Nordic Credit Rating

SECTOR COMMENT

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Swedish real estate: Likely interest rate cuts allow for cautious optimism

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Financial ratios in Sweden's real estate sector look set to benefit from ongoing interest rate cuts that we expect to continue through 2025 towards normalised floating levels of about 2%. We also believe that some issuers in the sector could have seen their average interest rates peak. Our expectations follow a period in which the debt-laden sector has been buffeted by surging inflation and subsequent increases in policy rates by the central bank. Real estate companies now face some respite: inflation has decreased from a peak in December 2022 and the central bank responded with rate cuts totalling 50bps in May and August.

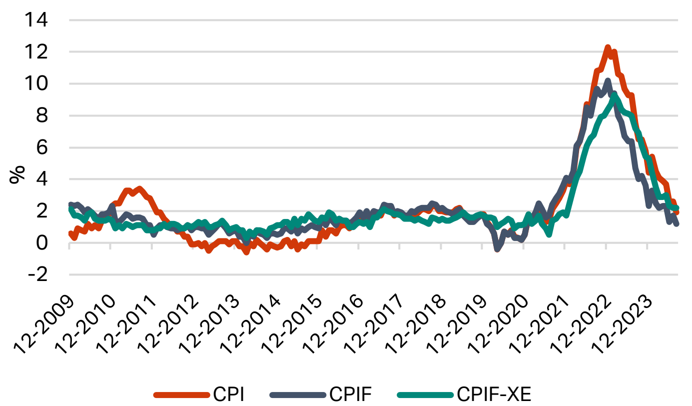
Capital market financing became increasingly accessible at longer tenors for property managers in the first half of the year, with substantial amounts of new issues at more normalised levels relative to the elevated capital market spreads of 2022 and 2023. We take a positive view of the reopening of the capital markets for the sector and the subsequent easing of refinancing concerns for most issuers.

We believe that the transaction market, which was sluggish throughout 2023 and the first half of 2024, will pick up in the remainder of the year as uncertainty over interest rates recedes and financing becomes more accessible at attractive levels. We also believe that we have already seen most of the likely value declines in the sector because financing costs are justifying book values in higher yielding subsectors. However, lower yielding subsectors such as residential properties could see further corrections due to continued misalignment of sellers' and buyers' price expectations. We believe that further corrections will be largely dependent on asset quality and current book yields. As the financing landscape normalises and transactions pick up, uncertainty about property values is likely to recede. We are cautiously optimistic about the implications of improved financing conditions for real estate managers. However, vacancies could increase in the sector as the economy weakens, with a negative impact on business risk profiles.

INTEREST RATE CUTS LIKELY TO CONTINUE

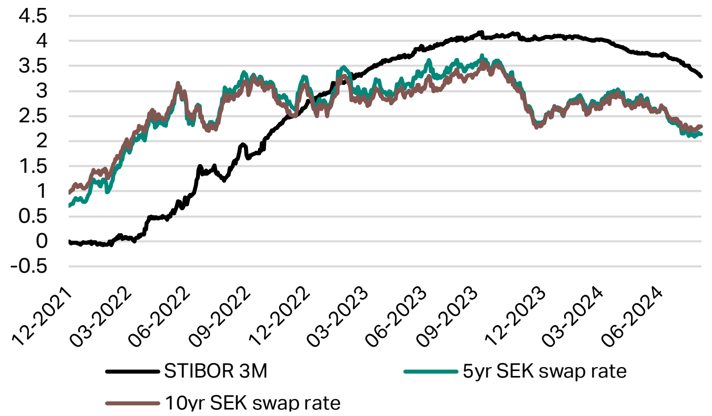
As inflationary pressure recedes, market interest rates on borrowing for long periods have fallen markedly. As of 30 Aug. 2024, the five-year swap rate stood at 2.1% compared with 3.5% a year earlier. In May 2024, the central bank lowered its key policy rate by 25bps, the first such cut in eight years. The rate was lowered by a further 25bps in August. In line with the market, we expect a continued fall in interest rates in the remainder of 2024 and 2025 towards a normalised floating rate of about 2%.

Figure 1. Sweden's inflation rate, 2009-Aug. 2024



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–Aug. 2024



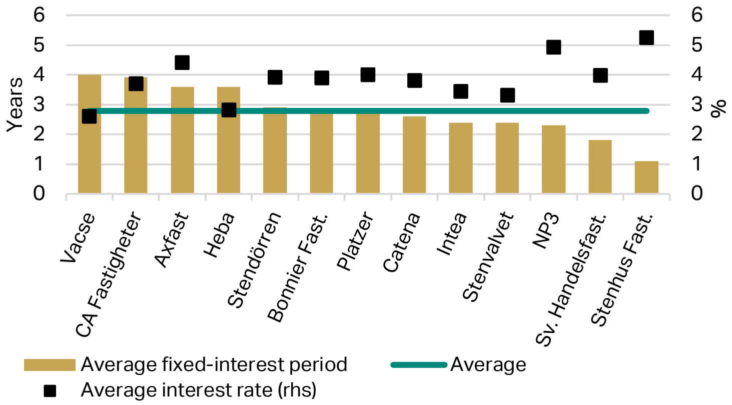
Source: Capital IQ.

Most real estate companies have secured portions of their financing costs with interest rate swaps or caps that have delayed and offset some of 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 high interest rates on their financial performance. They are also more likely to show more stable interest coverage ratios through an interest rate cycle. Imminent interest rate cuts, combined with continued strong rental growth, could result in improved interest coverage ratios for some issuers. For others, lower interest rates and rental growth are likely to be offset by the expiry of swap contracts entered into at favourable low interest rates. Depending on the extent of the renewal of swap contracts or contracts signed in 2022 and 2023, some issuers could see their average interest rates nearing their peak and their interest coverage ratios rebounding. In the short term, issuers can improve their interest coverage ratios by entering into new swaps at rates lower than the variable rates currently available, although we believe that some issuers could prove reluctant to lock in interest rates during a downward cycle.

REPORTED AVERAGE INTEREST RATES REACHING PEAK LEVELS

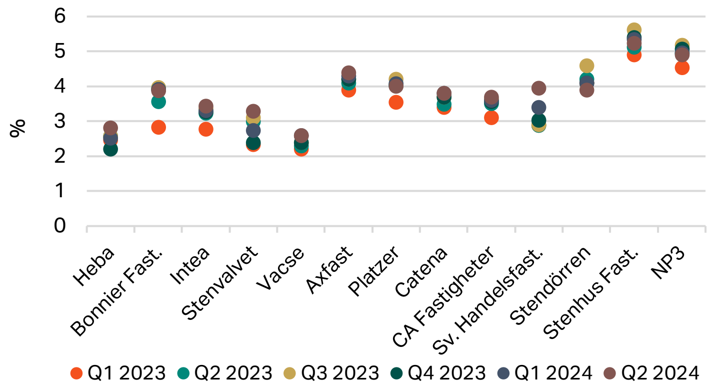
Among NCR-rated real estate issuers, the impact of rising interest rates has been clearly reflected in companies' interim reports. The average reported interest rate increased to 3.8% as of 30 Jun. 2024, compared with 3.6% a year earlier and only 2.2% two years previously. However, we believe that some issuers have already seen or are nearing peak financing costs. Long-term market interest rates have fallen from their highs, and we have seen greater use of interest rate derivatives. We expect companies' average interest rates to decrease as market interest rates fall over the next few quarters, which should reduce pressure on interest coverage.

Figure 3. Average fixed-interest period and average interest rates of NCR-rated real estate issuers, 30 Jun. 2024



Source: companies. Bonnier Fast. reports on a four monthly basis.

Figure 4. Average interest rates of NCR rated real estate issuers, Q1 2023–Q2 2024



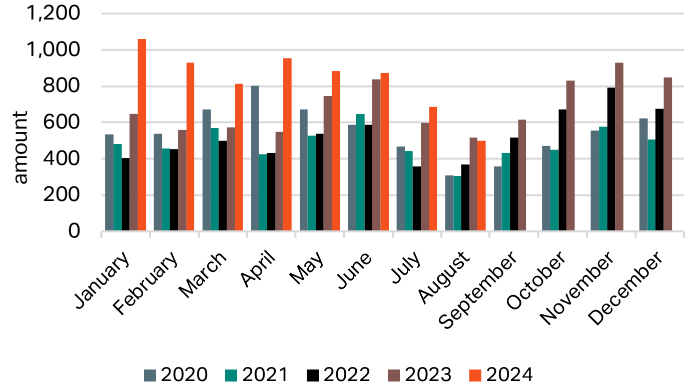
Source: companies.

RECESSION RISK STILL ELEVATED

The main challenges in the real estate sector have largely been related to financing rather than operational performance, and business fundamentals such as rental values and occupancy rates have remained relatively stable. Despite slightly higher vacancies for some issuers, occupancy rates are still strong, and we see only a limited impact on the business risk profiles of the real estate companies we rate. However, corporate defaults are still at record highs, with car retailers, restaurants and property developers among the worst-affected sectors. We believe that a continued slowdown in the economy with high default rates is likely to lead to increased vacancies over the next few years. Concerns about future occupancy rates and rent levels are likely to overshadow the real estate sector for the remainder of 2024.

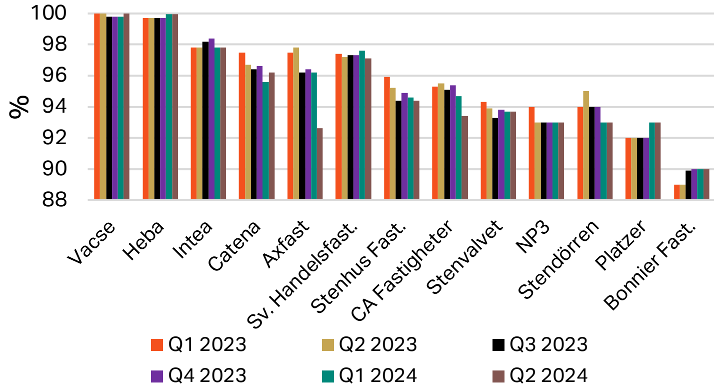
We expect continued strong occupancy rates in specialised community service properties and residential real estate, while discretionary retail, office and logistics properties could face higher vacancies and lower rental growth as some tenants struggle with profitability, which in turn could lead to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

Figure 5. Company defaults in Sweden 2020–Aug. 2024



Source: Creditsafe.

Figure 6. Occupancy rates of NCR-rated Swedish real estate issuers, Q1 2023–Q2 2024



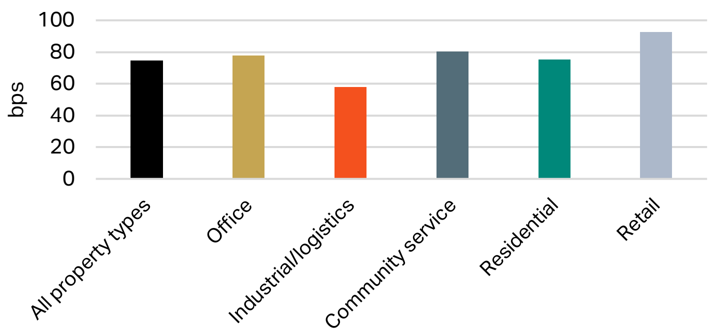
Source: companies. Bonnier Fast. reports on a four monthly basis.

MOST LIKELY VALUE DECLINES ALREADY IN PLACE

Since mid-2022, we have seen only modest declines in reported property values. Based on a selection of 30 real estate issuers, the average cumulative valuation yield increase from the third quarter of 2022 to the second quarter of 2024 has been around 75 bps, while the corresponding decline in reported property values has averaged 9%. Reported property values have been supported by CPI indexation of commercial rental contracts. Market transactions have been relatively limited, and we believe the transaction market, which was sluggish through 2023 and the first half of 2024, will pick up in the remainder of 2024 as interest rate risk recedes and the price expectations of buyers and sellers increasingly align. A higher volume of transactions could result in some further revaluations in the sector, especially in lower yielding subsectors, but we believe that we have already seen most of the likely valuation changes already because of adjusted yield requirements.

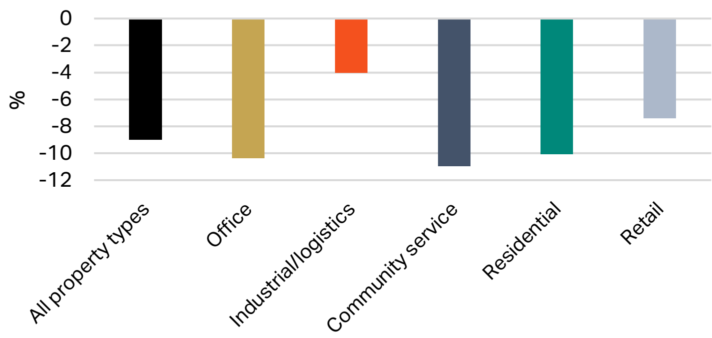
Our base-case projections a year ago pointed to a 10% decline in prime office property values by end-2024. Values in both the office and the residential subsectors have declined by about 10% from peaks in 2022 (see Figure 8). The industrial/logistics subsector, characterised by high cash flow generation and yields, has seen average value declines of only 4% over the same period, despite an average yield increase of about 60bps.

Figure 7. Average cumulative valuation yield changes, Q3 22–Q2 24



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

Figure 8. Average cumulative property value changes, Q3 22–Q2 24



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

DISTRESSED CREDIT EVENTS KEEP RISING

Since mid-2022, several distressed credit events have affected the 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 9). Some companies have seen their debt repayments accelerated, triggering fire sales of key properties, for instance by Kvalitena AB (publ) bondholders and Oscar Properties Holding AB (publ)'s banks. In addition to publicly disclosed credit events, we assume that a number of companies have breached their financial bank covenants and/or requested changes to the terms of their bank financing out of the public eye.

The following table summarises key credit events affecting issuers in the sector.

Figure 9. Selection of credit events affecting real estate issuers 30 Jun. 2022–31 Aug. 2024

Issuer	Event	Event date	Description
Holmström Fastigheter Holding AB (publ)	Deferral of principal	28 Jun. 2024	Extended maturity by two years (from 14 Oct. 2024 to 14 Oct. 2026)
Aktiebolaget Fastator (publ)	Non-payment	25 Jun. 2024	Non-payment of interest. Breach of maintenance test
Företagsparken Norden Holding AB (publ)	Change of covenant	22 May 2024	Covenants waived; consent fee 0.5%
K2A Knaust & Andersson Fastigheter AB (publ)	Deferral of principal	20 May 2024	Extended maturity by 1.25 years. Increase in margin from 3% to 7% upon original maturity. Consent fee of 0.5%
Oscar Properties Holding AB (publ)	Bankruptcy proceedings	26 Apr. 2024	Issuer filed for bankruptcy on 25 Apr. 2024
Point Properties Portfolio 1 AB (publ)	Deferral of principal	27 Mar. 2024	Issuer not able to redeem its bonds on 22 Mar. 2024
Ilija Batljan Invest AB	Deferral of principal	27 Feb. 2024	Extended maturity by more than 2 years (from 15 Dec. 2024 to 20 Jan. 2026)
Magnolia Bostad AB	Deferral of principal	26 Feb. 2024	Extended maturity by eight months.
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 three 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 two 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 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 January and April; 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 to floating rate from fixed; 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	Interest changed to fixed from floating rate; maturity extended by one year; fee of 1.5%

Source: company websites, Stamdata.

NCR-RATED REAL ESTATE COMPANIES

The following table summarises NCR's ratings on Swedish real estate companies as of 31 Aug. 2024. In addition, NCR has ratings on two Norwegian property managers and maintains a database of credit assessments of key Nordic players in the sector.

Figure 10. 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	Stable
Catena AB (publ)	Logistics	BBB	Stable
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-	Positive

See NCR's company reports for details.

RELEVANT RESEARCH AND METHODOLOGIES

(i) Swedish real estate snapshot (Q2 2024): Interest rate cuts likely to continue, 5 Sep. 2024.
(ii) Nordic Credit Rating's view on distressed exchanges, 29 Aug. 2024.
(iii) Real estate snapshot (Q1 2024): A step towards long-term normalised interest rate levels, 23 May 2024.
(iv) Real estate quarterly snapshot (Q4 2023): Strong performance despite highest Swedish corporate defaults, 11 Mar. 2024.
(v) Swedish real estate sector adapts to tougher financing climate, 18 Jan. 2024.
(vi) Corporate Rating Methodology, 8 May 2023.
(vii) Rating Principles, 24 May 2022.

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