

## THE SWEDISH REAL ESTATE SECTOR REMAINS IN A SWEET SPOT

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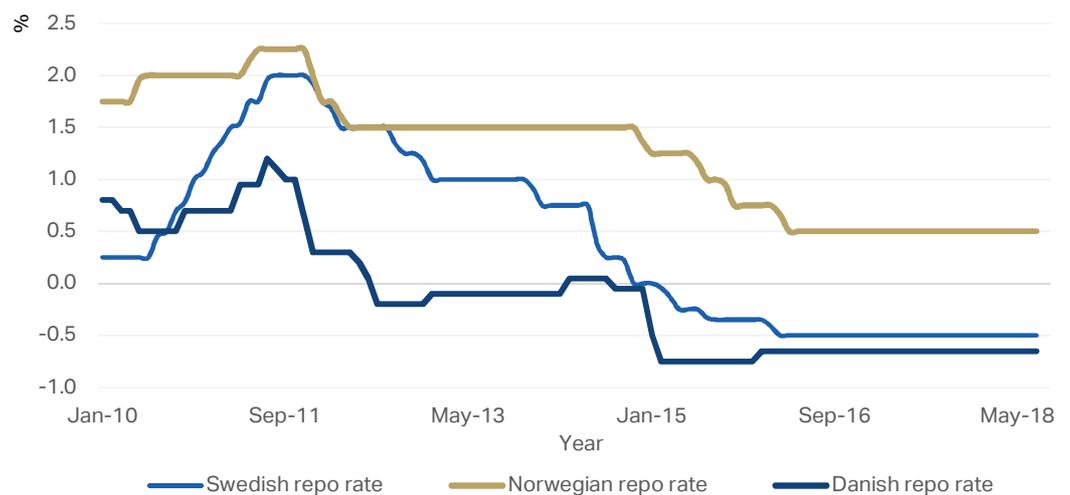
*Nordic Credit Rating is presenting its view of the Nordic real estate markets in a series of articles analysing the key credit risk drivers in the sector. The first article is mainly focused on our view of the Swedish market. Our real estate research is produced in close cooperation with our banking team as we believe that the two sectors are closely related. The articles can be read in conjunction with our recently published corporate and financial institution methodologies, which can be found on our website [www.nordiccreditrating.com](http://www.nordiccreditrating.com).*

### FUNDAMENTALS REMAIN STRONG DESPITE SOME CLOUDS ON THE HORIZON

We believe the strong operating environment that Swedish real estate issuers are currently experiencing will continue over the next few years. We do, however, note that there are some challenges ahead, both from a macroeconomic perspective, including rising interest rates, and at issuer level, including the continued growth of e-commerce and tougher environmental legislation.

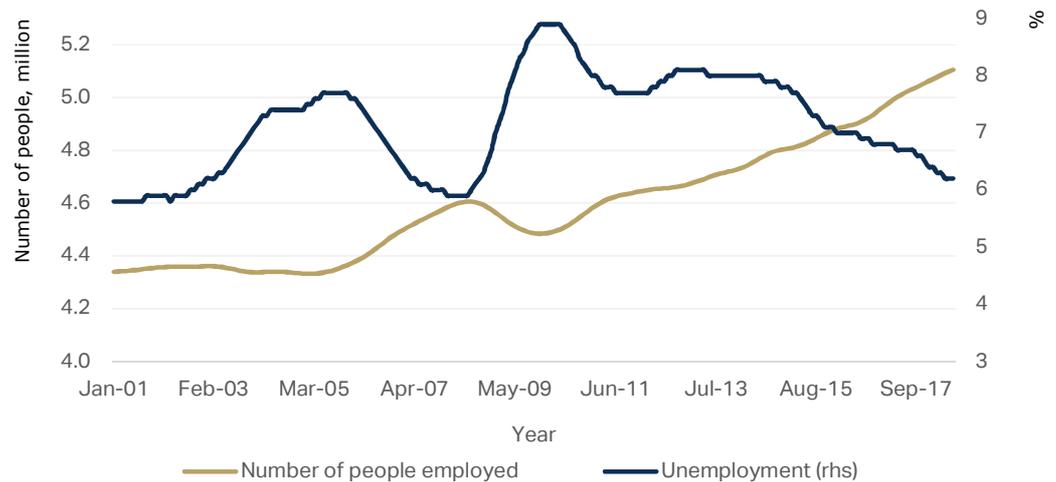
In recent years, Sweden has seen steady growth in both its economy and population. Unemployment has fallen and the total number of people employed has gradually risen. At the same time, like most other countries, Sweden's interest rates have fallen to record low levels. These factors have all supported the real estate sector, which has seen rising property values, increased occupancy rates and rising rents, resulting in strong operating and financial performance

Figure 1: Repo rates in Sweden, Norway and Denmark



Source: central bank of Sweden, central bank of Norway, central bank of Denmark

Figure 2: Swedish employment figures



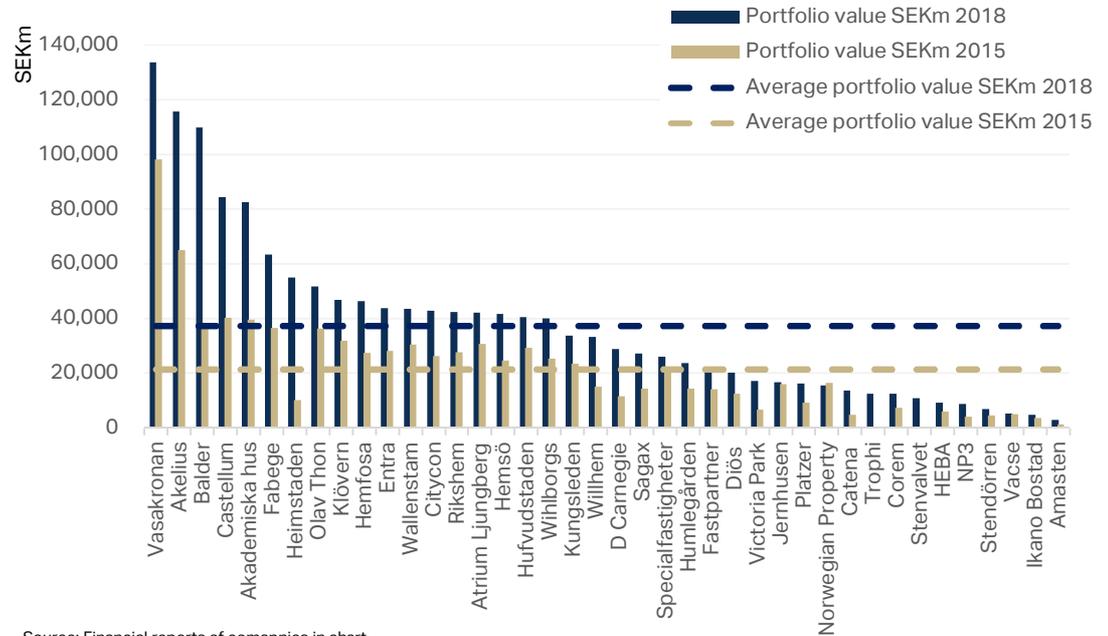
Source: SCB

Although we do not see any major crises around the corner, there are some challenges ahead. The central bank of Sweden (Riksbanken) believes that the unemployment rate in Sweden could increase somewhat over the next few years as the skillsets of many unemployed people do not currently match the needs of employers. Furthermore, the rate hikes that the market expects the central bank to make could have a negative effect on companies' financial costs. The fear of a housing price bubble has led to both the Norwegian and Swedish governments taking measures to slow mortgage lending, with new amortisation regulations in Sweden, stricter equity requirements and a cap on debt to income in Norway. This has resulted in the housing market cooling somewhat. Although this has yet to affect commercial real estate, it could impact economic growth over the next few years.

### MORE REAL ESTATE ISSUERS MOVING TOWARDS INVESTMENT GRADE

Increased economic activity, decreasing borrowing costs and a strong real estate market have contributed to stronger demand for almost all types of properties. The average vacancy rate in our sample group\* was down to 4.8% in mid-2018 from 8% in 2015. Despite some overproduction by housing developers, typically in high-end segments in metropolitan areas, new-build offices are usually pre-let at high occupancy rates before construction commences. Strong demand for properties and low interest rates over the past three years have pushed the value of assets to historically high levels (see Figure 3 below).

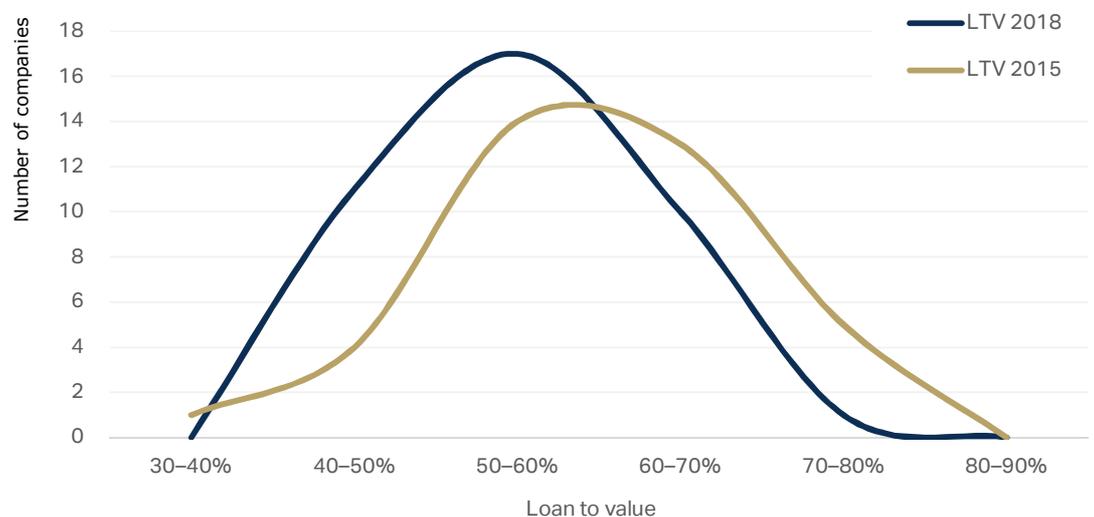
Figure 3: Companies' asset values



Source: Financial reports of companies in chart

As can be seen in Figure 4 and Figure 5, credit metrics such as the loan-to-value (LTV) ratio and interest coverage ratio (EBITDA/net interest) have improved on average over the last three years. This is despite higher total gross debt as property values have increased and interest costs have decreased. The average cost of debt has almost halved in the last five years to currently just above 2% in our sample.

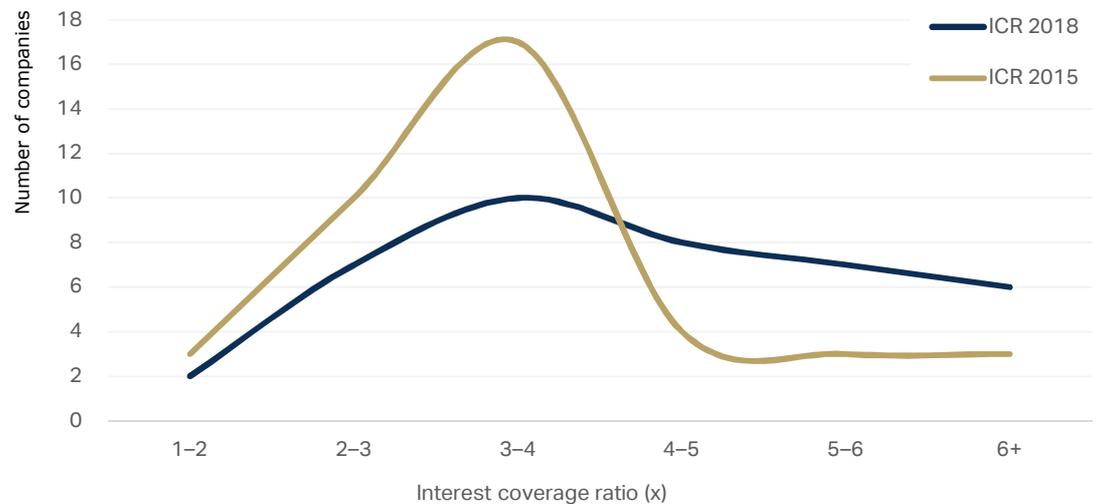
Figure 4: Loan to value distribution



Source: Financial reports of companies in asset value chart

Although higher property values and lower interest costs have been major drivers of the improving credit metrics, rising rents and lower vacancies have helped companies improve their operating efficiency considerably. However, average debt to EBITDA, for example, remains high at 12.5x and has actually increased somewhat over the last three years.

**Figure 5: Interest coverage ratio distribution**

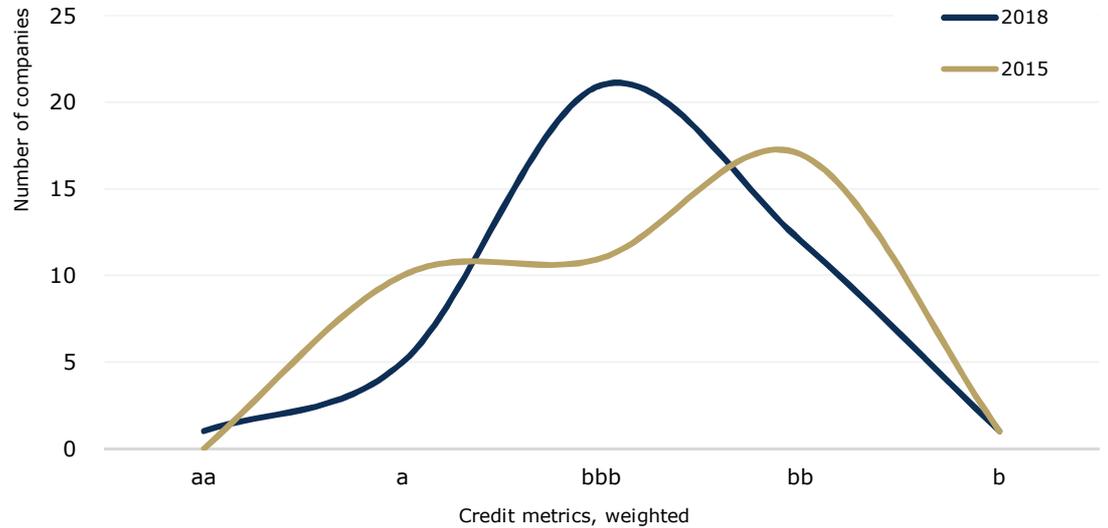


Source: Financial reports of companies in asset value chart

From a credit metric perspective, we note that the average financial credit assessment (according to NCR criteria) has shifted from the upper end of the 'bb' category towards the lower end of the 'bbb' category (i.e. investment grade; see Figure 6). This is just one indication of creditworthiness. A full rating takes account of a comprehensive analysis of the business and portfolio strength, the outlook, and factors such as financial risk appetite, debt maturity profile, environmental and social governance (ESG) factors, and potential ownership support.

However, as more bank debt is being refinanced in the capital markets, an increasing number of real estate companies have attained public ratings, which has reduced funding costs and incentivised companies to stabilise or lower their leverage. We expect this trend to continue.

Figure 6: Distribution of financial risk assessments



### CHALLENGES AND OPPORTUNITIES DIFFER BETWEEN SUBSECTORS

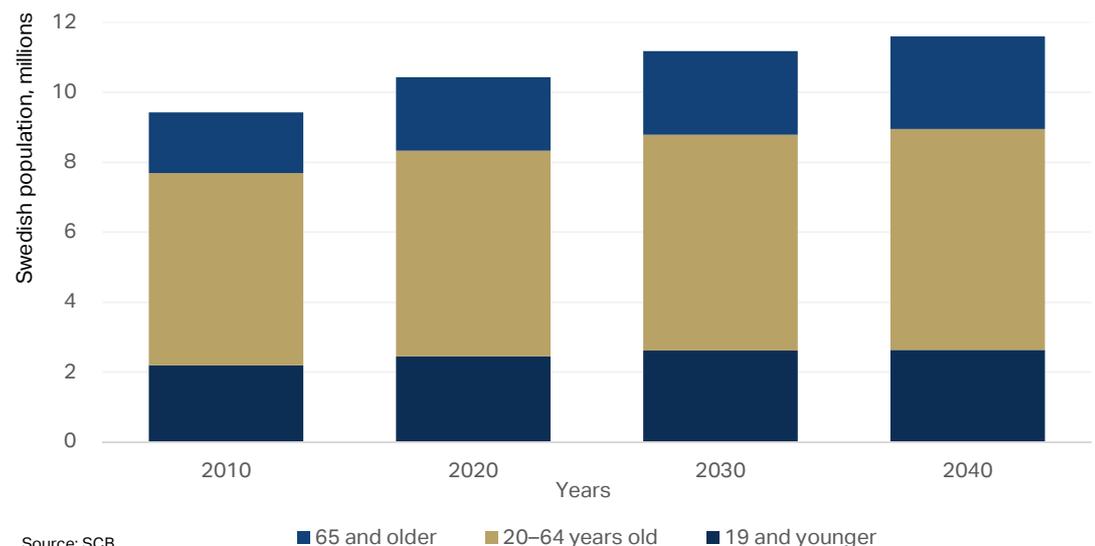
Real estate operations continue to be a very local business. An office or retail property can have very different prospects in different parts of the Nordic region, and even in different parts of cities such as Stockholm and Oslo. However, despite the importance of local factors, there are some broader trends that we expect to affect the sector as a whole, leading to different challenges and opportunities for real estate companies operating in different subsectors.



## RESIDENTIAL AND PUBLIC-SECTOR PROPERTIES SUPPORTED BY DEMOGRAPHIC CHANGES

Sweden's population is expected to grow to 11 million people by 2028, increasing already high demand for residential properties. The age groups of 19 and younger and 65 and older are expected to grow faster than the population as a whole, resulting in a further increase in demand for public services properties such as schools, healthcare and police stations, and supporting issuers focused on these areas. Lease terms for such properties are typically long and the level of adaption of properties to clients' needs is usually high. Furthermore, rents are often covered by either government-owned or government-related companies, resulting in stable and secure rental income.

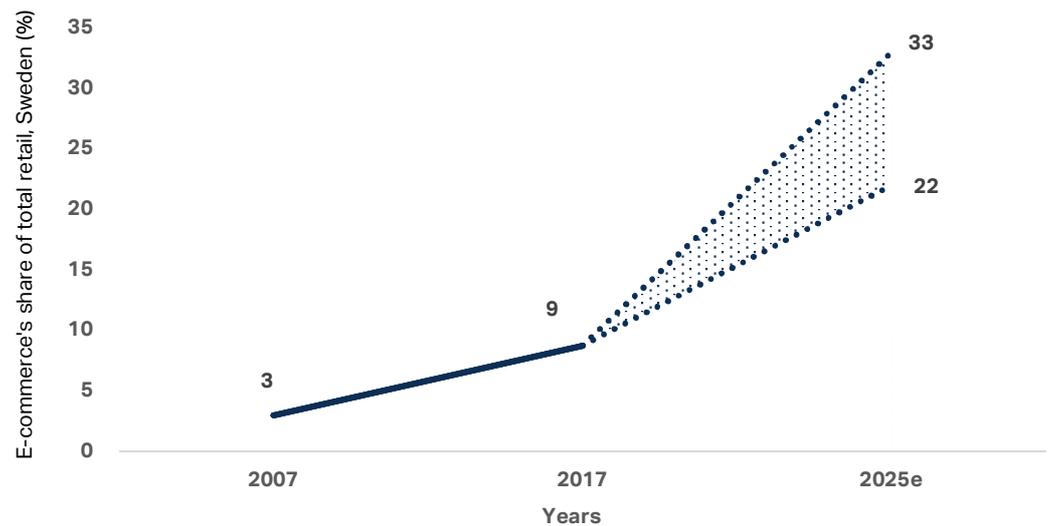
Figure 7: Population growth strongest in youngest and oldest age group



## LOGISTICS AND RETAIL SECTORS ADAPTING TO NEW TECHNOLOGY

Somewhat surprisingly, e-commerce in Sweden has lagged behind the sector in many European countries over the past year, accounting for less than 10% of the total retail market, although this trend is now quickly reversing. The e-commerce market accounted for 80% of growth in Swedish retail last year, and the Swedish Trade Federation expects the segment to have a market share of 30% by 2025, posing a real threat to traditional bricks and mortar retail channels. This will force owners of retail properties to rethink and focus more on the development of entire areas, including entertainment, restaurants and cafés, public-sector services and housing. On the other hand, logistics properties are seeing higher demand owing to increased transportation of goods. This trend is highly likely to increase even further over the next few years as a result of the entry of Amazon into the Nordic countries.

Figure 8: E-commerce growth in Sweden



Source: PostNord, Svensk Handel

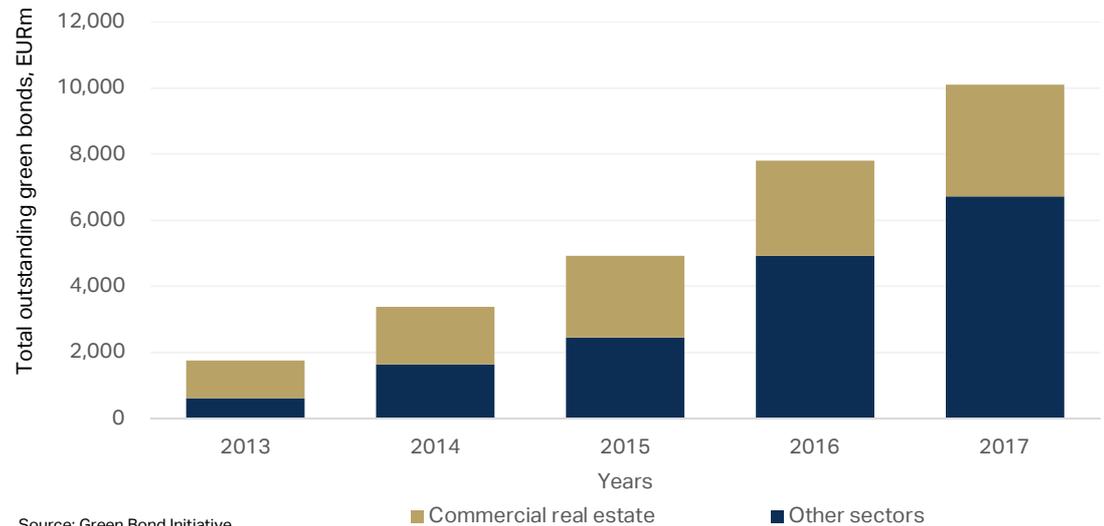
## SUSTAINABLE BUILDINGS AND GREEN FINANCING TO BECOME COMPETITIVE ADVANTAGE

We also believe the importance of green investments will increase further for suppliers, customers (or real estate tenants) and investors, resulting in higher demand for sustainable properties in companies' portfolios. For real estate companies, this will affect both new developments and the refurbishment of potentially unsatisfactory properties, irrespective of the subsectors in which they operate. As there will be more pressure to make cities free from fossil fuel-based vehicles, the value of properties close to metro systems is highly likely to increase further.

Swedish issuers, investors and banks have all been major advocates of green financing. Sweden is currently the largest issuer of green bonds in the Nordic countries, and real estate companies have contributed greatly to this trend, as shown by Figure 9.

We will continue to track and analyse the opportunities and threats we see arising for the companies that we monitor, as sustainable properties shift from being a beneficial feature to becoming essential.

Figure 9: Outstanding green bonds (Swedish issuers)



## RATING APPROACH

NCR recently published its rating methodologies for corporate issuers (including real estate management companies) and financial institutions. Our corporate ratings are forward looking and are derived by combining fundamental business and financial risk factors, resulting in an indicative credit assessment. The indicative credit assessment may then be adjusted, or 'notched', up or down after taking account of factors that have not been fully considered in the business and financial risk analysis. This includes an analysis of the company's liquidity position and its exposure to ESG factors. Lastly, we conduct an ownership analysis to consider the potential positive or negative aspects regarding the shareholder structure. Our full methodologies can be found on our website, [www.nordiccreditrating.com](http://www.nordiccreditrating.com).

*\*Companies in sample: Akademiska Hus, Akelius, Amasten, Atrium Ljungberg, Balder, Castellum, Catena, Citycon Oyj, Corem, D Carnegie, Diös, Entra ASA, Fabega, Fastpartner, HEBA, Heimstaden, Hemfosa, Hemsö, Hufvudstaden, Humlegården, Ikano Bostad, Jernhusen, Klöver, Kungsleden, Norwegian Property AS, NP3, Olav Thon Eiendomsselskap ASA, Platzer, Rikshem, Sagax, Specialfastigheter, Stendörren, Stenvalvet, Trophi, Vacse, Vasakronan, Victoria Park, Wallenstam, Wahlborgs and Willhem.*

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