CATELLA

CREDI
CATELLA REAL ESTATE DEBT INDICATOR

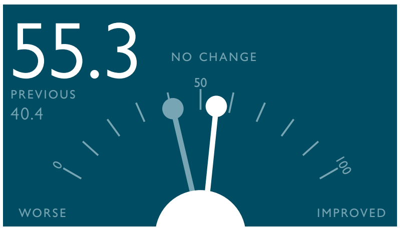
CREDI October 2020

Credit sentiment recuperates as dovish policy prevails

In the October issue of CREDI, the Main index increases from 40.4 to 55.3 as respondents consider the current credit sentiment revitalised in tandem with stable expectations going forward.

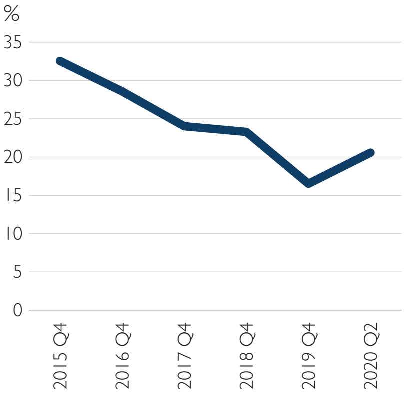
- The CREDI Main index revitalises as it increases from 40.4 to 55.3, implicating an important shift in credit sentiment as the index is back above the 50-mark.
- Lower demand in the bond market led to a decrease in the amount of outstanding bonds. As maturing bonds were refinanced by bank loans, the level of secured debt increased, breaking a long-term trend of continuously reduced levels of secured debt. A trend reversion towards secured debt can trigger a snow-ball effect as it impairs the position of unsecured bonds and thereby lowers demand for these bonds further still.
- Both banks and corporates anticipate increased availability of real estate debt. However, whether the bank loan market will rebound as thoroughly as the financial markets remains to be confirmed.
- The longer-term economic outlook has improved lately due to the massive monetary and fiscal stimuli. The global economy is however facing a number of obstacles while fiscal and monetary stimuli are pushing the economy in the right direction and heavily benefitting asset prices in general and property in particular.

CREDI Main index



Banks	Corporates
46.4	64.2
30.4	50.5

Secured debt to total assets ratio



Loan-to-value Q2 average 54%	Interest rate Q2 average 2.0%	Fixed credit term Q2 average 3.4 y	Fixed interest term Q2 average 3.1 y

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.

The CREDI Survey

The October publication of CREDI illustrates a credit market come-back as the Main index increases from 40.4 to 55.3. With the current credit sentiment revitalised, respondents also expect a stable market going forward.

MAIN INDEX COMPONENTS

Following the previously weak credit market in the July issue of CREDI, the Main index makes a come-back as it increases from 40.4 to 55.3 in the October survey. This implicates a strong shift in credit sentiment as the credit market seems to be back on track from the momentary pandemic hamper with the index back above the 50-mark.

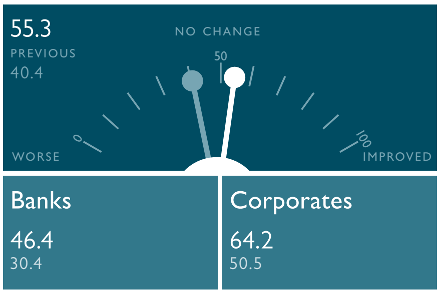
Going into further detail, the Current Situation index looks strong at 57.7, as compared to the previous recording of 24.6. Also, near-term expectations seem positive with the Expectation index at 52.9, however slightly below the previous recording of 56.3.

Per usual, banks are more pessimistic than their corporate counterparts. Noticeably, their future expectations are less positive and below the 50-mark which may be due to an underlying fear of further pandemic implications. Besides banks' Expectation index, the respondents seem categorically positive implying good credit sentiment and much better situation as opposed to the previous two CREDI surveys.

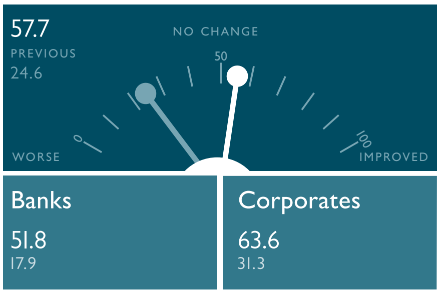
SUB-INDICES

The CREDI Main index is made up of eight underlying sub-indices. According to respondents in the October 2020 survey, credit availability has improved drastically while credit margins have decreased. Furthermore, the credit market remains cautious with leverage while duration increases. Going forward, respondents expect a stable credit market with improved availability, lower leverage, lower margins, and increased durations.

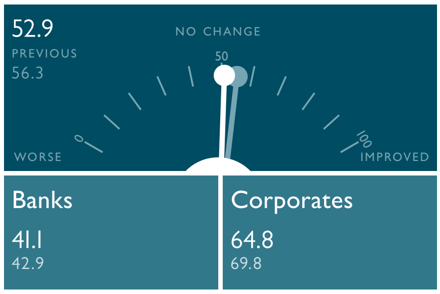
CREDI Main index



Current Situation



Expectation



The 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 Expectation for the coming three months.

CREDI Sub-indices

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. This part of the indicator is called the CREDI Survey.

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. As such, the final index figure represents an average of all weighted answers. Weights are applied such that a "no change"-answer equals 50 index points. Consequently, the turning point in sentiment is 50 and any reading below this level 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 second quarter reports of 2020 shows little to no signs of an ongoing pandemic within the CREDI Indices.

The interim reports for the second quarter of 2020 resulted in a minor decrease in aggregate book value of property portfolios, as such not affected by the market turmoil in the same way as listed financial assets. At the same time, interest-bearing debt decreased due to currency fluctuations and net cash flow being used to repay maturing debt, but also to finance ongoing investments. In aggregate, the average loan-to-value increased slightly from 53 to 54 per cent.

Fixed interest terms decreased as firms did not prioritize to extend interest hedging during the period.

Fixed credit terms were affected by reduced levels of short-term debt as the commercial paper market was severely hampered by turmoil in the financial markets – as is normal.

The reduction of commercial paper financing, which is the cheapest form of financing, also contributed to an increase in the average interest rates. However, this was offset by other factors as average interest rate remains unchanged.

ABOUT THE CREDI INDICES

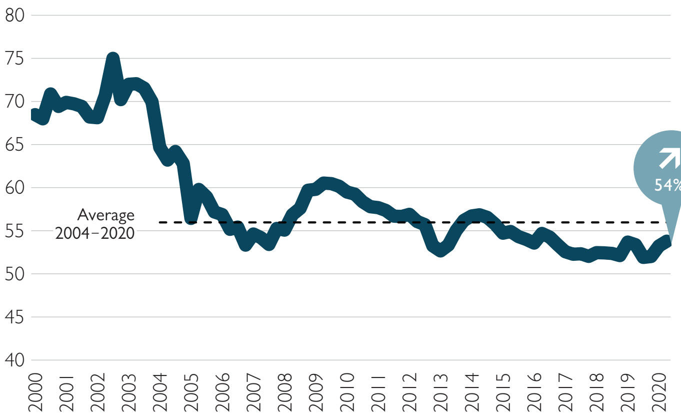
CREDI is based in part on a set of indices illustrating the aggregate change in leverage, duration and cost of debt for the Swedish listed property sector.

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

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

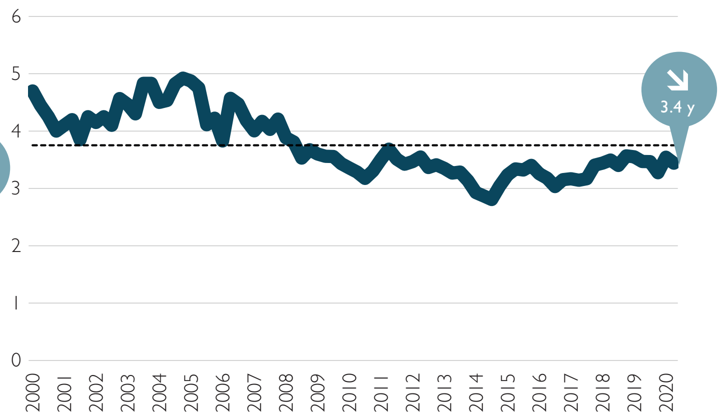
The purpose of CREDI Indices is to track trends and changes in real estate financing by aggregating publicly available data.

Loan-to-value[1]



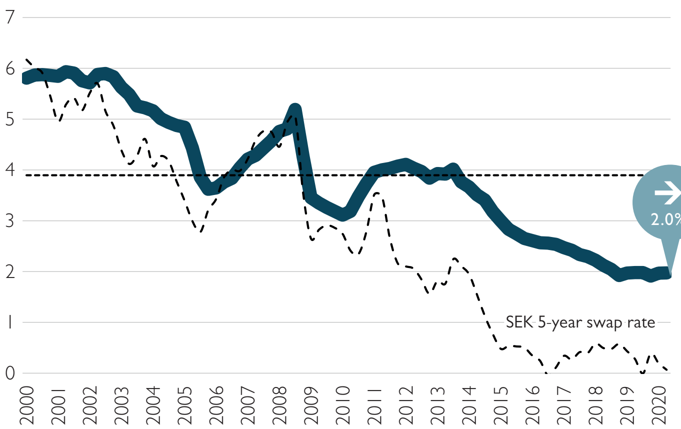
[1] Interest-bearing debt on property, excluding cash, divided by property value.

Fixed credit term[3]



[3] Average maturity referring to interest-bearing debt.

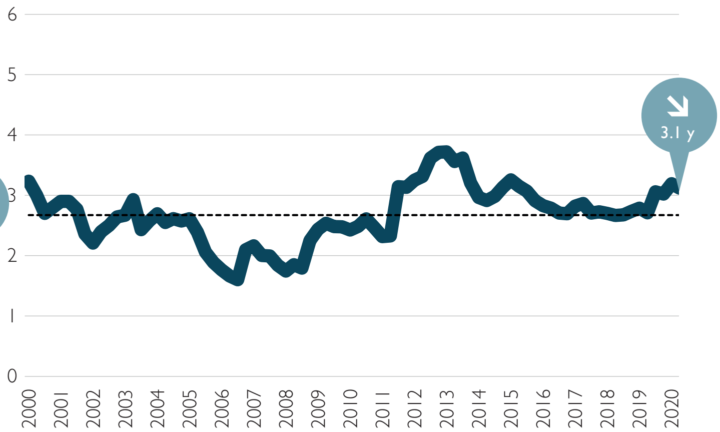
Average interest rate[2] listed



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

-------- Average 2000–2020

Fixed interest term[4]



[4] Average maturity referring to interest-bearing debt.

Bank Debt

During the second quarter, secured debt replaced unsecured debt amidst bond market troubles. As such, the loan market encountered a significant trend reversal where the secured debt to total asset ratio increased.

INCREASED LEVEL IN SECURED INDEBTEDNESS

The level of secured debt has increased since the last quarter of 2019. As lack of confidence engulfed the corporate bond market, Swedish real estate companies found it difficult to refinance maturing bonds. When investors boycotted bond issues from the real estate as well as other sectors of the bond issuing universe, secured bank loans became the alternative solution. As issuers switch from unsecured bonds to secured bank loans, the level of secured debt increases on an aggregate level.

The level of secured debt started to decrease slowly as part of the real estate sector started to issue bonds in earnest more than five years ago. The trend was initially most profound in the AP-related companies, which were the first to receive investment grade credit ratings.

As the amount of investment grade credit ratings spread into the (equity-) listed part of the real estate sector, the amount of issued unsecured bonds greatly increased as well. The bonds were predominantly used to refinance bank loans, which meant a reduction of secured debt.

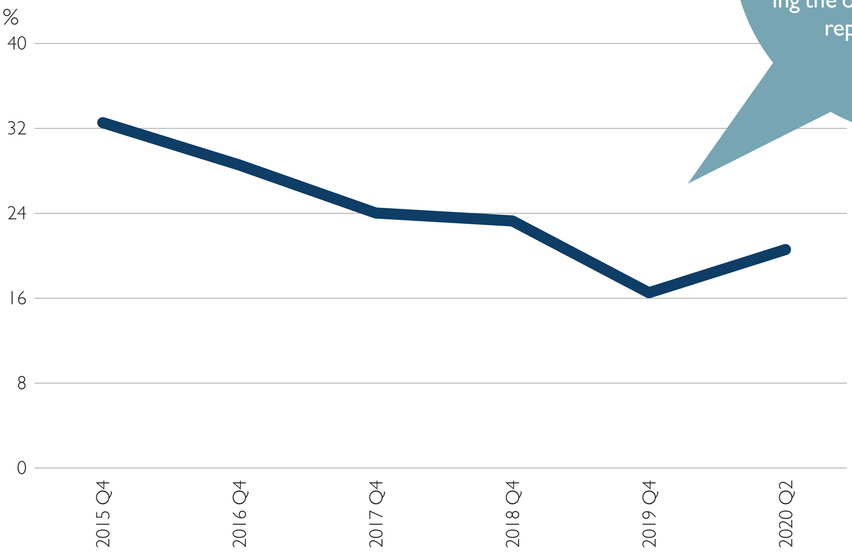
The domestic MTN-programmes are traditionally covenant free, meaning that the issuing of bonds did not entail any increased financial risk legally. Furthermore, the successive reduction of secured debt meant that the creditworthiness of unsecured debt improved correspondingly.

LEVEL OF SECURED DEBT INCREASED
Level of secured debt increased as unsecured bonds were refinanced by secured bank loans, partly reversing the opposite trend of bonds replacing bank loans.

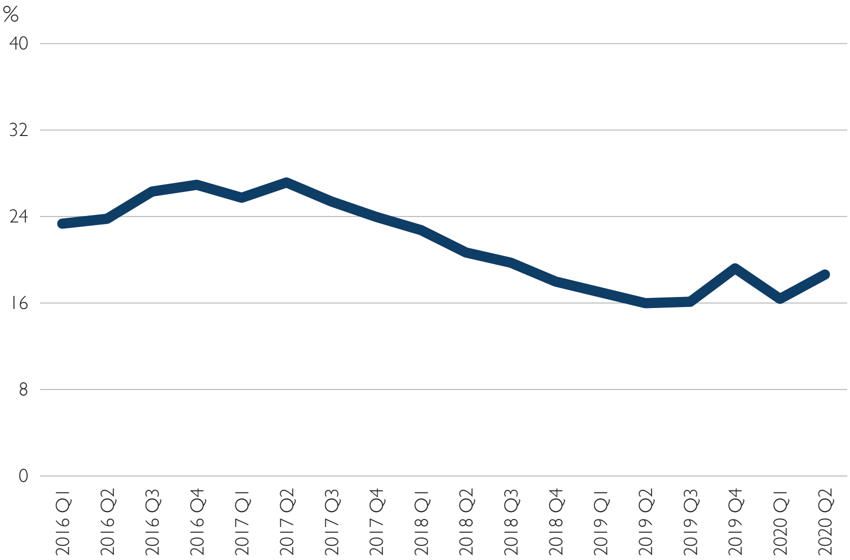
THE SNOW-BALL EFFECT

The movement from secured debt to unsecured bond debt has been incremental and orderly. However, a reversal of this trend is bound to be anything but that for two reasons. Firstly, a number of issuers have also entered the Euro-bond market and in the process signed up to covenants regulating the amount of secured debt. Secondly, a number of issuers with investment grade credit ratings are entirely reliant on low levels of secured debt to maintain their credit rating. In a scenario where secured debt increases because of shifting demand patterns in the unsecured bond markets, issuers are bound to approach the critical levels stipulated by bond documentation or rating methodologies. Once the risk of breaching these thresholds become more than a theoretical scenario, demand for unsecured debt will completely evaporate, triggering a need to refinance all outstanding unsecured debt in one go.

Secured debt to total asset ratio



Short-term debt to total debt ratio



Note: Based on publicly available data collected from the financial reports published by Swedish listed property companies.

Bonds

There was lower activity in the bond market as outstanding volume of bond debt decreased. At the same time prices have recuperated as central banks intervened.

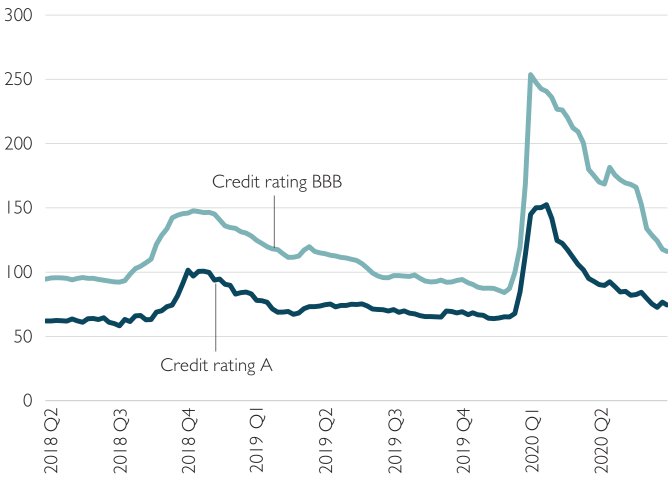
The bond market has, in line with other financial markets, rebounded strongly. The credit margins in both the SEK and Euro market have tightened significantly, although there are clear discrepancies depending on credit grade. Swedish real estate companies which are A-rated by the credit agencies have recovered lost ground while BBB-rated companies are still priced somewhat higher than before Covid-19.

The curve of credit margins is reminiscent of curves related to Covid-19 (number of cases, number of hospitalisations etc.) but the correlation is probably an illusion. The cardinal factor influencing the credit margins in the bond market is the actions of the central banks. These actions have, even in the midst of the rather extreme conditions of the 2010s, been substantial. The Fed balance sheet expanded with the equivalent of SEK 30,000 billion during the spring.This avalanche of money reverted the spikes in credit margins globally. The monetary avalanche was however not quite enough in the short term and the ability to issue bonds were restricted for a significant amount of issuers. The result was the first calendar quarter for years in which outstanding bond debt decreased as new issues did not keep pace with maturing debt.

BOND CREDIT SPREADS RECOVER
Massive interventions by the central banks managed to normalise credit margins.

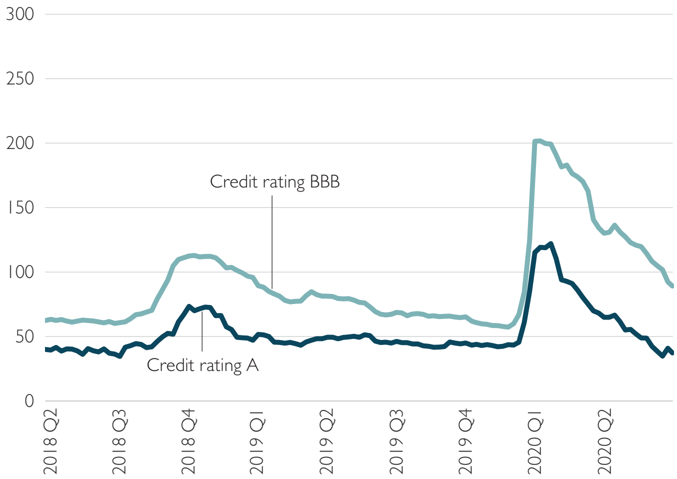
5-year bond credit spreads

Basis points



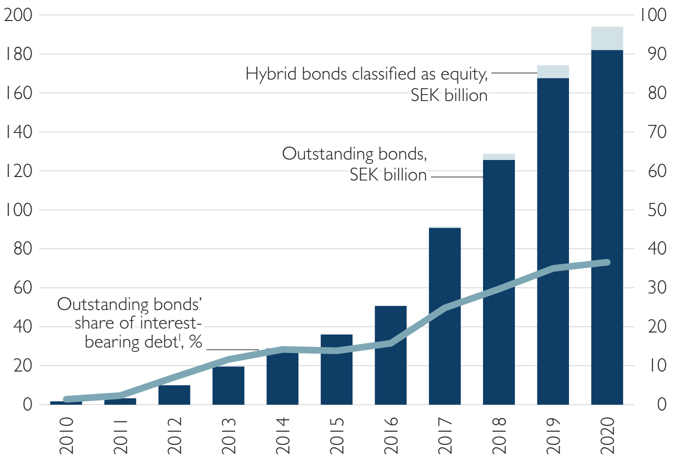
3-year bond credit spreads

Basis points



Outstanding bonds

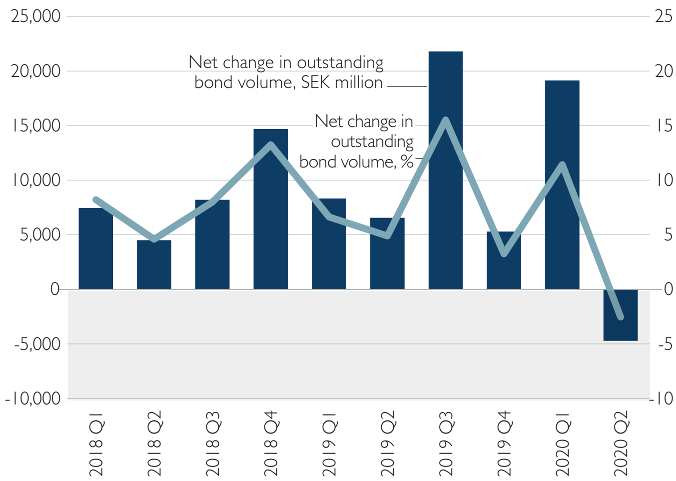
SEK billion / Per cent



[1] Excluding hybrid bonds classified as equity.
Note. Property companies on Nasdaq Stockholm Main Market.

Change in outstanding volume of bonds

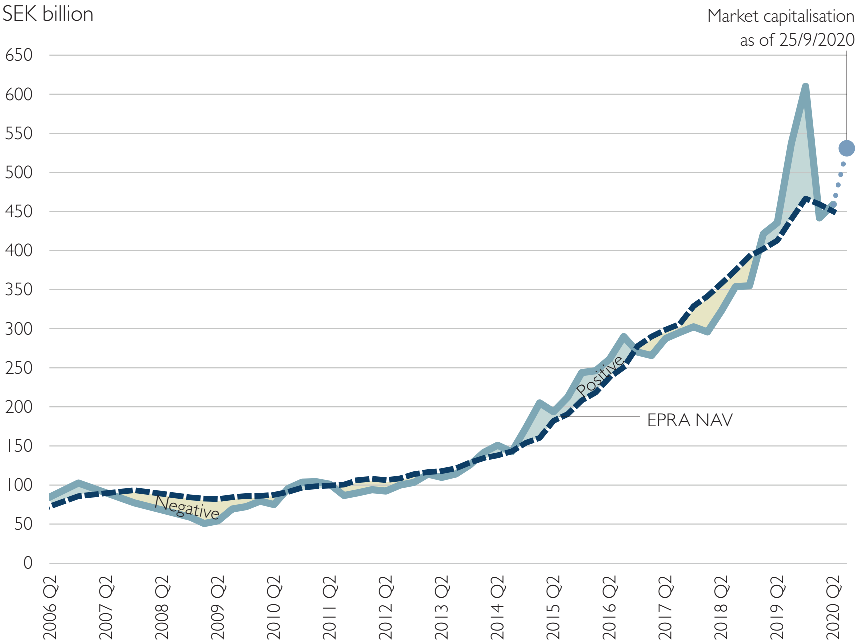
SEK million / Per cent



Common shares

The market for property-related shares recovered from the pandemic as policy turned dovish and governments acted swiftly with promises of capital injections. As such, premium is back at around 18 per cent.

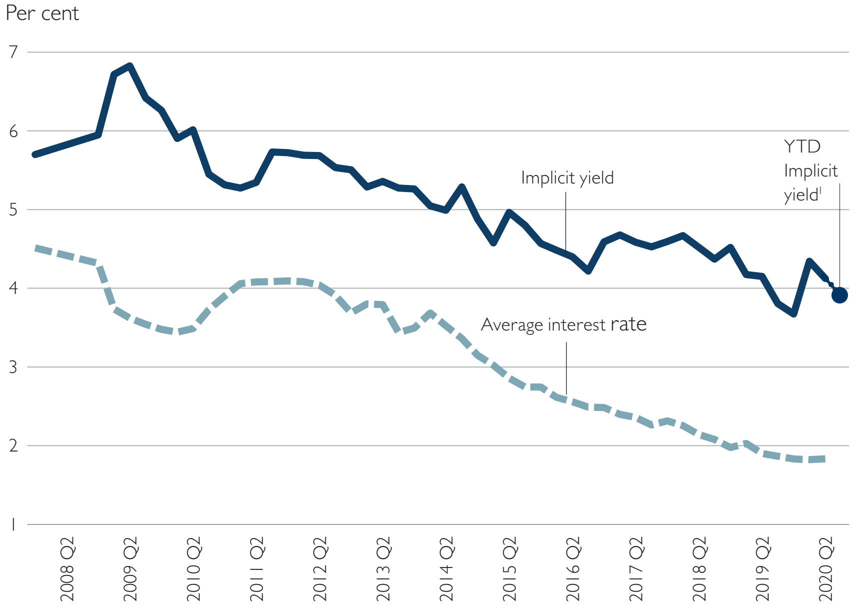
Premium or discount – market capitalisation and EPRA NAV



Note. Property companies on Nasdaq Stockholm Main Market. EPRA NAV includes a 25 per cent deduction for deferred tax, corresponding to 5.5 per cent when considering a tax rate of 22 per cent.

During the second quarter the listed market for property-related shares on the Nasdaq Stockholm Main Market was heavily influenced by the ongoing pandemic and global lockdowns. As such, market capitalisation was held comparatively low at SEK 459 billion, down almost 25 per cent since the last quarter of 2019 and a valuation close to par with EPRA NAV. From a fundamental perspective, investors assumed major tenant delinquencies and delayed payments. Following several rescue packages, only minor issues with tenant delinquencies and a clear shift towards a more dovish monetary policy, the market has made a strong recovery. As of 25/9/2020, the market capitalisation was SEK 531 billion, up 16 per cent since the end of the second quarter and suggesting a comfortable premium of around 18 per cent.

Implicit yield and average interest rate among listed property companies on Nasdaq Stockholm Main Market



[1] Market values 25/9/2020 and 2020 Q2 EPRA NAV.

Note. Property companies on Nasdaq Stockholm Main Market. Average interest rate is weighted by using the EPRA NAV to Book value of properties ratio. EPRA NAV includes a 25 per cent deduction for deferred tax, corresponding to 5.5 per cent when considering a tax rate of 22 per cent.

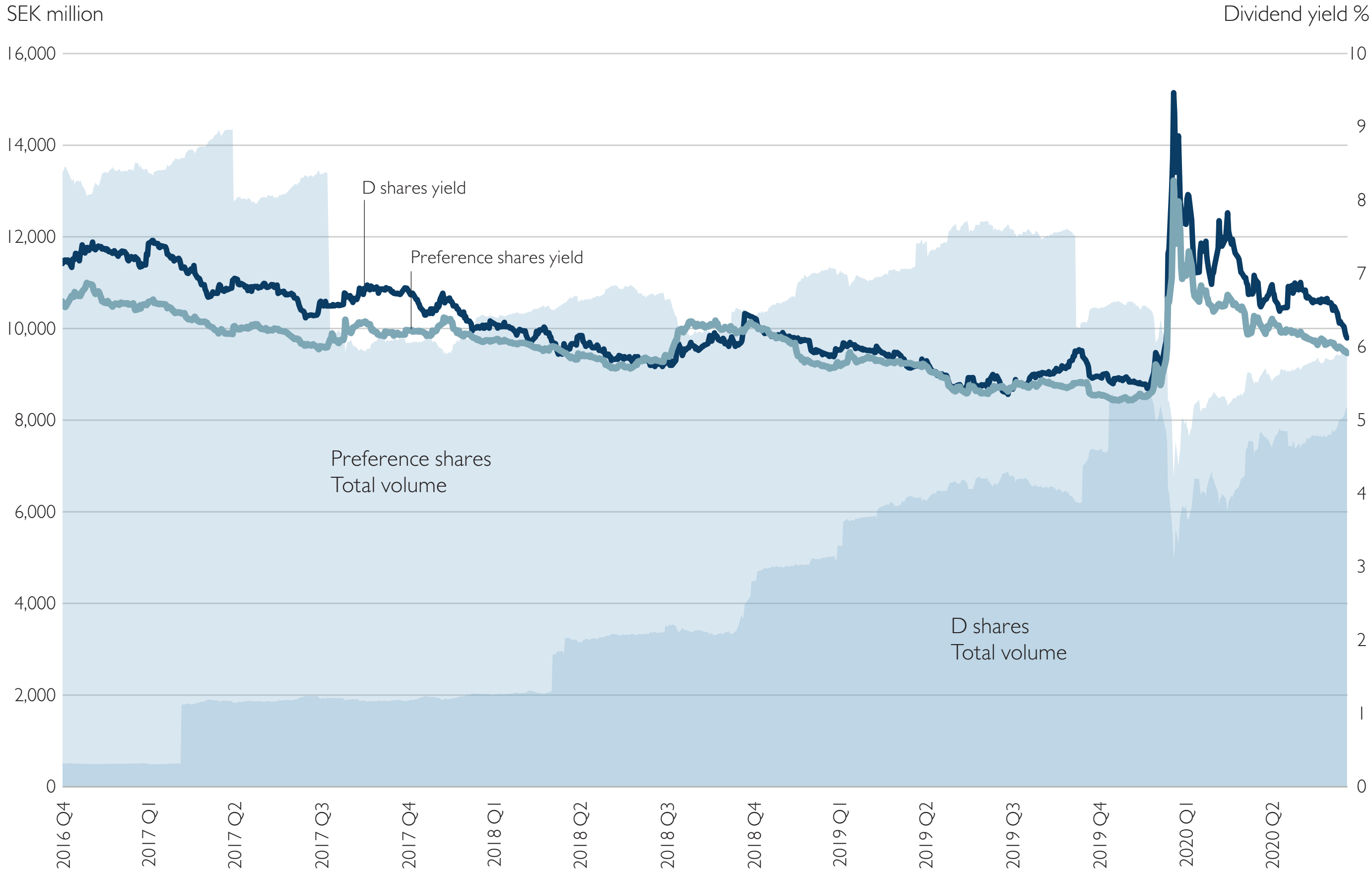
With market capitalisation back at a strong premium to EPRA NAV, the implicit yield of listed property companies is registered at 3.9 per cent. As the average interest rate stayed put, the spread between implicit yield and average interest rate decreased with investors expecting low interest rates to remain going forward. The previous expectations in higher interest rate margins due to added risk premium seem evaporated with promises of liquidity and low interest rates for the next couple of years from the world's central banks.

Source: Catella, annual reports, Nasdaq.

Alternatives

The secondary market for alternative equity shares has been strong and showed signs of recovery with declining dividend yield levels and strong investor interest since the market turmoil amidst the beginning of the pandemic.

Historical yield and volume – alternative equity shares



The secondary market for property-related alternative equity shares continued to recover from the previous pandemic related turmoil as average dividend yields fell to around 6 per cent for both share types. While the current average dividend yield is slightly above 6 per cent for class D common shares, the average dividend for preference shares is just below that, resulting in a current spread of about 20 basis points. The spread exists as the two types have different priority to cash flow, with preference shares coming before common shares, and is therefore considered to be partial debt by several rating agencies. A practical reference for the spread can be found in Fastpartner, as the company currently has both preference shares and class D common shares listed. In this case, the current dividend yield spread is about 40 basis points. Interestingly, the spread for both Fastpartner and in aggregate seems to have widened during the pandemic which perhaps is an effect of risk averse investors favouring priority to cash flow.

Looking at the graph, we see that the trend in volume growth is opposite for preference shares and class D common shares respectively. While preference shares have had a declining trend in volume, class D common shares have been a popular choice for alternative equity financing amongst property companies, a trend supported by the growth in bond markets and the importance of investment grade ratings. The partial debt inclusion by rating agencies impacts the debt-to-equity ratio and thus the rating, which in part explains why preference shares have been substituted by class D common shares.

During the second quarter, Sagax issued 18 million class D common shares for around SEK 513 million. The issue attracted great investor interest and Sagax utilised its full potential by increasing the offering with 2 million shares. Thus, investor demand for class D common shares seems solid, suggesting further issuances and perhaps new share listings going forward.

Catella's view through the looking glass

The longer-term economic outlook has improved lately due to the massive monetary and fiscal stimuli. The global economy is however facing a number of obstacles while fiscal and monetary stimuli are pushing the economy in the right direction and heavily benefitting asset prices in general and property in particular.

The consensus macro view among investors is low economic growth, low inflation and low interest rates for decades (even if more and more investors are starting to anticipate inflation ahead).

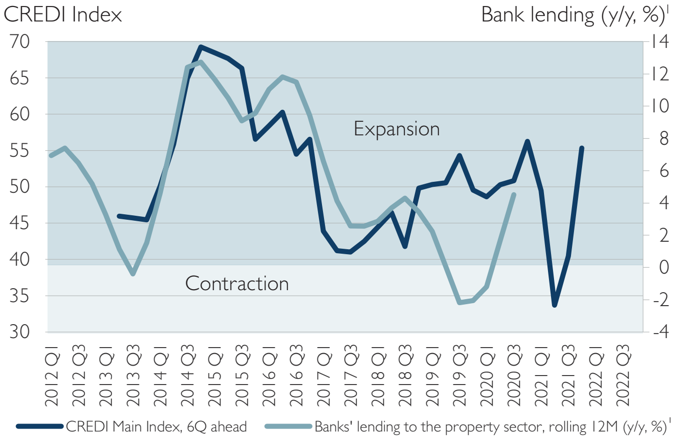
Investors are again focusing on building volume and there are portfolio premiums on the market. Residential rental properties, public properties and logistics/mix industrial properties in reasonably good locations with stable cash flows are now the main targets. Investors are increasingly concerned that Covid-19 may be a starting point of a structural shift on the office market. High quality offices in Stockholm are still considered trophy assets though, and there are still plenty of investors as long as there are not too much vacancies and projects.

The policy response to the corona crisis has been impressive. The fiscal stimulus has been massive in all large economies and central banks have flushed the market with liquidity, buying a wide range of assets. In total six of the largest central banks (the Fed, ECB, Bank of England, PBoC, BoJ and the Riksbank) have increased their total balance sheet from USD 21 trillion in March to over USD 27 trillion in mid-September. Over the last 12 months, the six central banks have added over USD 7 trillion into the financial markets, and this liquidity has been instrumental in the recovery on the financial markets. Average yield levels on the Swedish office transaction market are tightly correlated to assets of the six central banks. The level of central banks' liquidity added to the market recently is indicating further declines in property yields. This development is further strengthened by the sharp drop in long term interest rates lately (as indicated by the US 30-year TIPS).

The massive central bank response to the corona crisis has pushed down credit spreads and the banks' lending to the property sector will likely hold up relatively well during the autumn 2020 and in 2021. However, companies with high risk in their business models will meet higher credit costs going forward. This will especially be the case if there are further setbacks on the financial market during the coming 12–18 months (which is not unlikely).

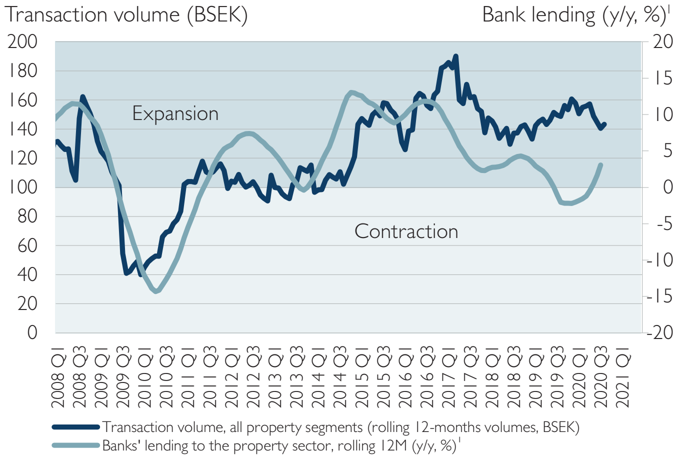
CREDI Main index, bank lending commercial property

CREDI Index | Bank lending (y/y, %)[1]



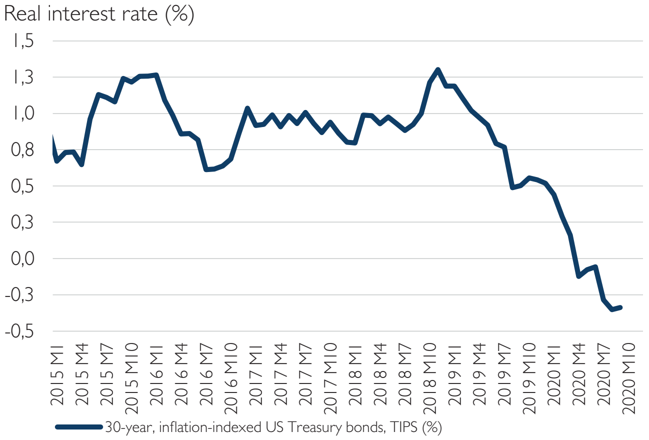
Transaction volume bank lending commercial property

Transaction volume (BSEK) | Bank lending (y/y, %)[1]



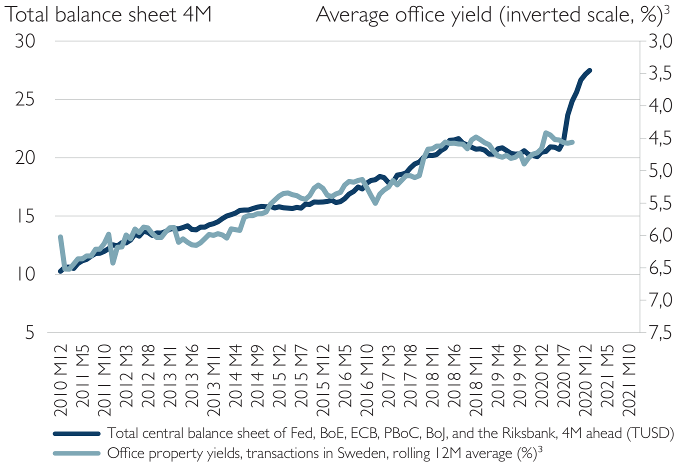
30-year, inflation-indexed US Treasury bonds

Real interest rate (%)



Balance sheet[2] and yields office property transactions

Total balance sheet 4M | Average office yield (inverted scale, %)[3]



Source: Catella, SCB and Factset

[1] The bank lending is adjusted for irregularities and changes in definition in the underlying data.
[2] Total central balance sheet of Fed, BoE, ECB, PBoC, BoJ, and the Riksbank, four months ahead.
[3] Property yields are based on historical office transactions in Sweden. Yields are either verified or estimated by Catella.

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