

COMMUNITY SERVICE PROPERTIES - A STABLE BUT BROAD ASSET CLASS

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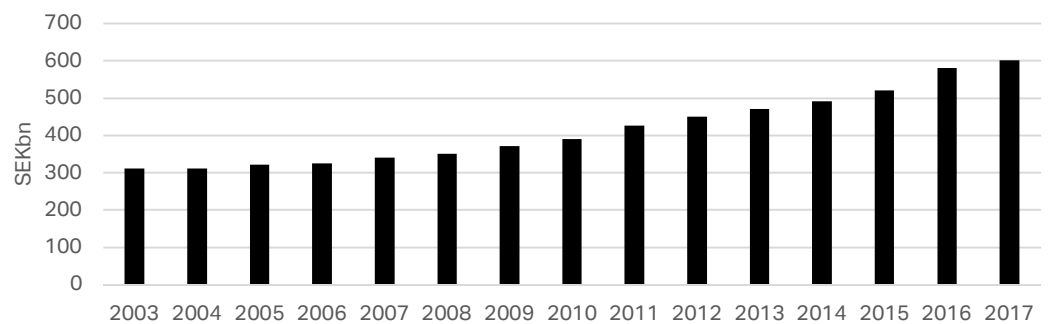
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This commentary does not reflect a rating action.

Nordic Credit Rating (NCR) views the community service asset class as a supportive factor when assessing the creditworthiness of real estate companies. The definition of community service is, however, quite broad, and for this reason company property portfolios, financial strength and strategy require thorough analysis. In a recently published report "Stability in the Financial System" (published 28 May 2019), the Swedish Financial Supervisory Authority (FSA) highlights banks' lending to the commercial real estate sector and suggests that they need to hold more capital to cover losses in the event of an economic downturn. Under the stress scenarios conducted by the FSA, commercial real estate companies' net operating income is assumed to fall by 15%, while that of community service property providers, the focus of the report, it is assumed to fall by 5%.

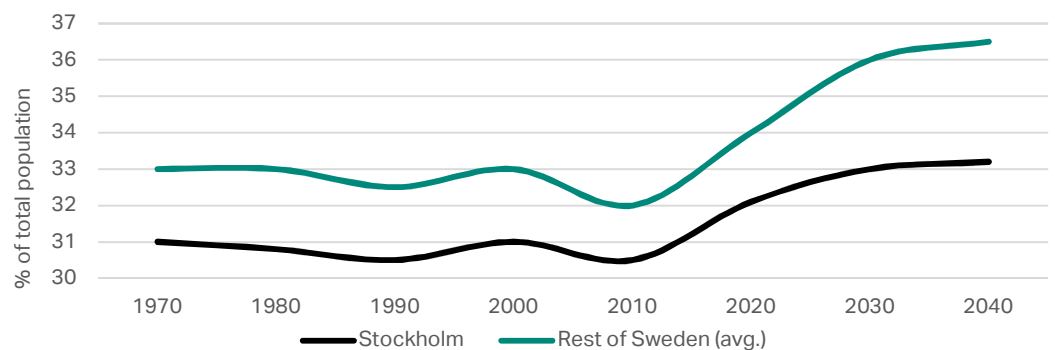
Demand for community service properties is increasing rapidly. The Swedish population has increased over the past 10 years, the population growth rate is expected to remain higher than historical levels, and the youngest (below 20) and oldest (above 75) parts of the population are expected to grow at an even faster rate. Accordingly, the need for schools, healthcare facilities, care and nursing homes, police stations and other public buildings is expected to increase rapidly. However, municipal resources are scarce and the debt of the Swedish municipal sector has more than doubled in the past 10 years.

Figure 1. Debt burden of the Swedish municipal sector, 2003-2017



Based on data from Kommuninvest

Figure 1. Recent and projected trends in the Swedish population below 20 and above 75



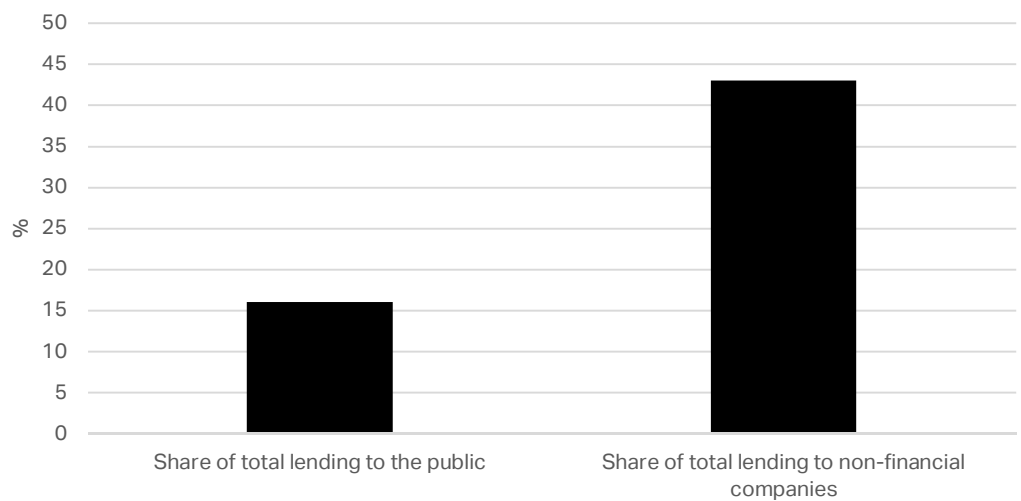
Based on data from Statistics Sweden and NCR

SWEDISH PROPERTY SECTOR HEALTHY BUT ACCOUNTS FOR SIGNIFICANT PART OF DOMESTIC BANK LENDING

In its report, the FSA proposes that large domestic banks should increase the risk weights in their internal ratings-based models in respect of commercial real estate lending from 23% to 30%, to retain sufficient capital to cover losses in the event of an economic downturn. As part of the stress scenarios conducted, commercial real estate companies' net operating income (which is similar to NCR's definition of EBITDA) is assumed to fall by 15%, while that of community service property providers is assumed to fall by 5%. Community service properties with public tenants and owners were excluded from the tests.

Like NCR, the FSA thinks that banks' resilience is satisfactory overall and that the commercial real estate sector is healthy. The Swedish economy is performing well, and the risk of large interest rate hikes is low. However, the commercial real estate sector accounts for a large part of bank lending, as well as the domestic corporate bond market, and many companies within the sector are vulnerable to higher interest rates and lower economic growth. As commercial real estate companies are primarily debt financed, the sector is closely interconnected with the financial system. At the end of the third quarter of 2018, lending to the sector accounted for about 43% (SEK 775bn) of lending to the domestic non-financial sector by the major banks (SEB, Handelsbanken, Swedbank, Danske and Nordea) (see figure 3). This corresponds to 16% of total bank lending to the public, and 101% of the banks' common equity Tier 1 capital.

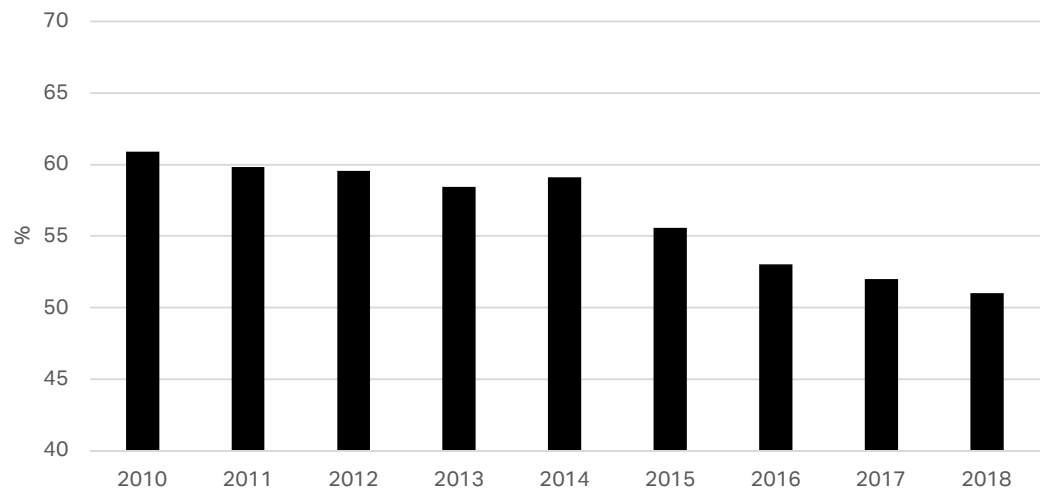
Figure 3. Commercial real estate lending as a share of total Swedish bank lending, Q3 2018



Based on data from the Swedish FSA

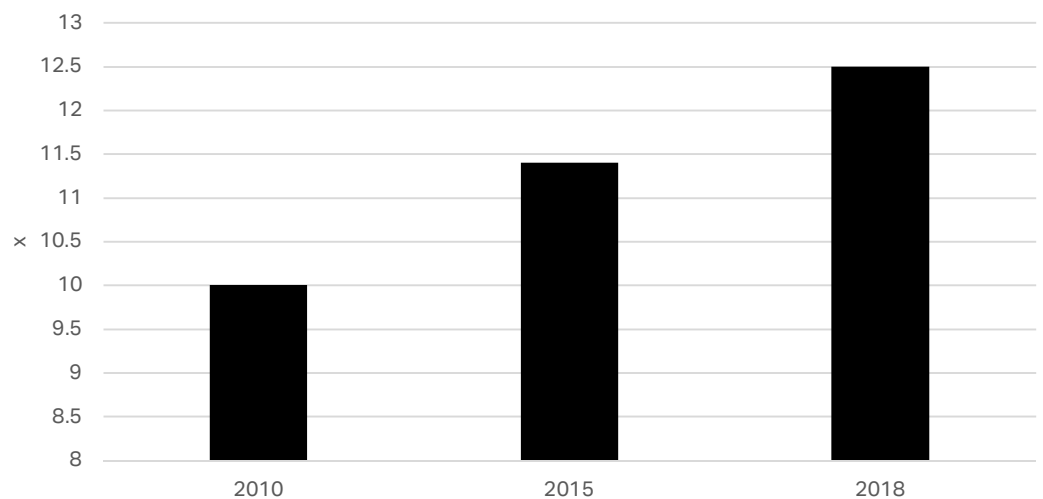
Interest rates and lending costs have declined over the past 10 years, in combination with high economic growth. Consequently, the commercial real estate sector is currently relatively healthy. Operational metrics such as occupancy rates and operating margins are strong. Other financial and credit metrics, such as loan to value (LTV) and interest coverage have improved significantly over the same period. However, this has been largely driven by lower interest costs and increased property values. The sector's total debt volume has increased, as have cash flow-related metrics, such as debt to EBITDA (see figure 5).

Figure 4. Average Swedish real estate sector LTV, 2010-2018



Based on NCR data and company reports

Figure 5. Swedish real estate sector debt to EBITDA, 2010-2018

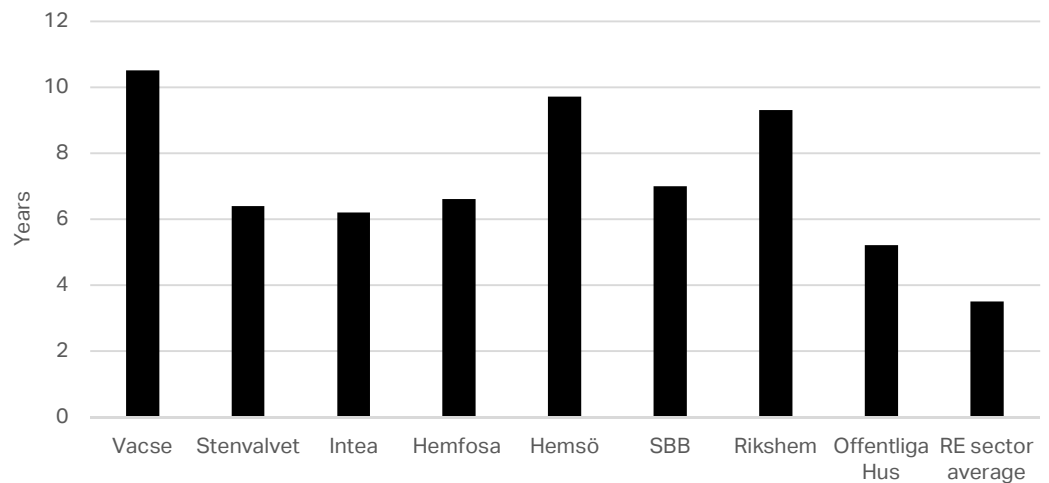


Based on NCR data and company reports

A STABLE BUT BROAD AND DIVERSE SECTOR

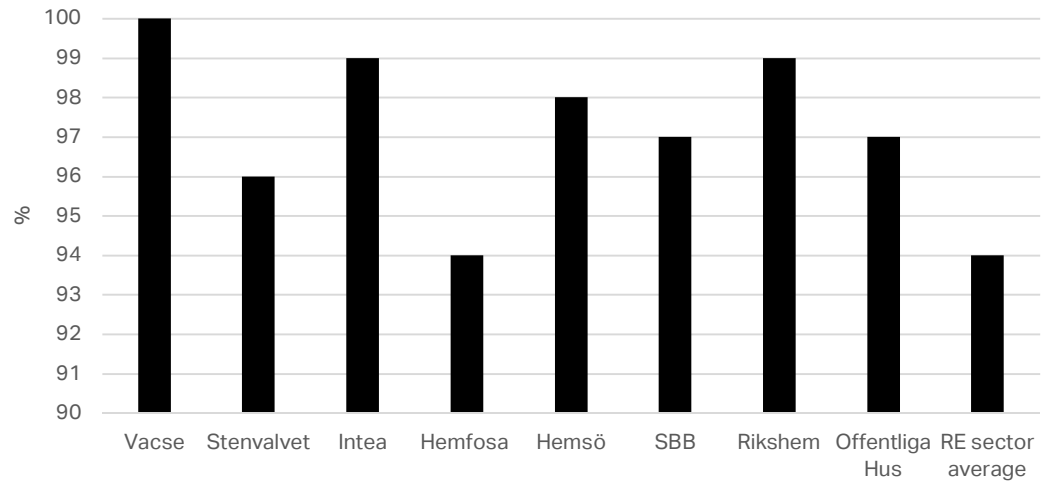
We have analysed a group of eight Swedish real estate companies, including NCR-rated Vacse (BBB+) and Stenvalvet (BBB+), that are focused on community service properties. Their property portfolios mainly consist of community services properties, such as homes for the elderly, health care institutions, schools, police stations, court houses and other government and municipal buildings. Most rental income comes directly or indirectly from public funds. We view a majority of the tenants as important for Sweden's welfare system and highly creditworthy, resulting in rental income that has little correlation with the economic cycle. We also see increasing demand for these type of properties as Sweden's population is growing, especially in the youngest and oldest age groups. Our understanding is that most Swedish political parties are committed to providing for public security and health and care services. We also note that most Swedish municipalities are increasingly seeking alternatives to owning these types of properties by themselves due to rapidly increasing debt burdens. Accordingly, we expect the operating environment to remain stable.

Figure 6. Average remaining lease terms in our sample, 31 Mar. 2019



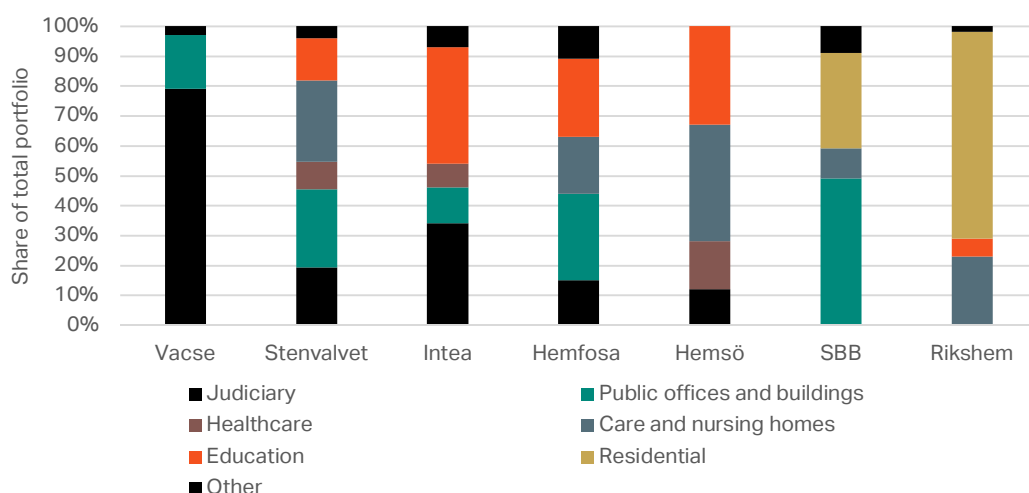
Another supportive factor from a credit perspective is that the eight companies typically operate with significantly longer lease contracts than typical commercial real estate companies due to the nature of their tenants. The average remaining lease term in our sample is eight years, compared to 3-4 years for companies that are focused on properties types such as office and retail. As many properties are tailor-made for the tenant, occupancy rates are also typically higher than the wider real estate sector average.

Figure 7. Occupancy rates in our sample, 31 Mar. 2019



Although we typically view these tenants and properties as supportive from a credit perspective, each portfolio requires thorough analysis. The community service definition has become increasingly broad and includes many 'normal' office properties that house different government bodies. Recently the Swedish Public Employment Service (Arbetsförmedlingen), stated that it would close 130 of its 242 offices throughout the country. These lease contracts were said to be guaranteed by the Swedish state, and it is expected that other government or municipal function will move in, but the risk of vacancies is higher than at a tailor-made school, police, prison or healthcare facility. Due to long-term urbanisation, other public buildings that are deemed not essential could be closed in sparsely populated areas.

Figure 8. Portfolio compositions across our sample, 31 Mar. 2019

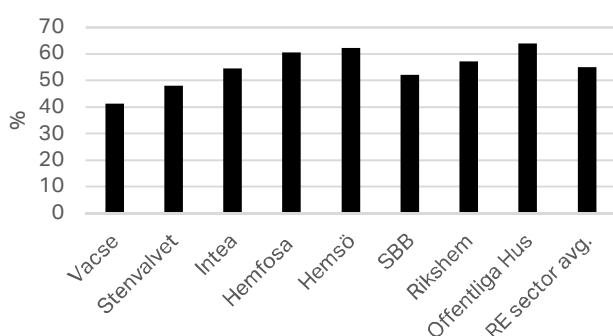


Based on NCR data and company reports

STRONG OWNERSHIP CAN SUPPORT DIVERSE FINANCIAL RISK PROFILES

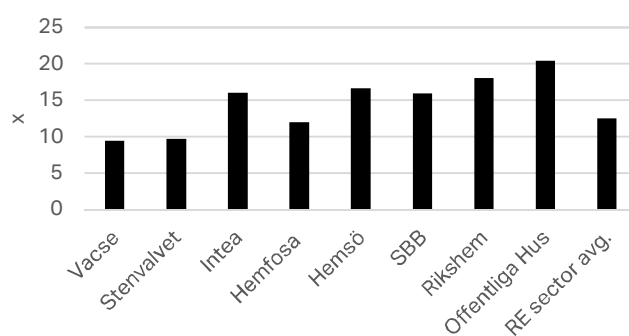
The financial risk profiles in our sample group differ, with credit metrics such as LTV ranging from 40% to more than 60%, and debt to EBITDA from 10x to 20x. When assessing the financial risk of an issuer, we consider several credit metrics, as well as its risk appetite, liquidity management, and ownership. Most of the issuers in our sample group have improved their credit metrics, in line with the wider real estate sector, in recent years. Recent rating trends have also been a positive factor in terms of deleveraging and lengthening of debt maturity profiles across our sample. In addition to Vacse and Stenvalvet, which are rated by NCR, Hemsö, Rikshem and Samhällsbyggnadsbolaget (SBB) all carry investment grade ratings.

Figure 9. LTV across our sample, 31 Mar. 2019



Based on NCR data and company reports

Figure 10. Debt to EBITDA across our sample, 31 Mar. 2019



Based on NCR data and company reports

Due to the stability and long-term focus in the sector, many issuers are owned or part-owned by pension capital. Vacse is owned by the pension foundations of seven Swedish blue-chip companies (Volvo, Atlas Copco, Skanska, Sandvik, Stora Enso, Apoteket). Stenvalvet is owned by Kåpan Pensions, the Church of Sweden's pension foundation and the Swedish Foundation for Strategic Research. Intea, a close peer of Vacse, has a similar ownership profile. Hemsö is majority owned by the Swedish government's Third AP pension fund, while Rikshem is owned by the Fourth AP pension fund and AMF, a major non-government pension investor. We generally view this kind of ownership as supportive in our overall assessments of these companies.

Figure 11. Peer group comparison across our sample, 31 Mar. 2019

	VACSE	STENVALVET	INTEA	HEMFOSA	HEMSÖ	SBB	RIKSHEM	OFFENTLIGA HUS
Portfolio size (SEKm)	6,176	11,963	7,134	36,943	49,559	27,200	48,461	4,058
LTV (%)	41	48	54	61	62	52	57	64
EBITDA/interest (x)	4.4	5.6	4.1	3.5	5.1	2	3.2	1.4
Debt/EBITDA (x)	9.4	9.7	16.0	12.0	16.6	15.9	18.0	20.4
Avg. debt maturity (y)	2.6	4.1	4.1	2.7	7.4	4.6	4.2	3.7
Avg. interest rate (%)	2.4	1.7	1.7	2.1	1.3	2.5	1.7	3.6
Avg. remaining lease term (y)	11	6	6	7	10	7	9	5
Occupancy rate (%)	100	96	99	94	98	97	99	97
Number of properties	14	112	15	385	311	644	559	212

Based on company reports and NCR data. Unadjusted figures

INVESTORS WILL BECOME EVEN MORE SELECTIVE

In view of higher capital requirements, we think that the major banks will become stricter in lending to commercial real estate companies. As the sector continues to grow, this is likely to lead to more companies funding themselves through the capital markets. Commercial real estate providers are already the largest single issuer class in the Swedish corporate bond market, but we think it likely that investors will become increasingly selective. The community service sector is characterised by many supportive factors in terms of credit quality. However, the sector is broad, and with many relatively new issuers coming to the bond markets, portfolio content and the financial risk of individual companies will require thorough analysis.

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