The financial impact of Covid-19 on the retail property sector

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European Council of Shopping Places

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A response from the European Council of Shopping Places and its members

The European Council of Shopping Places (ECSP) is a Brussels based trade organisation created to provide a dedicated voice for the European retail property sector.

Our industry designs, creates, funds, develops, builds, and manages places anchored by retail across Europe. We provide a focus for every community in every urban centre, often incorporating a mix of leisure, office, and residential space, creating dynamic destinations and spaces for people to buy the things they need and want, to meet and do business, and relax with family and friends. Our sector employs more than 6.3 million people, generates an annual turnover of €750 billion and represents almost 160 million m² of floorspace. It welcomes billions of visitors every year, contributing significantly to the vibrancy and attractiveness of communities across Europe.

The Covid-19 pandemic continues to have unprecedented consequences on the life of European citizens, the economy, and society as a whole. However, the commercial impact has been disproportionate. Retail property traditionally plays a key economic and social function in all European markets. It is a business model that has contributed significantly to economic growth, investment, and prosperity and was steadily growing before the pandemic. However, the closure of hundreds of thousands of shops, stores, bars, restaurants, and places of commerce across the EU is hitting our sector extremely hard. On average, footfall was down about 50% and rental income was down by 25-30% in 2020.

The uncertainty of repeated lockdowns, the inconsistent approach by different governments, and the overly onerous focus on retail property owners to support an industry in crisis is not sustainable.

Landlords across Europe are having to shoulder the economic consequence of significant drops in footfall, rent collection, and increased costs[1], with very little financial help, support or guidance. The sector is working hard to manage the situation from a commercial and operational perspective. It calls for a coordinated strategy and approach to ensure that this short-term crisis does not have a longer-term detrimental impact on an otherwise successful industry, which could result in closures, bankruptcies, and rising unemployment. This scenario would have a devastating effect on the communities shopping places serve.

SUMMARY OVERVIEW

In this paper we provide an overview of the unsustainable impact that the Covid-19 pandemic has already had on Europe's retail property sector; the substantial risks that this creates for the economy if left unchecked; and lastly, our urgent requests for immediate action to support our industry.

Impact: An unsustainable vicious circle

Since the pandemic began, governments have reacted quickly to support the retail industry, often through direct subsidies. However, retail property owners across Europe have been shouldering a disproportionate and inconsistent level of responsibility to support the retail value chain, often acting as private economic financiers.

ECSP and its members have identified the following key areas of impact on shopping places across Europe:

Inconsistent application of government measures in different countries

- Government decisions regarding lockdowns were imposed in an inconsistent manner. These often differentiated between shopping places of different size or number of visitors allowed, as well as opening on an arbitrary and non-scientific basis. In some countries, such as France, large shopping centres above 20,000 sq.m (square metres) were closed, whereas small shops were not - although safety requirements can be met much better in the former. Furthermore, opening hours of brick-mortar shops were severely curtailed while e-commerce could operate without any restrictions on a 24/7 basis, exacerbating an already existing unlevel playing field situation in terms of taxes paid, for example (such as business rates, corporate, and VAT).

[1] ECSP Survey on the impact of Covid-19 on the Retail Property sector, November 2020, available at https://www.ecsp.eu/measuring-the-impact-of-covid-19-on-the-retail-property-sector/

- Subsidies dedicated to the retail sector vary enormously between European countries. The available support is not being distributed evenly across the value chain. It was often insufficient, in particular for retailers that had to close during the most favourable periods of the year, such as Christmas. Very little government subsidies are going directly to the retail property sector. In some member states there is no support at all. When support was granted to landlords, it was limited and complex, as well as unintentionally negatively impacted by EU State Aid rules (e.g. thresholds of support by tenants).

Landlords required to take disproportionate share of the economic burden

- Landlords are being asked to be flexible with their tenants on rental payments. In some countries, such as Austria, Germany, Portugal, and Poland, we are being legally obliged to grant rent relief. Where subsidies have been made available to retailers, the difference between the rent and available subsidy has often been met by landlords, requiring the injection of cash into their businesses to cover for the rent revenues not being collected. Conversely, banks are not granting any flexibility on the payments of loans and covenants, only against the payment of additional fees.
- In some EU Member States, no guidance has been provided on how landlords should manage their relationships with tenants who are struggling to honour their lease agreements, or how subsidies should be used.
- It is important to bear in mind that any rental payments foregone are forever lost.

Requirement to continue to fulfil and maintain existing banking obligations

- As a sector we have traditionally had very good working relationships with the banking and finance sector. However, the flexibility we are being asked to grant to retailers, and our consequent loss of revenue, are not being reciprocated in terms of our financial obligations, such as the repayment of loans or the extension of covenants.
- Servicing debt or raising capital has also become harder given the impact of Covid-19 on valuations. But, as transactional activity has almost stopped since the beginning of the pandemic, expert valuations are often largely based on general market sentiment rather than commercial realities. It is important to emphasise that there is no link between market sentiment and actual performance. Performance of our sector was very strong before the pandemic in 2019, even though the market sentiment was already negative then.
- The overall volatility and instability of the market is also having a negative impact on our sectors' ability to rely on lenders, a key stakeholder in our business model - particularly for privately held companies. There is real risk of covenant breachers in relation with LTV, but also Cash Flow, Net Debt / EBITDA or Debt Yield. These breaches can apply to both corporate or mortgage debt.
- EBA repayment moratoria guidelines are welcome to the extent that they extend maturity of loans, but they are unfortunately not applied homogenously across the EU. Banks are too often demanding additional fees in return for waivers. They also entail the risk of leading to cross defaults across portfolios as default covenants could be triggered.
- The temporary situation should not lead to the withdrawal of refinancing options, the increasing of debt service, and waivers fees. Worryingly, banks are starting to withdraw from our sector.
- As banks are not property asset managers, it is in no one's interest to see them become property owners of otherwise successful and commercially viable shopping places due to potential loan defaults or the impossibility to respect LTV covenants following the dramatic drop in expert valuations.
- In some cases, where debts owners have been unable to meet their financial repayment commitments, banks have exacerbated an already difficult situation by imposing punitive interest rate charges on late payments.
- With reduced rental income and the use of cash resources to support our businesses, we are also experiencing increasing liquidity issues.

Lack of public awareness of potential impact and consequences

- Because retail property is not a public facing industry, there is a general lack of market awareness or understanding of the issues we face, and of the bigger economic and social consequences should parts of our industry start to fail. This is reflected in how some governments are responding to the crisis.
- The value of a vibrant urban centre or community should not be underestimated or taken for granted. If shopping places start to close it will have a far broader social and cultural impact beyond the direct loss of jobs and investment.

Overall instability of the rental market

- We recognise that retailers have been significantly affected by the pandemic. Our business is dependent on good working relationships with them. Our members have worked hard to renegotiate rents, wherever possible, to reflect the economic reality and to help them stay commercially viable.
- However, this impact is not universal. Some stores in certain markets, such as convenience shops and pharmacies, have performed relatively well, with some having even increased activity.
- We see more and more dominant and well performing anchor tenants taking an opportunistic advantage of the situation by forcing a very substantial renegotiation of their rental agreements under the threat of not renewing their leases at the next lease-break. This happens mainly in secondary cities and could have a dramatic impact on the tenant mix and, therefore, on the long-term sustainability and dynamism of urban areas.

Risk: No change is not an option

Europe's retail property sector understands and appreciates that the pandemic is not over and is still having a devastating effect. It also appreciates that these are exceptional circumstances and national exchequers are under considerable strain. Society will need to work together to support the economic recovery.

The sector has worked hard for almost 12 months to support its community, including customers, employees, retailers, and investors. However, this status quo is not sustainable. Given the above impact, it is highly likely the sector will start to experience serious structural challenges, which could have a longer-term impact.

ECSP and its members have identified the following risks and consequences for the retail property sector over the next six months and beyond:

Increased likelihood of bankruptcies and closures caused by business failure

- With shopping places facing ad hoc closures, declining rental income, and stretched corporate financing, some companies will fail. Smaller and weaker shopping places and shopping places in secondary cities are likely to close due to rationalisation of portfolios by property managers seeking to secure their longer-term futures. This will create loss of important services and investment value and will increase unemployment.
- Shopping places are vital to the life of communities and city centres. They are key generators of footfall and commercial activity; a shopping place with a regional attraction in a city of one million inhabitants generates between 8 and 15 million visits per year. As a sector, we attract billions of visitors across Europe every year. Urban centres risk stagnation and potential decline leading to urban blight if they do not succeed.

Inability to pay business rates, taxes and invest in communities

- The economic recovery will require significant public investment, and the retail property sector contributes significantly to the public purse with VAT and other tax payments. However, a failed business cannot pay its business rates or its taxes, resulting in the loss of critical public revenues. Even relatively robust companies cannot sustain a continued loss of income, the cost of supporting the broader value chain, repayment of debt and limited access to credit. This increases the risk of a default, creating further pressure on public finance commitments. Both scenarios would result in the loss of important investment in the communities in which they operate, from infrastructure to new services, sponsorships, and community programmes.

Risk to capital markets: downgrades, debt repayments, loss in in investment and M&A activity

- The retail property sector serves communities, but is predominantly financed either from bank loans or through the capital markets. The lack of flexibility on the repayment of loans and covenant deadlines increases the risk of default, forcing companies to retain capital on their balance sheets and reducing their investment activities, which in turn will impact bond markets and other vehicles used to raise finance to invest in the future.

Subdued valuations lead to downgrades, credit squeezes and a decrease in pension values

- The inconsistent approach by governments across Europe has a major impact on valuations. In countries where government support is completely absent, valuations have shown to be significantly lower.
- Reduced valuations would either result in the sale of a distressed asset below usual market value, or its potential sale to an investor whose primary objective is to asset strip and secure the best return on its investment, rather than the long-term viability and success of the shopping place.
- For companies relying on debt capital markets, the risk of subdued valuations is connected to downgrades which can potentially lead to (i) increase in spreads or (ii) difficulties to access funding for companies with ratings close to, or below, investment grade. For example, Standard & Poor's put the entire sector on a negative outlook last year, which had an immediate impact on the sector's access to debt capital markets.
- Moreover, equity markets have been closed for our sector since March 2020. Therefore, if/when companies intend to reinforce their balance sheet by raising equity, they may face (i) the absence of long-term equity investors in European countries and (ii) potential actions from short sellers driving share prices down and potentially thwarting equity increases.
- A steep decrease in asset values will impact the sector's ability to raise capital, service its debt and secure vital investment. Any loss in value will also have a disproportionate impact on balance sheets of property investment funds, institutional investors, and pension funds, further weakening a sector that has to date been a cornerstone for the investment industry and still represents more than EUR 2 trillion in market value.[2]

Increased likelihood of banks becoming property owners and asset managers

- Failure to meet debt obligations could result in the ownership of retail property assets passing to debt owners who are not best placed to manage them.

[2] EPRA, INREV, *Real Estate in the Real Economy 2020, available at https://www.epra.com/public-affairs*

Ask: Timely actions for an urgent situation

A vibrant community should never be taken for granted. A shopping place fulfils an important role in helping to achieve this. It is a focus for economic and social activity, providing employment and attracting investment. It is consequently an important hub in a much broader value chain.

ECSP and its members have prioritised the following measures that could help mitigate the impact and risk associated with the pandemic on Europe's retail property sector.

We ask that the following is taken into immediate consideration by the relevant authorities:

1. **Review financial provisions: suspension or waiver of financial covenants; no recalculations or reclassifications or additional (waiver) fees**
    - Reconciliation and a more homogenous application across the EU between honouring debt obligations and maintaining realistic market valuations and expectations of capital market investors.
2. **Increased flexibility and extended timelines**
    - Increased liquidity at subsidised terms, the opening of new credit lines, reduced interest rate loans, the extension or postponement of timelines on LTV covenants, and refinance for long maturities.
    - Extension of maturities and short-term covenant waivers and exemptions.
3. **A more holistic approach to subsidies, where the burden is shared**
    - Aligned government support across Europe in relation to the allocation of subsidies whereby the State, rather than the landlord, takes on the responsibility for unpaid rents.
    - An agreed approach on the application of subsidies, whereby governments could cover the percentage of rent that commercial tenants are unable to pay, similar to what has been put in place for residential leases.
    - Support should be paired with a reduction in property taxes, the amount of which could be determined based on the level of support provided.
4. **Prepare guidelines providing basic rules and principles on asset classification and property tax payments**
    - These should be temporary and reflect the current exceptional circumstances, to guarantee the crisis is managed coherently across Europe and offset the differences in impact on retail property owners caused by national measures adopted by different member states.
5. **Provide credit lines to retailers**
    - Reopen and establish new credit lines to support retailers and inject liquidity back into the market, so they are more protected against bankruptcy and better placed to manage resources and pay for any subsequent restructure or refinancing.