Rising interest rates dampen outlook for Swedish real estate

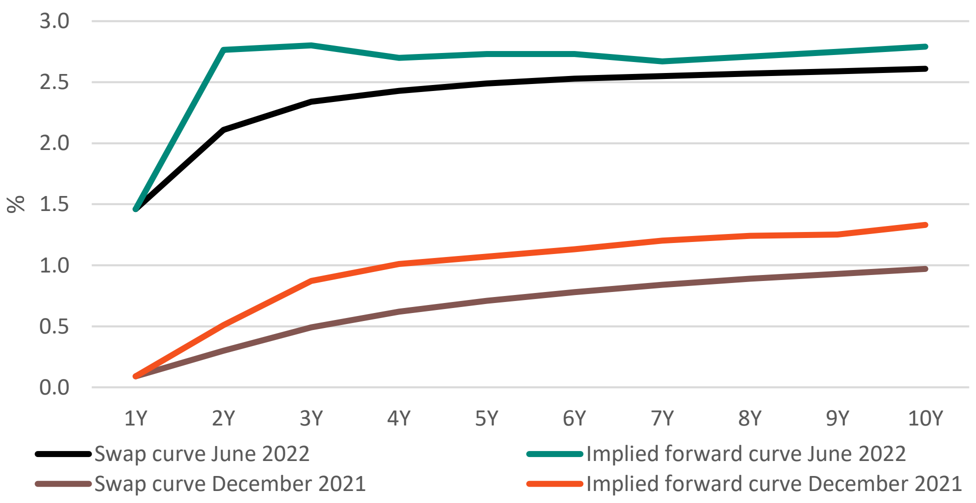
ANALYSTS
Marcus Gustavsson
+46700442775
marcus.gustavsson@nordiccreditrating.com

Yun Zhou
+46732324378
yun.zhou@nordiccreditrating.com

Increasing economic headwinds are weakening credit metrics across the Swedish real estate sector where sharply higher inflation and interest rates, partly due to the war in Ukraine, have radically altered the landscape since the beginning of the year. Although most companies in the sector reported market value gains in the first quarter, rising interest rates are effectively reversing the benign market conditions of the past few years, when low interest rates fuelled an active transaction market and a decline in property yields. The previously supportive conditions resulted in higher asset values and lower loan-to-value (LTV) ratios, encouraging companies to increase debt to finance growth, which in turn has weakened other key metrics such as net debt/EBITDA. Although interest-rate hedging can reduce the immediate impact of rising rates, the sector's high leverage means that even inflation-linked rental contracts will be unable to keep pace with increasing interest costs.

Rising interest rates are negative for the real estate sector for several reasons. Firstly, real estate investments are capital-intensive, exposing the sector to swings in interest rates which can rapidly result in higher interest costs, lower profits, and weakened interest coverage. Secondly, higher interest rates should, in the medium to long term, lead to higher property yields as costs related to financing real estate assets increase and alternative investments become more attractive. Resulting downward revisions in property values would, in such a situation, put pressure on LTV, forcing companies to inject equity or divest properties to maintain their metrics in line with policy levels, especially since cash-flow generation in the sector is generally weak. In addition, resulting uncertainty about future property yields is likely to dampen the transaction market, reducing volumes and liquidity. As investor confidence ebbs away, share prices fall and bond spreads widen, as has been the case in the past few months, reducing access to capital market financing.

Figure 1. Swedish krona swap rate curves, June 2022 and December 2021



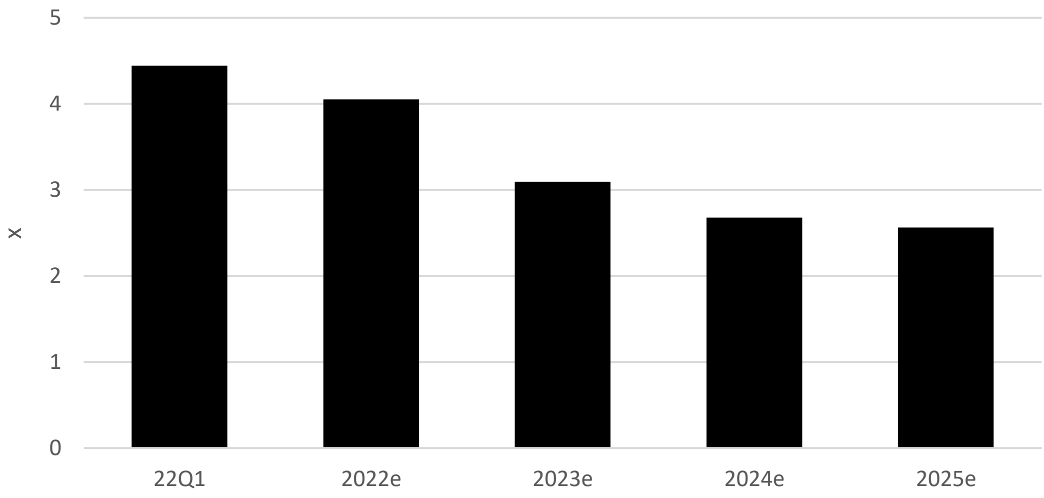
Source: S&P Capital IQ.

The real estate sector is characterised by high levels of inflation-adjusted rental contracts, which companies often put forward as a substantial mitigator of interest-rate risk. Although such contracts reduce the impact, the effect is relatively small in a highly leveraged sector such as real estate. Among NCR-rated real estate companies, the average net debt/revenue ratio is about 9x. Consequently, any simultaneous increase in inflation and interest rates will have a much greater impact on interest costs than on rental income. In addition, costs are likely to rise due to inflation, further reducing the mitigating impact.

We expect net interest coverage, the most interest-rate sensitive key credit metric in our financial risk assessment, to decrease only slightly by end-2022, followed by a more pronounced downturn in 2023. Our interest rate simulation considers the impact on interest coverage assuming short-term interest rates move in line with short-term interest rates as implied by the Swedish krona swap curve. It also takes into account the maturity profile of the individual companies' interest rate hedges. The simulation takes no account of increased credit spreads (negative) or inflation-adjusted rental contracts (positive).

In our view, the eventual level of interest rates is not yet clear and will ultimately depend on how the Swedish central bank plays its hand. Because domestic households are highly leveraged, it is unclear how fast and to what extent the central bank can act without forcing the economy into recession.

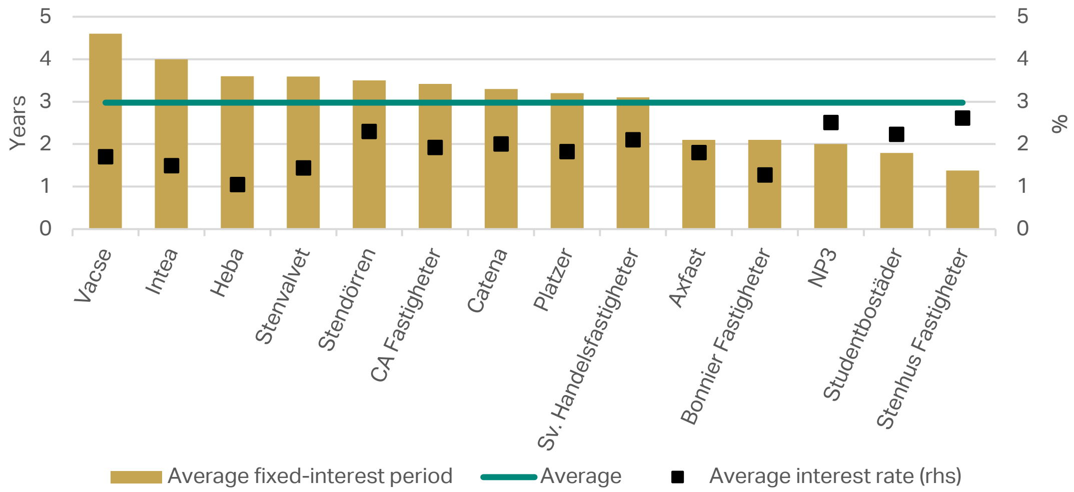
Figure 2. Average net interest coverage projections among NCR-rated Swedish real estate companies, 2022–2025



Based on company data and NCR calculations. e–estimate.

The impact on individual companies' interest coverage varies substantially and depends on their approach to interest-rate hedging and their initial average interest rate: the lower the rate, the more pronounced the impact. Most real estate companies hedge interest-rate risk with interest-rate swaps and caps. Individual approaches to hedging differ sharply, as indicated by the average fixed-interest period. While the metric is a good indication of a company's inclination to hedge its interest exposure, it is the proportion of fixed interest rates that limits the impact of rising interest rates in the short term. An average 42% of the debt of NCR-rated real estate companies carries floating interest rates or matures within one year. This means that, in a hypothetical situation in which short-term interest rates rise by 100 bps, the corresponding interest-rate increase would be 42 bps, effectively mitigating the short-term impact. However, levels of corporate exposure differ significantly and if rates remain high, the value of hedging recedes over time.

Figure 3. Average fixed-interest period among NCR-rated Swedish real estate companies, 31 Mar. 2022



Source: companies. Bonnier Fastigheter as of 31 Dec. 2021.

In our view, reduced interest coverage is not necessarily a materially negative factor for the overall real estate sector as most companies have satisfactory covenant and policy headroom. However, a sharp fall in coverage could lead to rating revisions, especially for issuers which are more severely impacted or already have little headroom against rating triggers. Moreover, if higher interest rates translate into rising property yields and lower property values, companies could approach or breach their LTV rating thresholds, putting additional pressure on ratings and outlooks.

NCR-RATED REAL ESTATE COMPANIES

Figure 4. NCR ratings on Nordic real estate companies

Issuer	Primary property type(s)	Long-term issuer rating	Outlook
Axfast AB (publ)	Offices	BBB	Stable
Bane NOR Eiendom AS	Community service	A	Stable
Bonnier Fastigheter AB	Offices	BBB	Stable
CA Fastigheter AB	Residential	BBB-	Stable
Catena AB (publ)	Logistics	BBB-	Stable
Fastighets AB Stenvalvet (publ)	Community service	BBB+	Stable
Heba Fastighets AB (publ)	Residential	BBB+	Stable
Intea Fastigheter AB (publ)	Community service	BBB+	Stable
LSTH Svenska Handelsfastigheter AB (publ)	Retail	BBB-	Stable
NP3 Fastighets AB (publ)	Industrial/warehousing	BB	Stable
Platzer Fastigheter Holding AB (publ)	Offices	BBB-	Stable
Stendörren Fastigheter AB (publ)	Industrial/warehousing	BB-	Stable
Stenhus Fastigheter i Norden AB (publ)	Retail/industrial	BB	Stable
Studentbostäder i Norden AB (publ)	Residential	BB-	Stable
Svensk FastighetsFinansiering AB (publ)	Offices	BBB+	Stable
Vacse AB (publ)	Community service	A-	Stable

See NCR's company reports for details.

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