Nordic Credit Rating

SECTOR COMMENT

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COVID-19 response upends Nordic commercial property market

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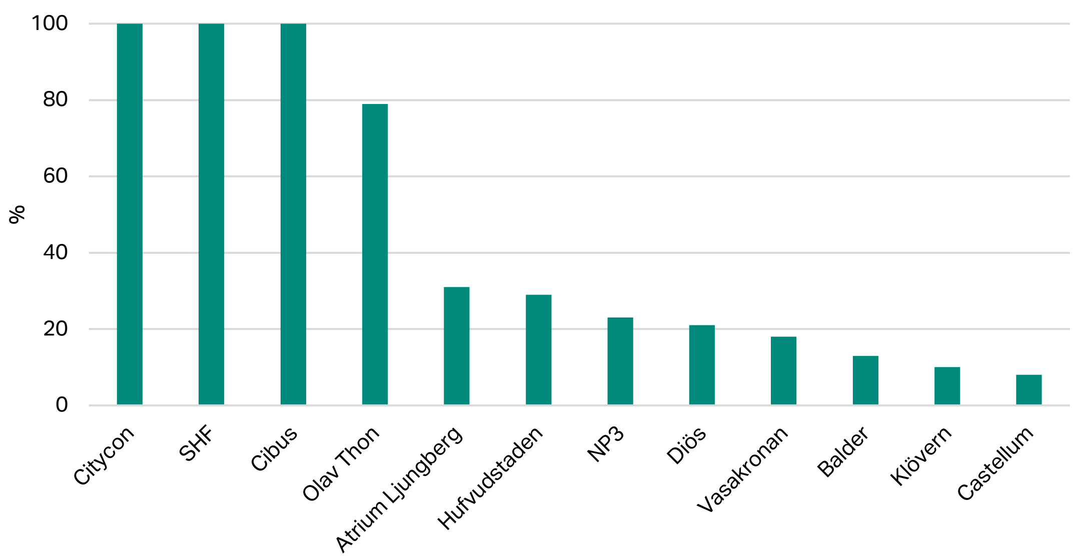
Social distancing due to COVID-19 is affecting many industries across the Nordic region, but the impact on commercial property owners is particularly striking. Destinations previously considered tier 1 properties such as popular shopping centres, hotels and leisure parks, often in prime city-centre locations, now have tenants whose revenues are in free fall as customers and guests stay away. In our base case we expect social distancing and near lockdown to ease by the end of the second quarter, but revenues for commercial real estate management companies are likely to remain under pressure for the entire year. We expect increasing loan-to-value (LTV) metrics for property managers exposed to the retail sector both through increased yields and decreasing revenues in the course of 2020.

CONSUMER BEHAVIOUR CHANGING QUICKLY

During March, social distancing resulted in empty office space, shops and hotels across the region. As customers avoided public areas, revenues for most commercial real estate tenants fell drastically. Google reports significant changes in consumer mobility, with people in both Norway and Sweden spending less time in the workspace, retail premises and recreation areas and more time at home. As public transport hubs see significantly fewer travellers, casual consumption has sharply declined. Payment provider Nets reports fewer card transactions, but higher average spending per transaction. Contactless card payments increased in March, and online shopping gained a stronger foothold.

As physical retailers, hotels and restaurants saw reduced revenue prospects, employers quickly began adjusting staff levels, both temporarily and permanently, with financial support from their respective governments. Unemployment in both Norway and Sweden reached record highs in March, though a significant proportion is likely to be temporary. Social adaptation to mobility restrictions could result in long-term shifts in consumer behaviour. Decreased consumer confidence can negatively affect large purchases and encourage savings, creating a negative macroeconomic spiral. Depending on the duration of the COVID-19 pandemic and the perception of increased efficiency provided by new lifestyle solutions, many industries could face lasting change, although some retailers providing essential products, such as grocers and pharmacists, appear to be sheltered from the storm.

Figure 1. Exposure to retail, restaurants and hotels, 31 Dec. 2019



Based on NCR data and company reports

PREVIOUSLY DESIREABLE PROPERTIES NOW EXPOSED

New office space contracts are expected to be virtually non-existent in the short-term, and vacant offices could remain vacant through the second quarter. Owners of coworking and flexible office space with short-term contracts could face a tough reality if the pandemic is long-lived. Property owners which have recently benefited from high rents and strong demand could also be affected. Depending on the severity of the current conditions, not all temporarily laid off employees are likely to return to work. In the longer term, we also think it likely that tenants would be more willing to relocate should they experience difficulties from their landlord.

Within the retail sector, several stores are now facing tighter financial conditions, and previously stable and popular shopping districts are now less attractive to shoppers. Stockman of Finland as well as several subsidiaries of RNB of have been forced to seek restructuring in a bid to survive the crisis. Meanwhile, MQ of Sweden has filed for bankruptcy. In Norway, the Olav Thon Group announced in March that it was reducing rents and offering postponed collection of rents to all restaurant and retail tenants facing liquidity constraints due to COVID-19. The physical retail segment was already facing competition from e-commerce (see Retail properties under pressure, 5 Sep. 2019) before the pandemic and several large retailers, such as Gresvig and Teknikmagasinet, have recently filed for bankruptcy in the face of competitive and difficult operating conditions.

The hotel and restaurant segment has seen the biggest direct impact with a drastic reduction in guests and customers due to social distancing and mobility restrictions. The Scandic hotel group has closed several hotels and laid off 7,000 employees internationally. Scandic is the largest hotel chain in the Nordic region and the effect of the closures on the respective property owners is likely to be significant; 37% of the rooms owned by property manager Pandox were leased to Scandic as of end-2019. Other hotel chains and restaurants have experienced similar drops in revenues as guests and customers stay away.

PROPERTY VALUES UNDER PRESSURE

As revenue prospects for tenants decrease, a shift in the power balance between tenants and landlords could affect property owners' credit metrics. Large tenants occupying customised premises are likely to be able to negotiate lower rents, or postpone rent payments altogether, as owners would face difficulty finding similar tenants amid tough conditions and low demand. Specialised properties with strong tenants have historically been considered a positive credit factor for real estate managers, due to their reliability. But since the outbreak of the pandemic, strong tenants are in a much stronger position to negotiate. This is likely to come into play over the next few weeks, but the extent of the tenants' increased bargaining power will not be visible until we see reported second quarter figures.

Commercial real estate is most often valued utilising a combination of yield requirements and the average sales price of comparable properties. As market activity will likely decline in the current conditions due to funding difficulties, as exemplified by the cancellation of a proposed property purchase between Nyfosa and Samhällsbyggnadsbolaget i Norden, comparable properties could be difficult to find. As yield is calculated using the revenues made from a property, valuations could come under pressure. Nordic real estate management companies have been in a sweet spot for some time due to low interest rates, yield compression, and increasing property values. Some companies have utilised the increased value of their properties to reduced debt levels, while others have increased their debt while maintaining stable LTV levels. We expect the situation to change, as exemplified by Atrium Ljungberg reporting an unrealised change in property values of almost SEK 1.5bn, both through reduced revenues and "other" items, as well as increased yield levels.

On 26 Mar. 2020, the Swedish government proposed to support real estate companies affected by the pandemic by covering 50% of the resulting revenue drop provided the companies cut their rents by 50%. Norway followed suit, offering to meet 80-90% of the fixed costs of qualified companies, up to a maximum of NOK 30m per month.

To assess the possible impact of the coronavirus-related downturn on the Nordic commercial real estate sector, we looked at the exposure of 12 leading regional players and the likely impact of an assumed 25% fall in revenue within retail, restaurants and hotels on their LTV ratios (see figures 1-3).

The projected changes in LTV vary significantly as the respective levels of exposure are different. A significant part of our sample saw higher vacancy levels in 2019 than in 2018, a trend that we expect to increase over the short term. We have not reviewed the individual companies' need to reduce rent levels.

Several of the companies have had external valuations of their properties carried out since the beginning of the second quarter and we assume some decline. We expect the companies in the sample to be able to withstand a short-term increase in LTV levels, but note that the refinancing of SEK 11bn of bonds maturing during 2020, some issued by some in the sample could result in increased average interest costs.

Our sample consists of Citycon, Svenska Handelsfastigheter (SHF), Cibus, Olav Thon, Hufvudstaden, Castellum, Atrium Ljungberg, NP3, Diös, Vasakronan, Klövern and Balder.

Figure 2. Vacancy levels across our sample, 2018 vs 2019

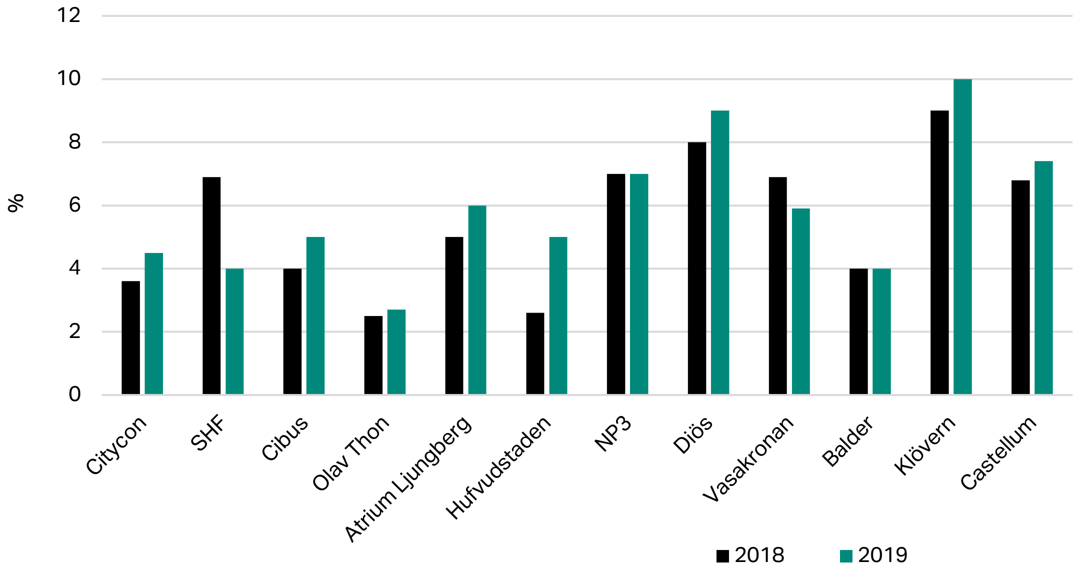


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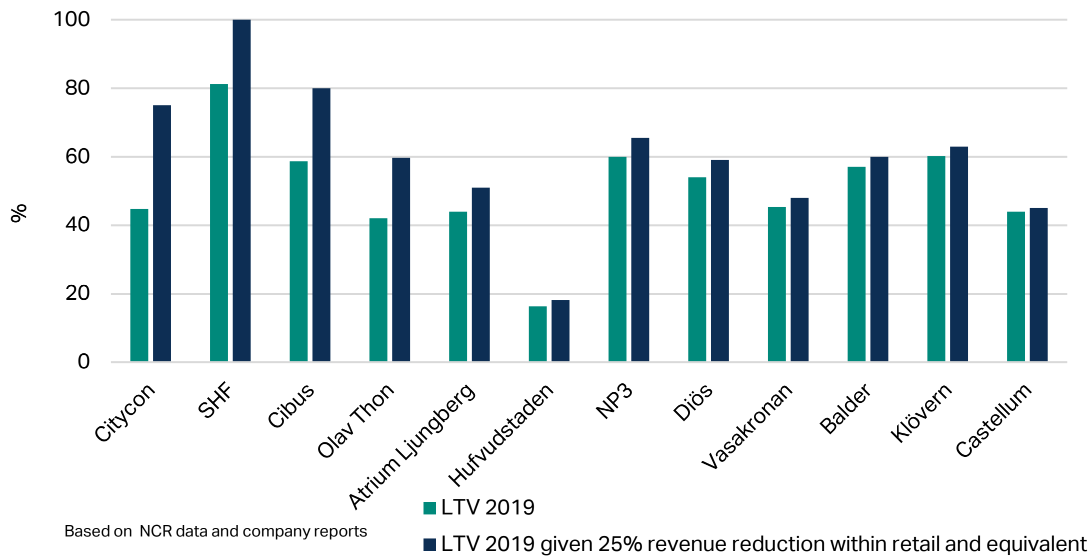
Figure 3. LTV across our sample, 31 Dec 2019



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