CATELLA

CREDI
CATELLA REAL ESTATE DEBT INDICATOR

CREDI December 2020

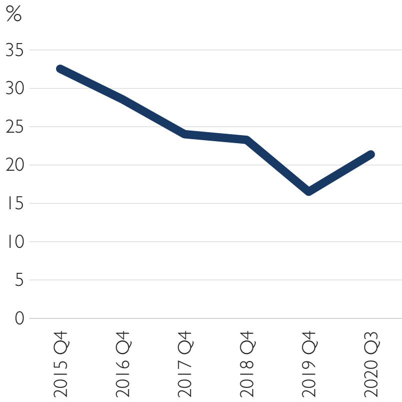
Credit market sentiment turns cold as credit margins increase

Banks turned bearish towards the property sector as credit margins increased while the stock market for property-related shares soared amidst positive vaccine trials.

- The CREDI Main index is back below the 50-mark as banks turned risk averse towards the property sector by increasing credit margins even for their more prominent corporate counterparts.
- Credit margins on the bank market have also increased somewhat since January. These also show that residential assets have seen a smaller increase in credit margins compared to offices and other commercial properties.
- Bond market rebounds while the changes in spreads vary in between property segments. Property companies focusing on offices have seen their credit margins increase three times more than the corresponding increase for property companies focusing on residential properties.
- The aggregate market for property related shares remains bullish following positive vaccine trials. Resilient sectors such as residential, public and industrial/logistics are cherished by investors while exposure towards retail, hotels and office remain unpopular.

CREDI Main index

Secured debt to total assets ratio



Loan-to-value Q3 average 55%

Interest rate Q3 average 1.9%

Fixed credit term Q3 average 3.4 y

Fixed interest term Q3 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 December publication of CREDI suggests a weakened credit market as the Main index decreases from 55.3 to 45.5 following increased credit margins.

MAIN INDEX COMPONENTS

Following the previously strong credit market in the October issue of CREDI, the Main index decreases from 55.3 to 45.5 in the December survey as respondents experienced higher credit margins. This implicates a rather substantial shift in credit sentiment as the credit market is back below the 50-mark.

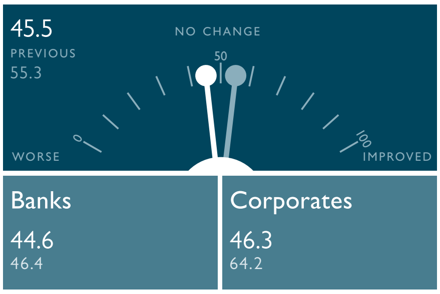
Going into further detail, the Current Situation index looks weak at 43.5, as compared to the previous recording of 57.7. Also, near-term expectations seem rather bearish with the Expectation index at 47.4, below the previous recording of 52.9.

The usual trend with more pessimistic banks than corporates continued, however, this CREDI survey illustrates a narrowing spread. Interestingly, a relatively large number of the respondents who saw increased current credit margins were corporates. Bearing in mind that the respondents of the CREDI survey are larger listed property companies with good access to debt capital in general, this suggests that banks are increasingly risk averse in the property sector as their adding risk premium to even their more prominent investment grade counterparts.

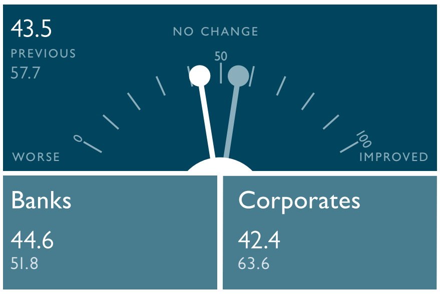
SUB-INDICES

The CREDI Main index is made up of eight underlying sub-indices. According to respondents in the December survey of 2020, credit availability remains stable while duration and leverage decrease slightly. Notably, tightening credit margins seems to have been the clear driver of the worsened credit market sentiment. Going forward, the theme remains similar while some corporate respondents are hoping for decreasing credit margins.

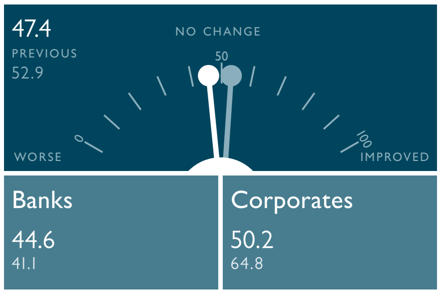
CREDI Main index



Current Situation



Expectation



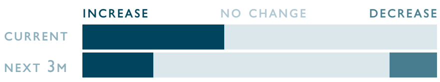
The CREDI sub-indices present survey data question by question. The bars represent the distribution of actual answers per question, separated into the components Current Situation and Expectation for the coming three months.

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 CREDI Indices remain stable in general and average interest rate is back below 2 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 QI 2000.

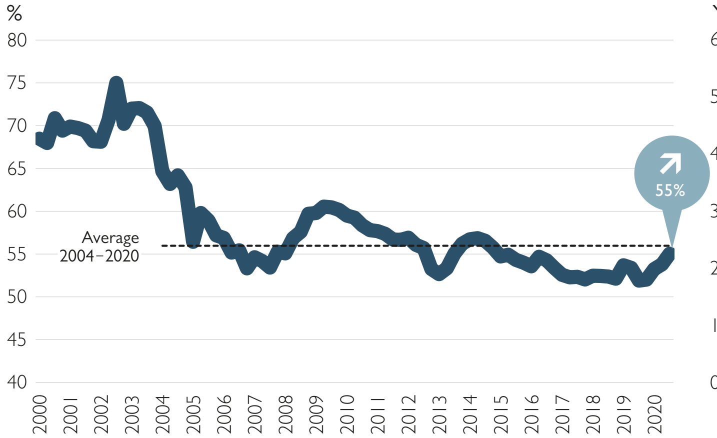
The purpose of the CREDI Indices is to track trends and changes in real estate financing by aggregating publicly available data.

During the quarter, the average interest rate reverted back below the 2 per cent mark as several property companies improve their financing terms and lower their rates. Most notably, Klövern, John Mattson and Nyfosa lowered their average interest rates by around 20 basis points. Diös lowered their average interest rate by 10 basis points to 1.2 per cent and is currently the company with the lowest average interest rate.

The average LTV level increased slightly during the quarter. Any major changes in book values stemming from the pandemic seems non-existent as the aggregated book values increased by circa 3 per cent in the third quarter.

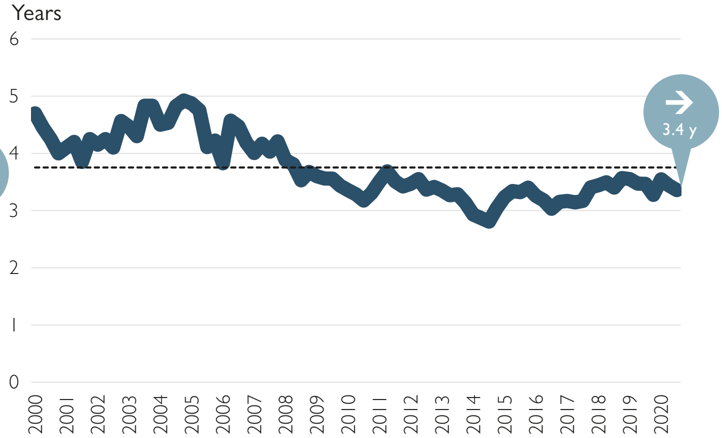
Furthermore, activity within fixed credit terms were calm as the average credit term remained at 3.4 years. Fixed interest terms decreased slightly to 3.0 years as activity remained low.

Loan-to-value[1]



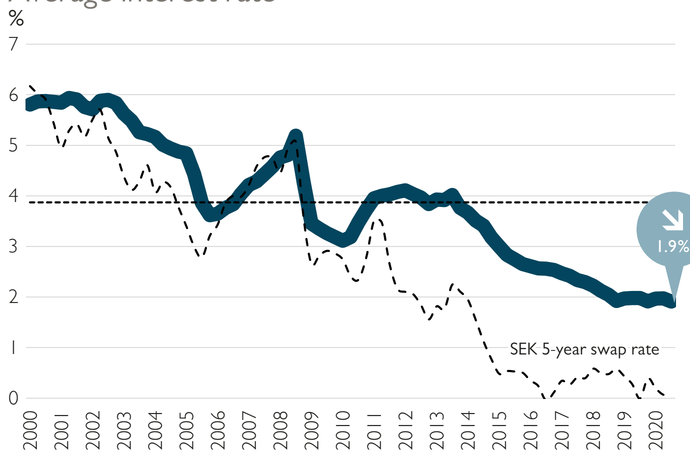
[1] Interest-bearing debt on property, excluding cash, divided by property value.

Fixed credit term[3]



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

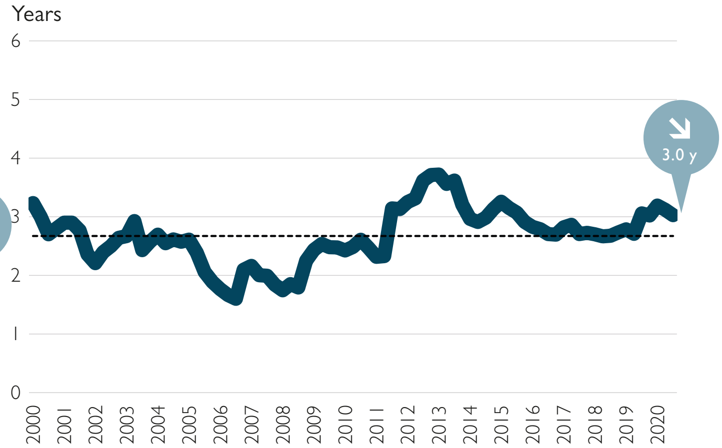
Average interest rate[2]



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

-------- Average 2000–2020

Fixed interest term[4]



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

Bank Debt

The market for bank debt has normalised during the third quarter, although credit margins are higher than in February.

An increased level of bond issuance in the third quarter resulted in net decrease in bank loans for larger property companies as these were being repaid. Credit margins for bank debt have increase during the year although this is somewhat mitigated by lower swap rates. Average bank interest rate for the residential sector was 1.5 per cent, the commercial sector 2.1 per cent and the construction sector 2.8 per cent, which means that bank credit margins for residential properties have developed more favourably than for commercial properties and construction.

The level of secured debt has started to decrease again after the significant trend shift during the spring when levels of secured debt increased. The changes in secured debt is a mirror image of the increase in unsecured bond debt during the period. Short-term debt was almost flat indicating a careful return to the commercial paper market.

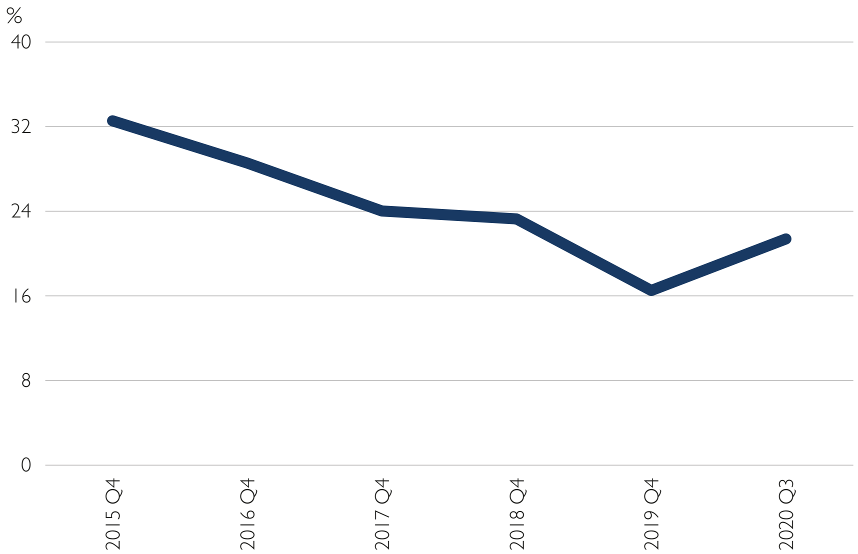
LEVEL OF SECURED DEBT INCREASED

Level of secured debt increased in 2020 as unsecured bonds were refinanced by secured bank loans, partly reversing the opposite trend of bonds replacing bank loans.

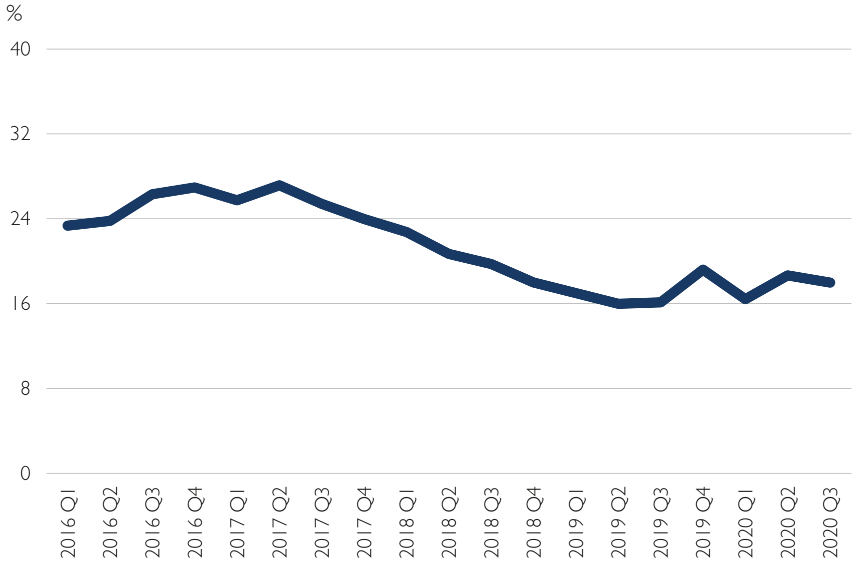
THE RIKSBANK FOCUS ON BANKS' ABILITY TO CONTINUE TO LEND

Towards the end of 2020 new increased risk weights will be implemented on real estate loans which may increase the credit margins further. In terms of volume the banks continue to increase their overall loan exposure towards real estate, and the Riksbank emphasizes in its latest report on the financial system that the banks are able to generate adequate supply of new bank loans.

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

Wave of new supply coming to the market as spreads are increasing yet again after strong improvement between March and early November.

Bond credit spreads improved steadily after the worst market turmoil in March until early November, at which point credit spreads started to increase again for borrowers with BBB-rating or below. A-rated companies were however not affected by the slight change in market sentiment and remain at similar levels compared to before the pandemic.

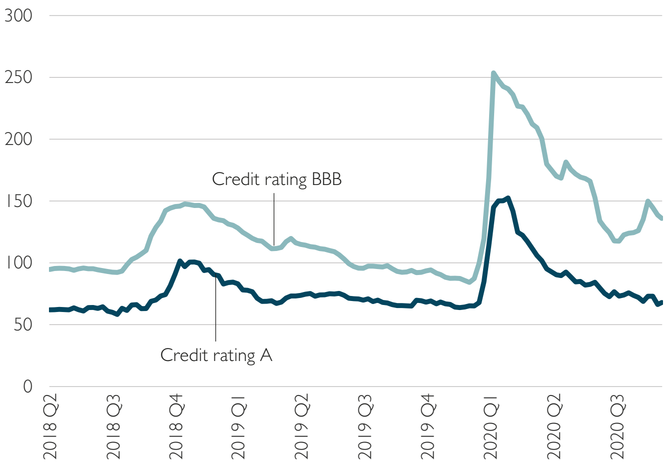
Different segments of the bond market have been affected differently by the pandemic. Bond spreads for the largest property companies with focus on offices have increased circa 30 basis points since February. This compares unfavourably to issuers with focus on the residential sector, where the increase in spread is only circa 10 basis points.

Assuming a 50 per cent LTV, a 30 basis points increase in bond spread equates to a 0.15 per cent increase in the cost of capital and a similar increase in property yields in order to achieve the same return on equity. However, swap spreads have decreased with about the same amount since February leaving the cost of capital and return on equity unchanged.

Volumes of issued bond debt improved and showed a significant net increase, indicating an active and liquid market. The net increase was however not as large as during the third quarter of 2019.

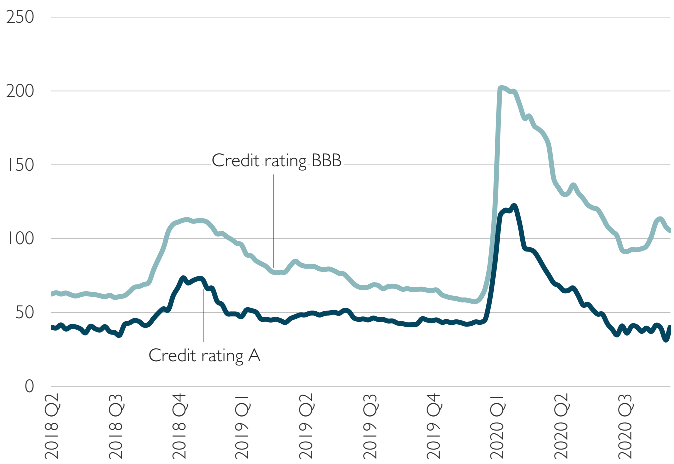
5-year bond credit spreads

Basis points



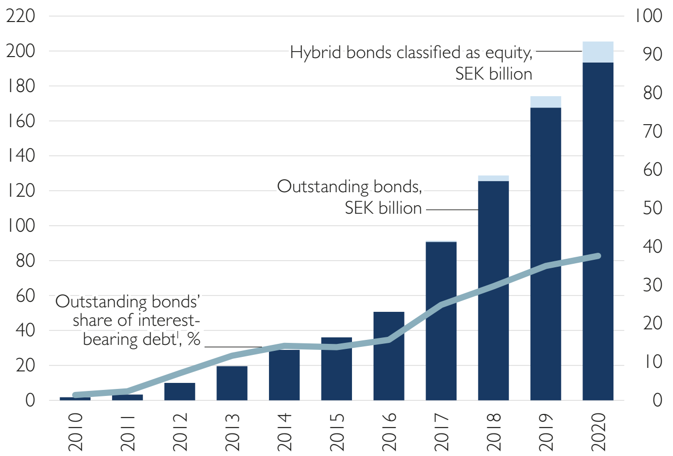
3-year bond credit spreads

Basis points



Outstanding bonds

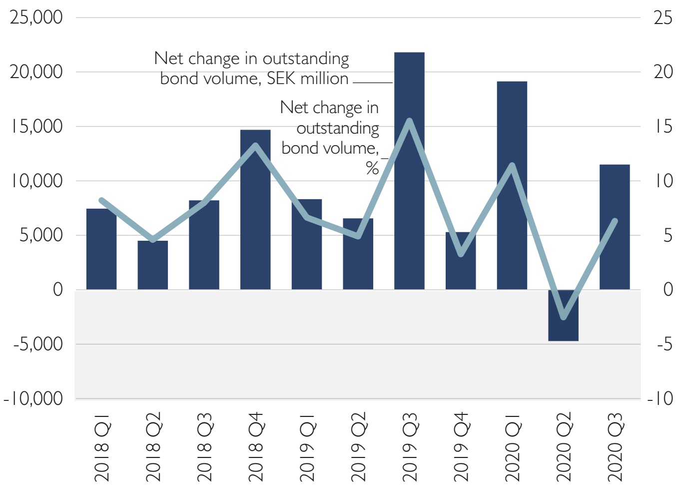
SEK billion / Per cent



[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

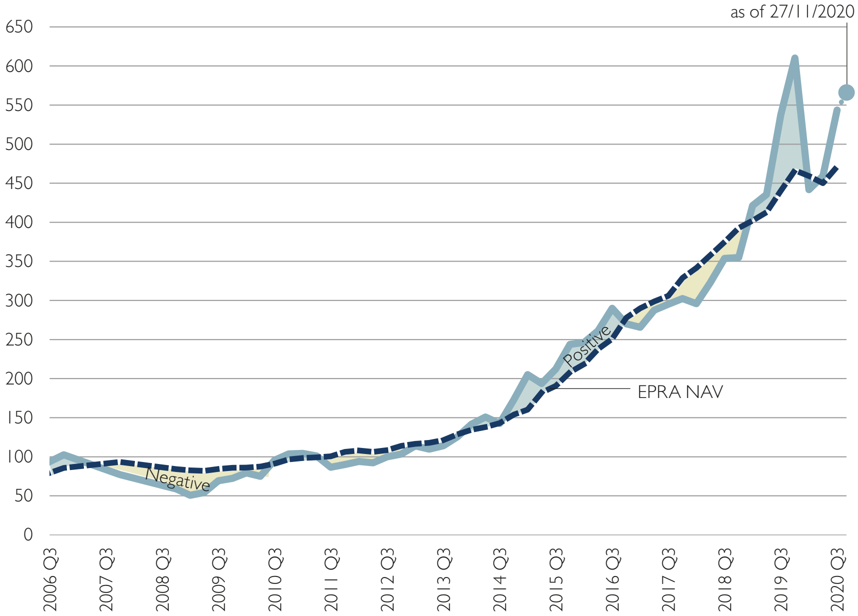


Common shares

The market for property-related shares remains bullish amidst positive vaccine trials. As of 27/11/2020, premium is recorded at around 20 per cent.

Premium or discount – market capitalisation as share of EPRA NAV

SEK billion

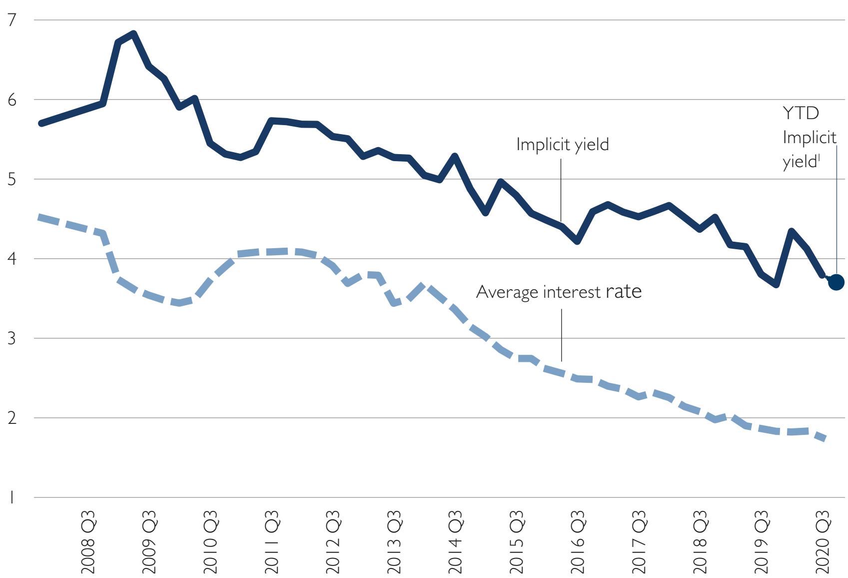


Note. Property companies on Nasdaq Stockholm Main Market. EPRA NAV includes a 25 per cent deduction for deferred tax, corresponding to 5.5 per cent when considering a tax rate of 22 per cent.

During the third quarter the listed market for property-related shares on the Nasdaq Stockholm Main Market remained strong with premium at 15 per cent at the end of the quarter. As of 27/11/2020, the premium increased further and is now at 20 per cent following positive vaccine trials. The pandemic has continued to affect the market as companies with exposure towards retail, hotel and office are traded at discounts while the more resilient sectors residential, public and industrial/logistics are traded at historically high premiums. In aggregate, the market remains strong as market capitalisation as of 27/11/2020 reached SEK 566 billion.

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

Per cent



[1] Market values 27/11/2020 and Q3 2020 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..

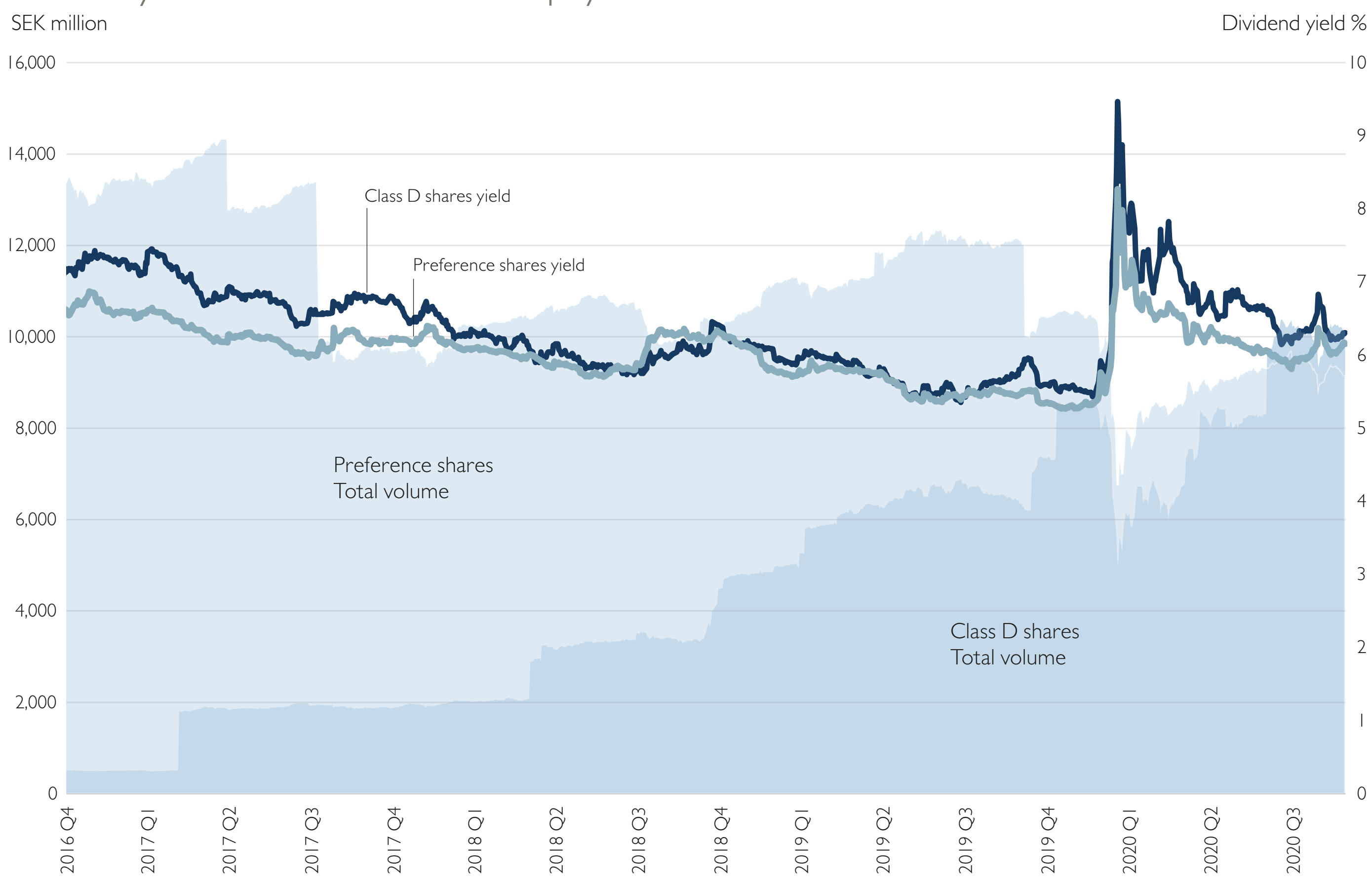
Implicit yields decreased further to 3.7 per cent as aggregated market capitalisation increased. Another trend that has caused implicit yields to fall is the increasing amount of property companies focusing on project development. As the stock market takes into account value from future projects, market capitalisation increases while cash flow stays put until projects are finished and tenants start paying rent. This has resulted in historically high premiums of project focused companies such as K-fastigheter and K2A, both of which are traded well-above 100 per cent premium to equity. As investors increasingly seem to favour project development activities, more and more companies are ramping up their project organisations suggesting lower implicit yields going forward.

Source: Catella, annual reports, Nasdaq.

Alternatives

The total volume for Class D common shares surpassed total volume for preference shares as SBB tapped the market for Class D common shares in order to fund large acquisition.

Historical yield and volume – alternative equity shares



The secondary market for property-related alternative equity shares remained stable during the third quarter as average dividend yields for both preference shares and class D common shares stayed just above 6 per cent. The yield spread between the two classes of shares decreased to around 15 basis points indicating a stabilised market as the spread previously widened in the market turmoil caused by the pandemic.

Looking at the graph, we can see that the total volume of outstanding class D shares went above the total volume for preference shares just after summer. The increase in class D common share volume is mainly attributable to the property company SBB who issued another 44,197,779 shares amounting to just below SEK 1.4 billion. The issue was made in connection with the acquisition of a NOK 4.25 billion portfolio of pre-schools in Norway and as such, the long-term trend of increased favour for class D common share financing amongst Nasdaq Main Market listed property companies has now resulted in the class D common share having a higher total volume. Going forward, class D shares remains the more attractive source of financing as the priority to cash flow and connection to credit ratings outweigh the small spread in financing cost.

Furthermore, we might see clearer variations in dividend yield amongst property companies with alternative equity, similar to what we have seen with common shares where resilient sectors gain investor attraction. However, segment exposure is only part of the equation as the dividend yield on alternative equity is also closely related to the issuers' individual balance sheet. Clouded by varying financial structures among different issuers, any clear variations depending on segment exposure are not yet visible.

Catella's view through the looking glass

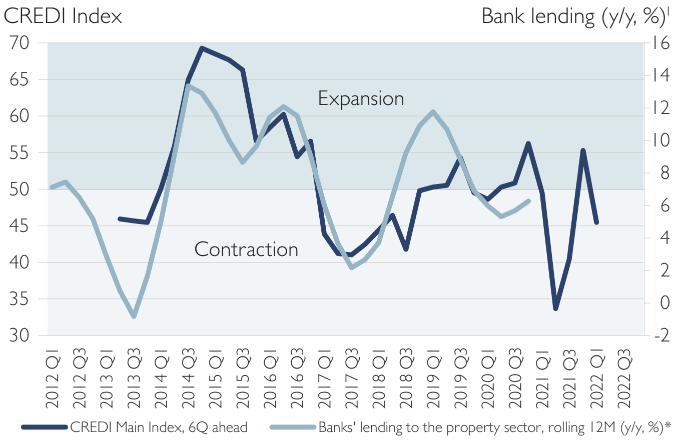
The world is currently in the midst of the second coronavirus wave and banks have started to become more careful in their lending as increased credit losses are expected going forward. The recent years' massive monetary and fiscal stimulus have however benefitted property in general.

Forecasts for the European economic growth have been revised downwards recently, and a second recession is expected during Q4 and Q1. In Sweden, however, the situation may look a little better. The consensus macro view among investors of low economic growth, low inflation and low interest rates for decades remains firm. Investors are 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 the main targets.

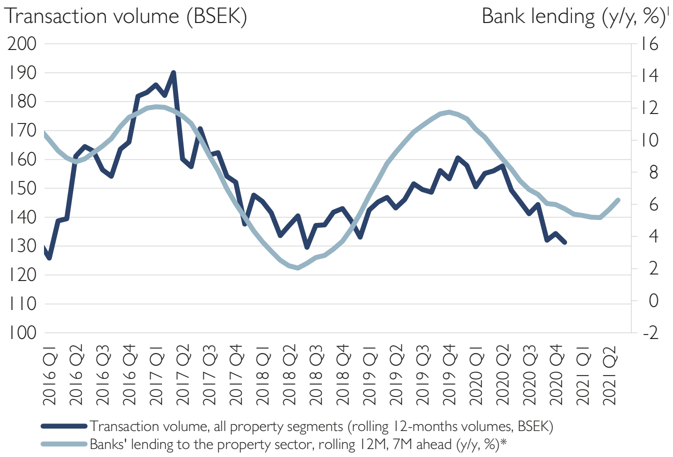
Over the last 12 months, the six central banks have added almost USD 7.8 trillion into the financial markets, and this liquidity has been instrumental in the recovery in asset prices. Average yield levels on the Swedish office transaction market are tightly correlated to assets of the six central banks. The level of central bank liquidity added to the market recently is indicating further declines in property yields going forward. This development is strengthened by the negative long-term real interest rates as indicated by the US 30 years TIPS.

From the late spring 2021 and onwards, economic growth may pick up significantly. By then vaccines and medical treatments of Covid-19 will be available at a large scale and potential new fiscal stimulus packages in both the USA and EU will have started to show effect on the economy. Growth could also be stimulated by government loan guarantees to investment projects that increase productivity/counter climate change. All this while the major central banks remain supportive with low policy rates and asset purchases. The current coordinated extreme fiscal and monetary policies are, however, also extremely inflationary (politicians are openly using the printing presses to stimulate the economy). More and more investors are starting to anticipate higher inflation ahead (which is exactly what the central banks want to achieve). The central banks will have a dangerous balancing act ahead, because there is limited room for higher long-term interest rates with today's property values.

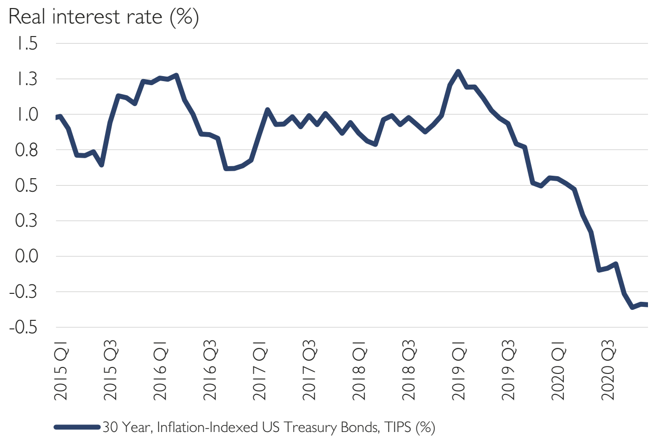
CREDI Main index, bank lending commercial property



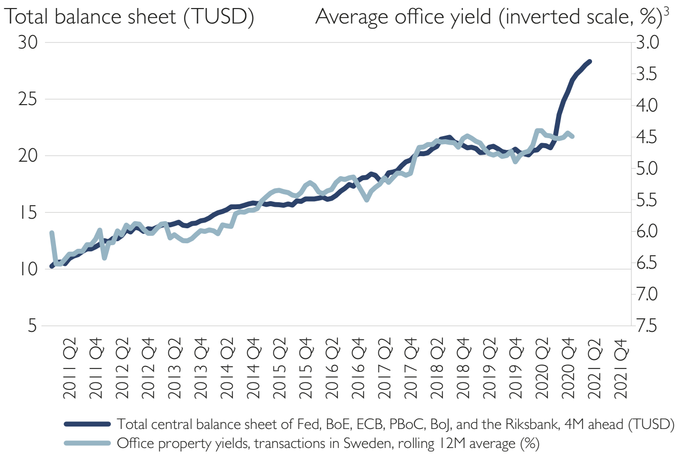
Transaction volume bank lending commercial property



30-year, inflation-indexed US Treasury bonds



Balance sheet[2] and yields office property transactions



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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CATELLA

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.

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