CREDI February 2022

Falling credit sentiments indicate higher credit margins ahead

In the February issue of CREDI the Main index decreases from 57.1 to 44.6, indicating a significant deterioration in the market for real estate debt. Increasing bond spreads show a similar development in the bond market.

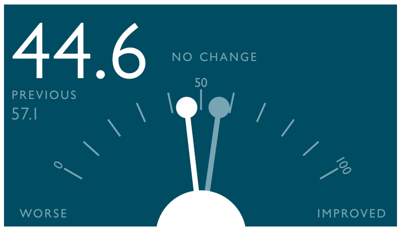
- The CREDI Main index fell heavily and is now below the 50-mark as banks turned risk averse towards the property sector by increasing credit margins.

- Omicron is likely the last phase of the pandemic and going forward there will be less monetary and fiscal stimuli. Although former stimuli will likely continue to support economic growth in most countries, the supply side may not recover to the extent where inflation falls back to post-pandemic levels.

- Swap rates and credit margins continue to move higher. Marginal borrower costs are now substantially higher than current average interest rates in the property sector indicating higher average interest rates going forward.

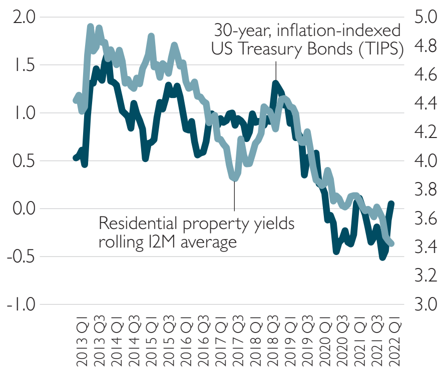
- Despite the correction, the equity market is still indicating lower property yields during the coming 6–12 months. Property is considered a traditional inflation hedge in portfolios, and this may contribute to a continuous flow of capital into the sector going forward.

CREDI Main index



Banks	Corporates
39.3	50.0
53.3	60.8

Real interest rates and average residential property yields



Loan-to-value Q4 average ↘	52%
Interest rate Q4 average ↘	1.7%
Fixed credit term Q4 average →	3.3 y
Fixed interest term Q4 average ↘	3.0 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 February publication of CREDI suggests a weakened credit market as the Main index decreases from 57.1 to 44.6 as increasing credit margins are expected.

MAIN INDEX COMPONENTS

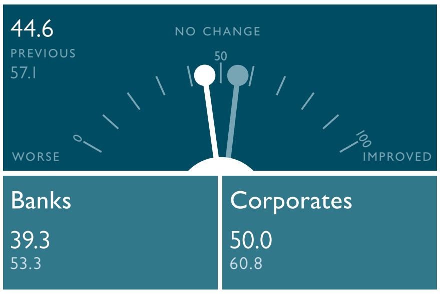
In the February issue of CREDI, the Main index sharply declined from 57.1 to 44.6. The Main index decreased as banks turned risk averse towards the property sector by increasing credit margins, indicates a strong shift in the credit sentiments.

The Current Situation index decreased to 49.5 compared to the previous recording at 60.6. The usual trend with more pessimistic banks than corporates remained, however, this CREDI survey illustrates a rather large difference. This is a common situation when the credit cycle has passed its peak (which is most likely the case). The Expectation index decreased even more than Current Situation, from 53.5 in the previous CREDI edition to 39.8. In summary, this issue of CREDI illustrates an exceptionally large drop for the Expectation index. Since the start of CREDI (May 2012), the Expectation index has never dropped as much from one edition to another, except for during the Covid-19 pandemic.

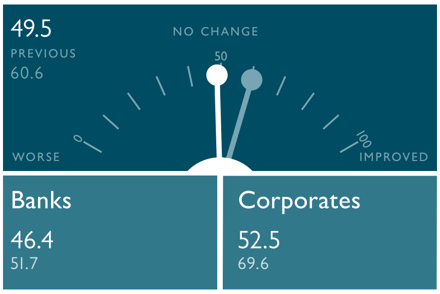
SUB-INDICES

The CREDI Main index is made up of eight underlying sub-indices. According to respondents in the February edition of 2022, the credit margins will increase and the leverage will decrease going forward. It is foremost the banks which expect higher credit margins, while the property companies seem unaware that conditions might deteriorate. Credit availability and duration, however, is expected to remain unchanged.

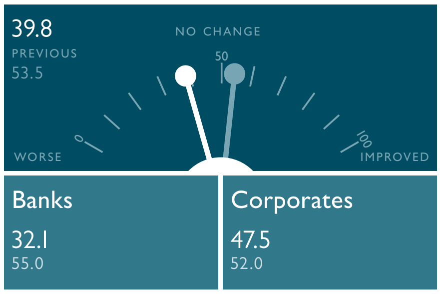
CREDI Main index



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 last quarter of 2021, there were only minor changes within the CREDI Indices as loan-to-value and average interest decreased to 52 per cent and 1.7 per cent respectively. Fixed credit term and fixed interest term remained stable at 3.3 years and 3.0 years.

NP3 slightly decreased their average interest rate by 0.19 per cent to 2.53 per cent. Heba remained as the company , included in the CREDI Indicies, with the lowest average interest rate at 0.93 per cent, while Genova had the highest average interest rate at 2.71 per cent.

ABOUT THE CREDI INDICES

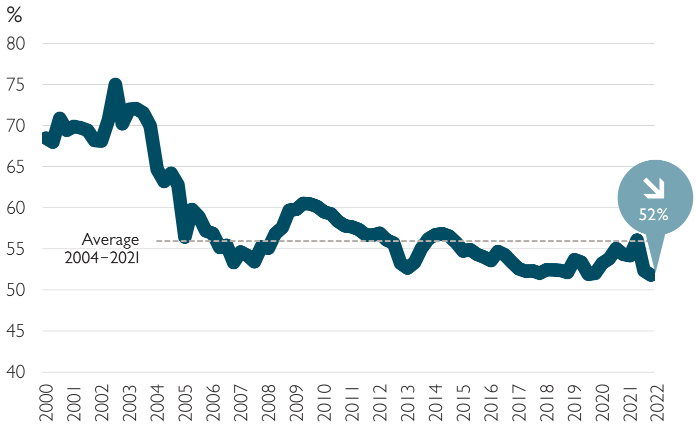
CREDI is based in part on a set of indices illustrating the aggregate change in leverage, duration and cost of debt for the Swedish listed property sector.

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.

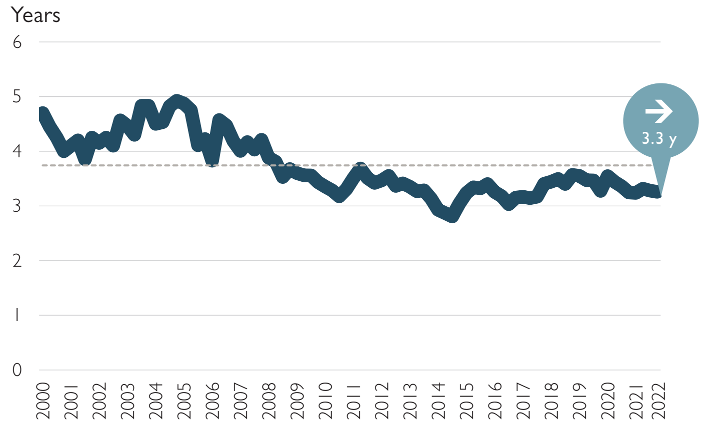
The purpose of the CREDI Indices is to track trends and changes in real estate financing by aggregating publicly available data.

Loan-to-value[1]



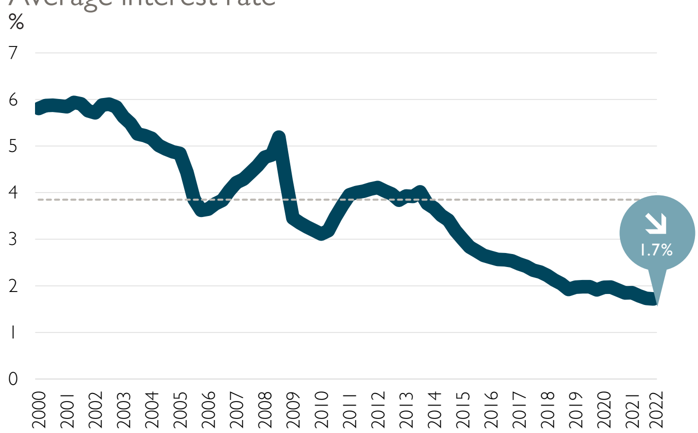
[1] Interest-bearing debt on property, excluding cash, divided by property value.

Fixed credit term[3]



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

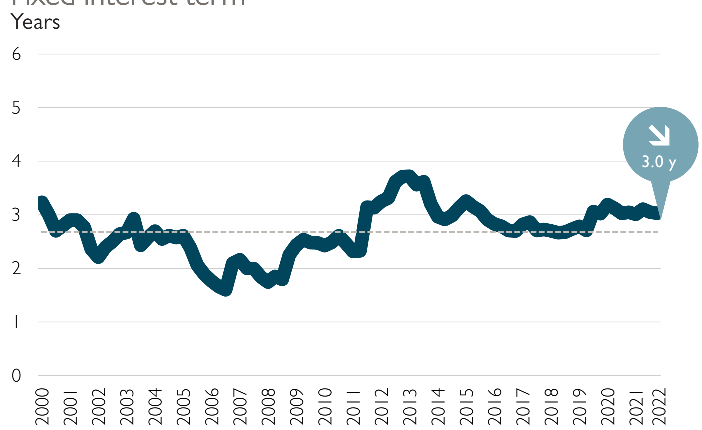
Average interest rate[2]



[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

Our October prediction that we would see a turn of the tide in interest and credit markets has so far proved succinct. Total interest costs in the bond and interest rate markets have continued to increase in the last couple of months.

In China the huge crash in real estate related credit is continuing. The process started in 2018 when the government started a squeeze on the 12 largest property developers, which were deemed to have unsound business models. The squeeze is now taking its toll with several developers, foremost Evergrande, moving closer to bankruptcy. The process is an example of the creative destruction of capitalism, applied however by the communist government of China. During the corona pandemic most western economies spent a considerable amount of resources in thwarting the uncomfortable effects of capitalism.

In the previous edition of CREDI we predicted that we would see a turn of the tide in interest and credit markets. In this edition we can conclude that the tide indeed has turned. The SEK swap rates have continued upwards (please see graph below). The market pricing for Fed rate hikes in 2022 has gone from 0 to 1 hikes to 5 to 9 hikes and there has been a similar, albeit not as dramatic, increase in the market pricing of ECB rate hikes. The market expectation of rate hikes from Riksbanken in 2022 is so far muted.

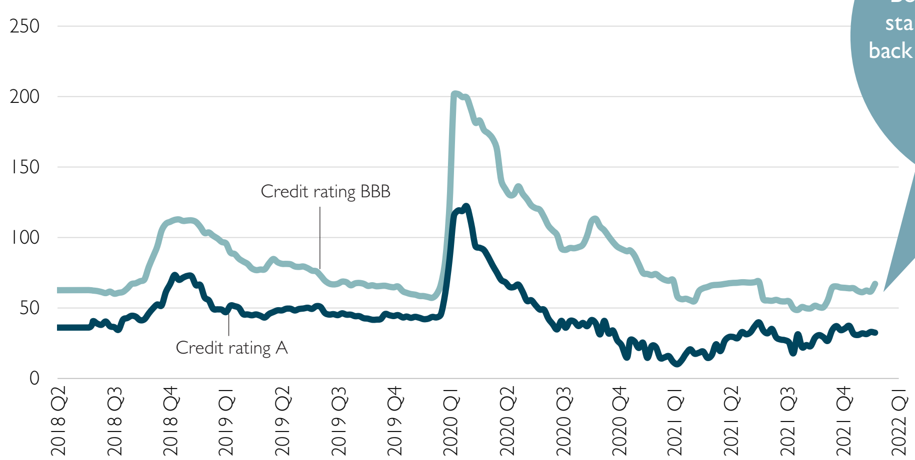
The expected rate hikes are all related to high inflation levels, which persistently have surprised on the upside.

The second component of the real estate sector's interest rate costs is the credit margins. In the bank market we have not identified any increase in credit spreads, in line with CREDI survey results, but the CREDI survey is clear that the market anticipates higher credit margins going forward. In the bond market credit margins have increased substantially in some markets, especially in the high yield market. The most important market for the Swedish real estate sector is however the investment grade market for Swedish real estate companies, and these credit margins are still at low levels. The spreads have however increased slightly during 2022. The scope for further increases is, as we have written earlier, substantial and a scenario which should be taken into account considering the fact that the central banks can all be expected to reduce, and probably reverse, their gigantic purchases of unsecured bonds. This substantial shift in supply and demand will have an adverse effect on pricing, i.e. credit margins.

INCREASE
Bond credit spreads have started to increase on the back of reduced QE from the central banks

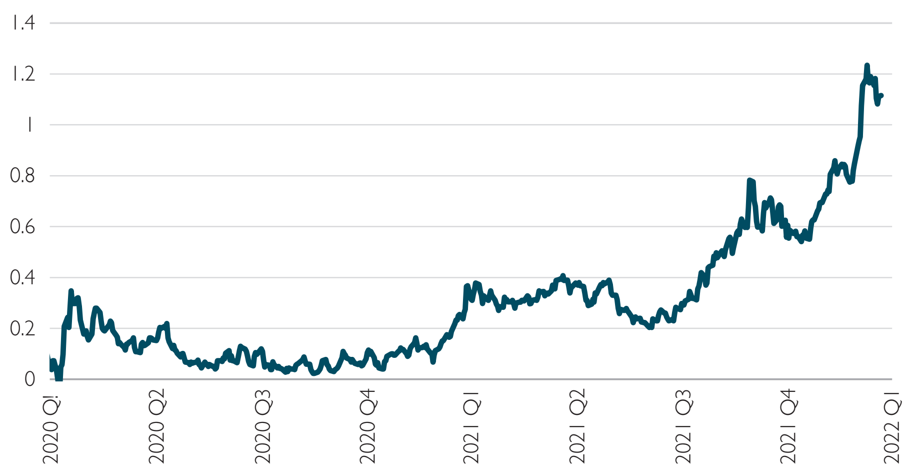
3-year bond credit spreads

Basis points



5-year swap rates

%



Common shares

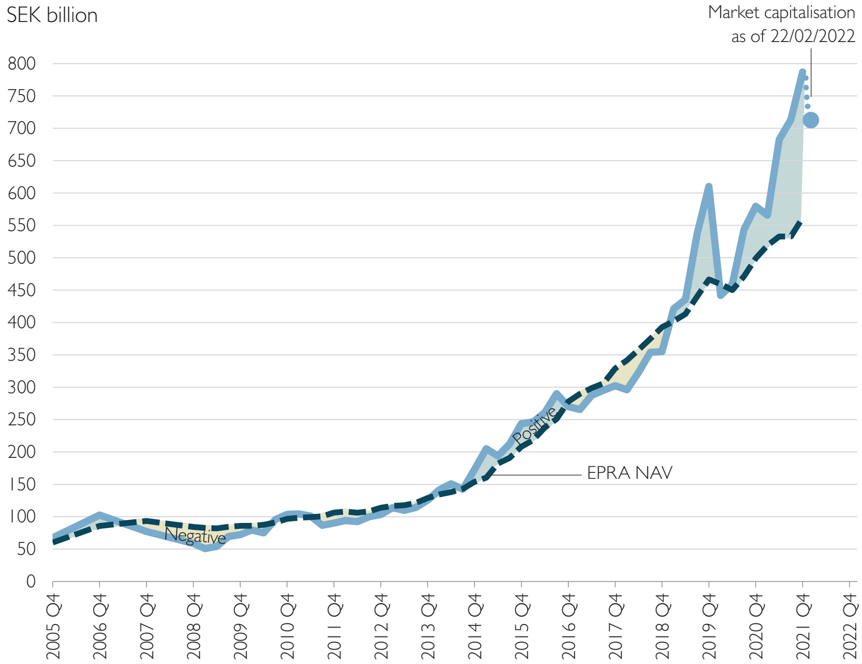
The market for property-related shares has sharply declined, however, the premium towards market capitalisation and EPRA NAV remains at a record high 30 per cent.

During the fourth quarter 2021 the listed market for property-related shares on the Nasdaq Stockholm Main Market increased significantly to a record high at SEK 787 billion, up almost 39 per cent since the last quarter of 2020. During the same period, EPRA NAV increased by 13 per cent. From a fundamental perspective, investors arguably assumed a strong post-pandemic recovery with continued monetary stimuli from the main central banks. However, during the first quarter of 2022, the stock-related shares experienced a correction phase as the market capitalisation fell by almost 7 per cent, to SEK 714 billion (as of 22/02/2022). Notably, many of the property-related shares reached an all time high before the end of the fourth quarter, hence, the decline was arguably more severe than portrayed by the quarter-to-quarter perspective. Many large major property companies have seen a sharp decline in their market capitalization of more than 30 per cent YTD.

Although the market capitalization has declined over the last months, the property-related shares still have a strong premium to EPRA NAV, hence, the implicit yield of listed property companies is registered at a low 3.1 per cent. As the average interest rate stayed put, the spread between implicit yield and average interest rate marginally decreased. There are major equity market premiums on companies that focus on mix industrial properties, well located logistics, residential rental properties and/or public properties. There are, however, discounts for several of the companies with a focus on retail and/or office properties.

Premium or discount – market capitalisation as share of EPRA NAV

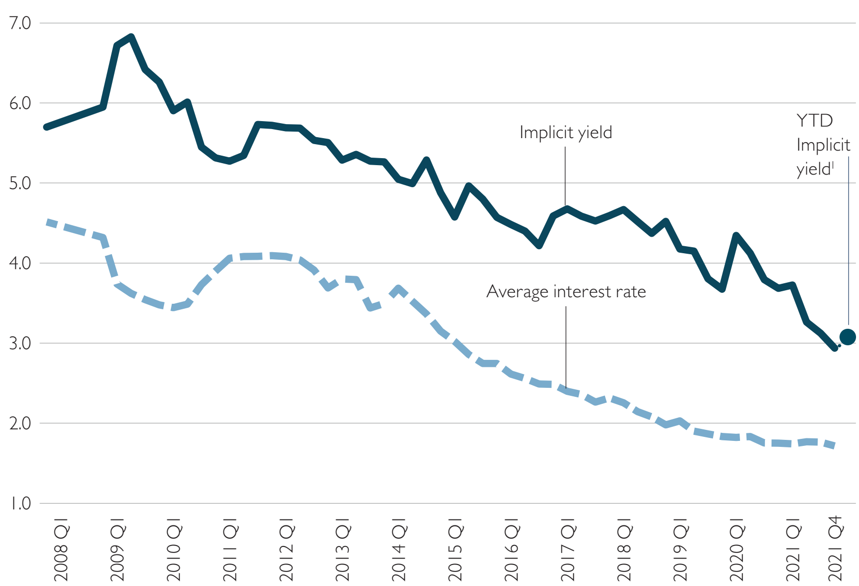
SEK billion



Note. Property companies on Nasdaq Stockholm Main Market.

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

Per cent



[1] Market values 22/02/2022 and Q4 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

The preference for class D common shares continues as Fastpartner announces redemption of all preference shares while Klövern concludes last day of trading for their preference shares.

The secondary market for property-related alternative equity shares remained stable during the first weeks of 2022. As of 10/02/2022 the average dividend yields for both preference shares and Class D common shares were recorded at 6.1 and 6.4 per cent respectively. Thus, the yield spread between the two classes shares has increased somewhat to around 30 basis points which is higher than the three-year average of around 15 basis points.

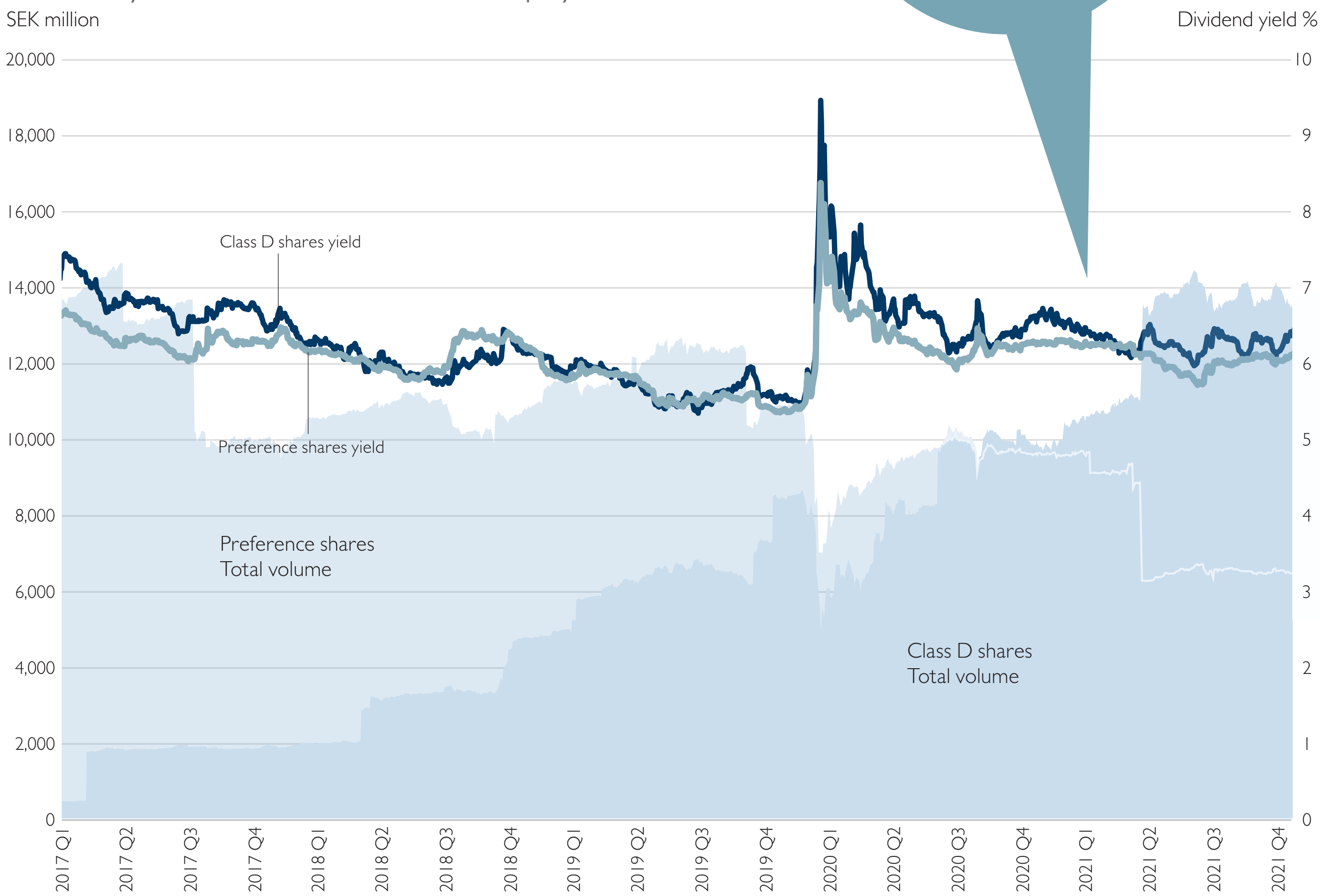
As described by the graph, the Class D common shares have become increasingly popular over preference shares. The trend of favouring Class D common shares intensified as Klövern delisted all outstanding preference shares as a part of Corem's tender offer. According to Corem, the reason for this is to increase financial flexibility and create better conditions for the company to reach an Investment Grade rating.

In the beginning of February 2022, Fastpartner announced an early redemption of all their outstanding preference shares. The reason behind the redemption of the company's preference shares is according to Fastparner a step in the process of optimising their balance sheet.

Fastpartner initially issued their preference shares in 2013, at the time preference shares were fully regarded as equity by rating agencies. However, as Fastpartner received an Investment Grade rating in 2021, the rating agencies considered preference shares to be equally part equity and debt and thus the board of the Fastpartner made the assessment that the preference share has played its role as a form of financing.

CLASS D COMMON SHARES MORE POPULAR
The trend of favouring Class D common shares intensified as Klövern delisted all outstanding preference shares as a part of Corem's tender offer.

Historical yield and volume – alternative equity shares



Source: Catella, annual reports, Nasdaq.

Catella's view through the looking glass

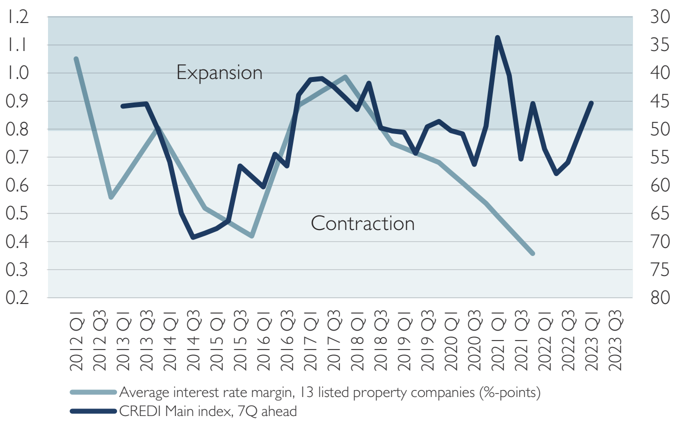
The financial markets are now expecting significant reductions in monetary stimuli from the main central banks going forward.

The listed property companies have gone through a correction since late November due to increasing real interest rates and have significantly underperformed the OMX Stockholm 30 so far in 2022. The market has, however, stabilised somewhat during the recent weeks and the average equity price for 36 of the largest listed property companies is still up around 36 per cent since early 2021 (compared to around 23 per cent for the OMX Stockholm 30). There are major equity market premiums on companies that focus on mix industrial properties, well located logistics, residential rental properties and/or public properties. However, the discount for several companies with a focus on retail and/or office properties remains. Despite the correction, the equity market is still indicating a pressure downwards on property yields in the coming 6–12 months as property is considered a traditional inflation hedge in portfolios.

It is likely that Omicron is the last phase of the pandemic and going forward there will be less monetary and fiscal stimuli. However, former stimuli will likely continue to support economic growth in most countries. This may not cause the supply side to recover to the extent where inflation falls back to post-pandemic levels. The nominal economic growth rate is currently around 8 and 9 per cent year-on year in Sweden and the US respectively. Short-term interest rates are around the zero mark in both economies. These are extremely low nominal interest rates in relation to the economic growth rate (even if the US growth rate will be reduced by less fiscal stimuli in 2022). Under normal circumstances, short-term interest rates should be close to the nominal growth rate of the economy. To slow down economic growth to just below the growth potential (around 2 per cent real GDP growth plus 2 per cent inflation), the central banks would need to increase rates and/or reduce their balance sheets quite forcefully. The problem is that asset prices have become addicted to negative real interest rates (created by asset purchases and low policy rates). It has become very hard for central banks to reduce support in a way that slows down economic growth/inflation, and still support asset prices enough to keep it from collapsing (which would create a credit crunch and a deep recession). In other words, central banks may be forced to accept an inflation/wage spiral from late 2022 and onwards. Catella's main scenario is that inflation and interest rates will follow a gradual uptrend from late 2022 until the next recession. Real interest rates will, however, likely remain low. This will support the property market and keep transaction volumes at reasonable levels.

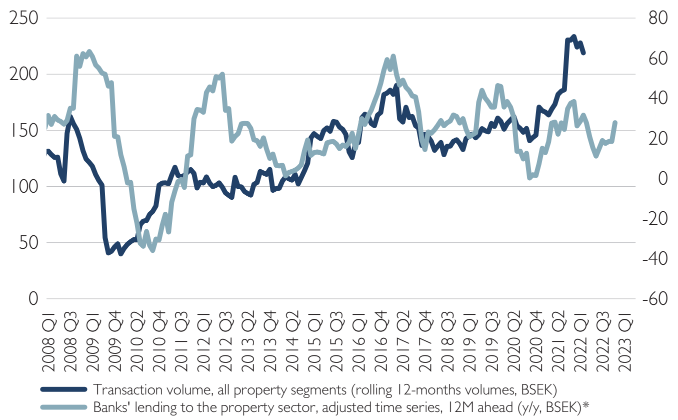
Average interest rate margins and CREDI Main index

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



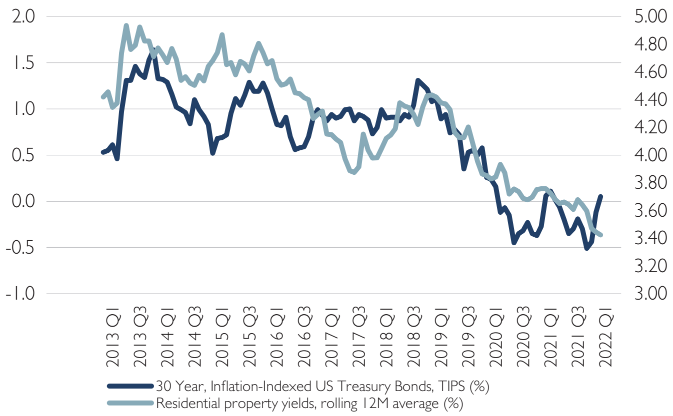
Transaction volume, bank lending commercial property

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



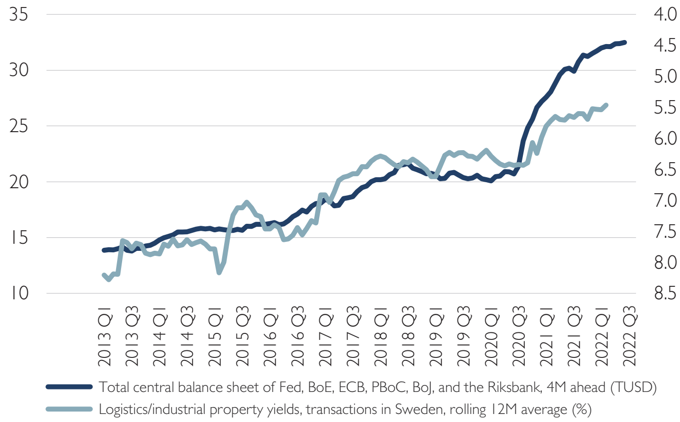
Real interest rates and residential yields

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.

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CATELLA

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