FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Hemsö Fastighets AB 'A' IDR; Outlook Stable

Wed 01 Apr, 2020 - 7:23 AM ET

Fitch Ratings - Frankfurt am Main - 01 Apr 2020: Fitch Ratings has assigned the Swedish property company Hemsö Fastighets AB Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'A' with Stable Outlooks and a Short-Term IDR of 'F1+'.

Fitch rates Hemsö under its Revenue-Supported Rating Criteria and takes into account factors such as revenue defensibility, operating risk and financial profile. Hemsö's ratings factor in its high leverage, which we expect to decline towards 14.4x in the medium term on the back of a large development plan supporting the entity's cash flow and increasing EBITDA. The high leverage is somewhat offset by Hemsö's strong liquidity position.

Fitch applies a two-notch uplift to Hemsö's 'bbb+' Standalone Credit Profile (SCP), reflecting its strong link to its owner.

Hemsö is one of the largest property providers focused on social infrastructure including nursing homes and educational, health care and judicial properties. It is 85% owned by AP3, one of five Swedish pension funds. AP3 has a call option for the remaining 15% owned by Sagax, a Swedish private for-profit property company. Due to this, AP3 directly and indirectly owns and controls 100% of Hemsö. Hemsö operates in Sweden (63% to its net operating income; NOI), Finland (20%) and Germany (17%). Following its business strategy, Hemsö is actively divesting its non-core properties towards social infrastructure properties, where it is an important niche player.

KEY RATING DRIVERS

'bbb+' SCP

'Stronger' Revenue Defensibility: Fitch assesses Hemsö's demand characteristics as 'Stronger' based on a high demand for social infrastructure in Sweden (AAA/Stable). The country is expecting population growth of 10% from 2017-2029 and growth of 58% for people over 80 years old. Finland and Germany, which form part of Hemsö's international business, are also expecting an increase in population and an increasing share of elderly people.

Hemsö has a well-established relationship with the public sector, contributing positively to its demand. This is reflected in a large, and increasing, share of its rental revenue coming from public service-oriented properties (2019: 62%) with long leases, and relatively highly rated counterparties. This is supportive of the company's revenue sustainability and strengthens its business profile.

At present, Hemsö has exposure to a significant level of private rental income, but this is mitigated by undersupply in the market place and the obligation of Swedish municipalities to provide these services. If a private provider stopped operating it is expected the public sector would step in, in order to meet this obligation of service provision. Hemsö has identified social infrastructure as a growth area, driven by the population growth and undersupply, so we assume the share of rents stemming from private tenants to continue to decline. Hemsö is actively divesting its non-core properties, which should further reduce the vacancy rate (2019: 1.9%).

Hemsö increased lease duration to 9.9 years in 2019 from 8.0 years in 2016, supporting the predictability of cash flows.

We have assumed some additional stress in our rating case in light of the COVID-19 outbreak, which may have a limited impact on Hemsö's financial results. However, considering this, we expect the public sector tenants (which includes municipalities, counties and the central government in Sweden), generating 62% of its revenues in 2019, to maintain its contractual agreements, further considering the public mission and the obligation of Swedish municipalities to provide these services. Thus, the overall effect on Hemsö should not affect the EBITDA and leverage assumptions in our rating case.

Fitch considers the pricing characteristic as 'Stronger'. Hemsö is not following a policy mission and changes in prices are not sensitive to demand. Considering the last 10 years performance, property income covered property cost by over 3x and this increased to 4x in 2019 from 3.4x in 2010. To ensure a stable, predictable and inflation-adjusted income, Hemsö is aiming to expand its long-term lease agreements. The average lease was 9.9 years at end-2019 and lease agreements for new construction are showing tenors of 15-25 years. The agreements include annual rent adjustments to reflect increases in the consumer price index. New construction is showing tenors of 15-25 years. The agreements include annual rent adjustments to reflect increases in the consumer price index.

'Stronger' Operating Risk: In Fitch's view, Hemsö's operating costs are well identified and are not affected by significant volatility. They have been consecutively increased over the past 10 years, but their growth remained below that of the properties income. Hemsö's EBITDA increased to SEK2,139 million in 2019 from SEK899 million in 2010. We expect the trend to continue reflecting improving cash flows, inflation-linked contractual agreements and no meaningful increase in the share of staff costs to operating spending. The increase of Hemsö's expenditure stems from its development and corresponding maintenance costs, which are scheduled to grow more slowly than operating revenue stemming from new projects.

Hemsö has an ambitious investment plan in 2020-2024, but we assume it has flexibility in timing of major costs and is able to postpone scheduled investments in case of need.

We assume vacancy risk is not material, considering the high demand for properties managed by Hemsö. Property costs are mainly derived from operating costs related to heating, electricity, maintenance, property tax and leasehold fees. We assume this risk to be mitigated based on Hemsö's expertise and prudent management forcing efficiency gains in order to reduce property costs and Hemsö is active in improving building standards.

'Midrange' Financial Profile: We expect Hemsö's debt to increase to SEK41.6 billion (2019: SEK35.5 billion) by 2023, driven by an ambitious investment plan, resulting in an increase in assets to SEK74.8 billion in 2023 from SEK57.9 billion in 2019. Since this investment plan is considering projects that should improve Hemsö's cash-flow in 2020-2023, we expect its EBITDA to increase to SEK2.9 billion in 2023 from SEK2.1 billion in 2019 and its Fitch calculated net debt/EBITDA to decline to 14.4x from 16.3x in the same period, further supported by scheduled divestments of commercial properties. Hemsö's financial profile is supported by its sound liquidity position of SEK988 million at end-2019 and ample access to liquidity as well as SEK12.7 billion of committed credit lines, adding available liquidity to SEK13.6 billion at end-2019, which covers Hemsö's debt maturing in 2020 by 173%.

Additional Risk Factors Assessed as Neutral

Fitch does not consider Hemsö faces any additional risk that could negatively impact its SCP. Fitch views Hemsö's financial management as prudent, particularly given the regular update of its multi-year financial plan and the entirely hedged FX and interest-rate risk.

Support Assessment

Our assessment of the four factors under our Government Related Entities (GRE) Criteria leads to a score of 17.5 points and the application of the bottom-up approach with a two-notch uplift.

'Strong' Status, Ownership & Control: Hemsö is a commercial law company and is exposed to bankruptcy law and there is no automatic liability transfer of its assets and liabilities to its owner. Hemsö is 85% owned by the Swedish pension fund AP3 and AP3 has a call option to acquire the remaining share from the minority shareholder Sagax and as such has a controlling stake of 100%. In our view, Hemsö is tightly controlled and monitored by AP3, which appoints its board and sets and approves Hemsö's long-term business strategy.

AP3 is a public pension fund and is one out of five independent governmental authorities, managing its insurance funds for income based pensions independently. AP3 is subject to the Public Pension Funds (AP Funds) Act and is require by law to provide all proceeds to the Swedish Pension Agency, paying out pensions on behalf of the retirees. The members of AP3's board are appointed by the government and they are required to report at least annually to the government, which reports to the parliament. AP3 is supervised by the Swedish Financial Supervisory Authority and in Fitch's view, the Swedish government has significant control over the fund via the appointed board members. AP3 has access to liquidity at the National Debt Office, which is managing Sweden's debt. Fitch views AP3 ultimately strongly linked to the state, further considering the important public mission the fund provides.

'Moderate' Support Track Record & Expectations: AP3 views Hemsö as a strategic investment, which is paying dividends to its owner (2019: SEK721 million). Hemsö is not reliant on operational grants and subsidies. Support to Hemsö is granted by AP3 in form of a committed credit facility of SEK5 billion, strengthening Hemsö's liquidity profile. Based on a subscription agreement, AP3 is further committed to buy up to SEK5 billion of commercial paper out of Hemsö's SEK8 billion Commercial Paper Programme, should Hemsö face difficulties placing it in the capital markets. Direct financial support is granted irregularly in form of capital injections. AP3 has agreed to increase Hemsö's equity capital by SEK2 billion to support its business growth. SEK1 billion was contributed in 2019, and SEK1 billion is envisaged for 2020. Given continuing growth beyond 2020, we expect additional equity will most likely be injected also in 2021.

There are no restrictions towards support and AP3 could buy Hemsö's bonds or grant loans to it but it is not allowed to provide a guarantee towards Hemsö's debt.

'Moderate' Social-Political Implications of a Default: Hemsö is a niche player in an important and increasing market, driven by Sweden's estimated population growth and the obligation of the government to provide a sufficient level of social infrastructure. Fitch considers a default of Hemsö would not automatically lead to an interruption of its services, as the operating properties are self-funded by long term lease contracts with the tenants. A default would endanger the company's position in the capital market and future funding of its investment and development programme. However, this is moderately political sensitive, as we assume owner support for Hemsö as likely to remain operative. We also believe Hemsö's activities could be gradually taken over by other private or public players, considering its relative low market share (the issuer estimates its market share for nursing homes in Sweden at 5% of the total market and for education excluding universities at 1%).

'Moderate' Financial Implications of a Default: Hemsö benefits from a strong and sustained presence in the financial markets as a frequent issuer of local and foreign currency bonds and loans, having successfully established a EUR3 billion EMTN Programme, a SEK12 billion MTN Programme and a SEK8 billion CP Programme. Given its commercial law status and non-policy-role, its link to the public sector are based on the 85% ownership of AP3. We are not assuming Hemsö to be a proxy-funding vehicle and its debt is marginal in the context of the central government's debt (AP3 is debt-free). A default of Hemsö would have only a moderate impact on the availability and cost of funding for the public sector and other Swedish GREs.

DERIVATION SUMMARY

The combination of a 'bbb+' SCP and the bottom-up approach with a two-notch uplift leads to a Long-Term IDR of 'A'.

The 'F1+' Short-Term IDR reflects a 'Stronger' assessment of revenue defensibility, a coverage ratio above 4x at end-2019 and a liquidity profile and debt characteristics assessed as 'Neutral'.

RATING SENSITIVITIES

An upgrade of Hemsö's IDRs could result from a strengthening of its SCP, based on net-debt-to-EBITDA declining to 12x. An upgrade could also result from our assessment of an improved strength-of-linkage or incentive-to-support under our GRE Criteria.

A downgrade of the IDRs could result from a weaker assessment of Hemsö's SCP, with a net-debt-to-EBITDA sustainably above 15x. A downgrade could also result from our assessment of diminished strength of linkage or incentive-to-support under our GRE Criteria.

BEST/WORST CASE RATING SCENARIO

Ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING		
Hemso Fastighets AB	LT IDR	A	New Rating
•	ST IDR	F1+	New Rating
•	LC LT IDR	A	New Rating
•	LC ST	F1+	New Rating

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 13 Nov 2019)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

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