FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Hemsö Fastighets AB to 'A+'; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 31 Mar 2021: Fitch Ratings has upgraded Swedish property company Hemsö Fastighets AB's (Hemsö) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'A+' from 'A' with Stable Outlooks. Fitch has affirmed the Short-Term IDRs at 'F1+'. Fitch has also upgraded the senior unsecured rating of the outstanding EUR500 million bond issued by Hemsö Treasury OYJ to 'A+' from 'A'.

The upgrade of the Long-Term IDRs is based on Fitch's application of a three-notch uplift applying the bottom-up approach instead of the former application of a two-notch uplift. Neither the GRE support score (17.5 points) applying the Government Related Entities (GRE) Criteria, nor the Standalone Credit Profile (SCP; bbb+) has changed.

Feedback

Fitch has applied the highest uplift possible having considered SEK1 billion capital injections in 2019 and 2020 from Hemsö's owner, the Swedish pension fund AP3. We assume Hemsö will receive another SEK1 billion in 2021. We view AP3's investment in Hemsö as a consistent and sustained from of support of Hemsö's business activities. The support mitigates the impact of the entity's ambitious development plans on credit metrics (notably leverage).

The upgrade of Hemsö Treasury OYJ's bond rating is based on the unconditionally and irrevocably guarantee by Hemsö. Hemsö Treasury OYJ is a subsidiary of and fully owned and controlled by Hemsö and any change in Hemsö's Long-Term IDR will be reflected in the senior unsecured rating assigned to the bond, issued out of Hemsö's EUR4 billion EMTN programme.

Hemsö is one of the largest Swedish 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. Consequently, AP3 directly and indirectly owns and controls 100% of Hemsö. Hemsö operates in Sweden (68% of its net operating income; NOI), Finland (16%) and Germany (16%). 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

Status, Ownership and Control: 'Strong'

Hemsö is a commercial law company exposed to bankruptcy law and there is no automatic liability transfer of its assets and liabilities to its owner. 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.

The members of AP3's board are appointed by the government and are required to report at least annually to the government, which reports to 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 manages Sweden's debt. Fitch views AP3 as ultimately strongly linked to the state, also considering the important public mission the fund provides.

Feedback

Support Track Record: 'Moderate'

AP3 views Hemsö as a strategic investment, which pays dividends to its owner (2020: SEK860 million). Hemsö is not reliant on operational grants and subsidies. However, there are tangible signs of support granted by AP3 in form of a multi-annual committed credit facility of SEK5 billion, strengthening Hemsö's liquidity profile. This is based on a subscription agreement and AP3 is committed to buy up to SEK5 billion of commercial paper (CP) out of Hemsö's SEK8 billion CP Programme, should Hemsö face difficulties placing it in the capital markets.

Direct financial support has been granted through capital injections to support Hemsö's business growth. SEK1 billion was contributed in 2019 and SEK1 billion again in 2020. Given continuing growth beyond 2020, we assume the issuer will receive additional equity of SEK1 billion in 2021.There are no restrictions on support. AP3 could buy Hemsö's bonds or grant loans to it but is not allowed to guarantee Hemsö's debt.

Socio-Political Implications of Default: 'Moderate'

Hemsö operates in an important and increasing market, driven by Sweden's estimated population growth and the government's obligation to provide sufficient 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 damage the company's position in the capital market and funding of its investment and development programme. However, this is moderately politically sensitive.

We 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%).

Feedback

Financial Implications of Default: 'Moderate'

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 EUR4 billion EMTN Programme, a SEK12 billion MTN Programme and a SEK8 billion CP Programme. Given its commercial law status and non-policy-role, Hemsö's links to the public sector are based on AP3's 85% ownership.

We do not consider Hemsö 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.

STANDALONE CREDIT PROFILE

Fitch rates Hemsö under its Revenue-Supported Rating Criteria and takes into account factors such as revenue defensibility, operating risk and financial profile. Its SCP factors in its high leverage, which we expect to decline towards 14.1x in the medium term. The high leverage is somewhat offset by Hemsö's strong liquidity position, amounting to SEK13.4 billion at end-2020 (including credit facilities of SEK12.5 billion, of which a high proportion is committed over several years and SEK0.9 billion of cash).

Revenue Defensibility: 'Stronger'

Fitch assesses Hemsö's demand characteristics as 'Stronger' based on a high demand for social infrastructure in Sweden (AAA/Stable). The country expects population growth of 10% between 2017-2029 and growth of 58% for people over 80 years old. Finland and Germany also expect an increase in population and an increasing share of elderly people.

Hemsö has a well-established relationship with the public sector, which contributes positively to its demand. This is reflected in a large and increasing share of its rental revenue coming from public service-oriented properties (2020: 63%) with long leases, and relatively highly rated counterparties. In 2020, 94% of rental income was directly or indirectly backed by public tenants (tax financed). This supports 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 the public sector would likely step in to meet this obligation. 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 will continue to decline.

Hemsö is actively divesting its non-core properties, which should keep the vacancy rate below 2%. Hemsö increased average lease duration to 9.8 years in 2020 from 8.0 years in 2016, supporting the cash flow predictability.

We have assumed a moderate stress in our rating case, and we assume the pandemic to have a limited impact on Hemsö's financial results. We expect public sector tenants (including municipalities, counties and the central government in Sweden), which generated 63% of revenues in 2020, to maintain contractual agreements.

Considering the entity's 2020 results, long-term leases, high occupancy rate of 97.9% in 4Q20, low vacancy rate of below 2% in 2020 and the high demand of the properties within Hemsö's portfolio, the overall effect of the pandemic will not affect our EBITDA and leverage assumptions in the rating case.

Fitch considers 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 costs by over 3x and was 3.4x in 4Q20. To ensure a stable, predictable and inflation-adjusted income, Hemsö aims to expand its long-term lease agreements. The average lease was 9.8 years at end-2020 and lease agreements for new construction are 15-25 years. The agreements include annual rent adjustments to reflect increases in the consumer price index.

Operating Risk: 'Stronger'

Fitch assesses Operating Risk at 'Stronger', with Operating Cost and Resource Management also 'Stronger'. In Fitch's view, Hemsö's operating costs are well identified and are not affected by significant volatility. They have consecutively increased over the past 10 years, but growth remained below that of the properties' income.

Hemsö's EBITDA increased to SEK2,358 million in 2020 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 in 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 aims for further growth including investments averaging at SEK4.5 billion (SEK2.1 billion on a net basis) in 2021-2025, 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 is mitigated, based on Hemsö's expertise and prudent management and Hemsö improving building standards.

Financial Profile: 'Hemsö's financial profile is assessed at 'Midrange'.'

We expect Hemsö's net adjusted debt to increase to SEK50.3 billion (2020: SEK37.8 billion) by 2025, driven by cumulative investments of SEK22.7 billion. SEK6.6 billion may be spent in 2021 and SEK5 billion in 2022. Investments will decline below SEK4 billion in 2023-2025. This will result in an increase in assets to SEK94.8 billion in 2025 from SEK65.2 billion in 2020.

As the investment plan includes projects that should improve Hemsö's cash flow in 2021-2025, we expect EBITDA to increase to SEK3.6 billion in 2025 from SEK2.4 billion in 2020 and for Fitch calculated net debt/EBITDA to decline to 14.1x from 16x in the same period, supported by scheduled divestments of commercial properties.

Hemsö's financial profile is supported by its sound liquidity position of SEK891 million at end-2020 and ample access to liquidity as well as SEK12.5 billion of committed credit lines, of which a large proportion is committed over several years by strong counterparties, adding available liquidity to SEK13.4 billion at end-2020, which covers Hemsö's debt maturing in 2021 by 3x.

ADDITIONAL RISK FACTORS ASSESSMENT

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.

OPERATING PERFORMANCE

Hemsö's operating performance improved during 2020. Hemsö aims to further divest commercial properties and increase the share of social infrastructure. Since this goes along with new constructions and long-term leases, asset quality will improve and maintenance costs decline, while the revenues are sustained and overall risk decreases, as an increasing share of rent is paid by public entities.

In 2020, Hemsö's EBITDA improved to SEK2,358 million (2019: SEK2,141 million) and the company's leverage remained stable at 16.0x (2019: 16.1x). Despite an increase in debt and higher interest expenditure, interest coverage remains strong above 4x.

Hemsö will focus on organic growth, aiming to increase EBITDA to SEK3.6 billion. The envisaged improved asset base and rental income will overcompensate for the debt increase and leverage is likely to decline to 13.7x based on the issuer's figures. In our rating case, this may be 14.1x by 2025, in line with the current financial profile assessment.

DERIVATION SUMMARY

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

SHORT-TERM RATINGS

The affirmation of the 'F1+' Short-Term IDR reflects a 'Stronger' assessment of revenue defensibility, a coverage ratio above 4x at end-2020 and a liquidity profile and debt characteristics assessed as 'Neutral'.

RATING SENSITIVITIES

FACTORS THAT COULD, INDIVIDUALLY OR COLLECTIVELY, LEAD TO NEGATIVE RATING ACTION/DOWNGRADE:

A downgrade of the IDRs could result from a weaker assessment of Hemsö's SCP, with 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.

FACTORS THAT COULD, INDIVIDUALLY OR COLLECTIVELY, LEAD TO POSITIVE RATING ACTION/UPGRADE:

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

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure 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, visit [https://www.fitchratings.com/site/re/10111579].

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER RATING

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

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Hemso Fastighets AB	LT IDR	A+ Rating Outlook Stable	Upgrade	A Rating Outlook Stable
•	ST IDR	F1+	Affirmed	F1+

ENTITY/DEBT	RATING			PRIOR
•	LC LT IDR	A+ Rating Outlook Stable	Upgrade	A Rating Outlook Stable
•	LC ST	F1+	Affirmed	F1+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 23 Feb 2021) (including rating assumption sensitivity)

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ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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