Box B

Risks in Retail Commercial Property

The pandemic has accelerated structural change and so has added to strains for retail commercial property

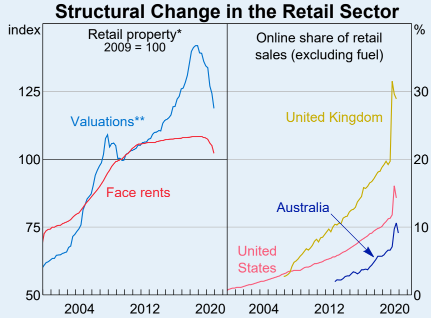
Retail commercial property in Australia was already facing a challenging environment prior to the pandemic. The margins of retailers, particularly bricks-and-mortar retailers for discretionary goods, were being compressed by intense competition from both large international and online retailers.[1] In addition to this reducing retailers' ability to pay high rents, the shift to online retailing was decreasing the demand for retail commercial property premises. These forces had resulted in falling retail commercial property rents and prices (Graph B.1). The need for social distancing through the pandemic rapidly accelerated the trend towards online retailing in 2020. With Australia having a relatively low share of online retailing relative to other advanced economies, it is likely this shift will continue to depress demand for retail properties.

As demand for retail tenancies declined through 2020, retail vacancy rates increased sharply (Graph B.2). They are likely to increase further with some department stores and large retailers announcing plans to further reduce the size of their floor space over the next couple of years. This will place further downward pressure on rents and valuations, which have declined by 6 and 15 per cent since early 2019 respectively.

The outlook is particularly uncertain for regional and sub-regional shopping centres (those anchored by full-line or discount department stores anywhere in Australia, including in capital cities and CBDs). These centres rely on maintaining a breadth of tenants to sustain high levels of occupancy. Together these centres account for roughly two-thirds of gross lettable area of all shopping centres. In contrast, risks around earnings and profitability in 'neighbourhood centres', are somewhat lower. The anchor

Graph B.1

Structural Change in the Retail Sector



* Regional shopping centres

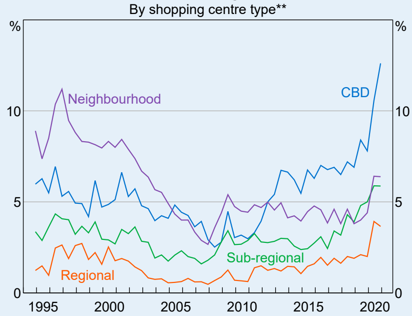
** JLL Capital Value Indicator

Sources: ABS; JLL Research; ONS; RBA; US Federal Reserve

Graph B.2

Retail Vacancy Rates*

By shopping centre type**



* Vacancy rates for specialty stores

** Regional centres are anchored by department stores, sub-regional by discount department stores, and neighbourhood by supermarkets; CBD includes a variety of retail formats

Sources: JLL Research; RBA

tenant in these centres are supermarkets, which have fared better during the pandemic. While vacancy rates in CBD shopping centres are very high, they account for only around 4 per cent of gross lettable area.

While there are risks for commercial property investors the financial stability risks seem low

When vacancy rates increase and rents decline, indebted landlords need to use a larger share of their earnings to meet debt repayments. Although lower interest rates work to lower debt-servicing burdens, for a large enough decline in earnings some may find it difficult to service their debt. This raises the potential for asset fire sales, further depressing retail property prices. Large price falls would see a wider range of leveraged investors breach loan covenants, requiring a review of their situation with their lenders and possible further property sales.

Historically in Australia and internationally, losses on commercial real estate (CRE) have accounted for a large share of banks' losses in downturns.[2] For this reason, lenders and financial regulators typically pay close attention to the exposure of the financial sector to CRE. The available information suggests that financial stability risks from retail CRE are currently lower than previous retail sector downturns. This reflects that CRE lending has experienced only moderate growth over recent years and has been subject to conservative lending practices. Moreover, the largest landlords have maintained conservative balance sheets, which will position them well to cope with the challenges posed by weakening rental demand.

The financial position of larger listed retail landlords remains sound

Large real estate investment trusts (REITs) own around three-quarters of regional and sub-regional shopping centres. Most of these large REITs are listed on the Australian Securities Exchange (A-REITs), and there is good information available to assess the financial stability risks from this part of the sector. A-REITs had total assets equivalent to about 10 per cent of GDP at the end of 2020 (most of which are CRE assets), or about 15 times the holdings of unlisted trusts. Nearly all A-REIT securities are held by institutional investors, with around two-thirds held by superannuation funds, and the bulk of the reminder held by insurance companies, other investment funds and offshore entities. There are also unlisted REITs of varying sizes that own retail commercial property. Some unlisted REITs are limited to only wholesale and institutional investors, though others are also available to retail investors.

Over one-fifth of all A-REITs have sizable exposures to shopping centres. Reflecting the decline in expected future earnings since the start of the pandemic, their share prices have under-performed relative to other A-REITs and the broader market (Graph B.3).

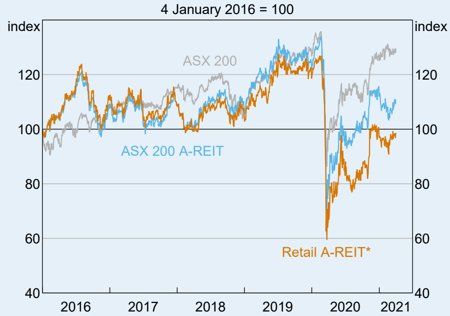
Retail A-REITs entered the pandemic in good financial health. As a result, they were well-placed to absorb the sharp temporary reduction in earnings as rental waivers were granted under a mandatory code of conduct established by the National Cabinet (to support tenants experiencing temporary financial stress during COVID-19). Retail A-REITs have relatively low leverage and have been easily able to make debt repayments despite some reduction in their profitability.

Profitability of retail A-REITs rebounded towards the end of 2020, as tenants resumed paying rent given trading improved, though it remains low relative to recent years (Graph B.4). There are ongoing risks to earnings, but a mitigating factor is that retail A-REITs have diversified portfolios with assets in various locations, and most have assets across a range of retail or broader commercial property segments. Retail A-REITs also have ample liquidity, which they generally increased in early 2020 in response to the more uncertain outlook.

Graph B.3

A-REITs' Share Price Indices

4 January 2016 = 100

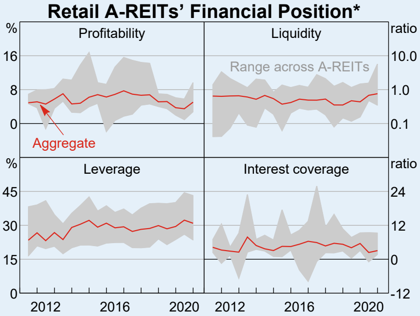


* Index constructed from 9 listed A-REITs with substantial shopping centre ownership; weighted by size

Sources: Bloomberg; RBA

Graph B.4

Retail A-REITs' Financial Position*



* Profitability measured by return on assets, liquidity by current assets over current liabilities (log scale), leverage by debt over assets, and interest coverage by earnings over interest expenses; sample covers 7–10 A-REITs with substantial retail property holdings over period shown

Sources: Morningstar; RBA

Both listed and unlisted REITs typically have low leverage and debt service obligations. This reflects internal risk-management strategies as well as lenders' underwriting parameters in their policies, which are designed to protect lenders against losses in the event of sharp falls in income or asset prices. Over the past year, retail A-REITs have been easily able to cover their interest expenses with current earnings, with the low level of interest rates supporting their ability to do so. Leverage has also remained low, and declined for most A-REITs in the second half of 2020.

For the largest retail A-REITs, the vast majority of debt outstanding has been sourced from capital markets, both onshore and offshore. In addition to issuing senior bonds and commercial paper, some retail A-REITs have issued debt via private placement. Drawn bank debt accounts for just 7 per cent of total debt outstanding for the 6 largest retail A-REITs, although they also currently have much larger undrawn bank loan facilities (equivalent to over one-third of total debt currently outstanding). Smaller retail A-REITs rely more heavily on banks for their funding needs, though in aggregate retail A-REITs' bank debt outstanding accounts for less than 2 per cent of banks' overall commercial property exposures.

There was good access to debt funding in 2020 for at least large retail REITs. A number of entities issued equity, raised debt and refinanced existing facilities to help them cover upcoming maturities. The largest A-REIT by market capitalisation, SCENTRE, issued 60-year subordinated hybrid notes in 2020. Accordingly, funding pressures in the next few years appear well contained. Less than a quarter of outstanding bonds are due to mature by the middle of the decade.

Some smaller retail landlords, with less diversified portfolios, may find it difficult to manage declines in earnings

Neighbourhood and CBD centres are often owned by smaller investors, which reduces the information available on their financial resilience. The wider ownership base for these types of centres reflects that they are typically smaller and therefore require less capital to purchase or develop. Some are owned by REITs, but many others are owned by private companies, self-managed superannuation funds or high net worth individuals. Because of this diversified ownership by private entities there is little information on the financial health of these smaller landlords. However, given their small size most leverage presumably comes from banks and, to a far lesser extent, non-bank lenders, and so will conform to those lenders' risk controls.

Smaller landlords' greater exposure to neighbourhood centres, which have fared better during the pandemic, implies somewhat less risk of a loss in earnings. However, some smaller landlords may still be vulnerable to significant declines in earnings if their underlying balance sheet position is weak, if the quality of their assets is poor, or if their portfolio has little asset diversification.

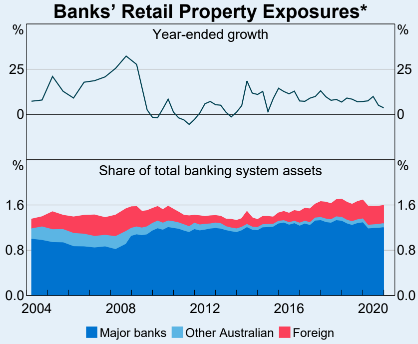
Overall, risks to lenders from losses on retail property exposures appear low

While some indebted landlords will find it difficult to meet their debt repayments, the near-term risks to financial stability from retail property appear to be low overall. Growth in banks' lending for retail commercial property has been moderate in recent years (Graph B.5). Retail commercial property exposures are low as a share of total banking system assets. The 4 major banks account for the bulk of exposures, with a smaller share belonging to foreign-owned banks. Individually, Australian-owned banks' direct retail CRE exposures are also low, ranging between 0 and 3½ per cent of their total assets. Further, banks' lending standards for commercial property have improved considerably in recent years. According to the Australian Prudential Regulation Authority's (APRA's) 2018 review on commercial property lending, the vast majority of CRE loans have been written with loan-to-valuation ratios (LVRs) well below 65 per cent and with earnings equal to 1.5 times interest expenses.[3] The application of loan covenants – such as minimum ICRs and low LVRs – has become more nuanced over the past decade, and provide an early signal for landlords and their lenders if the capacity to repay debt looks to be deteriorating.

Banks also have indirect links to retail property though business loans that use smaller, standalone retail property as an underlying security. These are not included in data on banks' exposure to CRE and the overall size of these bank exposures is not known. While secured business lending

Graph B.5

Banks' Retail Property Exposures*



* Excludes overseas exposures

Sources: APRA; RBA

accounts for a quarter of total credit, the share of these loans secured by retail property (rather than other assets) will be much smaller. There is a risk that business insolvencies could lead to distressed property sales of these assets, potentially leading to price declines in some areas and perhaps even losses to lenders. However, the overall risk to banks seems low, given that collateralised loans typically incorporate a healthy positive equity buffer and that these are highly diversified across regions and owners.

Endnotes

[1] Carter M (2019), 'Competition and Profit Margins in the Retail Trade Sector', RBA *Bulletin*, June, viewed 1 April 2021.

[2] Ellis L and C Naughtin (2010), 'Commercial Property and Financial Stability – An International Perspective', RBA *Bulletin*, June pp. 25–30.

[3] APRA (Australian Prudential Regulation Authority) (2018), 'Strictly Business: An Update on Commercial Real Estate Lending', *APRA Insight*, Issue 4. Available at <https://www.apra.gov.au/strictly-business-an-update-on-commercial-real-estate-lending>