Swedish property managers face shift in customer demand

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Nordic Credit Rating (NCR) expects Swedish property managers to face long-term challenges as office employees embrace working from home. The COVID-19 pandemic has hit the hotel and travel sectors particularly hard and tenants continue to have difficulty honouring their leasing commitments. However, as the pandemic wears on, managers of conventional office properties stand to see a change in industry dynamics as working from home becomes more prevalent.

NCR expects COVID-19 to affect Swedish working life indefinitely. The longer we wait for a solution to the pandemic and abide by social distancing measures, the more adapted companies and employees will become. We expect tenants to demand increased flexibility in contract structure, affecting long-term dynamics for office premises.

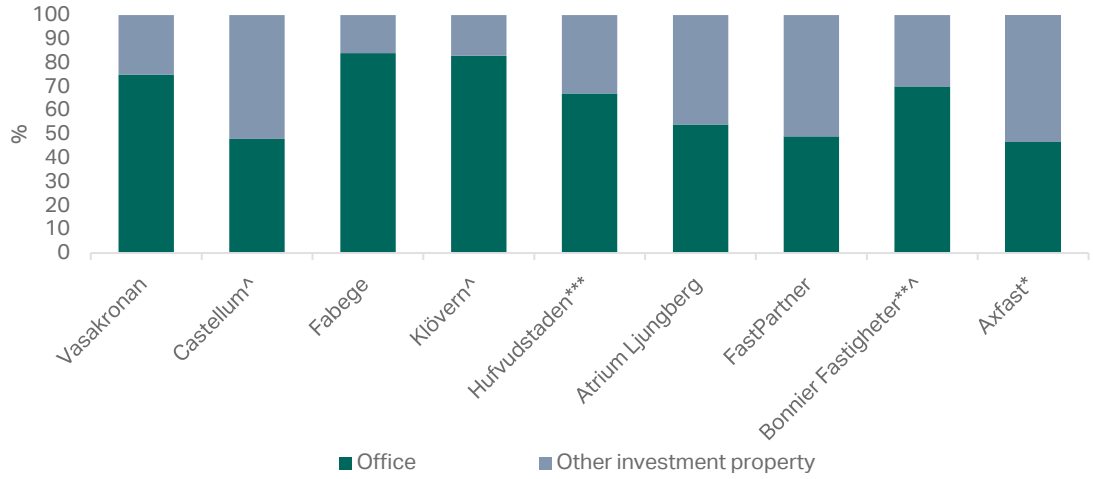
While we expect office space to remain an essential part of corporate life, we believe that tenants will become increasingly demanding and require more flexible accommodation solutions. A significant number of employees enjoy the increased flexibility that home working provides and, according to a study by market research company Novus Group International AB, nine out of 10 Swedes working from home want to continue to do so, at least part time.

Below, we examine how these changing dynamics could affect our credit analysis of Swedish office managers.

OFFICE RENTAL VALUES REMAIN STABLE DESPITE DECLINES IN OFFICE USE

Demand for office space has long been driven by developments in the wider economy. The implementation of social distancing guidance in March and a general decrease in mobility went hand-in-hand with increased unemployment and furloughs. While some property managers have reported a decrease in property values this year, the long-term effect is still not clear. To highlight the changes in the office market, we have focussed on nine companies with varied exposure to office premises (see Figure 1), but note that most Swedish real estate companies have some office exposure in their portfolios.

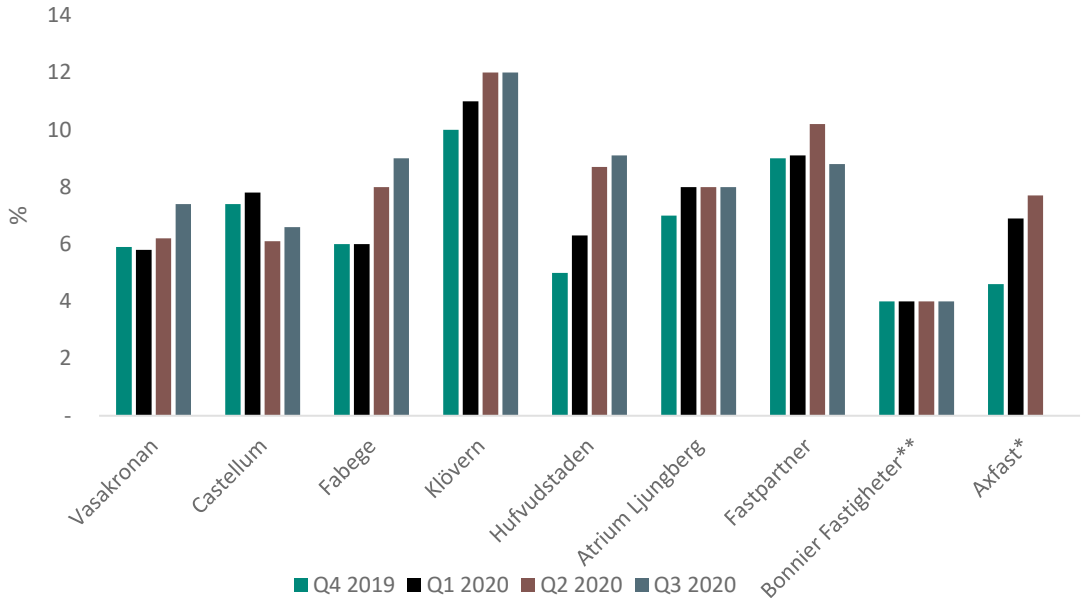
Figure 1. Swedish property managers' office exposure based on rental value, 30 Sep. 2020



Based on NCR and company data, *data as of 30 Jun. 2020, **data as of 31 Aug. 2020, ***data as of 31 Dec. 2019,^based on property value Vasakronan–Vasakronan AB (publ), Castellum–Castellum AB, Fabege–Fabege AB (publ), Klövern–Klövern AB (publ), Hufvudstaden–Hufvudstaden AB (publ), Atrium Ljungberg–Atrium Ljungberg AB (publ), FastPartner–FastPartner AB (publ), Bonnier Fastigheter–Bonnier Fastigheter AB, Axfast–Axfast AB (publ)

The vacancy ratio for the companies in our sample varies from 4% to 12% over the most recent quarter. Despite relative stability in the valuations of investment portfolios, we note that a number of property managers have reported increased vacancies since the onset of the pandemic. In some cases, the increases were due to the impact of social distancing and travel restrictions on retail, hotel and restaurant customers.

Figure 2. Swedish property managers' vacancy ratios, 31 Dec. 2019–30 Sep. 2020



Based on NCR and company data, *data as of 30 Jun. 2020, **data as of 31 Aug. 2020

NCR believes that current valuations of office properties factor in a temporary reduction in economic activity without fully considering the longer-term uncertainty that increased working from home will create in the sector. Some managers expect that the reintroduction of private offices and distinct common areas, requiring more floor space per employee, could offset some of the long-term effects of working from home. However, a higher level of working from home could force tenants to reconsider the number of their locations or find more efficient ways to use office space when large numbers of their staff work from home regularly.

THE OFFICE SEGMENT AND OUR ASSESSMENT OF PROPERTY PORTFOLIOS

In our business risk assessment of property managers, the operating environment and the company's competitive position are key. Besides looking at the company's market and brand position and the credit quality of its tenants, we look closely at a company's ability to maintain strong occupancy ratios, revenue transparency and ensure overall financial stability. The expected increased demand for flexibility from tenants could affect several of these factors.

Direct and indirect tenant diversification could provide support

A high degree of tenant concentration, for example when the top 10 tenants account for half or more of the tenant base, could represent heightened risk for the manager as dependence on single-name tenants is increased. This in turn affects the relationship between tenant and landlord in terms of bargaining power. The tenant mix can create indirect exposure to several industries. An office portfolio with diverse indirect industry exposure through its tenant base would be considered to reflect the wider economy, while a portfolio with exposure to specific segments, or tenants which respond similarly to shifts in the economy, would not. Several major Swedish real estate managers have exposure to the office segment, and while significant tenant diversity among the larger companies reduces the risk of sudden vacancies it is unlikely to reverse the emerging trend of declining demand for fixed contracted office space.

Long average remaining lease terms could ensure transparency

Average remaining lease terms are an important factor in our assessment as long remaining terms provide stability, while short remaining terms could accelerate a shift towards shorter, more flexible contracts. Moreover, differing remaining lease terms can have varied effects on revenue streams. Reduced contract lengths could increase the volatility of vacancy ratios and revenues, which are key factors in several areas of our credit analysis.

Furthermore, reduced average remaining lease terms would likely increase cyclicality within the segment, as rent levels and occupancy rates would be more sensitive to major economic changes. Accordingly, the operating environment could be negatively affected if the transition from office working to a mix of home-office working becomes widespread and permanent.

Property valuations could come under pressure

Revenue and occupancy rates are key factors in property valuation and any volatility could negatively impact asset prices. We note that the valuation of several of the property portfolios in our sample are based on an expected average vacancy ratio that is below current vacancy levels, and we therefore expect some downside risk. Valuations are often cited with a +/- 10% margin of error; an indication that the reported market value often differs from the actual sale value. Property valuations affect the loan-to-value ratio used in our financial ratio analysis. They also affect our recovery analysis which seeks to clarify the potential loss given default that bondholders will suffer in the event of default by a non-investment grade issuer.

Alternative usage could support property valuations should demand deteriorate

When assessing portfolio quality, we pay close attention to potential alternative usage. Typically, office space is characterised by a low degree of customisation for tenants, except for some headquarters buildings and landmark offices. Some office space can be repurposed as residential property, retail outlets, restaurants or hotels. However, changing property usage involves large outlays and property managers could be reluctant to do this, unless the shift is likely to guarantee increased returns or financial stability.

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