Nordic Credit Rating

Swedish real estate outlook

Challenging times for real estate companies

28 Sep. 2023

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Executive summary

Increased risk is mostly financial… so far

- The underlying business of property managers remains strong, with high margins and occupancies
- Interest coverage ratios continue to weaken as swap contracts expire and higher interest-rates feed into financial statements
- Further declines in property values are expected, which will put pressure on loan-to-value unless other measures are taken
- A rise in distressed credit events, written procedures and restructuring


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SECTOR COMMENT

28 Sep. 2023

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

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

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 remarkedly 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

CPI, CPIF, CPIF-XE

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

STIBOR 3M, 5yr SEK swap rate, 10yr SEK swap rate

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.

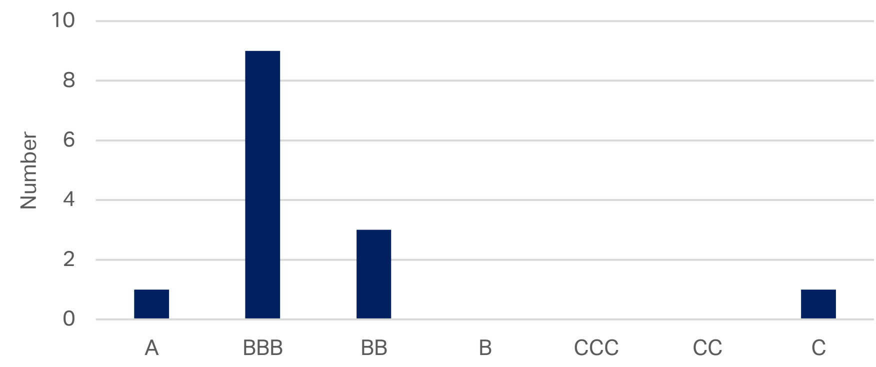
Nordic Credit Rating has wide real estate coverage

Overview of NCR's Swedish real estate coverage

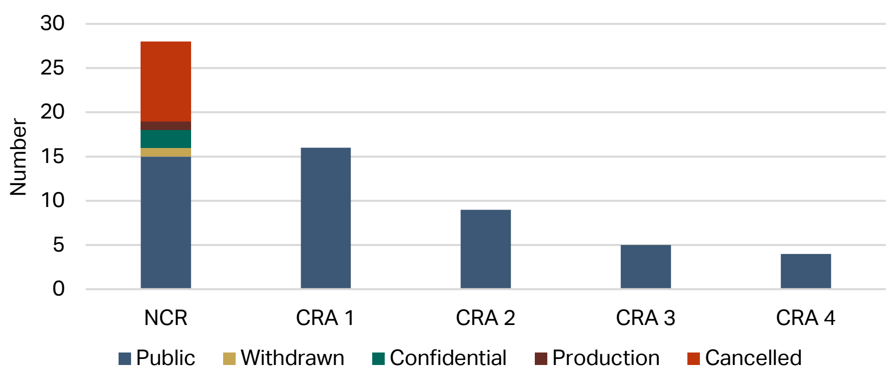
Broad real estate coverage

- Nordic Credit Rating covers 14 Swedish real estate issuers across different property segments
- Ratings range from 'A-' to 'C'
- Most issuers are currently on stable outlook, reflecting our expectations that financials will remain within our rating drivers

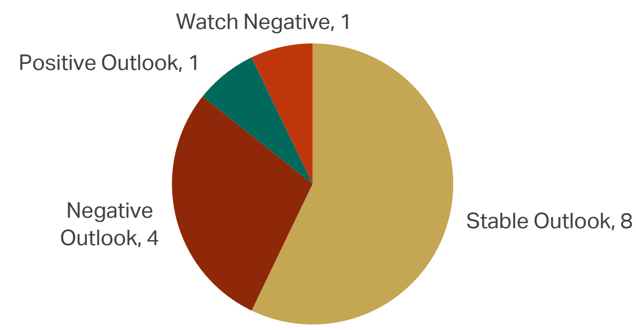
Rating distribution of NCR's Swedish real estate coverage



Number of Swedish real estate ratings



Outlooks and watch distribution



NCR public Swedish real estate ratings

Detailed public Swedish real estate ratings[1)]

Issuer	Vacse	Intea	Stenvalvet	Axfast	Bonnier Fastigheter	Heba	CA Fastigheter	Catena	Platzer	Svenska Handelsfastigheter	NP3	Stenhus	Stendörren	Studentbostäder i Norden
Long-term rating	A-	BBB	BBB	BBB	BBB	BBB	BBB-	BBB-	BBB-	BBB-	BB	BB	BB-	C*
Outlook	Stable	Stable	Stable	Stable	Negative	Negative	Stable	Positive	Stable	Stable	Negative	Negative	Stable	Watch Negative
Business risk assessment	a-	a-	bbb+	bbb-	bb+	bbb+	bbb-	bbb	bbb-	bbb-	bb+	bb+	bb+	bb+
Primary property type(s)	Public	Public	Public	Office	Office	Residential	Residential	Logistics	Office	Retail	Industrial	Retail & Industrial	Logistics	Residential
Portfolio size (SEKbn)	9.3	20.6	16.5	21.2	16.1	15.5	15.2	27.9	27.4	15.5	19.8	14.3	12.5	7.5
Financial risk assessment	bbb+	bb+	bbb-	bbb+	bbb+	bb+	bb+	bbb-	bb+	bbb-	b+	bb-	b+	b-
EBITDA/ net interest (x)	5.3	3.5	4.6	3.3	3.0	2.8	6.6	5.0	3.2	3.7	2.5	2.2	1.8	1.4
Net debt/ EBITDA(x)	9.5	16.3	10.6	12.0	12.1	19.6	11.9	8.2	13.3	10.8	10.2	12.8	14.2	31.8
Net LTV (%)	37.4	53.4	39.2	26.9	34.3	47.8	40.7	35.8	44.2	51.7	60.7	55.2	55.3	69.2
Ownership	Pension funds	Pension funds	Pension funds	Private (Ax:son Johnson family)	Private (Bonnier family)	Listed	Private (Claesson family)	Listed	Listed	Pension funds	Listed	Listed	Listed	Listed

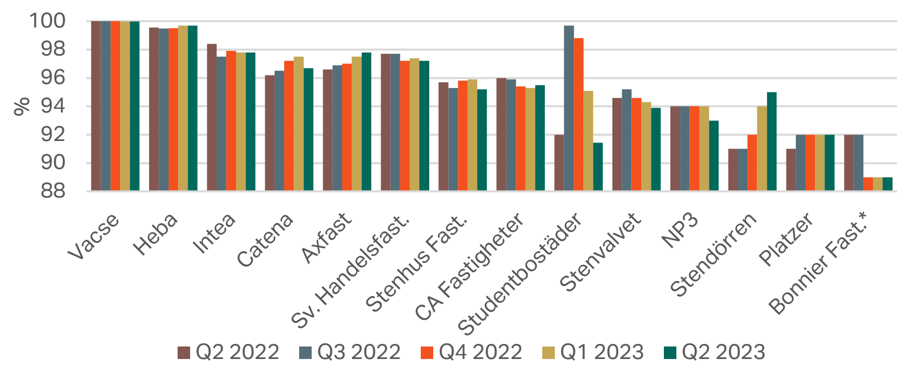
1) Based on available data as of 2023-06-30. All metrics adjusted in line with NCR methodology. *Rating revised to 'C' with Watch Negative on 22 Sep. 2023.

Underlying business remains strong

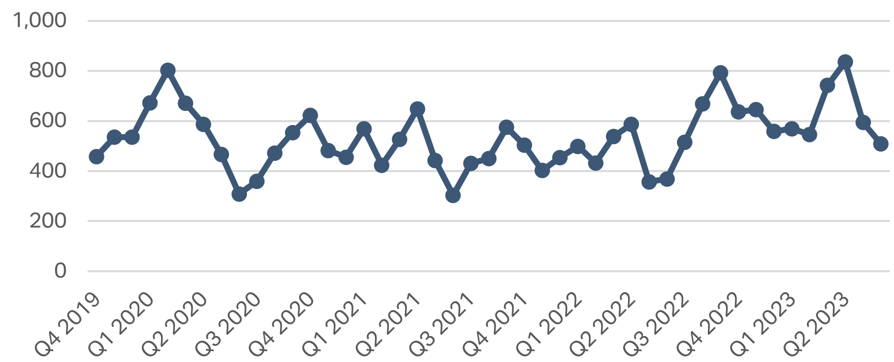
Solid business fundamentals

- Business fundamentals remain strong and it is still possible to increase rates for new rentals
- Bankruptcies at pandemic-levels with retail, construction and hotel restaurants being the most heavily affected sectors
- Tenant strength and locational attractiveness are key determinants of continued strong occupancy and cash flows

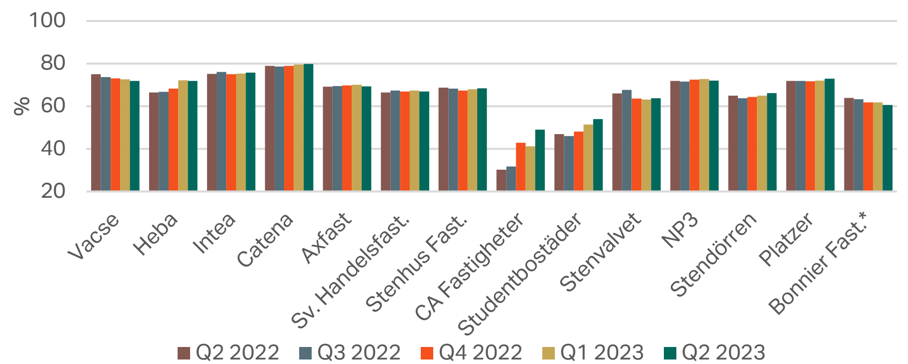
Occupancies rates have been relatively flat



Company defaults in Sweden Dec. 2019–Aug. 2023



EBITDA margins have barely moved for most issuers



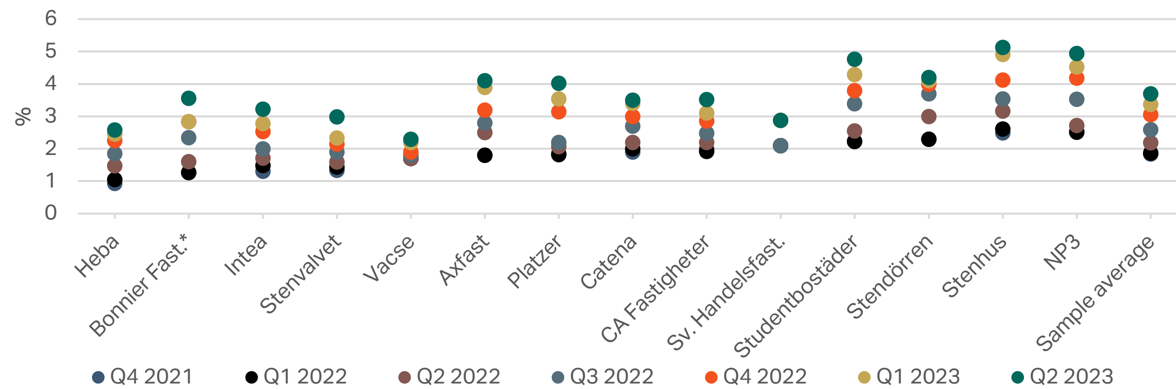
Source: companies and Creditsafe. All metrics adjusted in line with NCR methodology. *Bonnier Fastigheter reports on tertiary basis.

Full impact of higher interest rates yet to be felt

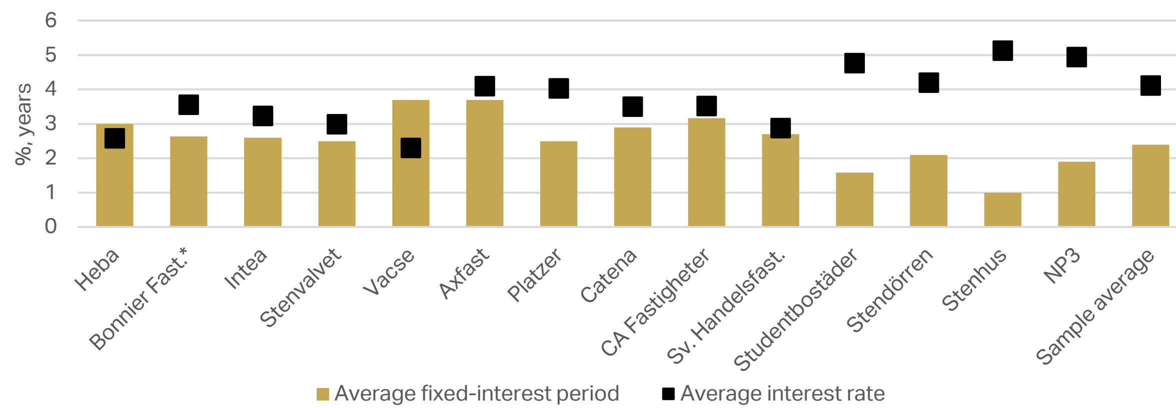
Interest costs will continue to climb

- Average interest rates have doubled for the sample since end-2021
- Issuers with short fixed-interest periods have seen their average interest rates increase more sharply
- Investment grade issuers have experienced a larger relative increase in average interest rates than high yield issuers, despite entering the higher interest rate environment with longer fixed-interest periods
- Impact of higher rates will become more pronounced as existing interest-swap contracts expire

Average interest rates have risen sharply across the sample since end-2021



Average fixed-interest period and average interest rates, Q2 2023

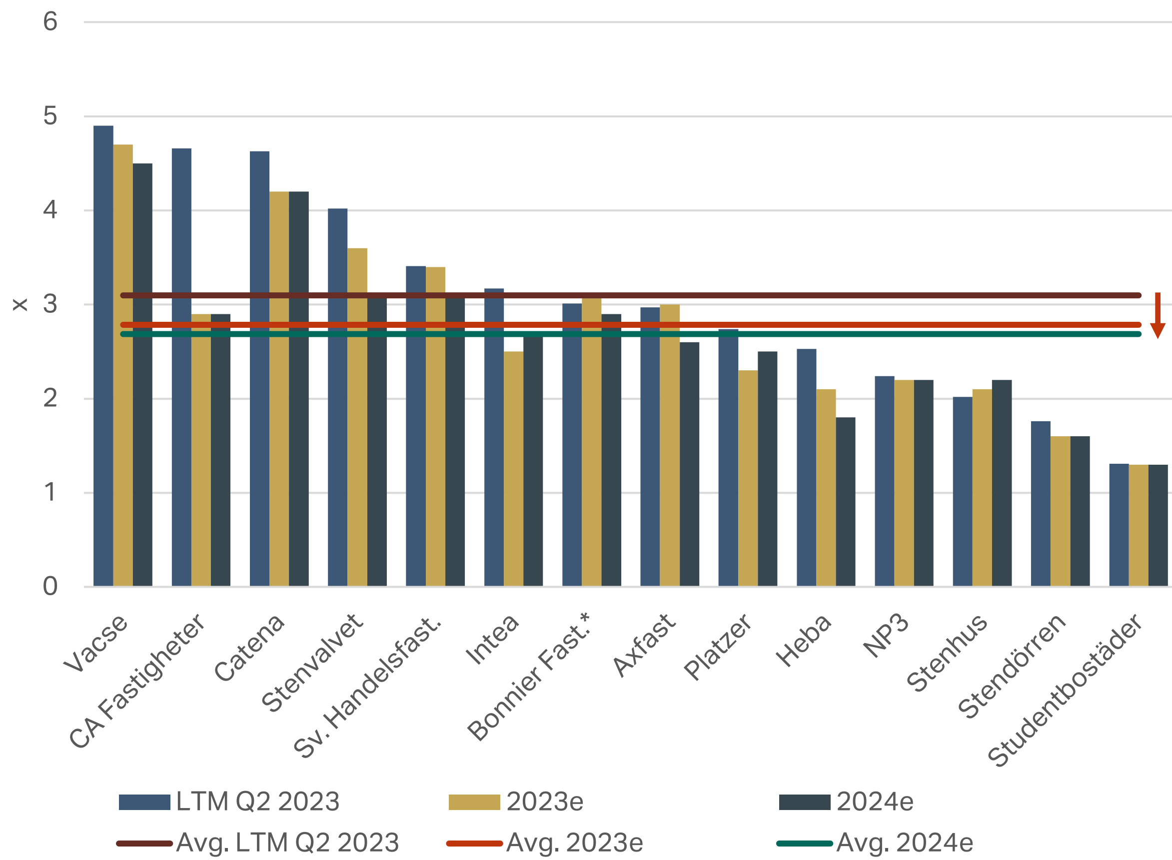


Source: companies. *Bonnier Fastigheter reports on tertiary basis.

Interest coverage ratios NCR-rated companies

Interest coverage ratio set to weaken further

- Heavily debt-financed real estate sector is sensitive to interest rate changes
- Most companies have interest rate swaps that delay and mitigate impact from higher interest rates
- Impact is different depending on extent and duration of interest rate hedging
- We expect further weakening of interest coverage as interest rate swaps mature, offset to a limited extent by indexation in 2024



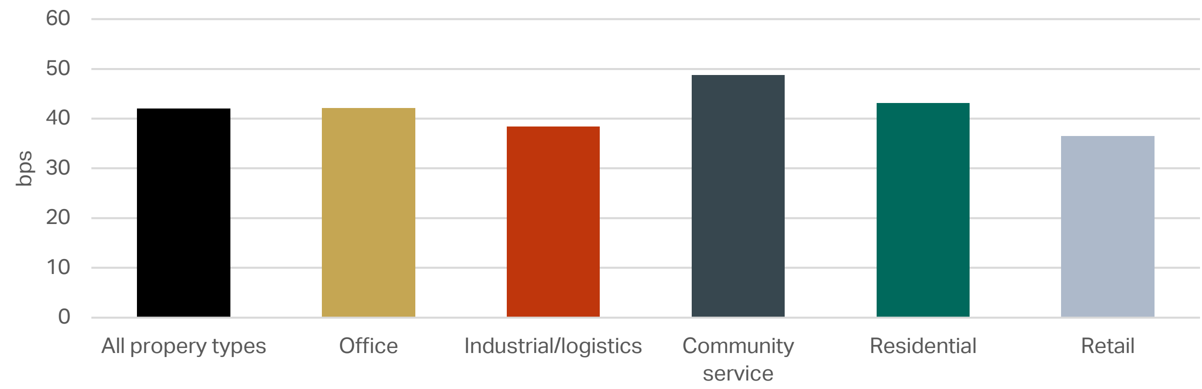
Source: companies. All metrics adjusted in line with NCR methodology. *Bonnier Fastigheter as of 30 Apr. 2023.

Uncertainty around property values remains

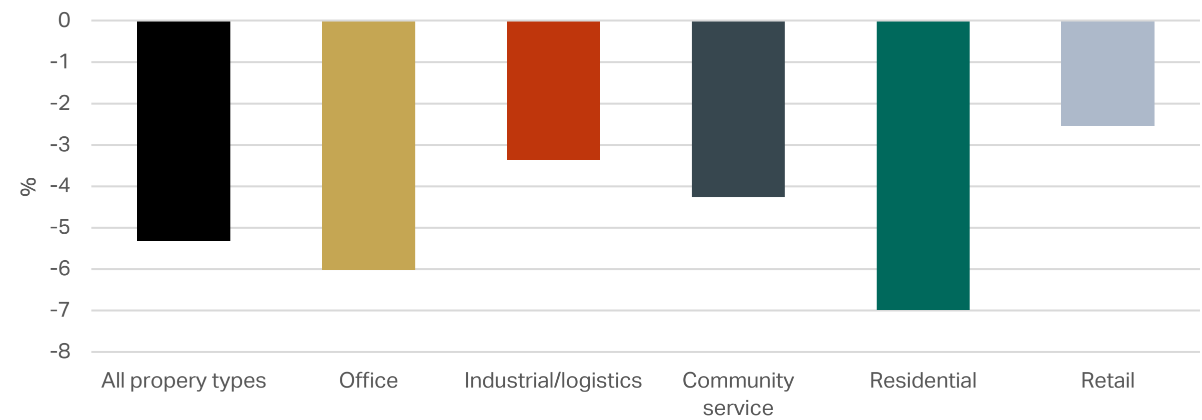
Property values set to decline

- Yields have widened by about 40bps from Q3 2022 to Q2 2023
  - CPI-linked rental leases offset impact for most segments
- Expected transaction volumes for 2023 on par with 2017-2018 levels
  - About 60% lower volumes than 2021
- Higher quality assets are trading, but it is insufficient to observe a repricing trend in the market
- Share of foreign buyers has increased, 33% year-to-date 2023 vs historical average of 20%
- We expect property values to continue to decline through 2024 as transaction activity increases

Property yields widened by about 40bps on average, Q3 2022-Q2 2023



Property values have only declined by 5% on average, Q3 2022-Q2 2023

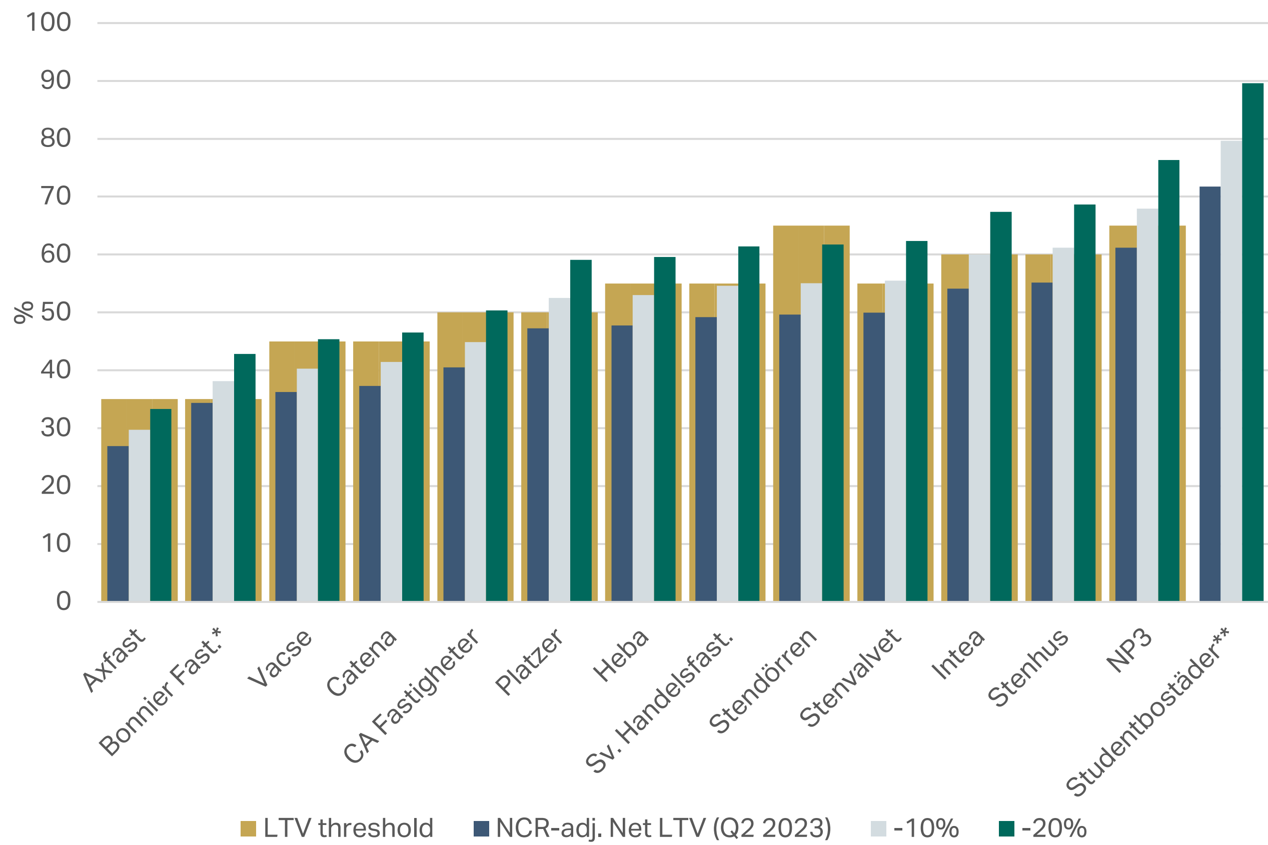


Based on a selection of 30 Swedish real-estate issuers.

Headroom LTV ratios NCR-rated companies

Property value declines have reduced headroom to rating drivers

- Half of NCR-rated real estate issuers could sustain a further 10% decline in property values without breaching their rating triggers
- Our expectations for further declines varies by segment, market and current yields

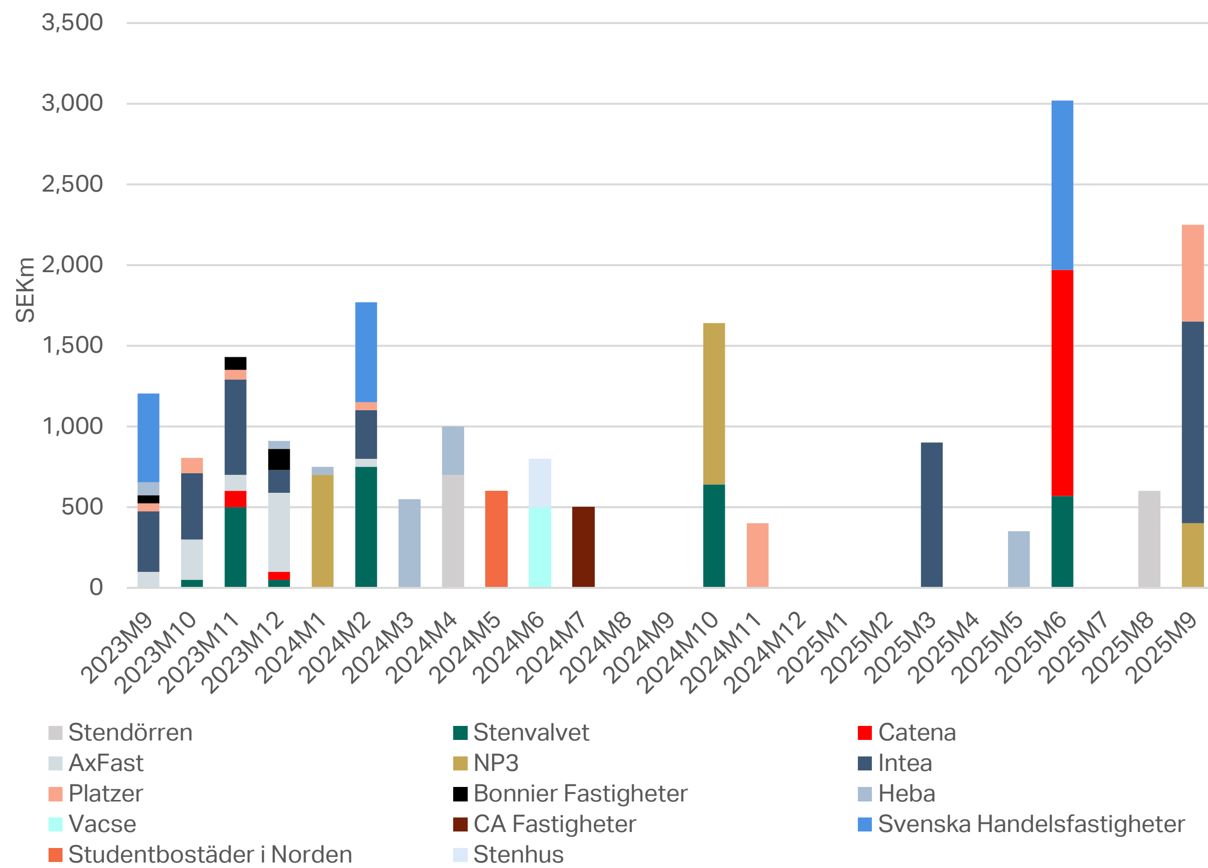


Source: companies. All metrics adjusted in line with NCR methodology. *Bonnier Fastigheter as of 30 Apr. 2023.
**Studentbostäder i Norden has no quantitative rating triggers due to stressed capital structure.

NCR-rated real estate bond maturities

NCR-rated issuers have a relatively small amount of capital markets debt maturing over the next twelve months...

- SEK 10bn in capital market maturities among NCR-rated issuers over the next twelve months
    - Of which SEK 3.5bn in commercial paper maturities
- We expect a combination of property disposals, equity injections and bank financing for meeting maturities
    - Bank refinancing is available in most cases
- Studentbostäder i Norden has initiated a written procedure to extend its bond maturing in May 2024



Source: Stamdata.

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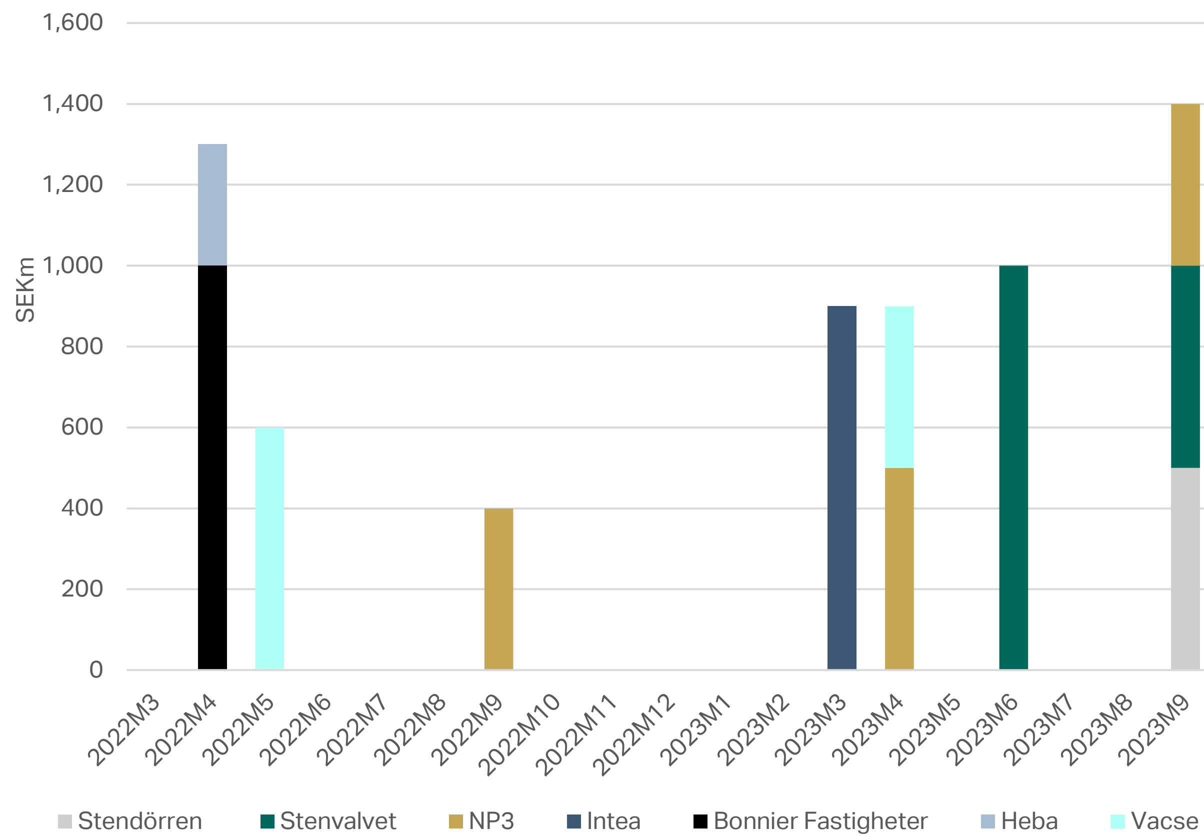
NCR-rated real estate bond issues

...but proven access to the bond market

- Issued volumes have been low since inflation and interest-rates surged in 2022 and 2023
- However, issues in capital markets have recently picked-up despite wider spreads
- Refinancing in capital markets is available, for most issuers it is only a matter of pricing
- We believe that companies will continued to use bank financing and reduce outstanding bond volume until spreads have normalised

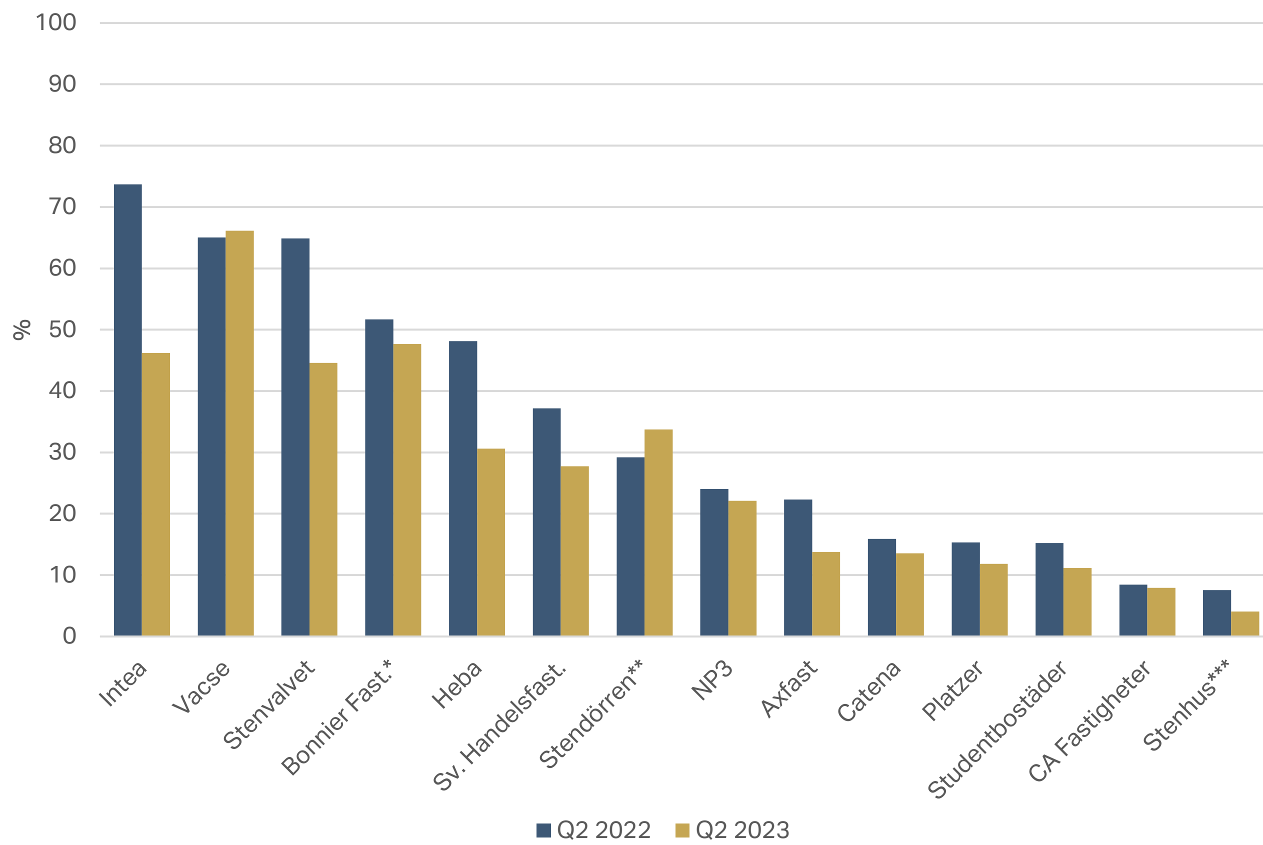


Source: Stamdata.

Capital market exposure varies vastly among issuers

Capital market funding has decreased by 8% of total outstanding gross debt since Q2 2022

- Capital markets financing has increasingly been replaced with bank financing
- Issuers with higher credit quality are typically more exposed to capital markets



Source: Stamdata. *Bonnier Fastigheter as of 30 Apr. 2023 (Q2 2023) and 30 Apr. 2022 (Q2 2022). **Includes hybrid bond. ***Subsidiary MaxFastigheter i Sverige.

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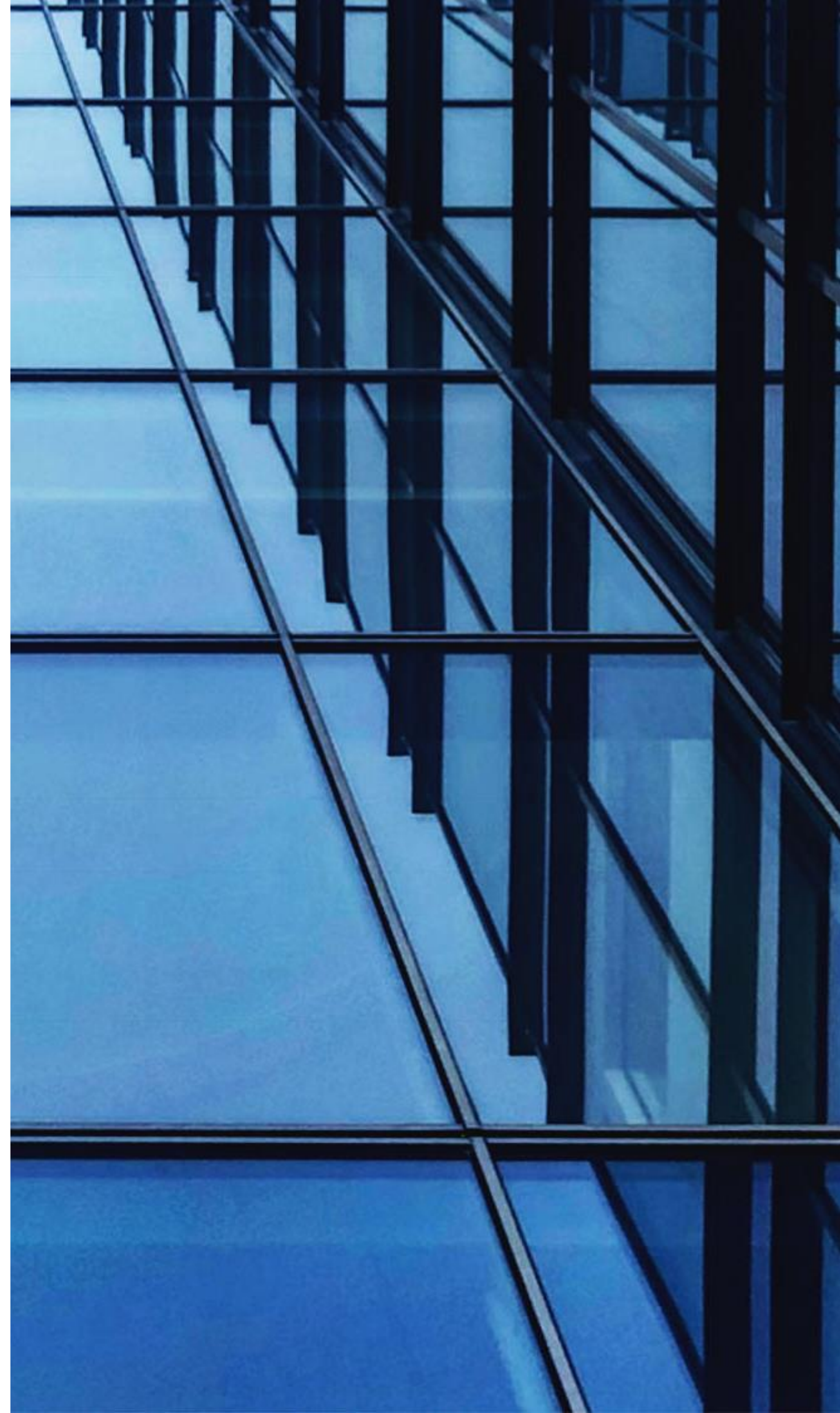
Outlook

We expect…

- Higher market interest rates in the short term, stabilising at lower than current levels
- Weaker interest coverage ratios
- Declines in property values
  - An additional 4-5% for prime offices
- Elevated downside risk to occupancy and rent levels
- Refinancing risk for most issuers is limited, the bond market appears to have opened but at a premium to bank financing



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