Sweden's real-estate sector faces growing challenges

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The Swedish real-estate landscape has changed significantly in 2022 as interest rates have risen and financing conditions worsened. We expect the sector's challenges to remain in 2023 as higher financing costs continue to feed into companies' financial statements, with a resulting negative impact on interest coverage. Despite a lack of transaction activity, we also expect property values to decline, putting pressure on loan-to-value (LTV) ratios. In addition, we believe the high volume of sector-wide bond maturities will increase uncertainty as companies take action to strengthen their financial risk profiles, for example, by divesting properties. Our base case foresees this process as being orderly, but the longer capital markets remain wary of Swedish real estate, the higher the risk that many companies will want to dispose of properties at the same time, putting further pressure on property values.

Our base case assumes property value declines of around 10% for prime office properties through 2024. Property types such as residential, where rent increases are moderate, could see a considerably larger decline as property yields rise from very low levels. The lack of transactions could delay the timing and extent of revaluations in companies' balance sheets. However, following a 250bps increase in market rates since February, we believe yields will inevitably increase across all property types.

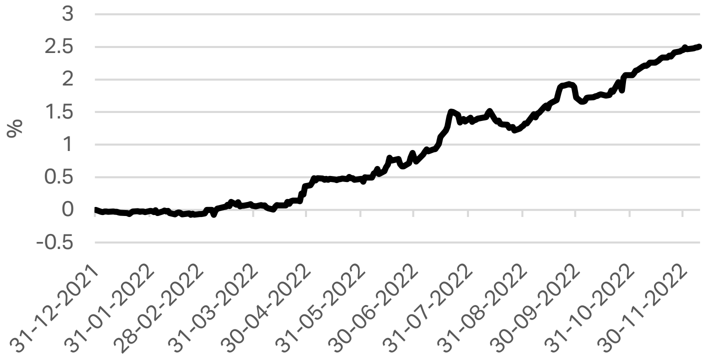
On the back of challenges in the sector, we expect some companies with comparatively high financial gearing to breach covenants in 2023. We would expect to see breaches of interest coverage covenants first, but even LTV and equity ratio covenants could come under pressure, depending on the timing and extent of revaluations. This will likely result in an increase in written procedures and higher risk premiums for bank loans.

We believe that most NCR-rated real-estate issuers are well equipped to deal with the more challenging market conditions, although more than one-third of NCR-rated real-estate companies currently have negative outlooks, indicating an increased risk of rating downgrades. Many companies that we rate have strong owners capable of injecting equity, if necessary, while others have adequate policy and rating headroom.

RISING INTEREST RATES POSE CHALLENGES FOR THE SECTOR

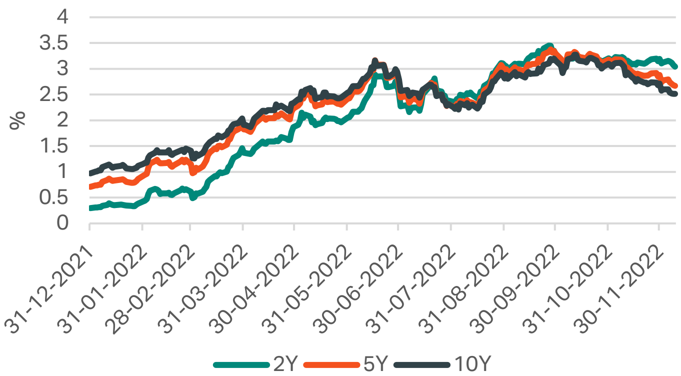
Inflation and interest rates have risen sharply in 2022. Due to the high debt levels in the overall real-estate sector, the impact from rising interest rates is material. However, most of the effect is yet to be seen, as most companies use interest rate hedges to postpone the impact on interest costs.

Figure 1. STIBOR 3 months, 2022



Source: S&P Capital IQ.

Figure 2. Swedish krona swap rates, 2022

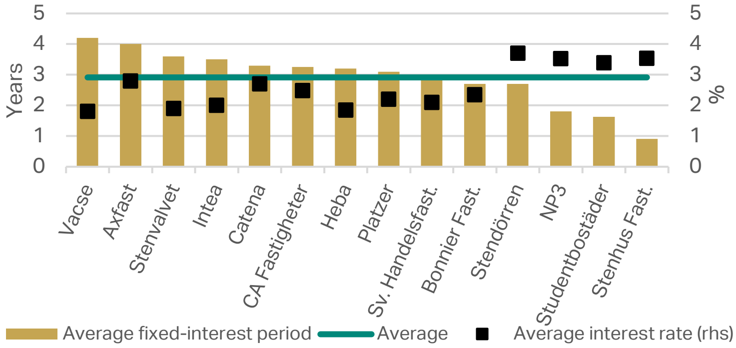


Source: S&P Capital IQ.

The extent of interest rate-hedging differs vastly between companies. These differences have started to become visible in individual companies' reported interest rates. Among NCR-rated issuers, the average reported interest rate increased to 2.6% at the end of the third quarter, compared with 1.8%

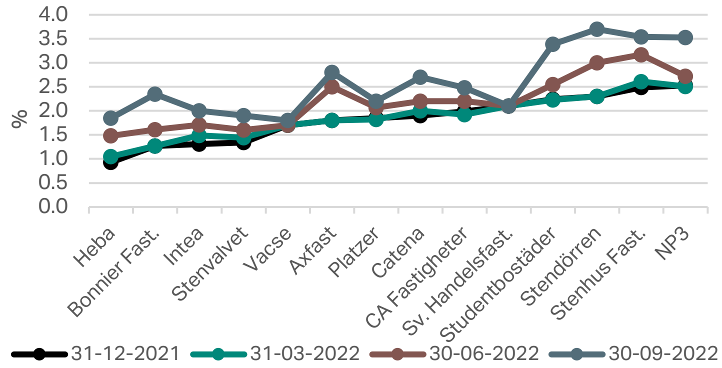
at year-end 2021. We expect this figure to increase further over the coming quarters, as the benefits of former hedges subside, with a resulting negative impact on interest coverage. The extent of hedging will have a marked impact on the pace at which interest coverage decreases for each company over the next few years.

Figure 3. Average fixed-interest period and average interest rates of NCR-rated real-estate issuers, 30 Sep. 2022



Source: companies. Bonnier Fast. as of 30 Aug. 2022. Sv. Handelsfast. average interest rate as of 30 Jun. 2022.

Figure 4. Average interest rates of NCR-rated Swedish real-estate issuers, 2022



Source: companies. Sv. Handelsfast. most recent average interest rate as of 30 Jun. 2022.

LACK OF TRANSACTIONS AFFECT TIMING AND EXTENT OF DECLINES IN VALUE

Thus far, reported declines in value have been modest, primarily because value appraisals are based on market transactions, which remain few. As transaction volumes eventually pick up, as we expect, downward value adjustments should become more common. We believe this impact will differ significantly between property types, with subsectors that use inflation-linked rental contracts expected to benefit from substantial rent increases in 2023 and 2024, while subsectors in which rental increases and property yields are low will likely be more severely affected. Our base case assumes property value declines of some 10% for prime offices through 2024, while we expect residential properties to see the most pronounced impact, with changes in value possibly being considerably larger than those for offices.

Although we foresee material rent increases in most commercial and community service properties, we expect them to be lower than the rate of inflation. This is because tenants might be unwilling to accept imposed rent increases, while property managers would likely accept lower increases in exchange for contract extensions. In the residential property subsector, rents are negotiated between property owners and tenants' associations. Although residential rent increases will probably exceed those of recent years, they will likely be significantly lower than increases in other property types, putting additional pressure on interest coverage ratios for residential managers.

We foresee many companies taking action to strengthen their balance sheets and financial risk profiles, and, in some cases, to protect existing credit ratings. This could be accomplished by raising new equity, disposing of assets and/or cancelling dividends. Raising equity could be challenging, due to reduced investor demand for real estate, while new equity issues could result in material dilution for current owners. Disposing of assets is also difficult as buyers and sellers await clarity on property values. As a result, we expect to see reduced or cancelled dividends in 2023 as companies protect their liquidity positions and equity ratios. However, cancelling dividends also poses issues for companies with owners that are dependent on dividend cash flows.

Our base case expects the process of asset disposals to be orderly as transaction volumes increase in 2023. However, the longer capital markets remain wary of Swedish real estate, the higher the risk that many companies will want to dispose of properties at the same time, putting further pressure on property values.

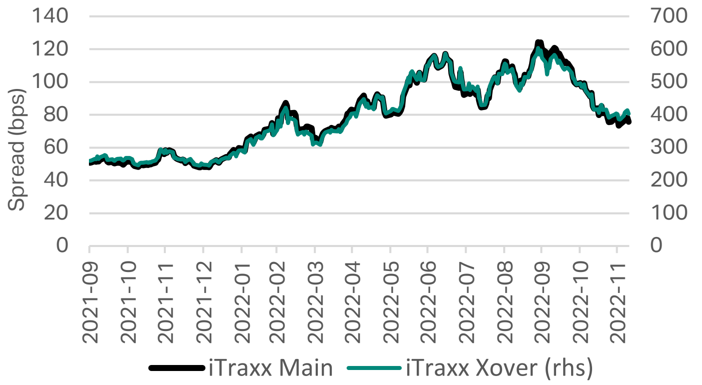
REDUCED APPETITE AMONG DEBT INVESTORS INCREASES REFINANCING RISK

Financing conditions for real-estate companies have deteriorated rapidly in 2022. The Swedish real-estate sector has been shunned by many, not least by international debt investors. This has resulted in increases in credit spreads far exceeding those of other corporate issuers, which have come down from September's peak levels (see Figure 7). The Nordic corporate bond market remains more or less closed to all but the highest-rated real-estate companies. Consequently, we expect most issuers to refinance bond maturities in the banking system, where companies can exchange security for more moderate credit spreads. We expect unsecured debt as a proportion of total debt to continue to decrease as companies increasingly switch to secured bank lending.

The Swedish real-estate sector's total bond maturities in 2023 amount to close to SEK 100bn, most of which can be refinanced using revolving credit facilities, if necessary. We expect the Swedish banking system to be selective in absorbing such large volumes and to increase its margins for real-estate lending as a result of increasing real-estate exposures.

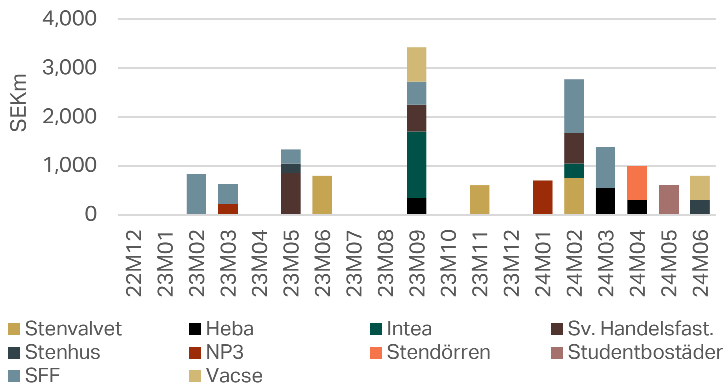
Among NCR-rated real estate issuers, maturing bond volumes are relatively limited in 2023. However, there is a peak of maturities in September. We expect companies to be proactive in refinancing and to maintain liquidity buffers and backup facilities for forthcoming maturities.

Figure 5. iTraxx spread indices, 2021–2022



Source: S&P Capital IQ.

Figure 6. Bond maturities of NCR-rated Swedish real-estate issuers

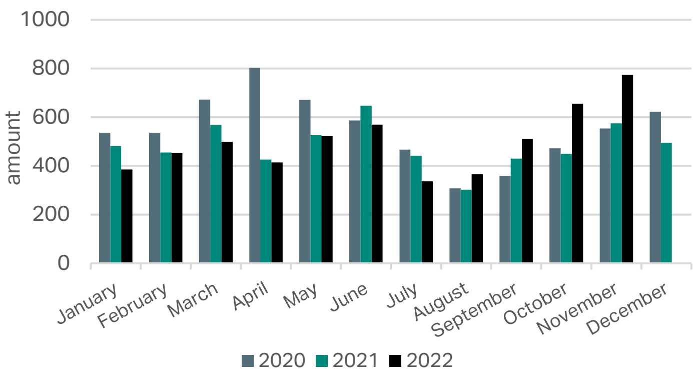


Source: Stamdata.

RECESSION RISK MOUNTING

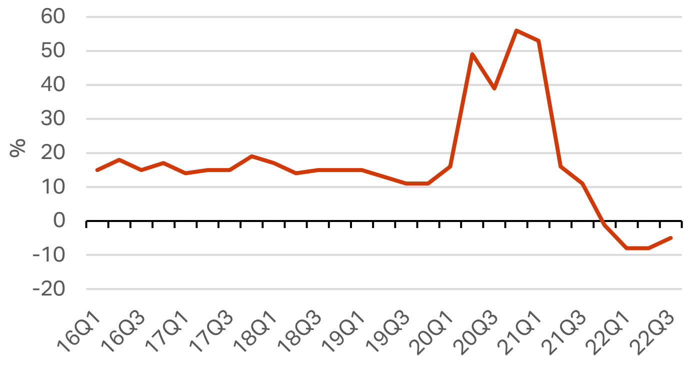
Over the past few months, long-term interest rates have trended downwards, while short-term rates have continued to rise. Market pricing of interest rates suggests that the Swedish central bank's actions to curb inflation could lead to a recession, as indicated by the inverted Swedish krona swap curve. Thus far, however, the real-estate companies' business profiles remain unaffected, although there are some signs of a weakening economy. Over the past three months, default rates among Swedish companies have exceeded those of previous years, while growth in e-commerce has been negative in 2022. We expect defaults to continue to rise compared with a year earlier as many sectors struggle with reduced consumer spending and rising costs. We do not see the decrease in e-commerce as materially negative, as it comes from the high levels of the pandemic. If the economy were to move into a full-blown recession, tenants could struggle, vacancies could rise and rent levels could fall. We expect this increased recession risk to hang over the real-estate sector for the next few years.

Figure 7. Company defaults in Sweden, 2020–2022



Source: Creditsafe

Figure 8. Year-on-year e-commerce growth in Sweden, 2016–22Q3



Source: PostNord Sverige AB.

Figure 9. 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	Negative
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+	Negative
Intea Fastigheter AB (publ)	Community service	BBB+	Negative
LSTH Svenska Handelsfastigheter AB (publ)	Retail	BBB-	Stable
NP3 Fastigheter AB (publ)	Industrial/warehousing	BB	Negative
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	Negative
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.

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