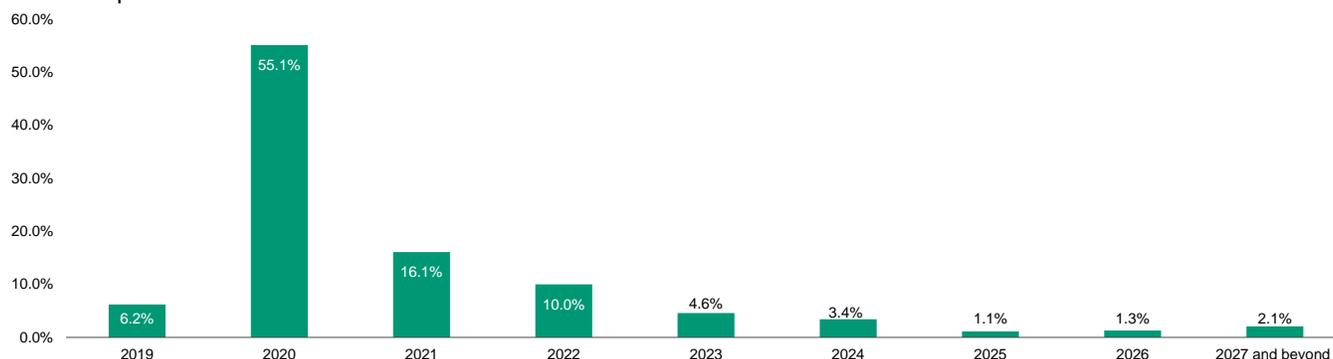
Arabian Centres has a well-diversified tenant base representing 1,100 brands, with reliance on key brands from the Al Hokair Fashion Retail Group, one of Saudi Arabia's most prominent retail franchise companies, which owns over 95 brands, leases 32% of Arabian Centres' total GLA and contributed to 26% of its total rental income as of 30 June 2019. While the close relationship with the Al Hokair Fashion Retail Group provides a stable tenant base for Arabian Centres' existing and new malls, given the fashion retail groups size and importance to Arabian Centres, Al Hokair Fashion Retail Group is in a stronger negotiating position.

Short-term tenant lease expiries reduce cash flow visibility

Arabian Centres manages more than 1,500 lease agreements with terms ranging from one to 10 years. Most of the agreements have three-year terms, with a weighted average lease expiry of 1.9 years as of 30 September 2019 and a high proportion of leases expiring in the next two years (Exhibit 7), which reduces contractual cash flow and exposes the company to potential rental reversion or higher vacancies. Management strategy is to improve the tenant mix with higher-yielding tenants with longer leases, which would create a more evenly distributed lease expiry profile.

Exhibit 7

High proportion of tenant lease expiring over the next two years Tenant lease expiries as a % of total rental revenues



By calendar year as of 30 September 2019.

Source: Offering memorandum

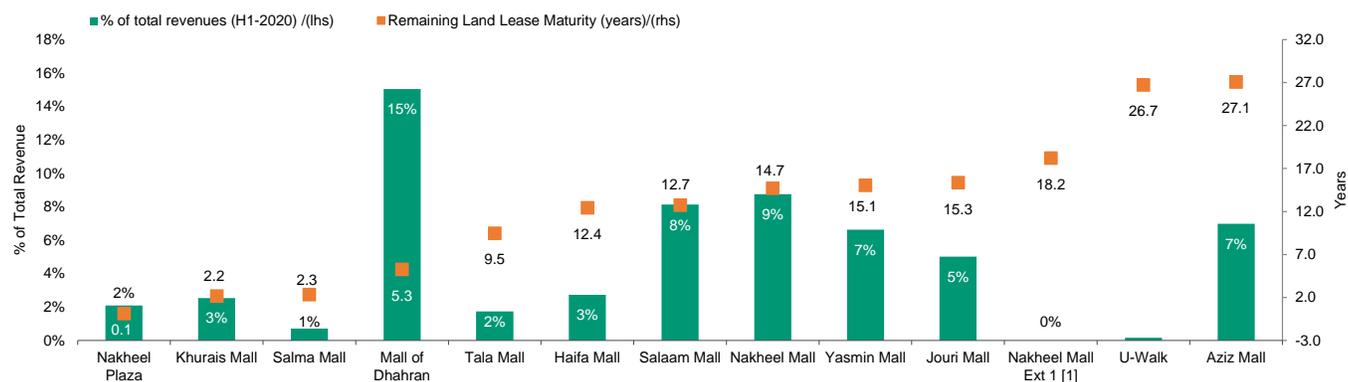
The property portfolio is internally managed with monitoring systems that are expected to strengthen as Arabian Centres collects tenant data that will provide the company with improved analytics to monitor and manage its tenants more closely.

High proportion of leasehold properties exposes the company to renewal risk

Twelve of the company's malls, representing 77% of its property portfolio by GLA as of 30 September 2019, are lease hold properties, where the land is leased and the building is owned by Arabian Centres. While most land leases are between 10 and 20 years, with a weighted average land lease expiry of 14.5 years, there are three malls with land leases maturing between two and five years. The Mall of Dhahran's land lease expiry in five years is a key risk to Arabian Centres, given it is the largest contributor to revenue (15% of H1-2020 revenue) and represents 13.2% of total GLA with an estimated market value of SAR1.2 billion (5.5% of total portfolio).

Exhibit 8

Medium- to long-term land lease renewal risks



Data as of 30 September 2019. [1] Nakheel Mall Extension 1 is not yet opened.

Source: Offering memorandum

Should Arabian Centres be unable to renegotiate the land lease, the building will be transferred to the landlord without any compensation to the company. Arabian Centres has some leverage, given it has lease contracts with the tenants with no tenant leases expiring after the land lease expiry. While the risk of losing ownership of the leasehold malls is not our base-case assumption, we would expect higher lease costs for Arabian Centres with land leases between 15% and 25% of mall revenue. Compared with the average land lease expenses of 9% of revenue, we expect operating margin to weaken over the long term. The track record of land lease renewal is limited, given most initial land lease agreements are still in place. To date, management has renewed one land lease (Aziz Mall), with the Nakheel Plaza land lease nearing completion. Over time, we see this risk increasing as more sizeable leasehold properties approach their expiry dates.

Portfolio growth strategy has moderate development risk

We regard management's risk appetite for development as moderate, highlighting a more speculative approach to adding capacity, with new malls experiencing a longer ramp-up period for reaching full capacity. While Arabian Centres' asset development programme is largely complete, the company has medium-term plans to continue to grow its footprint in key cities, which are under served by sizeable malls. These expansion plans will require additional financial resources over the near term and add execution risk with regards construction and achieving sufficient occupancies and rental yields to generate the expected revenue.

Management has a further four malls and one extension planned over the next five years. These are in prime locations in Saudi Arabia, focusing on densely populated residential areas close to major transportation hubs. The land has been secured, design plans approved and construction contracted with Fawaz Abdulaziz Al Hokair & Partners Real Estate Company (FARE) signed; however, the decision to proceed will depend on market conditions with the appropriate funding in place. Our analysis has factored the company's medium-term development pipeline into our ratings with the capital spending funded by internal cash flow generation and new debt.

Solid key metrics, underpinned by conservative financial policies

Arabian Centres' adjusted leverage, as measured by debt/gross assets, was 58.1% for fiscal 2019. However, the company's debt/gross assets is overstated, given the portfolio value is recorded at cost at SAR11.2 billion. Using independent third-party valuations of SAR21.9 billion results in debt/gross assets of around 41% for fiscal 2019. We consider the company's debt/gross assets (at fair market values) moderately positioned, but recognise that the commercial real estate market in Saudi Arabia is still maturing and the secondary market liquidity is limited, which may lead to wider variability between the actual disposal property values and third-party value estimates.

Moody's-adjusted EBITDA/interest expense + capitalised interest (fixed-charge cover) for fiscal 2019 was 3.6x, mapping to a Baa score in our grid. We expect this to decline towards 3.2x due to higher capitalised lease interest expense and gradually improve as contributions from the recent mall opening are taken into account. Similarly, we expect net debt/EBITDA leverage of 6.3x for fiscal 2020, before it falls to more moderate levels of around 5.0x over the next 18 months.

We consider management's financial policies conservative, as reflected by the loan-to-value target of less than 30% (based on fair market values), net debt/EBITDAR of less than 4.0x and interest coverage ratio of more than 4.0x (before the IFRS 16 adjustment).

Liquidity analysis

Arabian Centres' liquidity profile will be sufficient to meet committed cash outflows over the next 12-18 months. The company's primary sources of liquidity include unrestricted cash balances of SAR422.8 million as of 30 September 2019 and funds from operations, which we expect to be around SAR2.2 billion over the next 18 months. Arabian Centres has a minimum dividend payout policy of 60% of funds from operations, which will give it some financial flexibility to fund its medium-term developments with internal cash flow.

Liquidity will also benefit from an undrawn RCF totaling \$200 million at the start of the transaction. We note that the RCF is available for corporate purposes and to service the sukuk instrument, and excludes servicing the senior secured debt. The company has sufficient capacity under its financial covenants.

The company also has a limited amount of unencumbered assets representing 34% of gross assets based on fair value.

Structural considerations

The Ba2 rating assigned to the unsecured trust certificates is one notch below the Ba1 corporate family rating to reflect their effective subordination to the secured debt, which represents most of the pro forma debt. Encumbered assets linked to the secured debt represent SAR7.7 billion, with SAR4.5 billion freehold properties and SAR9.7 billion leasehold properties remaining unencumbered. Any shortfall related to the secured debt will rank *pari passu* with the trust certificates. We understand that over the next 12-18 months management intends to move towards a predominantly unsecured debt structure, at which point we would assess the rating impact on the sukuk trust certificates.

Certificate holders will effectively be exposed to Arabian Centres' senior unsecured credit risk. Holders of the certificates will not be exposed to the performance risk of the sukuk portfolio assets and do not have any preferential claim or recourse over the relevant Mudaraba assets, or rights to cause any sale or disposition of the Mudaraba assets except as expressly provided under the English Law transaction documents.

Environmental, social and governance considerations

Arabian Centres is listed on the Tadawul Stock Exchange with a 20% free float and the remaining stake owned by three brothers under the Fawaz Al Hokair Group. Arabian Centres is one of the three material subsidiaries of the Fawaz Al Hokair Group, the others being Fawaz Abdulaziz Al Hokair & Company (a fashion retailer that owns over 95 brands) and FARE (a construction company). Arabian Centres has sizeable related-party transactions with FARE for the construction of shopping malls and with Fawaz Abdulaziz Al Hokair & Company, which leases 32% of Arabian Centres' total GLA and contributed 26% of the total rental income as of 30 June 2019.

Rating methodology and scorecard factors

The principal methodology used in these ratings was the REITs and Other Commercial Real Estate Firms rating methodology, published in September 2018. The scorecard-indicated outcome of Ba1 is based on audited financial statements as of 31 March 2019, which records property values at cost.

Exhibit 9

Rating factors

Arabian Centres Company

Real Estate / REIT Industry Scorecard	Current FY 03/31/2019		Moody's 12-18 Month Forward View	
Factor 1 : Scale (5%)	Measure	Score	Measure	Score
a) Gross Assets (USD Billion)	\$4.2	Baa	\$4.5 - \$5	Baa
Factor 2 : Business Profile (25%)				
a) Market Positioning and Asset Quality	Baa	Baa	Baa	Baa
b) Operating Environment	Ba	Ba	Ba	Ba
Factor 3 : Liquidity and Access To Capital (25%)				
a) Liquidity and Access to Capital	Ba	Ba	Ba	Ba
b) Unencumbered Assets / Gross Assets	46.2%	Ba	50%-55%	Ba
Factor 4 : Leverage and Coverage (45%)				
a) Total Debt + Preferred Stock / Gross Assets	58.1%	Ba	60% - 65%	B
b) Net Debt / EBITDA	5.0x	Baa	5x - 6x	Baa
c) Secured Debt / Gross Assets	43.2%	B	25% - 30%	Ba
d) Fixed Charge Coverage	3.6x	Baa	3x - 3.5x	Baa
Rating:				
a) Indicated Outcome from Scorecard		Ba1		Ba1
b) Actual Rating Assigned				Ba1

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Source: Moody's Financial Metrics™

Appendix

Exhibit 10

Peer comparison

	Arabian Centres Company		Emaar Malls PJSC			Immobiliare Grande Distribuzione SiiQ S.p.A.		
	Ba1 Stable		Baa2 Stable			Ba1 Stable		
(in US millions)	FYE Mar-18	FYE Mar-19	FYE Dec-17	FYE Dec-18	LTM Jun-19	FYE Dec-17	FYE Dec-18	LTM Jun-19
Gross Assets	\$3,847	\$4,160	\$7,200	\$6,579	\$6,581	\$2,815.5	\$2,879.0	\$2,840.2
Unencumbered Assets / Gross Assets	45.5%	46.2%	100.0%	100.0%	100.0%	65.1%	60.1%	62.3%
Total Debt + Preferred Stock / Gross Assets	54.1%	58.1%	29.5%	18.5%	19.0%	48.3%	46.4%	47.7%
Net Debt / EBITDA	4.8x	5.0x	1.7x	1.5x	1.5x	10.2x	9.5x	9.5x
Secured Debt / Gross Assets	40.4%	43.2%	na	na	na	13.7%	14.6%	21.8%
Fixed Charge Coverage	4.2x	3.6x	9.9x	10.3x	12.3x	3.0x	3.5x	3.6x

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Source: Moody's Financial Metrics™

Exhibit 11

Moody's-adjusted debt breakdown

Arabian Centres Company

(in US Millions)	2018	2019
As Reported debt	1,554.1	1,797.4
Pensions	8.1	8.5
Operating Leases	520.4	608.9
Moody's-Adjusted debt	2,082.6	2,414.8

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Source: Moody's Financial Metrics™

Exhibit 12

Moody's-adjusted EBITDA breakdown

Arabian Centres Company

(in US Millions)	2018	2019
As Reported EBITDA	376.9	395.9
Pensions	0.2	0.4
Operating Leases	52.0	60.9
Unusual	0.5	0.1
Non-Standard Adjustments	-2.6	-3.1
Moody's-Adjusted EBITDA	427.0	454.1

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Source: Moody's Financial Metrics™

Ratings

Exhibit 13

Category	Moody's Rating
ARABIAN CENTRES COMPANY	
Outlook	Stable
Corporate Family Rating	Ba1
ARABIAN CENTRES SUKUK LIMITED	
Outlook	Stable
Senior Unsecured	Ba2

Source: Moody's Investors Service

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