CATELLA

CREDI
CATELLA REAL ESTATE DEBT INDICATOR

CREDI June 2015

# Closing in on the summit?

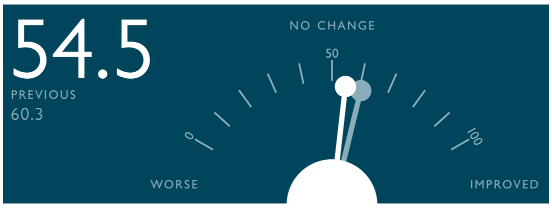
Between the February survey and this June survey, the CREDI Main index dropped by 5.8 index points, to 54.5. The CREDI Main index is thus declining once again, indicating a return to the slowdown in the improvement in access to financing observed during 2014. The CREDI Survey demonstrates that the polled lenders and borrowers believe that access to financing has improved over the past three months and that these conditions are expected to remain generally unchanged in the coming three months.

So far in 2015, the real estate market has continued to benefit from a positive financing climate and the transaction volume has remained high during 2015. However, in the past month the fixed income market has experienced two separate developments. Although short-term interest rates have continued to nudge downwards below zero, long-term rates have increased substantially during the last two months. The increasing long interest rates can be interpreted as a step towards a normalization of the financial markets with positive term premium on debt.

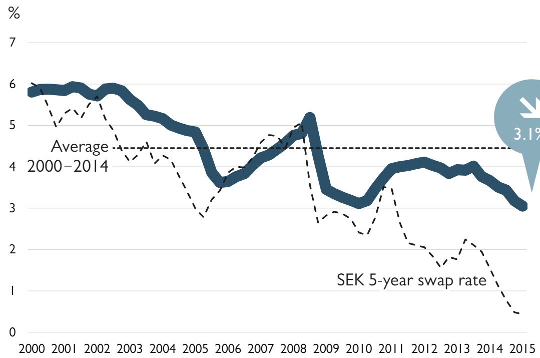
In the June survey the spread between the current and forward-looking indices decreased by approximately 40 per cent compared to the previous February survey. This suggests a smaller divergence between the current view of the market and future expectations. The current and forward-looking indices dropped to 58.6 and 50.3 respectively, indicating that the polled banks and listed property owners believe that the financing market is currently in the zone of credit expansion and will remain there. However, the result in the June survey also shows a drop in the CREDI Expectation sub-indices, with three out of four sub-indices slightly below the 50 turning point level.

The average interest rate for the listed real estate sector continued to decrease and amounted to 3.1 per cent during Q1 2015, a historically low level. The average loan to value for the listed real estate sector also declined during Q1 2015, to 54.8 per cent. The outstanding volume of bonds has been almost unchanged since Q2 2014, supporting the deleveraging trend observed over the last quarters. With the currently favourable financing climate, the listed companies have been able to finance their operations with preference shares, as an alternative to traditional debt instruments.

## CREDI Main index

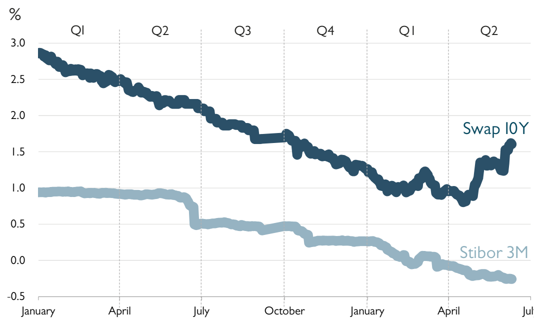



## CREDI Indices – Q1 Average interest rate*




* Average interest rate on outstanding debt portfolio as reported by each company.

## Swedish key interest rates, 2014 and 2015




About CREDI: The Catella Real Estate Debt Indicator, CREDI, is a market sentiment indicator for the Swedish real estate debt financing market. CREDI consists of two parts; a quarterly current and forward-looking survey of Swedish listed property companies and banks providing real estate financing on the Nordic market; and a set of indices based on publicly available data illustrating the aggregate change in credit conditions such as leverage, duration and cost of debt for the Swedish listed property sector. Subscribe to CREDI at catella.se/CREDI

# The CREDI Survey

In the June 2015 edition of the CREDI Survey the Main index was reduced to 54.5 (down by 5.8 index points). The drop is mainly attributable to a significant decrease in the Current situation index. The Main index is, however, still above 50. This indicates positive sentiment, with the polled lenders and borrowers being in agreement that current financing conditions have improved, but envisaging no further improvement in the coming three months.

### Main index components

Behind the 5.8 index point contraction in the Main index there is an 8.9 index point drop in the Current situation index, to 58.6 (67.5), accompanied by a 2.7 index point drop in the Expectation index, to 50.3 (53.0). Consequently, the Main index of the June 2015 CREDI Survey is returning to the downward trend observed since October 2013.

Once again, the CREDI Survey shows a clear difference in the expectations of the polled banks and property owners. Whereas the property owners assume that access to debt financing will strengthen in the coming three months, the banks indicate that the access will weaken.

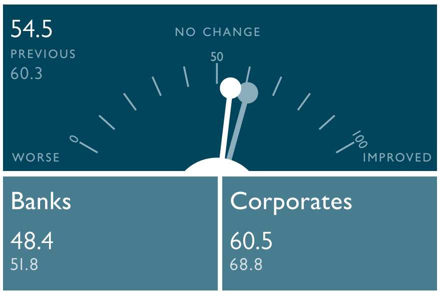
Since October 2014, the Swedish financial sector has been affected by initially reduced and lately increasing long-term interest rates. Overall, rates have been volatile over the period and the uptick observed in long rates in the last two months may have negatively impacted the June survey.

### Sub-indices

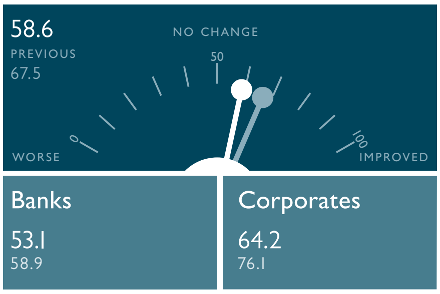
The Current situation sub-indices all remained above the 50 turning point. The largest shift observed in the Current situation sub-indices related to duration and credit margin sub-indices. A decrease was noted of 16.2 index points, to 55.2, and 14.6 index points, to 61.3, respectively. Despite the large drop in the duration and credit margin sub-indices, both indices remain above the 50 turning point level.

In contrast to the Main index, not all CREDI sub-indices are in the zone of credit expansion. The credit margin, loan to value and leverage Expectations sub-indices are all in the zone of credit contraction. A slight increase in the duration Expectations sub-index was noted.

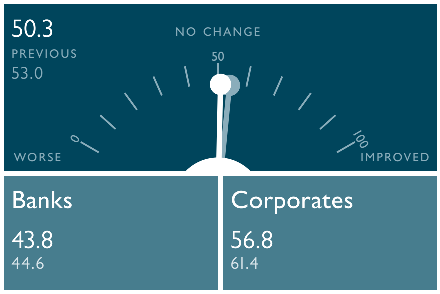
## CREDI Main index




## Current situation



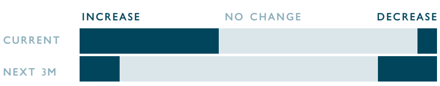

## Expectations




## CREDI Sub-indices

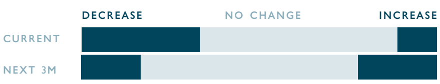
CREDI Sub-indices present survey data question by question. The bars represent the distribution of actual answers per question, separated into the components Current situation and Expectations for the coming three months.

CREDIT AVAILABILITY




LEVERAGE


CREDIT MARGINS




DURATION


### ABOUT THE CREDI SURVEY

CREDI is a market sentiment indicator for the Swedish real estate debt financing market. The indicator is based in part on a quarterly current and forward-looking survey of Swedish listed property companies, and banks providing real estate financing on the Nordic market.

The CREDI Survey contains four questions about recent changes in credit availability and credit conditions, and four questions about expectations regarding changes in credit availability and credit conditions in the next three months.

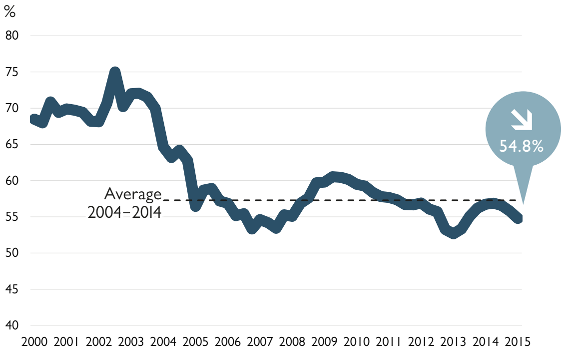
The CREDI Survey results are computed as separate diffusion indices per question, where answers are weighted according to their direction of change in the variable. The final index figure represents an average of all weighted answers. Weights are applied such that a "no change"-answer equals 50. Consequently, the turning point in sentiment is 50 and any reading below indicates more difficult financing conditions while any reading above indicates less difficult financing conditions.

Separate indices are aggregated per respondent category. The Main index and its components are then computed as an unweighted average of these two categories – ensuring that the answers of borrowers and lenders are equally weighted in the Main index.

# The CREDI Indices

The CREDI Indices show that the average interest rate for the listed property sector reached just below 3.1 per cent in Q1 2015; this is the lowest level observed since 2000. In contrast, during the same period loan to value continued to decline, to 54.8 per cent.

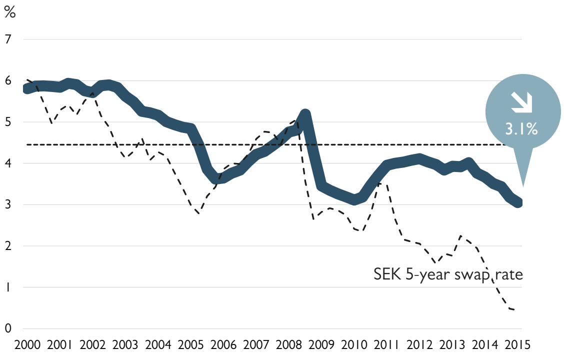
## Listed sector Q1 average loan to value[1]




Average loan to value in Q1 2015 decreased by almost 1 percentage point from the previous quarter, to 54.8 per cent. This is an extension of the decreasing leverage observed since Q3 2014. The declining loan to value can, to some extent, be traced to the appreciation of property values and the fact that the listed sector has increased the use of financing alternatives other than interest-bearing debt.

1 Interest bearing debt on property, excluding cash, divided by property value.

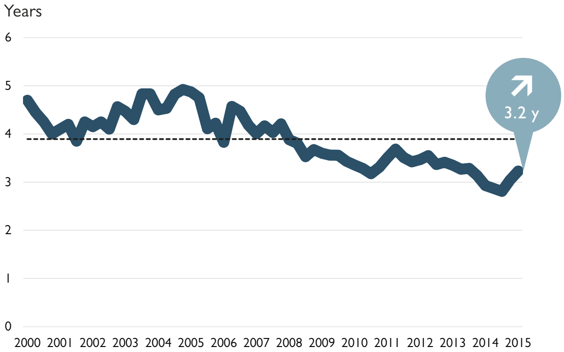
## Listed sector Q1 average interest rate[2]




The listed average interest rate continued to decline and reached a level of 3.1 per cent in Q1 2015, down by 4.1 per cent from the previous quarter and down 17 per cent from Q1 2014. The current average interest rate is the lowest observed since 2000. To a large extent, the declining average interest rates continue to be attributable to the low underlying interest rates.

2 Average interest rate on outstanding debt portfolio as reported by each company.

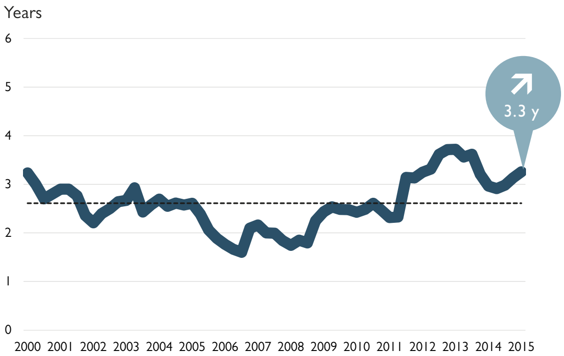
## Listed sector Q1 average fixed credit term[3]




Q1 2015, the average fixed credit term was up 0.2 years from the previous quarter, amounting to 3.2 years. The average fixed credit term is, however, still significantly below the mean recorded between 2000 and 2014. The trend of an increasing average fixed credit term suggests that the listed property sector is expecting the cost of borrowing to increase in the near future; this view is bolstered by the result of the CREDI Survey.

3 Average maturity referring to interest bearing debt.

## Listed sector Q1 average fixed interest term[3]




-------- Average 2000–2014

The average fixed interest term in Q1 2015 continued to increase and reached 3.3 years. However, this increase is mainly due to a minority of the listed companies having increased their fixed interest term by a considerable amount. In fact, the majority of the companies decreased their fixed interest term. This suggests a clear division between those borrowers who expect interest rates to stay at current levels or increase in the coming year, and those who believe in a drop.

3 Average maturity referring to interest bearing debt.

### ABOUT THE CREDI INDICES

CREDI is based in part on a set of indices illustrating the aggregate change in leverage, duration and cost of debt for the Swedish listed property sector.

The CREDI Indices are based on publicly available data collected from the financial reports published by the Swedish listed property companies.

Each data point in the CREDI Indices represents the aggregate figure for the Swedish listed property companies. Each company is weighted equally in order to fully reflect the company's individual financing strategy and financing situation. Start date is set as Q1 2000.

The intention with the CREDI Indices is to track trends and changes in real estate financing by aggregating publicly available data.

# CREDI – Preference shares

Preference shares represent a new form of debt capital for property companies' ordinary shareholders. Two great advantages with preference shares is that they allow for freedom of choice as to if, and when, refinancing takes place and they allow for automatic flexibility in tougher times with weaker cash flows. One disadvantage is that the dividends are not tax-deductible for the property company. Since 2006, the listed property companies on Nasdaq OMX Nordic Main Market have issued preference shares for a total volume of approximately SEK 12 billion, with annual dividends of approximately SEK 0.9 billion.

A lesson learned from the financial crisis is that access to financing varies over time and that the way property values are viewed as security varies over time. In contrast to equity, the traditional debt capital available to property companies (such as bank loans and bonds) is typically subject to time limits and must be refinanced from time to time. Preference shares are an instrument that, in principle, eliminate the refinancing risk and are becoming popular among listed property companies.

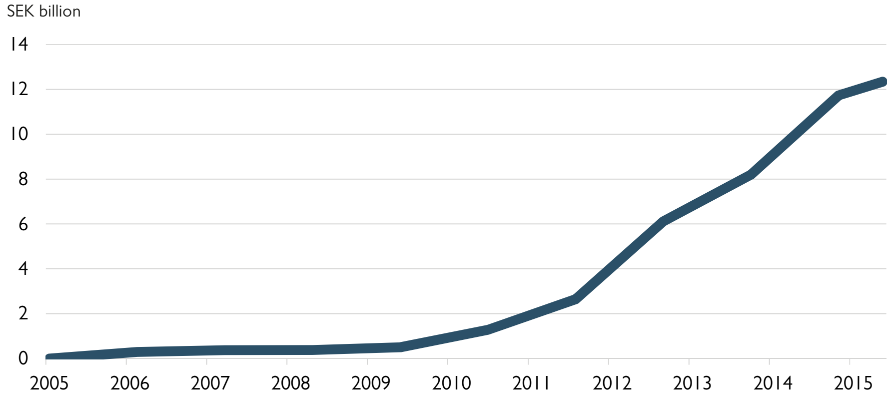
Preference shares can be viewed both as debt capital and as equity depending on perspective. From a traditional debt capital perspective, preference shares are regarded as equity and constitute a buffer against risks, alongside the ordinary share capital. From the perspective of the ordinary shareholders, the preference shares can be viewed as debt capital with often limited voting rights and a debt-like cash flow of predetermined dividends, and thereby have no stake in any future increase in value of the properties.

When viewed as debt capital, preference shares have several advantages for a property company. Apart from the fact that it is the property company that decides upon any redemption of preference shares, dividends on the preference shares are not subject to strict time limits, as distinct from traditional interest on debt capital. If the cash flow at any time is considered insufficient, dividends promised on the preference share can be postponed without running into insolvency.

For historical reasons and similar to most countries, debt capital in Sweden has been more tax efficient than equity capital since tax is not payable on interest payments. From a tax perspective, the regular payments to the preference shareholders are treated as dividends on share capital, and not as interest on debt capital. This is a disadvantage of preference shares, and property companies that choose to issue preference shares instead of raising traditional debt capital will be in a less favourable tax position. However, there is a historical trend towards an elimination of the imbalance between debt capital and equity capital, in part through corporation tax having been reduced over time, and in part through discussions on changed tax rules.

Today, preference shares account for a significant share of the total capital of the listed property companies included in CREDI Indices. In a short period of time, preference shares have become an established financing instrument with conditions to contribute to financial stability for property companies in times of economic downturn. Preference shares should have a future if the trend continues towards increasingly equal tax treatment of equity and loaned capital.

## Property companies total issued volume of preference shares on Nasdaq OMX Nordic Main Market




## Property companies with preference shares on Nasdaq OMX Nordic Main Market

All figures are in billion SEK unless otherwise stated

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Companies with preference shares/total | 0/15 | 1/15 | 1/16 | 1/16 | 1/16 | 2/16 | 3/16 | 3/16 | 6/19 | 7/22 | 7/22 |
| New issue | - | 0.3 | 0.4 | 0.4 | 0.5 | 0.9 | 1.9 | 4.8 | 6.8 | 10.4 | 11.0 |
| Stock dividend (*Sw.* fondemission) | - | - | - | - | - | 0.4 | 0.8 | 1.4 | 1.4 | 1.4 | 1.4 |
| Total issued volume | - | 0.3 | 0.4 | 0.4 | 0.5 | 1.3 | 2.6 | 6.1 | 8.2 | 11.7 | 12.3 |
| | | | | | | | | | | | |
| Annual dividend | - | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.2 | 0.5 | 0.6 | 0.9 | 0.9 |
| Annual dividend, % of total issued volume | - | 7.9% | 7.9% | 7.9% | 8.2% | 8.3% | 8.2% | 7.7% | 7.4% | 7.4% | 7.0% |
| | | | | | | | | | | | |
| Market value outstanding preference shares | - | 0.3 | 0.4 | 0.3 | 0.6 | 1.4 | 2.8 | 6.7 | 9.6 | 14.7 | 14.1 |
| Annual dividend, % of market value | - | 7.2% | 7.3% | 8.7% | 7.3% | 7.6% | 7.7% | 7.0% | 6.3% | 5.9% | 6.2% |

Note: The Nasdaq OMX Nordic Main Market, Large Cap, Mid Cap and Small Cap, does not include property companies listed on First North and Baltic. Dagon was delisted 2012 and is not included. Share price year 2015 as per June 15, 2015.

Source: Catella, Annual Reports, Nasdaq.

# CREDI – Catella's view through the looking glass

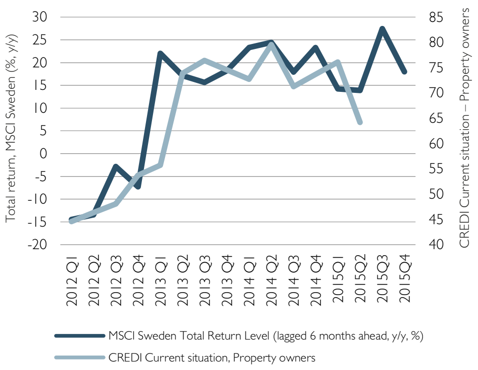
**Debt market sentiments are stabilising on high levels as the property market is entering the top of the investment cycle.**

The total return development on the Swedish stock market works as a leading indicator for the Current situation CREDI index for property owners, with a six-month time lag. The CREDI index has fallen back somewhat during the second quarter 2015 from the strong levels of the first quarter. The Current situation index level of 64.2 is well over the 50 mark, which separates an expansion from a contraction. It is reasonable that debt market sentiments are stabilising at high levels as the property market is gradually approaching the top of the investment cycle. However, the last quarter's volatility and setbacks on the stock market, as well as the high volatility on the bond market, has most likely contributed to the fallback in the CREDI index. Despite the higher insecurity on the financial markets the annualised total return on MSCI Sweden remains strong – a factor that is indicating a stabilisation of the CREDI index well above the 50 mark during the second half of 2015.

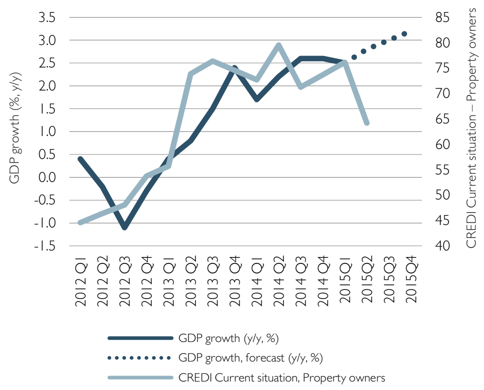
Sweden's internationally strong economic growth is another factor that indicates a continuously positive CREDI index development. Debt market sentiments are strongly correlated to GDP growth and there is currently an extremely strong macroeconomic mix for properties in Sweden – GDP growth is expected to end up at around 3 per cent per year in 2015–2016 and interest rates at historically low levels. Based on Catella's macroeconomic view with a continuous pickup in economic growth during the coming quarters, the CREDI index is expected to remain in expansion territory.

After a period with lower liquidity on the property market during the first quarter 2015, the activity has picked up significantly during the second quarter. The strong investor demand is pushing yields downwards in both prime and secondary locations. However, during recent months the majority of the transactions has been in higher-yielding secondary segments, like secondary locations in the major cities as well as prime locations in smaller cities. The Current situation CREDI index for property owners, is a good indicator of the development of both average yields and yield spreads on the property market. Recent months' focus on secondary locations has increased both the average yield level and the standard deviation of yields in finalised transactions. This development has coincided well will the softening CREDI index for property owners. The development indicates that there is a lack of liquid assets in prime locations. Good access to financing, attractive bank margins and high investor risk willingness generates an investor focus on secondary segments as the market is gradually entering the top of the investment cycle.

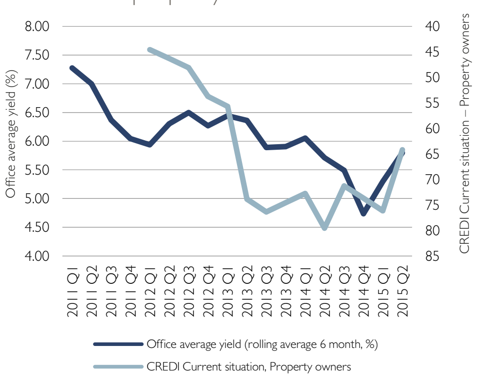
**Total return MSCI Sweden** and CREDI Current situation for property owners



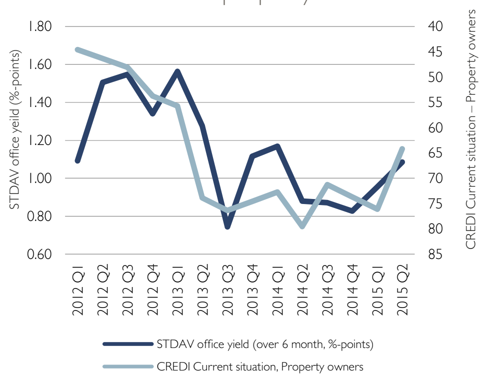

**GDP growth** and CREDI Current situation for property owners




**Office average yield** and CREDI Current situation for property owners




**Standard deviation in office yields** and CREDI Current situation for property owners




Source: Catella, Konjunkturinstitutet and Factset

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