

The Swedish real estate sector– waiting for sunshine after the rain

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The surge in inflation over the past two years and the subsequent interest rate hikes by Sweden's central bank have led to concerns for the debt-laden Swedish real estate sector. Although the inflation rate has decreased in the last couple of months, it seems to be relatively persistent, and the peak of the central bank's policy rate rises has yet to be reached, in our view. Interest coverage has weakened across the sector as financing costs have risen sharply on the back of markedly higher spreads and variable rates on borrowing since early 2022. We expect further deterioration in companies' interest coverage ratios over the next few quarters as fixed-interest swap arrangements mature, offset only to a limited extent by our expectations of rental indexation in 2024.

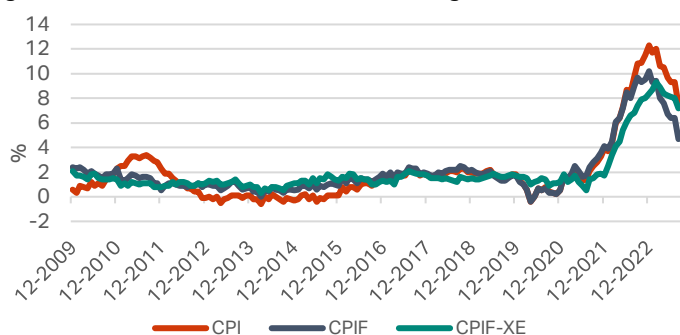
Reported property values have been remarkably resilient so far, with only moderate value declines despite higher yields. However, transaction activity has remained relatively low, delaying inevitable property value revisions. We expect more transactions to be completed as buyers and sellers' price expectations become increasingly aligned, which we believe will accelerate declines in reported property values and add pressure to loan-to-value ratios.

Several companies have already taken measures to strengthen their financial risk profile by postponing or cutting dividend payments, raising equity and divesting properties. NCR-rated real-estate issuers have generally been proactive in their actions and we believe that they are well positioned to deal with the more challenging market conditions, for the most part.

HIGHER INTEREST RATES ARE LIKELY TO PERSIST

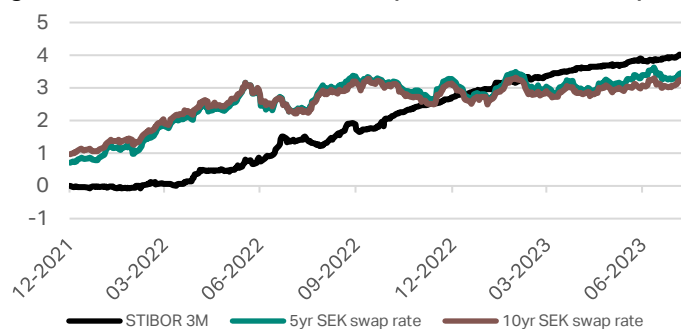
Inflation and interest rates have increased considerably since the end of 2021. Although the rate of inflation has decreased somewhat so far in 2023, the level is still markedly higher than recent historical levels and we expect the Swedish central bank to continue raising the policy rate by at least 25 bp during the remainder of 2023 in response to inflationary pressures.

Figure 1. Sweden's inflation rate, 2009-Aug. 2023



Source: Statistics Sweden. CPI–consumer price index. CPIF–consumer price index with fixed interest rate. CPIF-XE–consumer price index with fixed interest rate, excluding energy.

Figure 2. 3 mth STIBOR and SEK swap rates, Dec. 2021–Sep. 2023



Source: CapitalIQ.

The Swedish real-estate sector is heavily debt financed and the new interest rate environment, with substantially higher funding costs, is driving the unrest for the whole sector. Most companies have secured portions of their financing costs with interest rate swaps or caps that have delayed and mitigated the impact of higher interest rates. As a result, the timing and impact of higher market rates will differ depending on the extent and duration of interest rate hedging. Companies with longer interest-fixing periods have more scope to adjust their balance sheets before experiencing the full impact of higher interest rates on their financial performance. Higher interest rates can already be seen in the companies' reported figures, especially for those with short fixed-interest periods, for which the correlation with higher average interest rates is clearly shown in Figure 3.

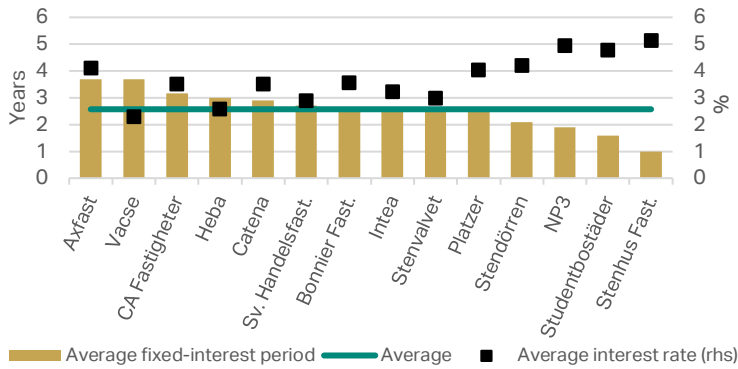
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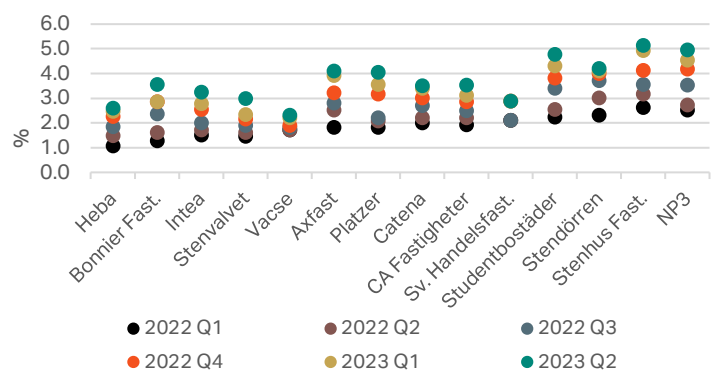
Among NCR-rated real-estate issuers, the average reported interest rate increased to 3.7% at the end of the second quarter, compared with 3.1% at year-end 2022. The corresponding weakening of the companies' interest coverage have also been clearly observable - the average interest coverage has decreased to 3.1x at the end of the second quarter, compared with 4.3x a year ago. We expect this to weaken further over the coming quarters as the benefits of previous hedges is reduced.

Figure 3. Average fixed-interest period and average interest rates of NCR-rated real-estate issuers, 30 Jun. 2023



Source: companies. Bonnier Fast. as of 30 Apr. 2023. Sv. Handelsfast. average interest rate as of 31 Dec. 2022.

Figure 4. Average interest rates of NCR rated real-estate issuers, Q1 2022–Q2 2023



Source: companies. Sv. Handelsfast. average interest rate reported on a yearly basis.

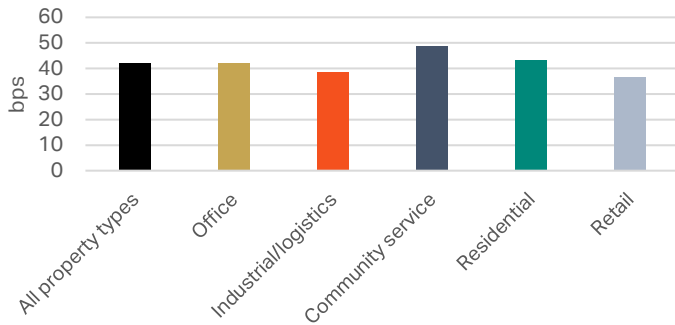
VALUE DECLINES LIKELY LARGEST IN RESIDENTIAL SEGMENT

Since the second half of 2022, we have seen only modest declines in reported property values. Based on a selection of 30 Swedish real-estate issuers, the average cumulative valuation yield increase from Q3 2022 to Q2 2023 has been around 40 bp, while the corresponding decline in reported property values has averaged 5%. Market transactions have been limited, resulting in relatively stable, but uncertain, reported values. As transaction volumes increase, however, we expect more pronounced property value adjustments in the companies' interim reports.

We expect the impact to vary depending on specific property types. We maintain our base case from a year ago, which projected a 10% decline in prime office property values by the end of 2024. Thus far during this cycle, we believe office property values have declined by about 6%, with further changes primarily dependent on the size of inflation-linked rental adjustments for 2024. On the other hand, we project that the values in the residential segment, with low property yields, will be more severely affected than other segments, as regulations limit the ability to compensate for increased costs. As shown in Figure 6 below, the average cumulative property value decline for the residential subsector has already outpaced that of other property segments and could be more pronounced if interest rates remain at current levels.

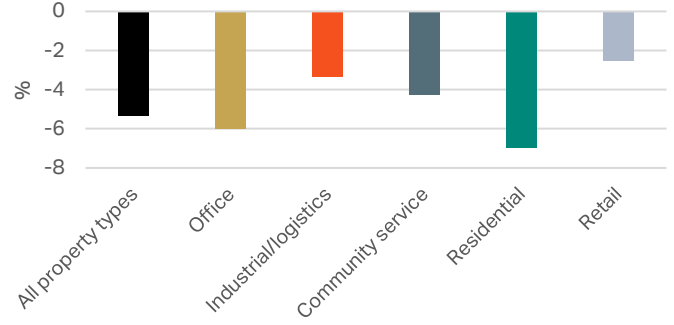
Several companies have taken measures to strengthen their balance sheets and financial risk profiles so far in 2023 and we expect to see even more going forward. Some companies have raised new equity, while others divested some of their assets. Transaction volumes are likely to pick up as buyers and sellers' expectations on property values increasingly align. We expect to see more transactions in the remainder of 2023, which should add clarity to the actual market values of commercial properties and accelerate the extent of valuation yield and property value changes going forward.

Figure 5. Avg. cumulative valuation yield changes, Q3 22–Q2 23



Source: companies. Based on a selection of 30 Swedish real-estate issuers.

Figure 6. Avg. cumulative property value changes, Q3 22–Q2 23

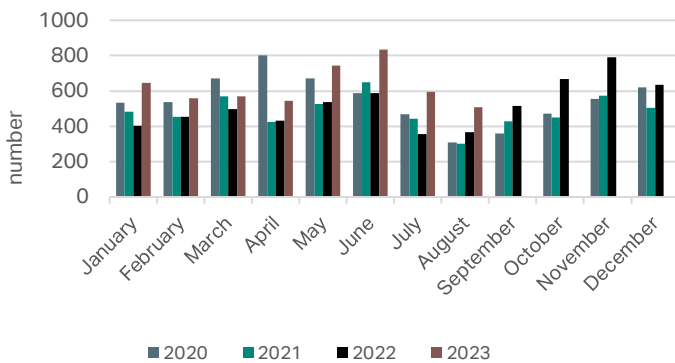


Source: companies. Based on a selection of 30 Swedish real-estate issuers.

CONTINUED STRONG OPERATING PERFORMANCE SO FAR, BUT RECESSION RISK LOOMS

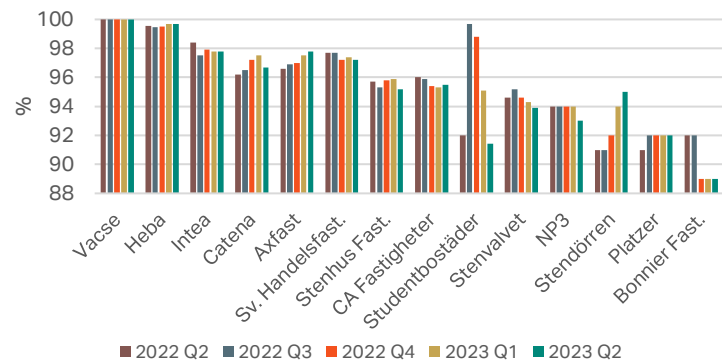
Thus far, business fundamentals such as rental values and occupancy rates have remained solid. The challenges in the real-estate sector have so far largely been isolated to financing rather than operational performance. However, recession risks are increasing in Sweden as the global economy is weakening, and default rates among Swedish corporations have hit record levels in 2023. Property, retail and hospitality have been the most affected sectors, but rising costs and reduced consumer spending are likely to lead to more sectors struggling. If the situation deteriorates further, vacancies could rise and downward adjustments of rental levels may be needed, which could jeopardise increases from inflation-linked rental contracts. Looking ahead, concerns related to future occupancy rates and rent levels are likely to grow and hang over the real-estate sector.

Figure 7. Company defaults in Sweden 2020–Aug. 2023



Source: Creditsafe.

Figure 8. Occupancy rates of NCR-rated Swedish real-estate issuers, Q2 2022–Q2 2023



Source: companies. Bonnier Fast. reports on a tertial basis.

RISE IN THE NUMBER OF DISTRESSED CREDIT EVENTS

Since the second half of 2022, there have been several distressed credit events relating to issuers in the Swedish real-estate sector. Several issuers have initiated written procedures to change the terms and conditions of specific instruments, and some have filed for bankruptcy (see Figure 9 below). In addition to publicly disclosed credit events, we assume that a number of real-estate companies have breached their financial bank covenants and/or required changes to the terms of their bank financing out of the public view. As we expect further weakening of issuers' financial metrics, we expect to see more distressed credit events in the remainder of 2023 and 2024.

NCR defines a default as a scenario in which an issuer fails to fulfil its original debt obligation commitments. This is most commonly a failure to make principal or interest payments according to contractual terms. A written procedure can be used to make changes to covenants or other minor changes to terms to allow early repayment, change the collateral, or similar. We do not consider a technical default, such as a covenant breach or covenant waiver, as a default, unless it is accompanied by a bankruptcy filing. However, where a written procedure results in a change to bond terms, such as an extension of bond maturity or a change in payment terms, and is carried out to avoid near-term

default, we classify the amendment as a distressed exchange and a default on the instrument in question. For further details, see Ratings Principles under Relevant Research and Methodologies below.

The following table summarises key credit events concerning issuers related to the real-estate sector.

Figure 9. Selection of credit events concerning real-estate sector issuers H2 2022–Sep. 2023

Issuer	Event	Event date	Description
Studentbostäder i Norden AB (publ)	Deferral of principal	22 Sep. 2023	Extended maturity by 2.5 years (14 May 2024 to 15 November 2026)
Aktiebolaget Fastator (publ)	Deferral of principal	22 Aug. 2023	Extended maturity by 2 months (22 September to 22 November 2023)
Wästbygg Gruppen AB (publ)	Change of covenant	14 Aug. 2023	Amendments of terms and conditions required
T.Andréasson Fastighetsaktiebolag (publ)	Bankruptcy proceedings	16 Jun. 2023	Issuer filed for bankruptcy on 14 Jun. 2023
Valerum AB (publ)	Deferral of principal	30 Mar. 2023	Extended maturity by six months; partial prepayment of SEK 400m
Nivika Fastigheter AB (publ)	Change of covenant	30 Mar. 2023	Terms amended to implement a right for issuer to make total redemption
Oscar Properties Holding AB (publ)	Change of covenant	2 Feb. 2023	Mandatory partial redemption in Jan. and Apr; amended maintenance covenants; 0.75% consent fee
Besqab AB (publ)	Covenant waiver	27 Jan. 2023	Covenants waived; consent fee paid
Sehlhall Holding AB (publ)	Non-default restructuring	16 Nov. 2022	Maturity extended; increased redemption price to 102%, interest changed from fixed to FRN; amended call structure; consent fee
Kvalitena AB (publ)	Non-default restructuring	3 Nov. 2022	Maturity extended; maturity price increased
Sollentuna Stinsen JV AB	Non-default restructuring	7 Nov. 2022	Changed from FRN to fixed; maturity extended by one year; fee of 1.5%

Source: company websites, Stamdata. FRN-Floating rate note.

Figure 10. NCR ratings on Nordic real-estate companies

Issuer	Primary property type(s)	Long-term issuer rating	Outlook/Watch
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-	Positive
Fastighets AB Stenvalvet (publ)	Community service	BBB	Stable
Heba Fastighets AB (publ)	Residential	BBB	Negative
Intea Fastigheter AB (publ)	Community service	BBB	Stable
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	C	Watch Negative
Svensk FastighetsFinansiering AB (publ)	Offices	BBB+	Stable
Vacse AB (publ)	Community service	A-	Stable

See NCR's [company reports](#) for details.

RELEVANT RESEARCH AND METHODOLOGIES

- (i) [Decoding Swedish real estate in an uncertain market environment](#), 29 Aug. 2023.
- (ii) [Sweden's real-estate sector faces growing challenges](#), 13 Dec. 2022.
- (iii) [Corporate Rating Methodology](#), 8 May 2023.
- (iv) [Rating Principles](#), 24 May 2022.

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NORDIC CREDIT RATING AS

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