CATELLA

CREDI®

CATELLA REAL ESTATE DEBT INDICATOR

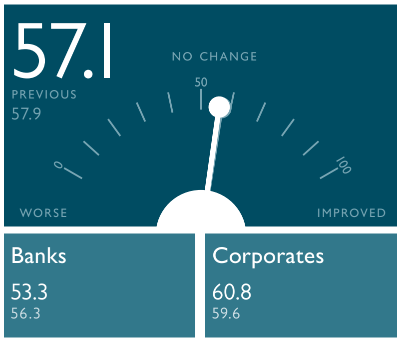
CREDI October 2021

Sentiment remains strong but the tide of the interest rates and the credit market may be about to turn

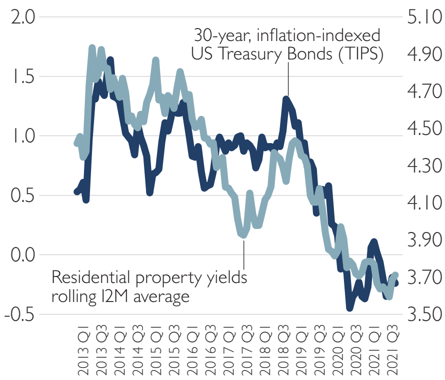
In the October issue of CREDI the Main index decreases slightly from 57.9 to 57.1 as corporates remains positive but the banks become more subdued.

- The CREDI Main index decreased marginally, from 57.9 to 57.1. Notably the banks viewed current conditions as a lot less benign compared to corporates which were robustly bullish.
- The sub-indices which contributed to a positive overall index were access to credit and credit margins, which both were viewed to have improved in the last three months according to the respondents.
- Interest rates are moving higher due to increasingly persistent inflation. Credit margins can also be expected to move higher due to a phasing out of current QE programs.
- The equity market is indicating further declining property yields during the coming 6–12 months. The largest declines are for logistics/industrial properties, offices in secondary locations in the Stockholm region, and residential properties in more or less all geographies (except for the absolute smallest/weakest municipals).

CREDI Main index



Real interest rates and average residential property yields



Loan-to-value Q2 average → 54%	Interest rate Q2 average → 1.9%	Fixed credit term Q2 average → 3.3 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. Subscribe to CREDI at catella.se/CREDI

The CREDI Survey

The October issue of the CREDI Survey suggests minor changes as the Main index decreases from 57.9 to 57.1. The sub-indices indicated strong developments both in terms of credit availability and credit margins.

MAIN INDEX COMPONENTS

In the October issue of CREDI, the Main index slightly decreased from 57.9 to 57.1. However, it is still above the average of 51.3. The high credit availability coupled with low credit margins kept the Main index at high levels.

In aggregate, the Current Situation index is recorded at 60.6, having barley changed compared to the second quarter 2021. However, the lack of change was not driven by similar responses by the respondents, but rather by a more cautious outlook by the banks while corporates became more positive. The Current Situation index for the banks was recorded at 51.7 compared to 69.6 for the corporates, a large spread.

The Expectation index was recorded at 53.5 with a low spread between the sub-groups (55.0 for banks and 52.0 for corporates).

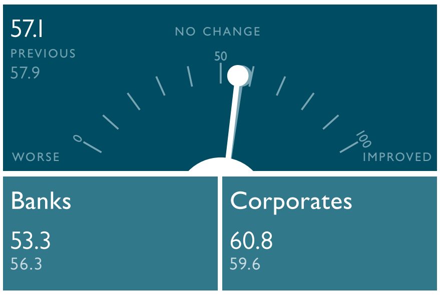
The relatively large spread between Current Situation and Expectation is a relatively common feature when the credit cycle is about to peak.

SUB-INDICES

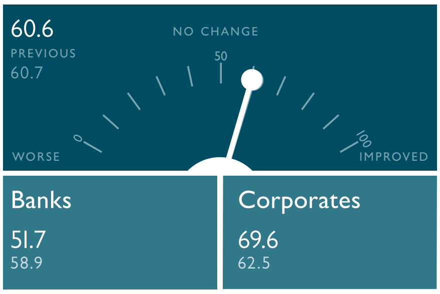
The CREDI Main index is made up of eight underlying sub-indices. According to respondents in the October survey of 2021, credit margins remained low while the credit availability was high.

All in all, sentiments on the credit market are at historically high levels. Access to credit is good and the margins are low.

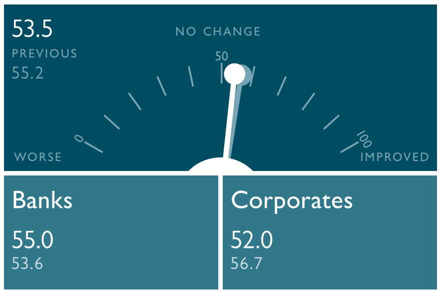
CREDI Main index



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 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

There have been minor changes within the CREDI Indices during the recent quarters/months. Although the average interest rate continued its secular decline.

During the second quarter of 2021, there were only minor changes within the CREDI Indices as loan-to-value and fixed interest remained at 54 per cent and 3.1 years. Fixed credit term slightly increased to 3.3 from 3.2 years, while the average interest rate marginally decreased from 1.9 to 1.8 per cent.

Heba decreased their average interest rate by 12 basis points to 1.01 per cent, making them the property company with the lowest average interest rate in the segment.

As 12 out of 26 companies have disclosed their third quarter figures their loan-to-value and average interest rate have remained stable while this initial data shows a slight increase in fixed interest and credit terms.

ABOUT THE CREDI INDICES

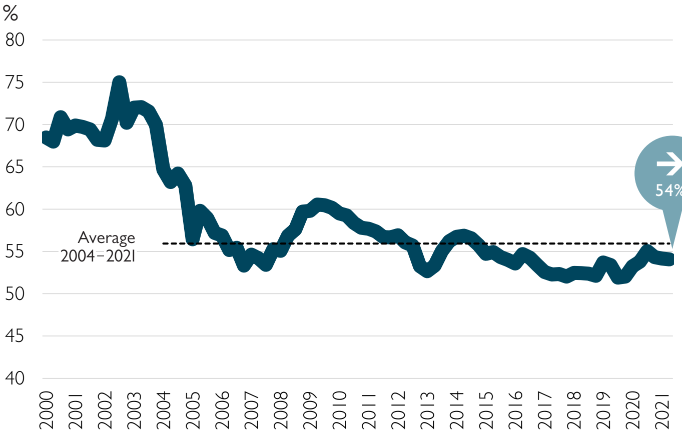
CREDI is based in part on a set of indices illustrating the aggregate change in leverage, duration and cost of debt for the Swedish listed property sector.

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.

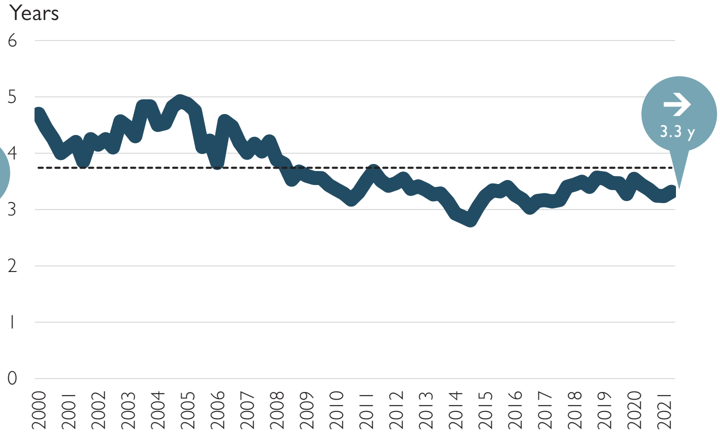
The purpose of the CREDI Indices is to track trends and changes in real estate financing by aggregating publicly available data.

Loan-to-value[1]



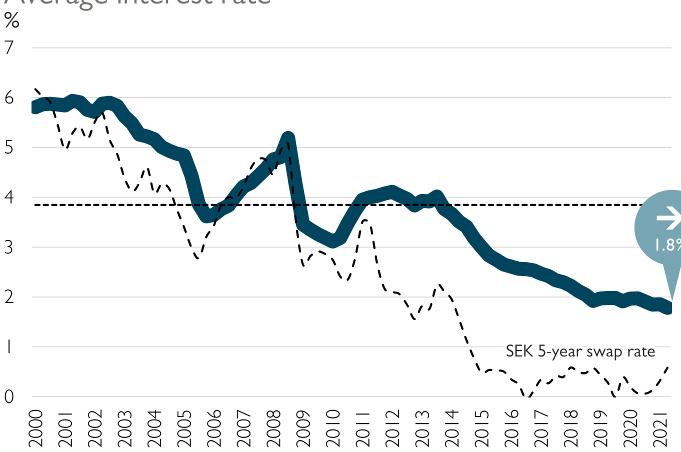
[1] Interest-bearing debt on property, excluding cash, divided by property value.

Fixed credit term[3]



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

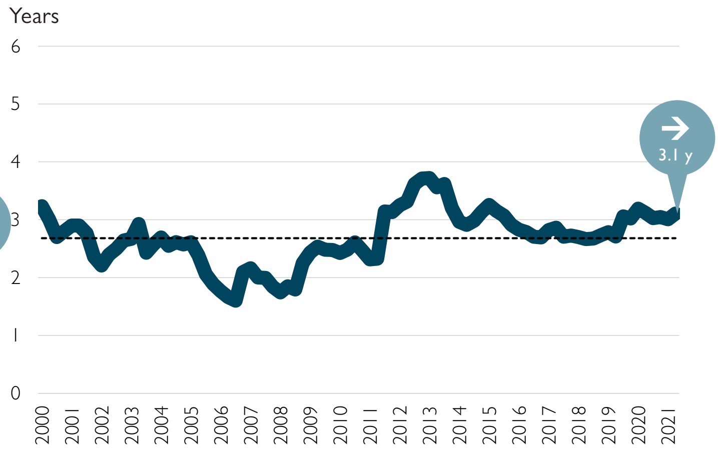
Average interest rate[2]



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

-------- Average 2000–2021

Fixed interest term[4]



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

Debt market

Increasing inflation and reduction of QE programs indicate that it could be the turn of the tide in interest rate and credit markets. A market shift which, if it happens, is bound to have an effect on property yields.

In the third quarter one of the largest property transactions ever in northern Europe occurred as Akelius Fastigheter sold its Nordic and German property portfolios. Akelius began its investment in residential properties in the 1990s as the interest rates started their secular decline. Over the decades of decreasing interest rates, Akelius has built a large residential property company with more than EUR 10 billion in assets. Akelius continued its growth strategy even as prices moved consistently higher, breaking barrier after barrier of what was perceived as reasonable. The decisions to finally sell could very well have come at the top after a very long hold period.

In the third quarter there has been a global shift towards increasing interest rates. The increase must partly be viewed from the fact that interest rates earlier was at absolute record lows, from which a move higher could only be expected. But interest rates are also propelled upwards by increasingly persistent inflation. The post corona inflation was originally viewed as short term and transitory as supply side issues were being dealt with. It now appears that inflation will be around for a lot longer as no quick fixes on the supply side are expected and that dramatic increases in energy prices, natural gas foremost, portents more price increases throughout the economy. Unemployment is not yet as low as before corona, but there is nonetheless clear evidence that labour markets are tighter with rapidly increasing wages as effect. Hence, even if inflation is in essence transitory, rather than self-propelling as during the stagflation during the 1970s, it seems like this transitory phase could last for several years. If so, there will be a clear upward move in interest rates, including in the swap markets which directly affects the interest costs for Swedish property companies.

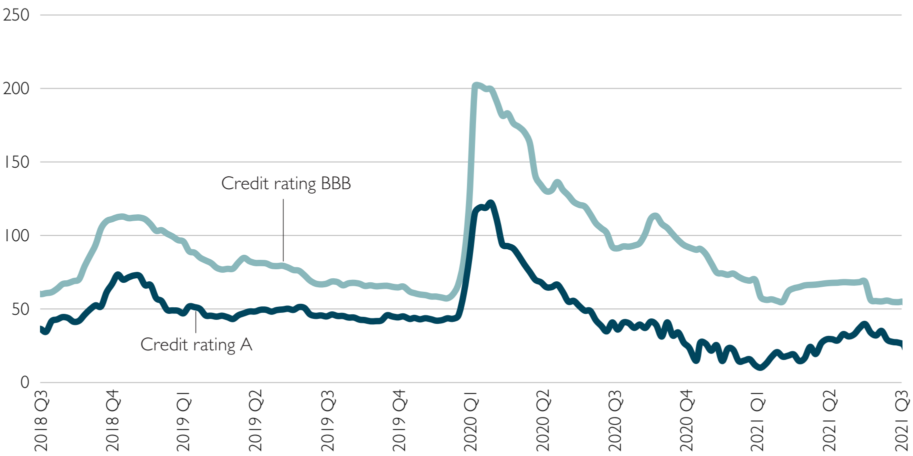
The 5-year swap rate increased from about 0.2 to 0.6 per cent during the second half of 2021. Since the swap rate reflects future STIBOR 3m rates it is difficult to envisage a swap rate that increases too far, but the region of 1–2 per cent is entirely possible.

The other financial market where the tide might be turning is the credit market. Credit spreads universally has been depressed on the back of the central bank's QE programs. As the QE programs are scaled back, we should expect credit margins to bounce back from the current record lows. It should be remembered that credit margins have a lot more potential to increase and remain at elevated levels, which, if it happens, will materially affect the leveraged property companies' cost of capital.

The global property bond market of course has the development of the Chinese real estate development company Evergrande in focus. It has about USD 300 billion of debt, of which about USD 30 billion is through unsecured senior bonds akin to the bonds issued by Swedish property companies. The remaining debt consists of bank loans and is secured with Evergrandes projects and properties. The most likely scenario, bar a government rescue of some sort, is that the secured lenders seizes their collateral while the unsecured bond holders take a hefty, maybe even total, haircut. This might serve as a remainder to bond investors about the risk nature of unsecured bonds.

3-year bond credit spreads

Basis points



5-year swap rates

%

Common shares

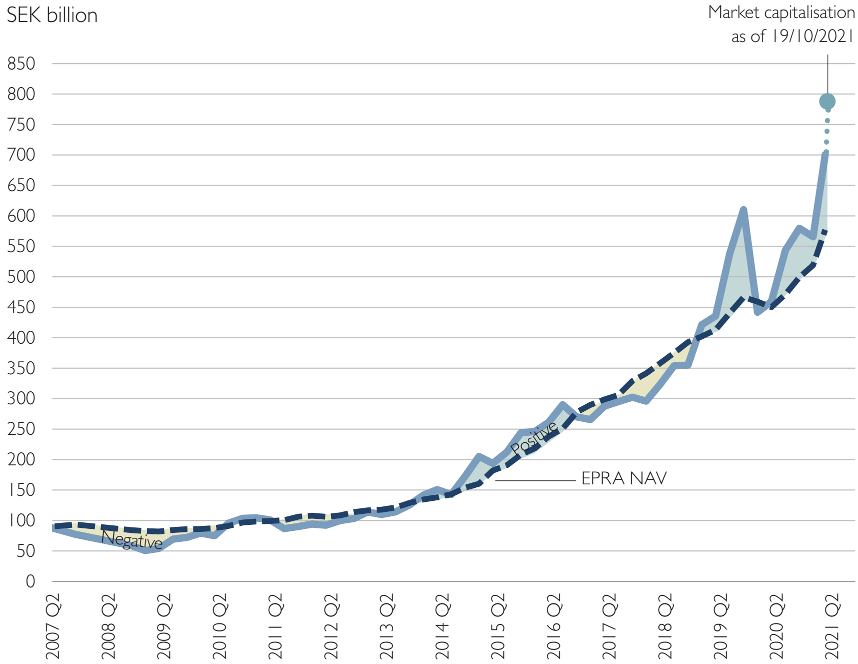
The equity prices on listed property companies went through a correction phase the beginning of the third quarter. The equity market has however recovered strongly over the last month and the equity market prices are pointing towards lower property yields during the coming 6–9 months.

In the second quarter of 2021, the aggregated market capitalisation for listed property companies on the Nasdaq Stockholm Main Market increased from SEK 566 billion to SEK 700 billion, equivalent of 19.2 per cent. However, as of 19/10/2021 the aggregated market capitalisation has soared to SEK 793 billion. Premium was recorded at 21.3 per cent in the previous quarter and around 37.4 per cent as of 19/10/2021 (compared to the EPRA NAV during the second quarter).

When looking at the data of 12 out of 26 companies that have disclosed their third quarter figures the premium towards NAV is approximately 17 per cent (as there has been an underlying growth in the companies' NAVs between the second and third quarter).

Premium or discount – market capitalisation as share of EPRA NAV

SEK billion

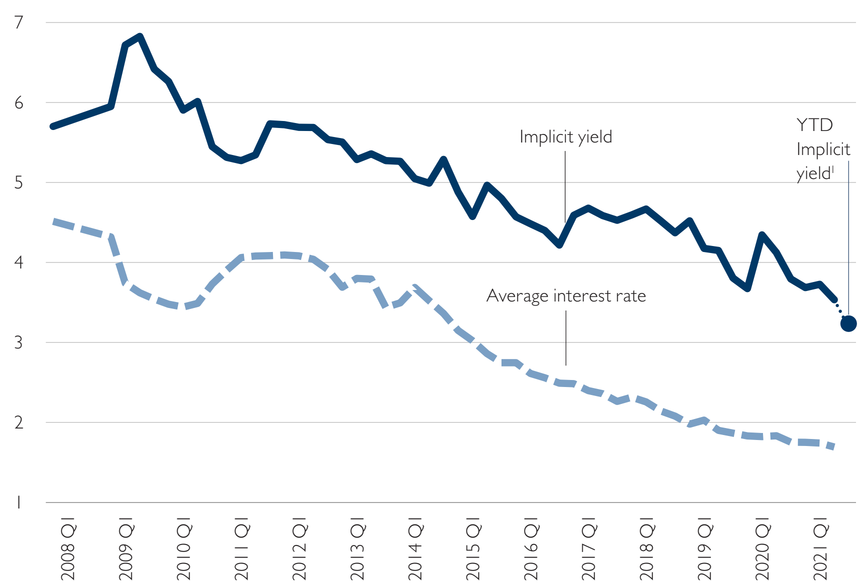


Note. Property companies on Nasdaq Stockholm Main Market.

As of 19/10/2021 the implicit yield has dropped to 3.12 per cent following the spike in market capitalisation. This is a 26 basis points drop from the 3.4 per cent during the second quarter 2021. The spread between the average interest rate and implicit yield is currently around 150 basis points, lower than the average spread of around 215 basis points in the last five years. Historically, the spread varies from quarter to quarter as implicit yields are rather volatile during market spikes while average interest rates move more slowly.

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

Per cent



[1] Market values 19/10/2021 and Q2 2021 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.

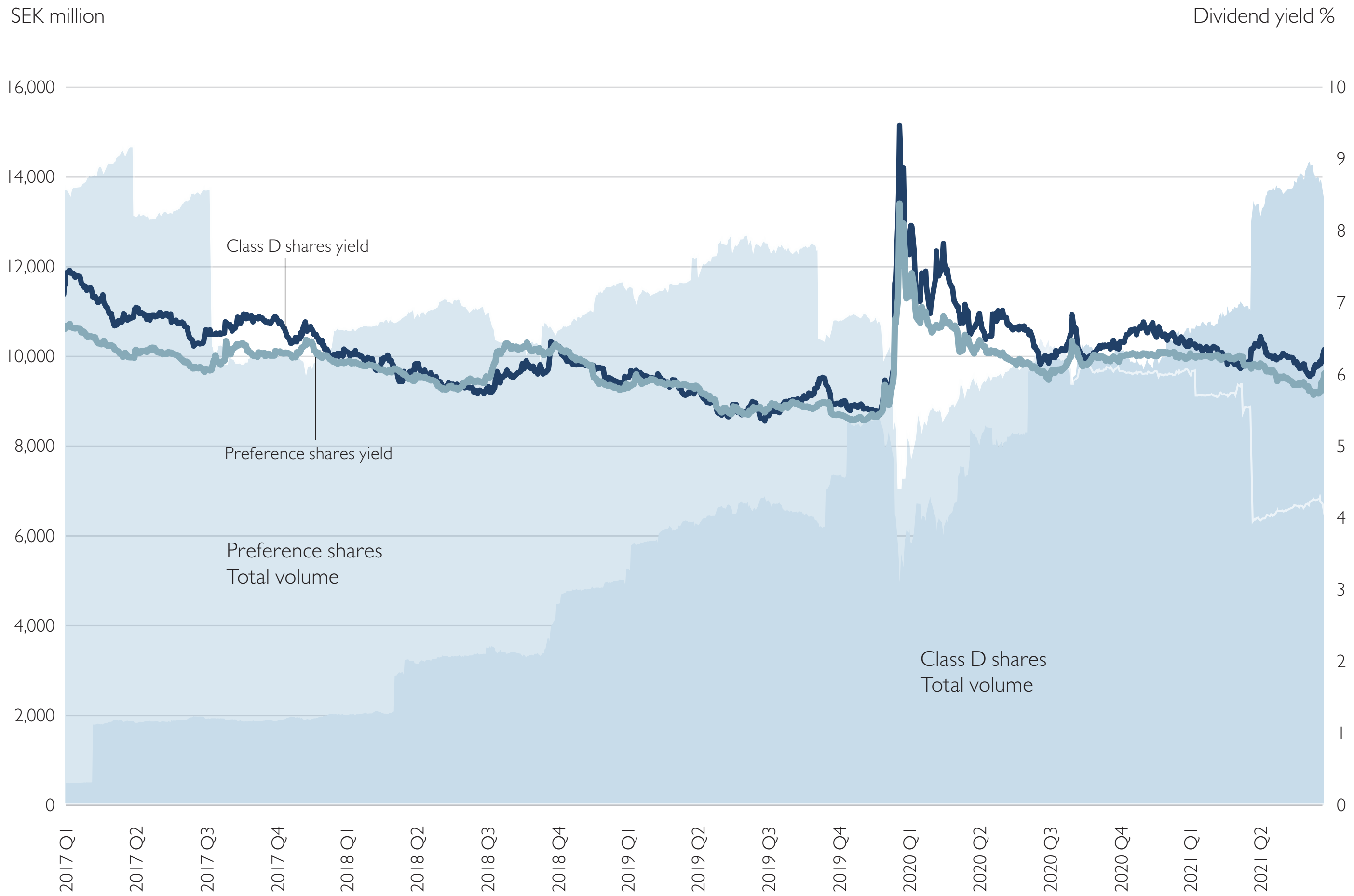
Alternatives

Class D common shares remain the more attractive source of alternative equity financing.

The secondary market for property-related alternative equity shares remained stable during the second quarter and as of 19/10/2021 the average dividend yields for both preference shares and class D common shares were recorded at 6.0 per cent and 6.3 per cent respectively. Thus, the yield spread between the two classes of shares has increased somewhat to around 30 basis points which is higher than the 3-year average of around 13 basis points.

In the summer of 2020 total volume of outstanding class D common shares went above the total volume for preference shares. Since then, Class D common shares has remained the more attractive source of alternative equity financing between the two. This is partly due to the increasing importance of credit ratings and the difference in equity/debt classifications between preference shares and class D common shares by credit rating agencies.

Historical yield and volume – alternative equity shares



Source: Catella, annual reports, Nasdaq.

Catella's view through the looking glass

The rolling 12-months transaction volume was on an all-time high level of around SEK 227 billion in mid-October 2021. This can be compared to SEK 169.4 billion for the full-year 2020.

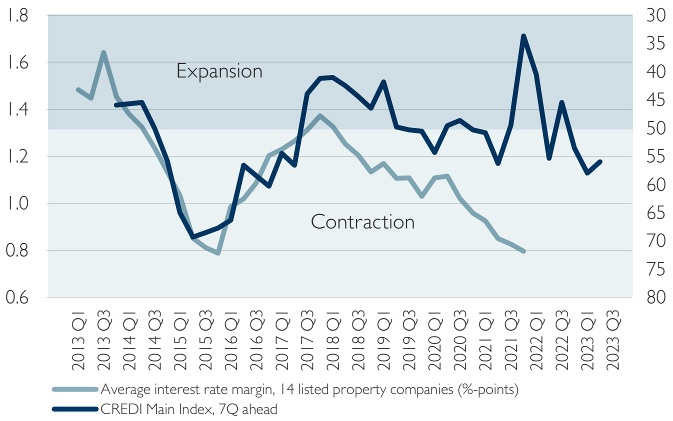
The listed property companies had an extremely strong development until mid-August and then entered a correction-phase due to factors like the increasing global inflation and more hawkish central banks. The market has recovered lately, however, and the equity prices are now up around 45 per cent in average for 36 property companies so far in 2021 (compared to 25 per cent for OMX Stockholm 30). There are major premiums on companies that focus on mix industrial properties, well located logistics, residential rental properties and/or public properties. There are, however, discounts for some companies with a focus on retail and/or office properties. As a result, the equity market is indicating further declining property yields during the coming 6–12 months. The largest declines are for logistics/industrial properties, offices in secondary locations in the Stockholm region, and residential properties in more or less all geographies (except for the absolute smallest/weakest municipalities).

There are major uncertainties regarding how the major central banks will respond to the current growth/inflation mix. The global economy cannot sustain much higher real interest rates than today's levels. Debt levels (private, corporate and government debt) are at record levels and are indicating that productivity and economic growth will be low in a long-term perspective. This makes it hard for central banks to control inflation if we end up in a stagflation scenario. If central banks end up tolerating higher inflation, there is a risk that financial markets see this as an attempt to inflate away the massive debts. If central banks instead respond by tapering asset purchases and/or increasing policy rates, asset prices will tumble and may trigger a new recession.

Central banks will try to find the middle-ground and gradually wind down their stimuli with one eye on the asset market. If productivity improves and economic growth remains healthy, the global debt levels would gradually decline as a share of GDP to manageable levels. This is not the most probable scenario, however. It is more likely that inflation/nominal interest rates enter a gradual uptrend, while economic growth is low and real interest rates remain negative. In this case it is a good chance that capital will flow to all types of real assets like commodities, infrastructure, and property.

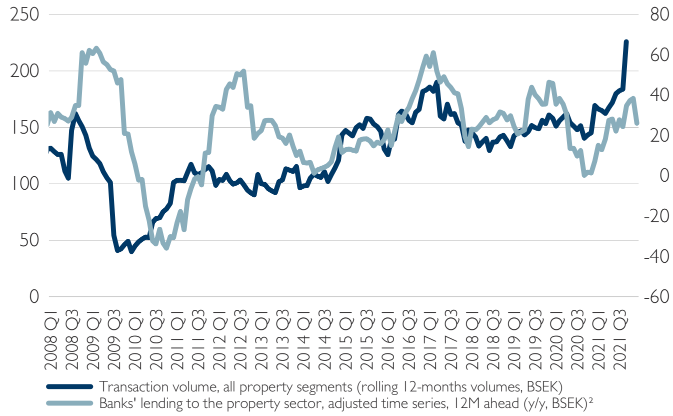
Average interest rate margins and CREDI Main index

Average interest rate margins % points[1] CREDI Index(inverted scale)



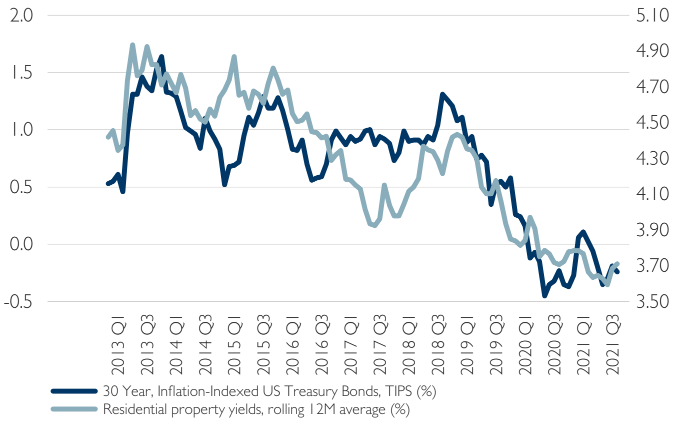
Transaction volume, bank lending commercial property

Transaction volume (BSEK) Bank lending (y/y, BSEK)[2]



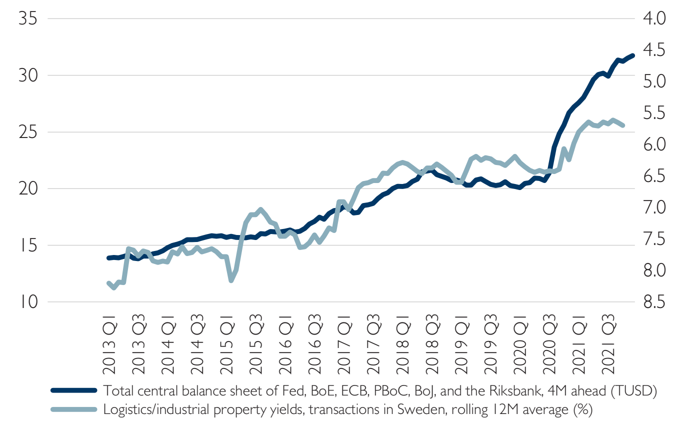
Real interest rates and residential yields

Real interest rate (%) Average residential yield(%)



Central bank balance sheet [3] and logistics yields

Balance sheet (TUSD) 4M ahead Average log./ind. yield (invert. scale, %)



Source: Catella, SEDIS and FactSet

[1] Calculated interest rate margins based on 3-year interest rate/maturity. Average figures for Atrium Ljungberg, Balder, Castellum, Catena, Corem, Diös, Fabege, Fastpartner, Hufvudstaden, Klövern, Kungsleden, Sagax, Wallenstam and Wihlborgs.
[2] The bank lending is adjusted for irregularities and changes in definition in the underlying data.
[3] Total central balance sheet of Fed, BoE, ECB, PBoC, BoJ, and the Riksbank, 4 months ahead.

Contacts

Jacob Bruzelius
Head of Debt Advisory
Direct: +46 8 463 32 67
SMS: +46 73 390 09 80
jacob.bruzelius@catella.se

Arvid Lindqvist
Head of Research
Direct: +46 8 463 33 04
SMS: +46 72 537 17 45
arvid.lindqvist@catella.se

Richard Tisell
Analyst
Direct: +46 8 463 32 34
SMS: +46 72 092 96 71
richard.tisell@catella.se

Catella is a European financial advisor and asset manager. In Sweden, Catella is a market leader for advisory services in connection with property transactions and property-related services within debt and equity capital markets. We have offices in Stockholm, Gothenburg and Malmö.

HQ: Birger Jarlsgatan 6, Stockholm info@catella.se
www.catella.com