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Research Update:

Swedish Property Company Hemso Fastighets AB 'A-/A-2' And 'K-1' Ratings Affirmed; Outlook Stable

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Overview

- Thanks to Hemsö's strategy for active divestments and refinement of its property portfolio, tangible vacancy risks are diminishing, securing strong asset quality and supporting Hemsö's strong enterprise risk profile.
- We observe that Hemsö is adding multiple multilateral sources to its funding mix. This, together with active treasury management, is set to lengthen its debt maturity profile, creating a more resilient financial risk profile amid continuing ambitious expansion.
- We are affirming our 'A-/A-2' and 'K-1' ratings on Hemsö.
- The stable outlook reflects our view that Hemsö will continue reporting strong and stable operating cash flow and debt-service metrics, mitigating risks associated with the company's expansion over the next 24 months.

Rating Action

On June 7, 2018, S&P Global Ratings affirmed its 'A-/A-2' long- and short-term issuer credit ratings on Swedish housing provider Hemsö Fastighets AB. The outlook is stable.

We also affirmed our 'K-1' short-term Nordic regional scale rating on the company.

At the same time, we affirmed our 'A-' long-term issue rating on Hemsö's senior unsecured debt.

Rationale

The affirmation reflects our view that Hemsö will continue to display robust financial performance on the back of strong profitability from projects coming on stream in the next few years. This will support the balance sheet's resilience through 2020 and offset risks from the company's expansion agenda, which entails notable increases in debt. As such, we expect Hemsö's debt sustainability metrics (debt to EBITDA and EBITDA interest coverage) to remain stable through 2020. We also project that the company's business strategy will not change materially, so the majority of rental revenues will continue to stem from public-sector tenants.

We determine the ratings on Hemsö by benchmarking against factors in our criteria for rating public housing providers: industry risk, economic fundamentals, market position, financial performance, debt, liquidity, and financial policies. Hemsö differs from its rated peers in the public housing and real estate sectors because it has higher exposure to private-sector corporate tenants (41% of revenues) and is actively expanding internationally. Hemsö's exposure to higher risk leads us to apply a negative adjustment to the long-term rating.

We consider that Hemsö has a strong enterprise risk profile, based on our view of its low industry risk, solid economic fundamentals, and strong market position. Due to the company's established relationship with the public sector and its efficient project-management processes, Hemsö enjoys robust demand for its services. As a result, the majority (59%) of its rental income stems from public-service-related properties with long leases. Hemsö's revenues therefore display modest cyclicality, and the high credit quality of its public-sector tenants supports its overall business profile.

However, we note that large private public services providers, especially in elderly care and education, are among Hemsö's tenants, adding an element of risk. Furthermore, we observe that there is a material undersupply of elderly care facilities and school buildings in the municipalities where Hemsö is active. Because Swedish municipalities are legally obliged to supply these services, there is a high probability that the public sector would assume those operations in the event of a fall-off of private operators, in our view. While default risk of individual private operators exists, we consider re-letting risk low, since the municipality would likely step in to ensure provision of legally mandated public services.

Hemsö is one of the largest providers of public service properties in Sweden, whose economic fundamentals also support a high demand for public services. Moreover, over the past two to three years, Hemsö has actively divested properties not considered attractive long-term holdings. We view as positive the company's refinement of its property portfolio into key growth areas where there is a strong demand for public services, and undersupply of public services facilities. In our view, these market characteristics mitigate some of the risks from having a high share of private public-services operators as tenants. Together, with a healthy rate of new construction, its portfolio of properties show further improving asset characteristics; its economic vacancy rate is a very low 1.9% as of March 31, 2018. Moreover, Hemsö worked actively to increase the average lease duration to 9.1 years as of that date, from 8.1 years at end-2016, which supports the predictability of its cash flows and further strengthens its business fundamentals.

Nevertheless, Hemsö's appetite for international expansion continues. Its non-domestic exposures (Germany and Finland) accounted for 25% of property value as of first-quarter 2018, up from 18% one year earlier. In this regard, we note that parts of the increase in external value is related to currency effects. Still, Hemsö's international presence, originally due to a legacy portfolio in elderly care in Germany, has increased lately due to the company's search for higher-yielding properties and desire to diversify across several property markets. Hemsö's international agenda contributes an element of risk that negatively differentiates it from its peers; however, a rising proportion of its international rental income comes directly from public entities. We also note that management is continuously gaining experience in the education and research segments in Germany and Finland, relatively new markets for Hemsö. Overall, we still regard Hemsö's strategy as well aligned with its organizational capabilities and market conditions, even though its nontraditional activities weigh on our assessment of its economic fundamentals.

We believe that Hemsö's ownership structure strengthens its ties with the public sector. The Swedish sovereign wealth fund Tredje AP-fonden owns Hemsö and is actively involved in defining the company's strategy. We understand that Tredje AP-fonden considers Hemsö to be a long-term core investment. The owner holds vast liquid assets and provides ongoing support through an agreement to subscribe to commercial paper of up to Swedish krona (SEK) 4 billion (about €400 million) if Hemsö has difficulties issuing in the market. In addition, based on publicly stated capitalization targets for Hemsö, Tredje AP-fonden appears committed to injecting capital if Hemsö's capitalization falls below the minimum target, and financial covenants in loans agreements indicate that Tredje AP-fonden will remain Hemsö's majority shareholder.

Hemsö is following an ambitious expansion plan. In our base case for 2018-2020, we assume that Hemsö's investments in new construction will average SEK2.3 billion per year, thereby contributing to its rapidly expanding balance sheet. In addition, because acquisitions are set to remain a key component of Hemsö's expansion strategy, we expect the company will finance this part of the growth through divestments, in addition to a further enhancement of its existing property portfolio.

We consider Hemsö's financial performance to be strong, as demonstrated by a five-year average EBITDA-to-revenue ratio of 69%. We foresee that higher-yielding German and Finnish properties coming on stream, in combination with gradual modernization of the Swedish property portfolio, will help strengthen profit margins. We expect EBITDA to revenues will slightly exceed 70% this year. Although we see potential risks from the company's expansion and associated debt buildup, we anticipate that continued strong performance will keep its financial position resilient.

Hemsö conducts mark-to-market valuations of its properties under International Financial Reporting Standards. As such, its balance sheet is exposed to market volatility. However, we observe that Hemsö's niche segment of public-policy-related properties has remained attractive, with no negative spill-over effects on yields or values from the subdued sentiment in the Swedish residential real estate market since August 2017. Therefore, we anticipate that fairly stable values of Hemsö's social infrastructure properties will underpin the balance sheet's resilience throughout our base case. Since we project strong profitability, we foresee Hemsö's debt to debt plus equity reducing to 68% in 2020 from 70% in 2017, despite a notable nominal increase in debt of SEK6.4 billion.

Hemsö holds a competent financial management with prudent risk tolerance levels and active treasury management. The maturity profile of its loans have increased notably in recent years standing at 5.7 years at the end of first-quarter 2018 compared with 3.9 years in 2017. We view Hemsö's financial prudence as positive in light of its expanding nominal loan portfolio. About 30% of interest exposures are repriced within 12 months and with the total interest duration at 5.4 years at end-March 2018, lengthened from 4.3 years one year earlier. Currency exposures are fully hedged, primarily through matching euro funding with currency requirements in its German and Finnish business segments.

Despite rising investments, we expect Hemsö's debt will stay relatively stable as a proportion of EBITDA, at around 15x, in 2018-2020 as a result of strengthening EBITDA margins. Moreover, EBITDA to interest coverage is currently very strong at around 4.5x due to very low interest rates. Stronger EBITDA, once new properties start operations, will secure the sustainability of Hemsö's increasing debt stock. But with interest rates likely to rise gradually, we expect Hemsö's EBITDA interest coverage will dip to 4.2x in 2020.

Liquidity

We consider Hemsö to have adequate liquidity, based on its robust internal cash flow generating ability, and ample committed liquidity facilities, which counterbalance maturing debt obligations and expected high spending on investments and acquisitions.

We estimate that Hemsö's sources of cash of about SEK15.0 billion will cover uses of about SEK12.3 billion by approximately 1.2x for the coming 12 months.

Our estimate of Hemsö's liquidity sources include:

- Around SEK1.1 billion in cash;
- Pre-interest cash flow from operations of around SEK1.8 billion;
- Expected proceeds from asset sales of about SEK50 million; and
- SEK12 billion of undrawn contractually committed facilities expiring beyond 12 months, including a SEK4 billion agreement from Hemsö's owner to refinance commercial paper.

We estimate that Hemsö's liquidity uses for the same period will include:

- Capital expenditures on repairs and new development of about SEK2.4 billion;
- Expected acquisitions of about SEK1.5 billion;

- Dividends of SEK650 million; and
- Debt service (including interest costs) of about SEK7.7 billion, of which about SEK4 billion relates to commercial paper.

We observe that Hemsö is lengthening the average term of its debt, which could markedly reduce refinancing risks. Moreover, we view as positive that Hemsö is expanding its funding sources by adding multilateral lenders. In addition to a fully drawn Nordic Investment Bank loan agreement of SEK800 million, we expect that Hemsö will add further multilateral lenders to its funding mix In addition, we estimate that Hemsö has flexibility to reduce the number of acquisitions, decrease planned capital expenditures, and likely waive dividends should funding markets suddenly dry up.

Outlook

The stable outlook reflects our view that Hemsö will continue to report strong and predictable operating cash flows, benefitting from its share of strong public-sector tenants, and stable debt servicing metrics over the next 24 months. Although we see potential risks from the company's expansion and the associated debt buildup, we anticipate that continued strong performance will protect its financial position and that proactive treasury management will contain refinancing risk. In our base-case scenario through 2020, we expect Hemsö's management will remain conservative, keeping its strategic target of generating more than 50% of rental income directly from public-sector tenants while controlling international expansion.

We could raise the rating if we observe that management's strategy of re-structuring debt portfolio toward longer-term redemption profile notably strengthened its debt service coverage levels, resulting in structurally improved liquidity coverage. Alternatively, ratings upside would emerge if we observed a strengthening of Hemsö's enterprise risk profile, for example from further improved asset quality and significant structural increase in direct rents from public-sector tenants in combination with maintained financial risk positions and contained international expansion.

We could lower the ratings if we observed that Hemsö was becoming more exposed to cyclicality and stiffer market competition, which could occur if the proportion of private-sector tenants approached 50% of rental revenues. In addition, rating pressure would accumulate if the company's financial performance deteriorated significantly, leading to higher debt totaling 20x EBITDA and a potentially weaker liquidity position.

Key Statistics

Table 1

Hemsö Fastighets AB Financial Statistics					
	--Fiscal year end Dec. 31--				
(Mil. SEK)	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**
Revenues	2,204.0	2,375.0	2,572.7	2,756.3	2,944.6
EBITDA	1,432.0	1,653.0	1,805.4	1,945.0	2,099.8
Operating income	1,432.0	1,653.0	1,805.4	1,945.0	2,099.8
Net income from continuing operations	2,308.0	2,591.0	2,395.9	2,086.9	1,896.0
Interest Expense	387.0	386.0	388.9	441.5	505.0
Funds from operations (FFO)	1,045.0	1,267.0	1,354.6	1,428.5	1,509.8
Capital expenditures	1,513.0	2,185.0	2,395.0	2,235.0	2,155.0
Total assets	34,953.0	40,677.0	44,915.0	49,324.1	53,048.1
Debt	22,483.0	25,575.0	27,400.6	29,884.8	31,981.4
Equity	8,672.0	10,795.0	12,533.9	13,885.0	15,003.2
EBITDA margin (%)	65.0	69.6	70.2	70.6	71.3
EBITDA interest coverage (x)	3.7	4.3	4.6	4.4	4.2
Operating cash flow/debt (%)	5.5	5.1	5.0	4.9	4.8
Debt/EBITDA (x)	15.7	15.5	15.2	15.4	15.2
Debt/debt and equity (%)	72.2	70.3	68.6	68.3	68.1

The data and ratios above result in part from S&P Global Ratings own calculations. The main sources are the financial statements and budgets, as provided by the issuer. SEK--Swedish krona. bc--Base case, reflects S&P Global Ratings expectations of the most likely scenario.

Ratings Score Snapshot

Table 2

Hemso Fastighets AB Ratings Score Snapshot	
Key rating factors	
Industry risk	2
Economic fundamentals and market dependencies	3
Strategy and management	3
Asset quality and operational performance	2
Enterprise profile	3
Financial performance	2
Debt profile	3
Liquidity	4
Financial policies	3
Financial profile	3

S&P Global Ratings' analysis of social housing providers' creditworthiness rests on our scoring of eight key rating factors: (i) industry risk; (ii) economic fundamentals and market dependencies; (iii) strategy and management; (iv) asset quality; (v) financial performance; (vi) debt profile; (vii) liquidity; and (viii) financial policies. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Methodology For Rating Public And Nonprofit Social Housing Providers," published Dec. 17, 2014, and "Rating Government-Related Entities: Methodology And Assumptions," published March 25, 2015, detail how we derive and combine the scores, and then determine each social housing provider's stand-alone credit profile and the issuer credit rating. In accordance with S&P Global Ratings' public and nonprofit social housing providers methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating, the committee can make use of the flexibility afforded by paragraphs 12-17 of "Methodology For Rating Public And Nonprofit Social Housing Providers."

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, Aug. 14, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Governments - General: Methodology For Rating Public And Nonprofit Social Housing Providers, Dec. 17, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Hemso Fastighets AB	
Issuer Credit Rating	A-/Stable/A-2
Nordic Regional Scale Rating	--/--/K-1
Senior Unsecured	A-

Additional Contact:
International Public Finance Ratings Europe; PublicFinanceEurope@spglobal.com

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.