

VACSE AB (PUBL)

Sweden

25 October 2018

Real-estate management

Rating initiation

LONG-TERM RATING

BBB+

OUTLOOK

Stable

SHORT-TERM RATING

N-1+

SR. UNSECURED RATING:

BBB+

PRIMARY ANALYST

Michael Andersson
+46 732 324 322
michael.andersson@nordiccreditrating.com

SECONDARY ANALYST

Mille O. Fjeldstad
+47 990 38 916
mille.fjeldstad@nordiccreditrating.com

CLIENT SERVICES

Gustav Liedgren
+46 736 496 543
gustav.liedgren@nordiccreditrating.com

RATING RATIONALE

Our 'BBB+' long-term issuer rating on Vacse AB ("Vacse") reflects the company's strong portfolio of modern, tailor-made properties leased on very long contracts (averaging around 11 years) to highly creditworthy public-sector authorities that are essential to Sweden's public security. The rating also reflects the company's 100% occupancy rate and strong operating margins. It is supported by Vacse's strong financial position of relatively moderate leverage, with loan to value (LTV) of 43%, excluding a shareholder loan; an interest coverage ratio of 4.0x; a low share of secured debt (12%) as of 30 Sep. 2018; and its strong ownership profile.

These strengths are somewhat offset by the company's limited number of properties (14). We believe this creates some, albeit low, risk at contract expiration as 8% of the total contract value expires within five years. In addition, the company has an increasing share of development properties, which are typically pre-let. Like most Swedish real-estate peers, the debt maturity profile is relatively short at 2.7 years, including a bond maturity of SEK 773m in June 2019, which weighs on the liquidity profile.

OUTLOOK

The stable outlook reflects our expectation that Vacse will continue to focus on similar types of properties, with long lease contracts with public institutions. We expect Vacse to extend its relatively short debt maturity profile and proactively refinance the outstanding SEK 773m bond maturing in June 2019. We also see Vacse retaining moderate leverage (including LTV below 50%), while successfully completing its development projects. The stable outlook reflects our view of a stable economic outlook for Sweden, with slowly rising interest rates, and an unchanged ownership profile for the company.

POTENTIAL POSITIVE RATING DRIVERS:

- Significantly lower leverage on a sustainable basis, including LTV of less than 35% and an EBITDA/net interest ratio of more than 5.0x.
- Improvement in debt maturity profile.

POTENTIAL NEGATIVE RATING DRIVERS:

- Increased leverage, including LTV of more than 50% over an extended period.
- An inability to refinance forthcoming debt maturities.
- A significant increase in development projects.

Figure 1. Vacse AB key credit metrics

SEKm	2014	2015	2016	2017	2018e	2019e	2020e
Revenue	268	336	339	334	343	358	372
EBITDA	226	277	269	265	260	271	282
Investment properties	4,764	5,025	5,344	5,257	5,707	6,087	6,337
Net debt	2,465	2,471	2,338	2,046	2,402	2,694	2,851
Total assets	4,863	5,135	5,472	5,389	5,932	6,341	6,541
Debt/EBITDA (x)	10.9	8.9	8.7	7.7	9.2	9.9	10.1
EBITDA/interest (x)	3.9	4.4	3.9	3.9	3.7	4.0	3.9
LTV (%)	52	49	44	39	42	44	45

Source: company data and NCR estimates. e – Estimate.
All metrics are adjusted as per NCR methodology.

COMPANY PROFILE

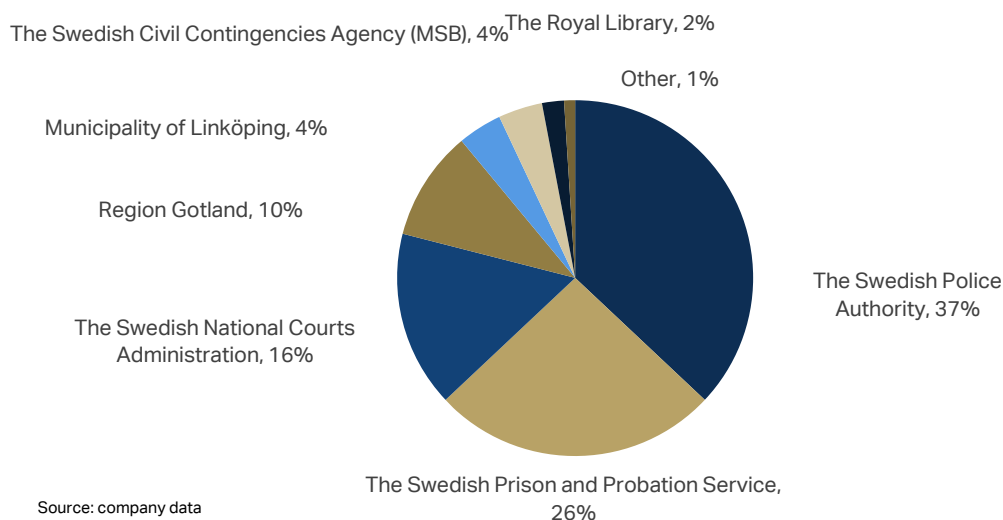
Vacse AB was founded in 2009 by the pension foundations associated to Apoteket AB, Atlas Copco AB, Ericsson AB, Sandvik AB, Skanska AB, Stora Enso AB and AB Volvo, the initials of which give Vacse its name. The company is a Swedish property company focused on owning, managing and developing public-sector properties leased under long-term contracts to agencies of the Swedish government and local municipalities (mainly the police, prisons and courts administration). As of 30 Sep. 2018, the company’s property portfolio consisted of 14 properties valued at a total of SEK 5.6bn.

STRONG LONG-TERM DEMAND FOR PUBLIC-SECTOR PROPERTIES

Our 'bbb+' business risk assessment for Vacse reflects the stable operating environment in which Vacse operates, its low-risk property portfolio and very high operating efficiency.

As Nordic Credit Rating (NCR) views the majority of Vacse’s tenants as essential to Sweden’s public security, we believe that the length of Vacse’s lease contracts guarantee long-term relationships and stable rental income with low correlation with the economic cycle. We view all the company’s tenants as highly creditworthy. Some 86% of the company’s rental income is linked to the Swedish government, with the remaining 14% coming from selected Swedish municipalities as of 30 Sep. 2018. Our understanding is that most political parties in Sweden are committed to increasing resources for the police and judiciary. We therefore expect the operating environment for Vacse to remain stable.

Figure 2. Vacse AB rental income by tenant, 30 Sep. 2018



SMALL BUT HIGHLY SPECIALISED AND DEFENSIVE PORTFOLIO

As of 30 Sep. 2018, the property portfolio consisted of 14 buildings totalling 149,500 sqm with an average contract lease length of about 11 years. As the properties are custom-built and highly specialised, there is a risk of not acquiring new tenants if contracts are not extended, which would result in a significant decrease in rental income and, consequently, property value. Leases have historically been renegotiated as Vacse’s tenants typically remain in the same building for decades, and only 8% of its current contracted annual rental income matures within the next five years.

Having acquired the Swedish Civil Contingencies Agency's new office in Karlstad from Skanska in June 2018, Vacse is currently involved in the three following new development projects:

- **Färgskrapan:** a major 15,000 sqm project in conjunction with Vacse's existing properties in Sollentuna (Attunda District Court). A rental contract for 60% of the property has been signed by the Swedish National Courts Administration and is expected to be finalised in 2020.
- **Jönköping:** a recently signed large 16,000 sqm project for the Swedish Board of Agriculture and the Swedish Forest Agency in Jönköping. Expected to be finalised in 2021 and contingent on final approval from authorities.
- **Tierp:** a 3,200 sqm project for Tierp Municipality and Region Uppsala. Expected to be finalised in the second quarter of 2019 with a contract term of 25 years.

The finalised properties will expand the portfolio to 183,000 sqm, a 23% increase from the current total. These projects will result in the total share of development in Vacse's portfolio increasing, which we believe is a risk factor. This is, however, mitigated by 84% of total development properties being pre-let, leaving only 3% of the total expected property portfolio in 2021 not contracted. New contracts typically have lease terms of 15–25 years. The uncertainty associated with these projects is one of our potential negative rating drivers, as delays could lead to negative publicity, increased costs and may affect Vacse's overall credit risk. Furthermore, we expect these projects to increase the company's leverage, with LTV estimated to increase to 44–45% and debt to EBITDA of 9.0–10.0x. This is, however, commensurate with our financial risk assessment and overall rating of Vacse.

Figure 3. Vacse AB property portfolio, including development projects, 30 Sep. 2018

PROPERTY	LOCATION	TENANT	SQM
Kullen 1	Falun	The Swedish National Courts Administration	5,240
Rölunda 1:6	Håbo	The Royal Library	11,645
Tabellen 4	Sollentuna	Swedish Prison and Probation Service	19,070
Tabellen 3	Sollentuna	Swedish National Courts Administration	9,556
Rotorn 1	Flemingsberg	The Swedish Police Authority	13,152
Mörten 3	Södertälje	The Swedish Police Authority	7,800
Instrumentet 1	Linköping	Municipality of Linköping	7,395
Tjädern 9	Visby	The Swedish Police Authority	7,810
Visborg 1:15	Visby	Region Gotland	17,905
Mimer 3	Västervik	The Swedish Police Authority	3,857
Tvättbjörnen 1	Kalmar	The Swedish Police Authority	11,173
Vevaxeln 8	Malmö	The Swedish Police Authority	16,636
Flundran 2	Malmö	Swedish National Courts Administration	8,997
Kullen 1	Karlstad	Swedish Civil Contingencies Agency	12,852
Development projects			
Tierp	Tierp	Swedish Rescue Services Agency	3,200
Färgskrapan	Sollentuna	Swedish National Courts Administration	15,000
Jönköping	Jönköping	The Swedish Board of Agriculture and Forestry	16,000

Source: company data

As Vacse's properties are modern and highly specialised, typically with one long-term tenant, operating efficiency in terms of occupancy rates and EBITDA margins is very high. We expect Vacse to continue to operate with very high occupancy rates of close to 100%. As a result of essentially no tenant turnover and with modern properties and outsourced maintenance contracts, we expect the company's operating margins to remain above 75%.

FINANCIAL RISK ASSESSMENT

We view Vacse's overall financial risk, balance sheet, ownership structure and credit metrics as commensurate with our 'bbb' financial risk assessment. Compared with many Swedish real estate peers, Vacse has relatively modest leverage. We view its overall financial policy and risk appetite as relatively prudent, and include the strong ownership profile in our overall assessment of financial risk. We view the recent reduction in maximum accepted LTV to 50% from 60% as further proof of this. We do, however, expect Vacse's leverage and LTV to increase as a result of the financing of new projects over the next two to three years, resulting in a LTV ratio of just over 45%. We find this ratio acceptable given the current financial risk assessment and overall rating. With Vacse having exited its current interest rate swap portfolio and entered into new agreements in the third quarter of 2018, we expect little increase in interest cost, despite somewhat higher debt levels over the next two to three years.

Figure 4. Vacse AB financial targets, 30 Sep. 2018

FINANCIAL POLICY	POLICY	30 SEP. 2018
Secured debt/total assets (%)	< 20	12
LTV (%)	< 50	43
EBITDA/interest (x)	> 2	4.0
Average debt maturity (years)	> 2	2.7

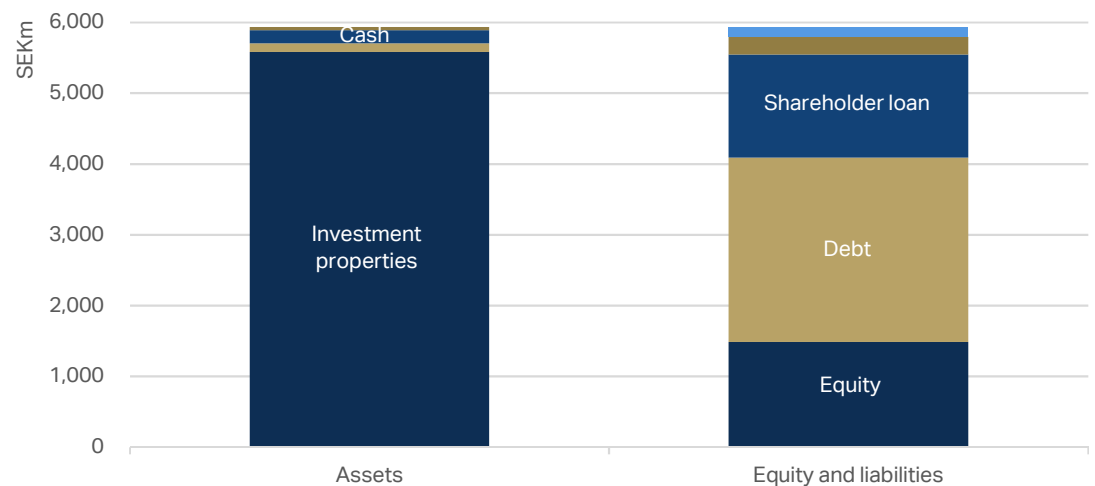
Source: company data

In the future we expect Vacse's main sources of funding to be unsecured debt, with secured debt remaining below 20% of total assets, in line with company policy. We classify the other main source of funding, the SEK 1.45bn shareholder loan, as equity and consequently exclude it from our credit metric calculations. This is because:

- we view Vacse's owners as long-term strategic owners;
- the loan matures in 2053, well beyond all other debt;
- it is subordinate to all other debt; and
- interest payments can be deferred.

We do not make any other adjustments to reported figures in our calculation of credit metrics. Vacse's balance sheet structure can be seen in Figure 5.

Figure 5. Vacse AB balance sheet, 30 Sep. 2018



Source: company data

Under our base case scenario, we assume the following:

- Rental income growth of 4.4% in 2019 and 3.9% in 2020, with growth mainly resulting from the leasing of new space.
- EBITDA margin to remain above 75%.
- Interest cost on external debt of around SEK 70m a year in 2019 and 2020.
- Annual investments in existing properties and new projects of about SEK 350m in 2019 and 2020.
- No increase in the value of the existing portfolio, only an increase from new projects being finalised.

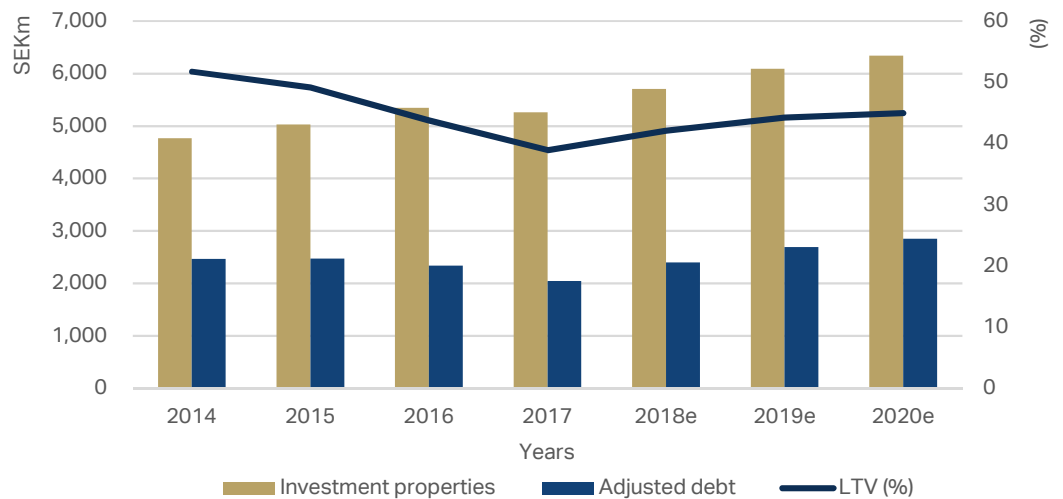
Based on these assumptions, we arrive at the following for 2018–2020:

- LTV of 44–45%;
- EBITDA to net interest of around 4x; and
- debt to EBITDA of 9–10x.

As mentioned above, we exclude the SEK 1.45bn shareholder loan and SEK 88m of shareholder loan interest in our credit metric calculations.

As shown below, we expect Vacse’s gross debt and LTV to increase somewhat over the next couple of years as a result of new investment and no increase in the value of existing properties.

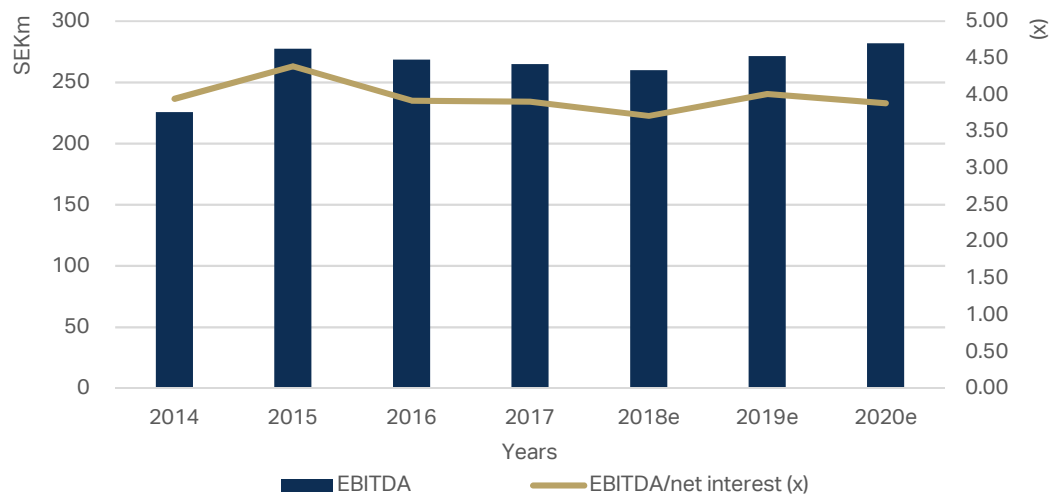
Figure 6. Vacse AB net debt, property value and LTV (%)



Source: company data and NCR estimates. e – Estimate.

However, due to the lower cost of borrowing, we expect EBITDA/net interest to increase despite the rise in total debt.

Figure 7. Vacse AB EBITDA and EBITDA/net interest (x)



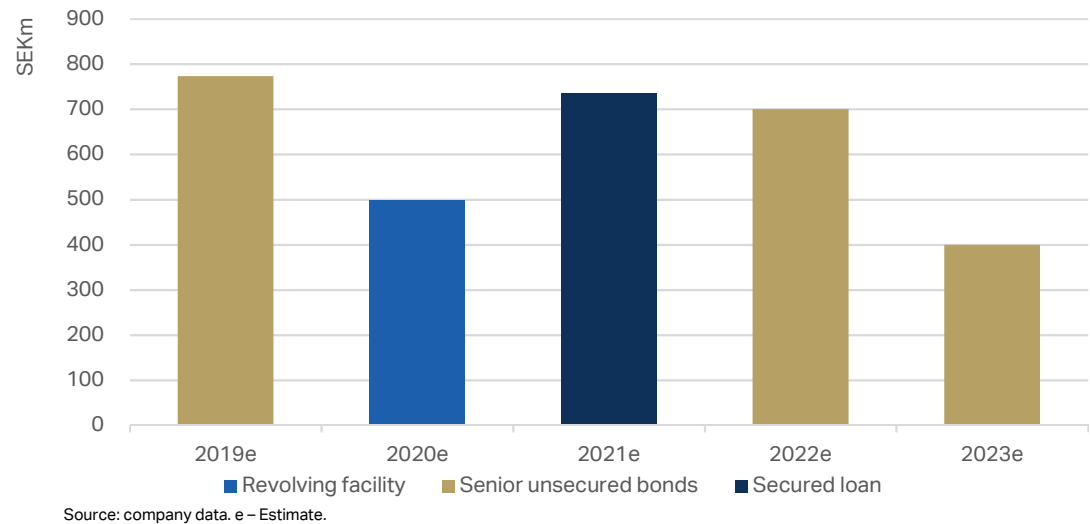
Source: Company data and NCR estimates

We believe Vacse essentially exists to provide its owners with long-term low-risk returns. Following relative rapid growth between 2011 and 2015, we believe that current management is prudent in its approach to growth and financing. Due to relatively high property prices in Sweden, including for the public sector, the company is focused on controlled growth and lowering its financial risk, which we also believe is the objective of the company’s owners. The overall risk appetite of the company therefore supports our view of the financial risk profile.

LIQUIDITY PROFILE

We assess Vacse's liquidity profile to be adequate despite the rather short maturity profile. As part of a more prudent financial strategy, we expect management to actively work towards extending the debt maturity profile, which we view as a negative rating factor, and proactively seek to refinance the SEK 773m bond maturing in June 2019 well in advance.

Figure 8. Vacse AB debt maturity profile, 30 Sep. 2018



Our assessment is supported by Vacse's good access to multiple capital sources and a satisfactory standing in the capital markets. This has been demonstrated by several successful bond issuances in the last six months (totalling SEK 1.1bn in green bonds); its good relationship with major Swedish banks; and the support of its owners, which have historically injected funds into the company. Vacse also has a SEK 600m credit facility with Svenska Handelsbanken AB, SEK 100m of which matures on 11 Dec. 2018 (which we expect to be rolled over) and SEK 500m of which matures on 11 Dec. 2020.

We estimate the following primary liquidity sources for the next 12 months as of 30 Sep. 2018:

- cash and equivalents of SEK 186m;
- a SEK 500m committed credit facility maturing in 2020; and
- funds from operations (FFO), which we expect to be SEK 202m.

We anticipate liquidity to be used for the following over the next 12 months:

- SEK 781m of debt maturities in 2019, of which SEK 7.5m is amortisation of the secured loan; and
- planned investment of SEK 380m.

As uses outweigh sources of liquidity, we expect this issue to be high on the management and owners' agenda.

ESG

Our environment, social and governance (ESG) assessment of Vacse is neutral. Vacse has demonstrated a commitment to environmental issues with certification targets for its new and existing property portfolio. For example, under its new medium-term note (MTN) programme, Vacse recently issued a total of SEK 1.1bn in green bonds and adopted an ambitious environmental policy, including the stipulation that 75% of its current portfolio must be BREEAM- or LEED-certified by the end of 2018. In addition, 100% of its new properties must be certified to these standards. Vacse's overall goal is for 50% of all its financing to consist of green bonds. With regard to social responsibility, Vacse runs, for example, a programme supporting foreign post-graduate students, and our understanding is that the company places an emphasis on being known as a good employer and landlord. We see little risk of change, conflicts or other governance-related issues with regard to the current management, board or owners.

SUPPORTING OWNERSHIP STRUCTURE

We view Vacse's ownership structure, shown in Figure 9, as supportive of its low-risk strategy and solid financial position, which we factor into our assessment via the financial risk profile and overall rating on the company. Vacse's owners are pension foundations associated with a number of well-known Swedish blue-chip companies. Supporting factors include the following:

- Vacse's owners are financially strong and, we believe, committed for the long term.
- Vacse is integral to the owners' long-term investment policy.
- A change-of-control clause stipulates that the bonds would be repaid in full if the current group of owners were to have less than 50% ownership.
- Committed equity capital of SEK 2.8bn in funding, of which 1.1bn is unutilised.
- A history of the owners injecting funds into the company.

Figure 9. Vacse AB ownership structure, 30 Sep. 2018

OWNER	SHARE
Ericsson Pensionsstiftelse	21.4%
Skanska Trean Allmän Pensionsstiftelse	21.4%
Apoteket AB:s Pensionsstiftelse	14.3%
AB Volvo Pensionsstiftelse	14.3%
Atlas Copco-Group Gemensamma Pensionsstiftelse	10.7%
Stora Enso Svenska Gemensamma Pensionsstiftelse	10.7%
Sandvik Pensionsstiftelse i Sverige	7.1%

Source: company data

Figure 10. Vacse AB scoring summary sheet

Factors	Weighting	Subfactors	Impact	Subscores	Factor score
Business risk assessment	50%	Operating environment	20%	a	bbb+
		Market position, size and diversification	12.5%	bb-	
		Portfolio assessment	12.5%	a-	
Financial risk assessment	50%	Operating efficiency	5%	aa	bbb
		Ratio analysis		bbb	
		Risk appetite			
Indicative credit assessment					bbb+
Adjustment factors		Liquidity			-
		ESG			-
		Peer comparison			-
Standalone credit assessment					bbb+
Ownership analysis					-
Long-term issuer rating					BBB+
Short-term issuer rating					N-1+
Senior unsecured issue rating					BBB+

Figure 11. Vacse AB financial overview

SEKm	2014	2015	2016	2017	2018e	2019e	2020e
Revenue	268	336	339	334	343	358	372
Cost of goods sold (COGS)	-32	-43	-46	-49	-62	-64	-67
SG&A	-11	-15	-25	-21	-21	-22	-23
EBITDA	226	277	269	265	260	271	282
Interest cost	-58	-63	-69	-68	-70	-68	-73
Interest on shareholder loans	-87	-88	-89	-88	-88	-88	-88
Change in property value	116	170	301	162	100	0	0
Change in financial instruments	-120	33	-23	13	8	0	0
Pre-tax profit	78	328	389	284	209	115	121
Current tax	-2	-5	-1	-3	-2	-1	-1
Deferred tax	-15	-67	-60	-56	-35	0	0
Net profit	61	256	328	224	172	114	119
Investment properties	4,764	5,025	5,344	5,257	5,707	6,087	6,337
Other non-current assets	0	0	1	2	2	2	2
Total non-current assets	4,764	5,025	5,345	5,259	5,709	6,089	6,339
Cash and cash equivalents	81	46	106	92	193	222	144
Other current assets	19	64	21	39	30	31	58
Total current assets	99	110	127	130	223	252	202
Total assets	4,863	5,135	5,472	5,389	5,932	6,341	6,541
Total equity	516	772	1,100	1,324	1,497	1,611	1,730
Long-term interest-bearing loans	2,226	1,397	2,137	2,130	2,596	2,915	2,995
Shareholder loans	1,454	1,454	1,454	1,454	1,454	1,454	1,454
Other long-term liabilities	202	237	320	348	348	348	348
Total non-current liabilities	3,882	3,088	3,910	3,932	4,398	4,717	4,797
Total current liabilities	465	1,275	461	132	38	13	14
Total equity and liabilities	4,863	5,135	5,472	5,389	5,932	6,341	6,541
Pre-tax profit	78	328	389	284	209	115	121
Cash flow before changes in working capital	86	119	91	98	92	104	108
Changes in working capital	57	-36	61	-23	-15	-15	-15
Operating cash flow	142	83	153	75	77	89	93
Cash flow from investing activities	-1,380	-89	-19	218	-350	-380	-250
Cash flow from financing activities	1,263	-29	-74	-308	375	320	80
Cash flow at start of year	55	81	46	106	92	193	222
Cash flow for the year	26	-35	60	-15	102	28	-77
Cash flow at end of year	81	46	106	92	193	222	144

Source: company data and NCR estimates.
e – Estimate.

Type of credit rating:	Long-term issuer credit rating Short-term issuer credit rating Issue credit rating The rating is an initial credit rating.
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Office responsible for the credit rating:	Nordic Credit Rating AS, Oslo, Norway
Primary analyst:	Michael Andersson michael.andersson@nordiccreditrating.com
Rating committee chairperson responsible for approval of the credit rating:	Sean Cotten
Methodology used when determining the credit rating:	'Nordic Credit Rating Corporate Methodology' 'Principles of Nordic Credit Rating' The methodology and principles documents provide analytical guidance to NCR's rating activities including but not limited to, assumptions, parameters, cash flow analysis, and stress-testing. Nordic Credit Rating's methodologies and principles can be found on our website: www.nordiccreditrating.com The historical default rates of entities and securities rated by Nordic Credit Rating AS can be viewed on the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml .
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0185 Oslo
Norway

STOCKHOLM

Engelbrektsgatan 9-11
114 32 Stockholm
Sweden

NORDIC CREDIT RATING AS

www.nordiccreditrating.com
post@nordiccreditrating.com