Nordic Credit Rating

SECTOR COMMENT

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Swedish real estate sector adapts to a tougher financing climate

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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 about the debt-laden Swedish real-estate sector. 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. However, it appears we have reached the peak of central bank rate hikes as inflationary pressures recede and the economic outlook remains gloomy, which are widely expected to result in interest rate cuts in 2024. Depending on the timeliness and extent of potential policy rate cuts over the next few years, some issuers' average interest rates may peak in 2024 and their interest coverage ratios look set to improve.

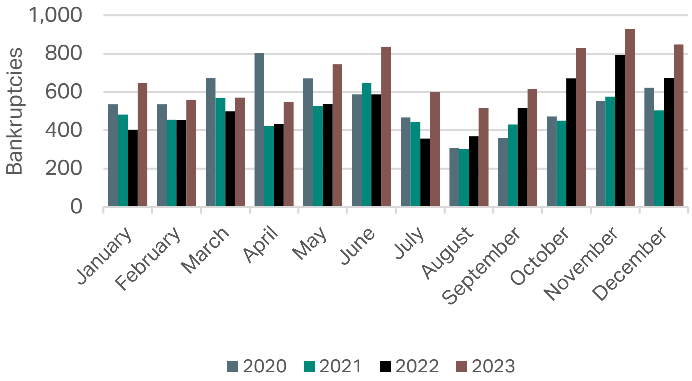
Reported property values in Sweden have been remarkably resilient so far, with only moderate value declines despite higher yields. However, transaction activity has remained relatively low, delaying inevitable property value revisions as long-term financing costs remain prohibitive for a large proportion of potential buyers. We expect more transactions to be completed in 2024 as buyers and sellers' price expectations become increasingly aligned, assisted by lower long-term borrowing rates, which we believe will accelerate declines in reported property values and add pressure to loan-to-value ratios.

We downgraded multiple issuers in 2023, as we believe that their capital structures will remain weaker than previously expected over a prolonged period. We currently have four companies on negative outlook, indicating that some issuers face an increased risk of downgrade in 2024. However, we also have one company, Catena, on positive outlook, as a result of two equity injections and more conservative leverage targets. Many companies that we rate have strong owners capable of injecting equity if necessary, while others have maintained adequate policy and rating headroom.

OCCUPANCY RATES TO BE AFFECTED IN MORE CYCLICAL SEGMENTS

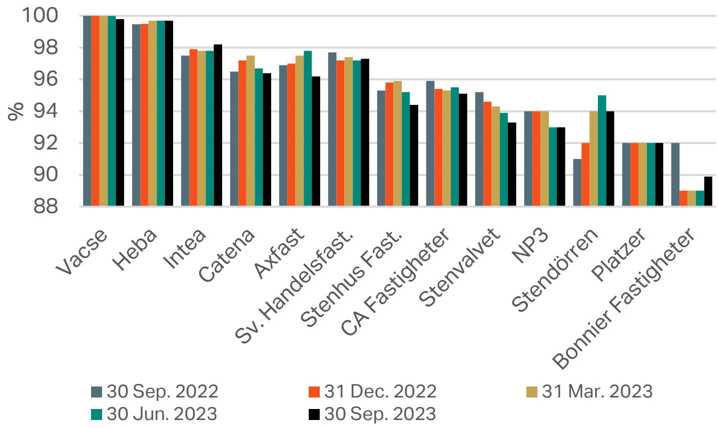
Thus far, the challenges in the real-estate sector have largely been isolated to financing rather than operational performance, and business fundamentals such as rental values and occupancy rates have remained solid. However, vacancy risks are mounting in Sweden, as the economy is weakening and default rates among Swedish corporations hit record levels in 2023. Construction, retail and hospitality have been the most affected sectors, but higher production costs and reduced consumer spending are likely to lead to more sectors struggling.

Figure 1. Company bankruptcies in Sweden 2020–2023



Source: Creditsafe.

Figure 2. Occupancy rates of NCR-rated Swedish real-estate issuers, 30 Sep. 2022–30 Sep. 2023



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

If the situation deteriorates further, vacancies could rise and downward adjustments of rental levels may be needed to avoid vacancies or loss of rental income, which could jeopardise indexation with inflation-linked rental contracts. Looking ahead, concerns related to future occupancy rates and rent levels are likely to grow and loom over the real-estate sector throughout 2024.

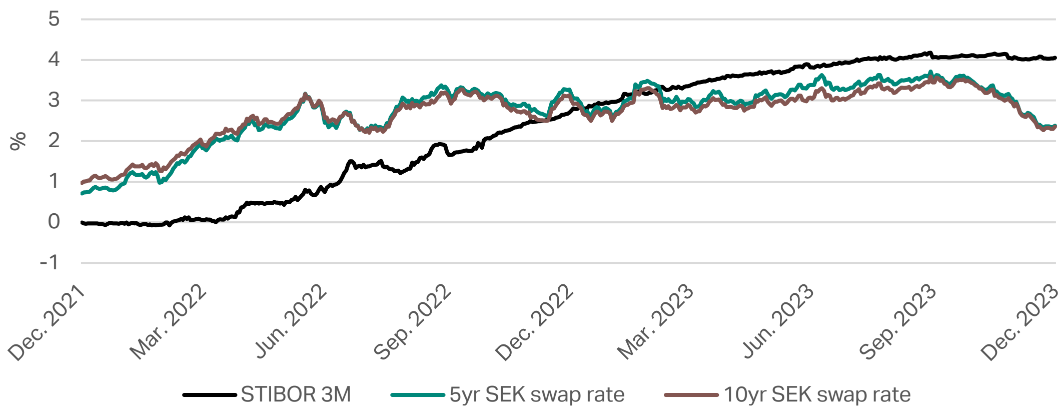
We expect continued strong occupancy rates in specialised community service properties and residential real estate in 2024, while discretionary retail, offices and logistics may face higher vacancies and lower rental growth as some tenants struggle with profitability, which may lead to downward adjustments of rental levels. We see a risk of downsizing in the office segment as the utilisation rate of offices has dropped due to increased hybrid working. Prime offices are likely to face lower vacancy risk but could face increased capital spending and loss of rental income during adaption periods to accommodate new tenants. In addition, there is an impending risk of prolonged vacancies in less attractive locations, which we view as a deterrent for continued increases in rental levels beyond the capacity of existing tenants.

The residential segment faces a limited ability to pass costs onto tenants and is likely to see its margins somewhat compressed in 2024, despite the new negotiation model for rental adjustments. Landlords and the national tenants' association have widely different expectations for rental increases in 2024. We believe negotiations will result in the two parties agreeing on a rental increase of about 4–5% on average for 2024, slightly higher than for 2023, based on the economic inputs used in rental negotiations and negotiations already completed.

EXPECTED INTEREST RATE CUTS COULD IMPROVE INTEREST COVERAGE FOR SOME ISSUERS

Over the past few months, market interest rates for longer durations have come down markedly as inflationary pressures appear to be receding. As of 31 Dec. 2023, the five-year swap stood at 2.4% compared with 3.7% as of end Sep. 2023, as the market expects the Swedish central bank to follow the European Central Bank in cutting rates in 2024 amid a gloomy economic outlook. The recent strengthening of the Swedish krona against major currencies should assist in gradually bringing inflation back to the target level of 2%. We believe the significant gap between current and longer market rates will decline in 2024, as we expect rate cuts to start in the second quarter of the year.

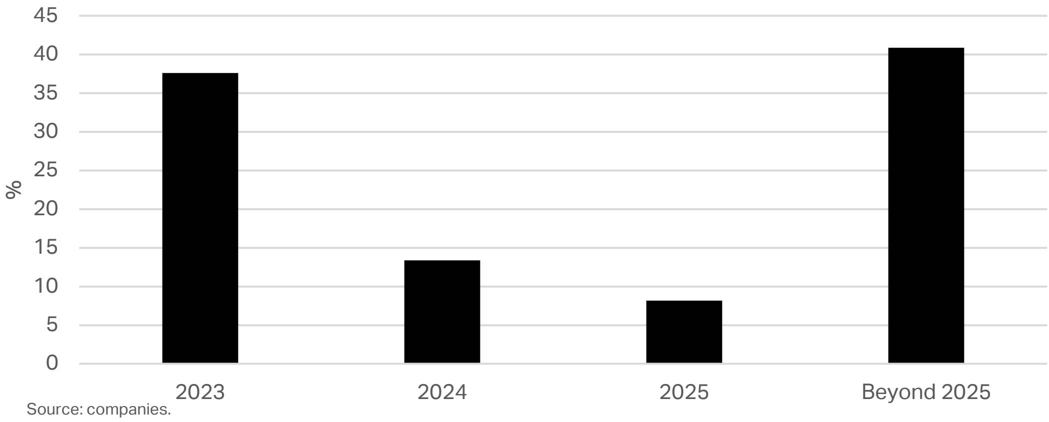
Figure 3. 3m STIBOR, 5yr SEK and 10yr SEK swap rates, 2021–2023



Source: CapitalIQ.

Most real-estate 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 fixed-interest periods have more scope to adjust their balance sheets before experiencing the full impact of higher interest rates on their financial performance. They are also more likely to show more stable interest coverage ratios through an interest rate cycle. Potential interest rate cuts in 2024, combined with continued strong rental growth, could result in improved interest coverage ratios for some issuers. For others, lower interest rates and rental growth is likely to be offset by the expiry of swap contracts entered into during the favourable zero-interest rate environment. By year-end 2024, half of the aggregated interest maturities among NCR-rated real-estate issuers could be variable if they choose not to swap. Depending on the extent of the renewal of swap contracts or signed contracts in 2022 and 2023, some issuers may see their average interest rates nearing their peak and their interest coverage ratios set for a rebound. In the short term, issuers can improve their interest coverage ratios by entering into new swaps at lower than current variable rates, although we believe that some issuers are reluctant to lock in interest rates during a cutting cycle.

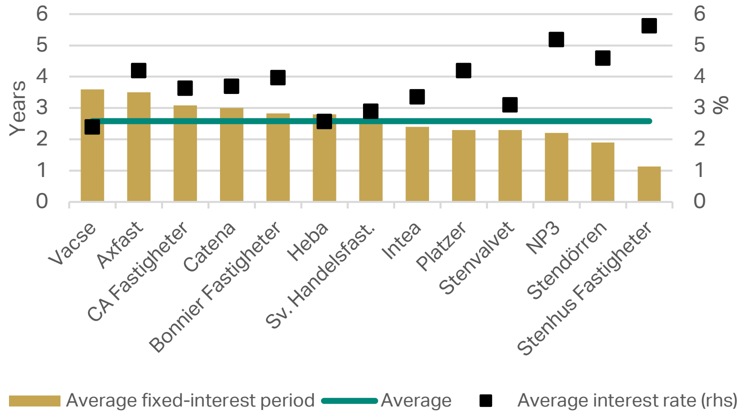
Figure 4. NCR-rated Swedish real-estate issuers' aggregate interest maturities, 30 Sep. 2023



Source: companies.

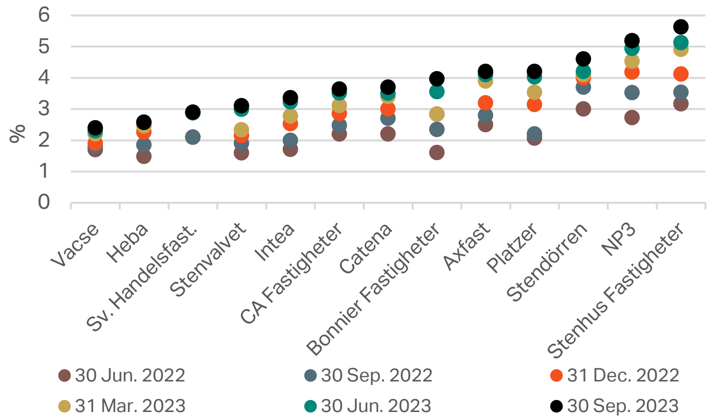
Higher interest rates can already be seen in the companies' reported figures, especially for those with short fixed-interest periods, which have experienced sharper average interest rate increases (see Figure 6). Among NCR-rated real-estate issuers, the average reported interest rate increased to 3.8% at the end of the third quarter, compared with 2.5% a year before. The corresponding weakening of the companies' interest coverage has also been clearly observable; average interest coverage decreased to 2.8x at the end of the third quarter, compared with 4.2x a year ago.

Figure 5. Average fixed-interest periods and interest rates of NCR-rated real-estate issuers, 30 Sep. 2023



Source: companies. Bonnier Fast. as of 30 Aug. 2023.

Figure 6. Average interest rates of NCR-rated real-estate issuers, 30 Jun. 2022–30 Sep. 2023



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

MORE INTEREST HEDGING OPTIONS, BUT TOUGHER REFINANCING CONDITIONS

We observed more frequent use of non-traditional interest rate swaps during 2023. There is an increased propensity to use option-based swap contracts with different features, as companies have increased their focus on maintaining their interest coverage ratio within target levels. Some issuers have entered into performance swaps, providing protection against interest rates within a range, whereas others have contracts under which the counterparty holds call options for extensions. We believe that some features increase complexity and reduce transparency relative to peers, with increased risk for issuers as this limits their protection against higher rates and several conditions that might adversely affect their financial standing. However, these usually constitute a relatively small proportion of the total swapped interest. We expect increased use of more non-traditional swaps in 2024 as borrowers extend their interest rate fixing periods and secure headroom for their interest coverage ratio covenants and financial targets.

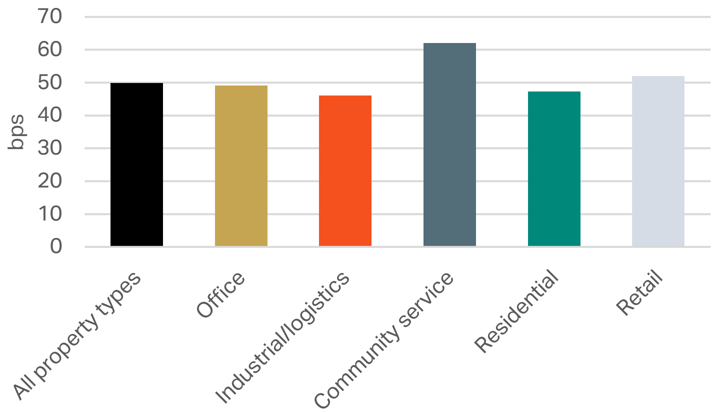
Tougher refinancing conditions are likely to persist even as interest rates fall. Banks are demanding wider credit margins than previously, which is likely to offset some of the benefits of the expected lower variable rates. They have also imposed new conditions for granting new loans. For instance, in some cases banks have required equity injections, cancelled or reduced dividends, and greater collateral for some loans, resulting in previously unencumbered assets being included in the collateral pool. We expect more conditions to be set for obtaining new bank financing in 2024 as banks become more prudent in their lending, with lower tolerated leverage to cushion against falling property values and improve debt servicing capabilities. We believe that these factors could result in continued revisions of financial policies among property managers. It is also likely that banks will push for more sustainability-linked loans due to new measuring and reporting requirements attributable to the introduction of the Corporate Sustainability Reporting Directive. We believe that companies with a strong focus on sustainability are better positioned to obtain financing on attractive terms.

FURTHER WIDENING OF PROPERTY YIELDS IN LOWER-YIELDING SEGMENTS

We have seen a limited degree of valuation changes since H2 2022, with a decline of about 7% on average for commercial properties, but we expect to see a continued decline in 2024. We believe that the transaction market, which has been sluggish throughout 2023, will pick up in 2024 as the risk of higher interest rates recedes and price expectations between buyers and sellers increasingly align. However, buyers and sellers are likely to meet at higher yield levels than currently reflected in reported valuations. A higher volume of transactions could result in wider revaluations in the sector, as more evidence-based data can be used in external valuations.

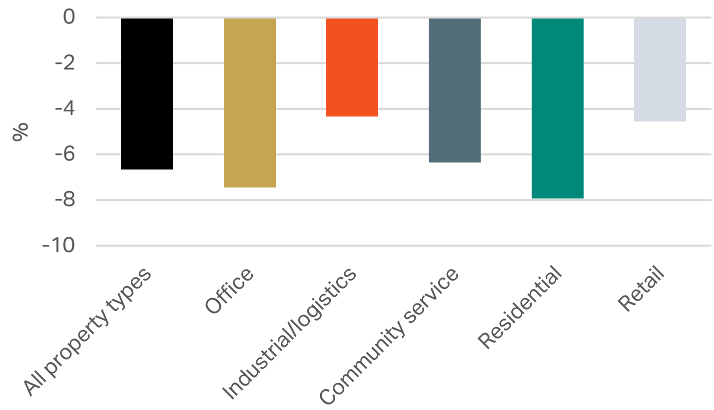
Historically, commercial property yields have increased by about half of the increase in the risk-free rate, which should result in a top-to-bottom yield adjustment of 100-125bps, based on our long-term expectations for the risk-free interest rate. The average cumulative valuation yield widened by approximately 50bps for all property types between the third quarter of 2022 and the third quarter of 2023. We incorporate yield adjustment in our financial forecast of property values, with some issuers having seen their yield requirement widen in line with our expectations while others are likely to face further widening. Fair value changes have been supported to some extent by CPI indexation of commercial rental contracts. However, we believe there is a greater need for revaluation in segments with a lower yield requirement and for issuers that have made smaller value adjustments relative to peers with similar asset fundamentals.

Figure 7. Avg. cumulative valuation yield changes, 30 Sep. 2022–30 Sep. 2023



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

Figure 8. Avg. cumulative property value changes, 30 Sep. 2022–30 Sep. 2023



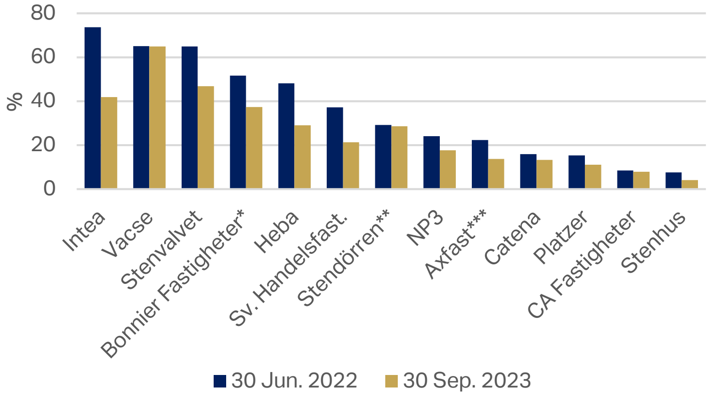
Source: companies. Based on a selection of 30 Swedish real-estate issuers.

We saw some divestments in the residential segment in 2023 at varying discounts to book values, with newly constructed, environmentally accredited buildings obtaining the lowest discounts. We believe, however, that there needs to be a repricing in the wider residential market, as financing costs remain prohibitive for buyers that are unable to use full equity financing. Other segments, such as grocery and discount retailers and industrials have smaller differences in price expectations between prospective buyers and sellers, which we believe will result in more stable values in 2024, unless these segments face increased vacancies. These assets are typically higher yielding with stronger cash flows, resulting in satisfactory interest coverage ratios at moderate leverage ratios.

BOND ISSUANCE SET TO INCREASE IN 2024

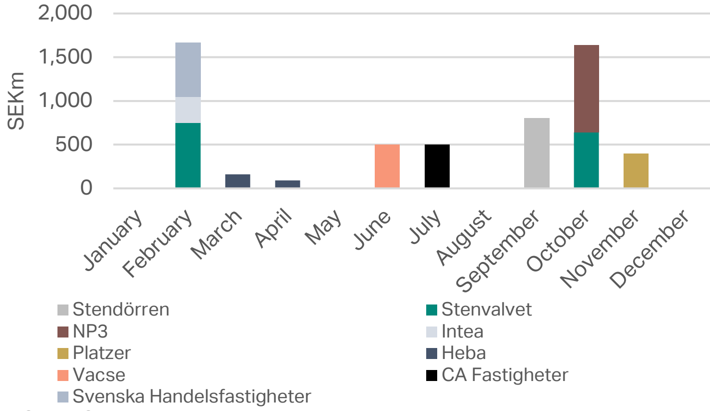
Bond market issuance picked up in the second quarter of 2023 after a period of low activity since Russia's invasion of Ukraine in 2022. Spreads, however, remain elevated in the 'BBB' rated segment, which we see as prohibitive for obtaining financing with durations beyond three years. Even the cost of shorter duration funding has widened considerably relative to bank financing, resulting in capital market financing increasingly being replaced by bank financing (see Figure 9). However, we anticipate that capital market spreads will tighten relative to bank financing, which could drive increased bond issuances in 2024. We also expect companies to be proactive in reducing refinancing risk in 2024, with repurchase offers being made when funds are available. We believe that issuers who are able and willing to issue in a tougher market will limit their refinancing risk in the long run and will not be regarded merely as opportunistic capital market issuers.

Figure 9. NCR-rated issuers' capital markets financing relative to gross debt, 30 Jun. 2022–30 Sep. 2023



Source: Stamdata. *As of 31 Aug. 2023. **Includes hybrid bond. ***As of 30 Jun. 2023.

Figure 10. NCR-rated issuers' bond maturities in 2024



Source: Stamdata.

MORE DISTRESSED CREDIT EVENTS AROUND THE CORNER

Since the second half of 2022, there have been several distressed credit events in the Swedish real-estate sector. Some issuers have initiated written procedures to change the terms and conditions of specific instruments, and some have filed for bankruptcy (see Figure 11 below). Some companies have seen their debt repayment accelerated, triggering fire sales of key properties, for instance by bondholders for Kvalitena AB (publ) and by banks for Oscar Properties Holding AB (publ). 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 eye. As we expect further weakening of some issuers' financial metrics, we believe we will see more distressed credit events in 2024.

Figure 11. Selection of credit events concerning Swedish real-estate sector issuers, 30 Jun. 2022–31 Dec. 2023

Issuer	Event	Event date	Description
SIBS AB (publ)	Deferral of principal	6 Dec. 2023	Extended maturity by 2.5 years (from 19 Apr. 2024 to 19 Oct. 2025)
Oscar Properties Holding AB (publ)	Non-payment	23 Oct. 2023	Non-payment of interest and principal of bank loans; acceleration by lenders
Kvalitena AB (publ)	Non-payment	9 Oct. 2023	Non-payment of interest and principal; acceleration by bondholders
Aktiebolaget Fastator (publ)	Deferral of principal	26 Sep. 2023	Extended maturity on 3 bonds by 2 years each.
Studentbostäder i Norden AB (publ)	Deferral of principal	22 Sep. 2023	Extended maturity by 2.5 years (from 14 May 2024 to 15 November 2026)
Aktiebolaget Fastator (publ)	Deferral of principal	22 Aug. 2023	Extended maturity by 2 months (22 Sep. to 22 Nov. 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 6 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.

NCR-RATED REAL-ESTATE COMPANIES

The following table summarises NCR's ratings on Swedish real-estate companies as of 31 Dec. 2023. In addition, NCR has ratings on two Norwegian property managers and maintains a database of credit assessments of key Nordic players in this sector.

Figure 12. NCR ratings on Swedish real-estate companies

Issuer	Primary property type(s)	Long-term issuer rating	Outlook/Watch
Vacse AB (publ)	Community service	A-	Stable
Svensk FastighetsFinansiering AB (publ)	Offices	BBB+	Stable
Axfast AB (publ)	Offices	BBB	Stable
Fastighets AB Stenvalvet (publ)	Community service	BBB	Stable
Intea Fastigheter AB (publ)	Community service	BBB	Stable
Heba Fastighets AB (publ)	Residential	BBB	Negative
Catena AB (publ)	Logistics	BBB-	Positive
Bonnier Fastigheter AB	Offices	BBB-	Stable
CA Fastigheter AB	Residential	BBB-	Stable
LSTH Svenska Handelsfastigheter AB (publ)	Retail	BBB-	Stable
Platzer Fastigheter Holding AB (publ)	Offices	BBB-	Negative
NP3 Fastigheter AB (publ)	Industrial/warehousing	BB	Negative
Stenhus Fastigheter i Norden AB (publ)	Retail/industrial	BB	Negative
Stendörren Fastigheter AB (publ)	Industrial/warehousing	BB-	Stable

See NCR's company reports for details.

RELEVANT RESEARCH AND METHODOLOGIES

(i) Real estate quarterly snapshot (2023Q3) - is it a sigh of relief?, 28 Nov. 2023.
(ii) The Swedish real estate sector– waiting for sunshine after the rain, 27 Sep. 2023.
(iii) Decoding Swedish real estate in an uncertain market environment, 29 Aug. 2023.
(iv) Sweden's real-estate sector faces growing challenges, 13 Dec. 2022.
(v) Corporate Rating Methodology, 8 May 2023.
(vi) Rating Principles, 24 May 2022.

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