SECTOR COMMENT

14 Sep. 2022

Interest rate concerns hang over Swedish real estate sector

ANALYSTS

Marcus Gustavsson
+46700442775
marcus.gustavsson@nordiccreditrating.com

Yun Zhou
+46732324378
yun.zhou@nordiccreditrating.com

Rising interest rates remain a concern for Sweden's debt-laden real estate sector. We expect interest coverage ratios in the sector to fall substantially over the next few quarters as higher interest rates impact financial statements. Positively, we expect most NCR-rated issuers to manage their credit metrics successfully thanks to strong interest coverage before interest rates began to rise. Negatively, the extent and pace of adjustments in property yields and values in response to higher interest rates are more likely to have a pronounced effect. We believe the brunt of the impact will not be fully felt until 2023.

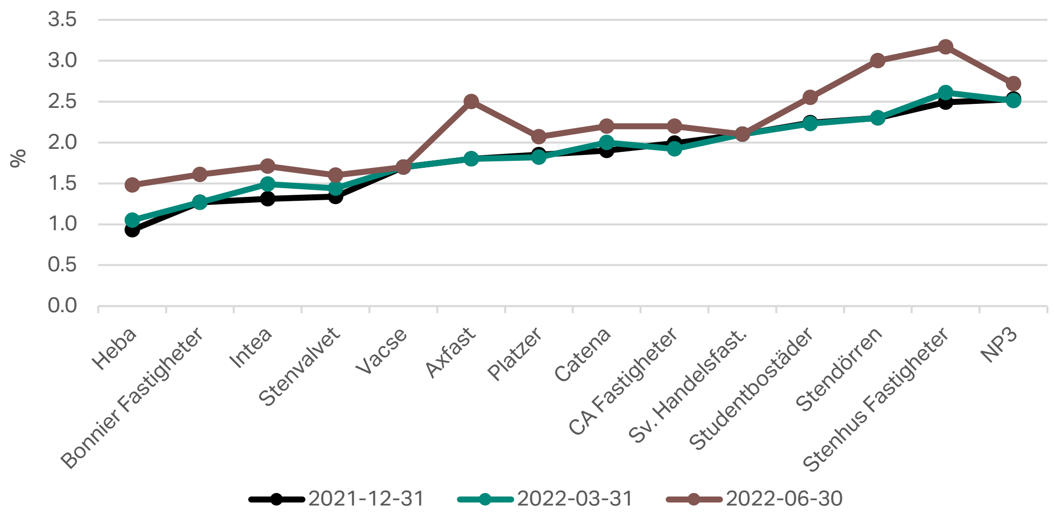
The current challenges are financial rather than operational, as business fundamentals such as rents and occupancy rates remain solid. However, the likelihood of a full-blown recession has increased. Positively, we regard refinancing risk as low through 2022 as the bank market appears supportive, while short-term bond maturities are limited. In addition, credit spreads have stabilised, though at elevated levels.

Although the overall trends are negative, we believe that most NCR-rated real estate issuers are well equipped to deal with more difficult market conditions. Many have strong owners capable of injecting equity, if necessary, while others have adequate policy and rating headroom. In addition, issuers have other options to support their financial risk profiles, such as divesting properties or postponing investments. Interest rate hedges and inflation-linked rental contracts can also help to reduce the impact.

RISING INTEREST RATES BECOMING VISIBLE IN REPORTED FIGURES

In the wider Swedish real estate market, most companies reported relatively stable interim reports at mid-year, although the trend of rising average interest rates was clearly visible. Among NCR-rated issuers, the average interest rate increased to 2.2% from 1.9% in the first quarter. Moreover, we believe that most of the impact on interest coverage ratios is not yet apparent as short-term interest rates are likely to continue to rise as maturing debt is, in many cases, refinanced at higher margins. Consequently, we expect interest coverage to decrease substantially over the next few quarters.

Figure 1. Average interest rates among NCR-rated Swedish real estate issuers



Source: companies.

RECESSION RISK MOUNTING

Short-term interest rates have continued to rise in the current quarter as a result of high inflation rates and increasing expectations that the central bank will raise policy rates decisively in response to inflationary pressure. Market pricing of interest rates now suggests that the central bank's actions to curb inflation could lead to recession, as indicated by the currently inverted Swedish krona swap curve. The spectre of recession is likely to hang over the real estate sector for the next few years.

We view the current challenges facing the sector from the perspective of financial risk, while business fundamentals remain sound. However, if the economy moves into recession, tenants could struggle, vacancies could rise, and rent levels could fall.

Figure 2. Swedish krona swap rates

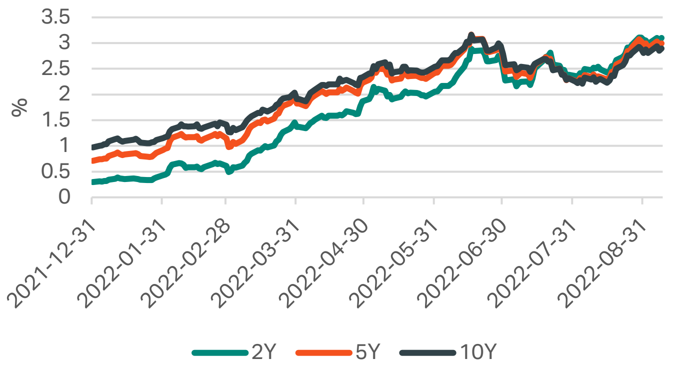
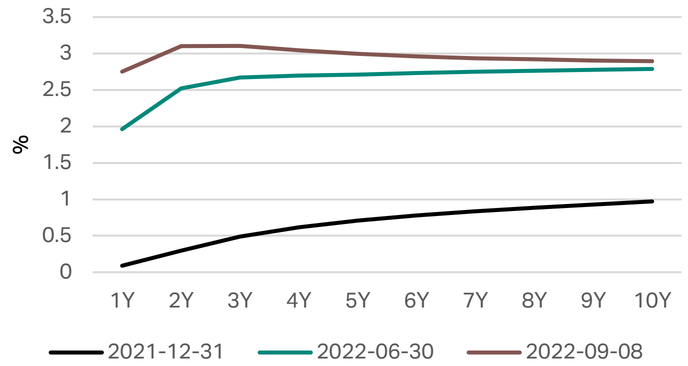


Figure 3. Swedish krona swap curve



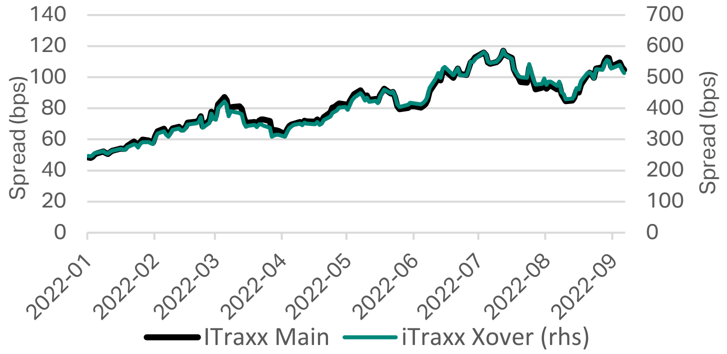
ELEVATED CREDIT SPREADS AND LIMITED BOND MATURITIES LIMIT DEBT ISSUANCE

The Nordic corporate bond market had a challenging second quarter, with real estate companies particularly affected. In their interim reports, several companies stressed the importance of bank financing, where credit spreads are currently much more moderate.

Credit risk premiums remain at historically high levels, despite falling for many real estate companies since mid-July. The bond market remains an expensive source of funding and we anticipate that spread levels will have to fall materially for corporate bonds to regain their appeal as a source of corporate funding. We expect unsecured debt as a proportion of total debt to decrease as companies shift increasingly to secured bank lending to offset the impact of higher interest rates.

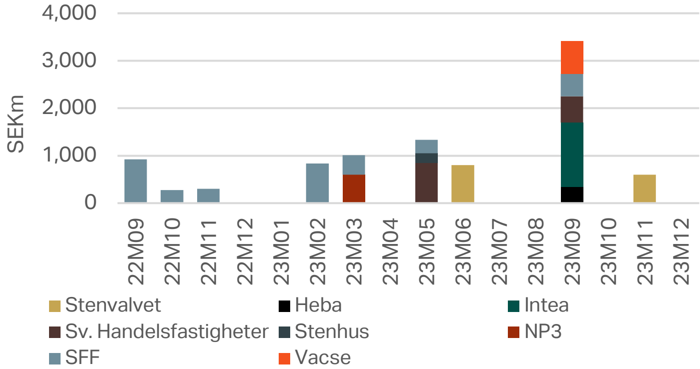
Among NCR-rated and other real estate issuers, maturing bond volumes are relatively limited through the remainder of 2022. We believe that this, together with current pricing in the bond market and reductions in many issuers' growth ambitions, will result in relatively low issuance volumes in the remainder of the year. However, we expect significantly larger maturities in 2023 and 2024, especially among large real estate companies with outstanding euro-denominated debt. The Swedish banking system is unlikely to be able to refinance such volumes, and consequently, we expect a substantial proportion of volumes in 2023 and 2024 to be refinanced in the bond market -- even if investor demand remains low.

Figure 4. iTraxx spread indices



Source: S&P Capital IQ.

Figure 5. Bond maturities among NCR-rated Swedish real estate issuers



Source: Stamdata.

PROPERTY VALUES LIKELY TO COME UNDER PRESSURE IN 2023

Most Swedish real estate companies reported property value gains in the second quarter, in several cases because of increased operating surpluses and gains from project development. Rising interest rates have not yet resulted in a broad trend of increasing property yields, mainly because value appraisals are based on market transactions, which recently have been relatively scarce. As transaction volumes eventually pick up, as we expect, downward value adjustments should come as no surprise. However, this is unlikely to become visible in the wider market until next year. Conversely, we believe that property values will be supported through year-end by rising rents on the back of high inflation.

Rental increases, however, are likely to differ significantly between property types. Among, for example, industrial properties inflation-linked contracts are likely to drive rental income. Although we expect rent increases to be material, we expect them to be lower than the rate of inflation. This is because tenants might be unwilling to accept imposed rent increases, while commercial property managers would likely accept lower increases in exchange for contract extensions. In the residential property subsector, rents are negotiated between property owners and the tenants' association. Although rent increases are likely to exceed those of recent years, they will most certainly be lower than increases in other property types, putting additional pressure on interest coverage ratios.

Adding to future valuation concerns is the potential for sell offs in some subsectors. While we expect property values to remain stable through year-end, we believe that the announced intention of some residential owners, such as Germany-based Vonovia SE, to divest properties could speed up yield adjustment in the subsector where low initial yield levels mean that property values are more sensitive to yield changes. In addition, aggressive deleveraging to avoid rating triggers could push yields higher in the community service and other subsectors.

Figure 6. 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
OBOS Eiendom AS	Retail	BBB-	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-	Negative
Svensk FastighetsFinansiering AB (publ)	Offices	BBB+	Stable
Vacse AB (publ)	Community service	A-	Stable

See NCR's company reports for details.

DISCLAIMER

NORDIC CREDIT RATING AS

nordiccreditrating.com