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Research Update:

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

March 25, 2020

Overview

- In light of the COVID-19 outbreak, we have revised our base-case assumptions by adjusting the revenue growth and capital expenditure forecast.
- Overall, we believe that Hemsö Fastighets AB has headroom in the rating to withstand potential pressure on its financial performance.
- Hemsö continues its strategy of divesting noncore assets in more rural regions to concentrate its property portfolio in and around larger cities where demand is higher, leading to improved asset quality and lower vacancy rates.
- In 2020, the company will receive another capital injection from its owner to allow for continued expansion while simultaneously strengthening the capital structure in line with updated financial policies.
- We are affirming our 'A-/A-2' and 'K-1' ratings on the company.
- The stable outlook reflects our view that Hemsö will uphold its strong financial performance and contain debt buildup, mitigating risks associated with the company's expansion over the next 24 months.

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Rating Action

On March 25, 2020, 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. At the same time, we affirmed our 'K-1' short-term Nordic regional scale rating on the company. We also affirmed our 'A-' long-term issue rating on Hemsö's senior unsecured debt.

Rationale

The affirmation reflects our view that Hemsö will remain committed to its low risk strategy and continue report robust financial results, despite risks related to COVID-19. We expect the strong cash flows will mitigate debt accumulation in a period of extensive capital expenditure projects, resulting in a gradually decreasing debt burden. The owner's capital injections will also allow for continued expansion, strengthening the capital structure in line with the company's financial policies.

According to our criteria "Principles Of Credit Ratings," published Feb. 16, 2011, we assess Hemsö's enterprise risk and financial risk profiles, the components of its stand-alone credit profile, by benchmarking against factors described 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 tenants (38% of total revenues) and is actively expanding internationally. The company's exposure to somewhat higher risk operations compared with rated public housing peers owned by Swedish municipalities has a slight negative impact on the long-term rating.

The company has established relationships with the public sector and has refined its project management processes over the years, leading to strong demand for its services. Given Hemsö's exposure to the public sector, both directly and indirectly, its revenues display limited cyclicality, and the high credit quality of its public-sector tenants supports the overall business profile.

Consequently, we expect that the effects of COVID-19 will have a limited impact on the company's financial performance. Public sector tenants, including local and regional governments (LRGs) and the central government, generate 62% of Hemsö's rental income. Given these entities' public policy mission, we expect the vast majority of them to continue paying rents in line with rental contractual agreements, even if schools and other facilities have to close temporarily. Of the company's properties, 70% are nursing homes and education-related facilities and, in Sweden, municipalities are required by law to provide these services to their citizens.

Furthermore, we also believe that the risks related to Hemsö's private-sector tenants are limited, given that these entities are tax-financed by the LRGs through a voucher scheme, meaning that whether the private operators can continue paying rent depends on the public sector entities' financial condition. Despite the current pressure on the sector, we generally expect LRGs will maintain adequate services and pay on time and in full. Furthermore, if a private operator fails to maintain its services, we believe that the public sector or another public operator would take over managing the affected properties.

One consequence of the COVID-19 spread could be a severe and prolonged lockdown in the construction sector that could lead to delays in Hemsö's investment projects. It is difficult to assess how protracted the outbreak will be, but we have lowered our completion rate assumptions somewhat in our capital expenditure forecast to reflect these uncertainties. In addition, given the potential delays and prevailing market conditions, we have adjusted our revenue growth forecast marginally.

Hemsö is one of the largest providers of public service properties in Sweden, where demographic challenges support continued high demand for public services, especially education and elderly care. In recent years, the company has actively divested properties not deemed attractive long-term holdings. We view as positive Hemsö's refinement of its property portfolio by prioritizing expansion in key growth regions where demand for public services facilities is high. A continued focus on new construction in high-demand areas has led to improved asset characteristics in recent years, resulting in gradually decreasing vacancy rates. However, market turbulence could result in temporarily increased vacancy rates.

Hemsö continues to expand in Finland and Germany. Together, the nondomestic exposures accounted for 32% of the company's property value as of year-end 2019. Hemsö's international expansion is primarily fueled by the search for higher-yielding properties and the desire to achieve geographical diversification. Management is continuously acquiring experience and insight into the market segments in Germany and Finland, facilitating further expansion. Overall, we continue to view the company's strategy as aligned with its organizational capabilities and flexible to adjust in line with prevailing market conditions, although 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 85% of the shares and has a call option to buy the residual shares from Sagax, a private for-profit company listed on the Stockholm stock exchange. In our view, Tredje AP-fonden plays an important role in the Swedish public sector and remains actively involved in defining Hemsö's strategy, supporting the owner's intent to keep the company as a long-term core investment. The owner holds vast liquid assets and provides ongoing support in the form of capital injections. In 2020, Hemsö will receive an additional 1 billion Swedish krona (SEK) capital injection to enable continued expansion while simultaneously maintaining its capital structure. Furthermore, the company has a subscription agreement with its owner, specifying that the latter pledges to issue commercial paper of up SEK5 billion (about €470 million) if it were to experience difficulties to secure financing in the market. The limit of this subscription agreement was recently extended by SEK1 billion to improve the liquidity position.

We consider Hemsö's financial performance strong, as demonstrated by a five-year average EBITDA-to-revenue ratio of 71%. In this respect, we believe the company has ample headroom to withstand potential pressure on margins stemming from the COVID-19 outbreak, be it lower revenues or higher costs. Higher-yielding German and Finnish properties, in combination with a gradual modernization of the Swedish property portfolio, result in improved profit margins. Although we see potential risks from the company's expansion and the associated debt buildup, we anticipate that continued strong performance will mitigate pressure on the stable financial position.

Hemsö conducts mark-to-market valuations of its properties under International Financial Reporting Standards, meaning that the company is exposed to market volatility. However, Hemsö's niche segment of public-service properties has remained attractive, with no negative spill-over effects on yields or values from the subdued sentiment in the Swedish private residential real estate market since August 2017. Therefore, we anticipate that the fairly stable values of the company's social infrastructure properties will underpin the balance sheet's resilience throughout our base-case period.

Hemsö's financial management is competent and adheres to prudent risk policies while maintaining an active treasury management. The average cost of debt remains low at 1.3% and the total interest duration was 6.4 years as of year-end 2019, compared with 5.9 years at year-end 2018. Currency exposure is limited because the company matches euro funding with its asset base in the German and Finnish business segments.

Despite high investments, we expect Hemsö's debt, as a proportion of EBITDA, will decrease somewhat throughout the forecast period, driven by capital injections from the owner and improved EBITDA margins. We forecast the debt to EBITDA to decrease to 14.5x in 2022 from 16.6x in 2019. Moreover, we expect average EBITDA-to-interest coverage to remain strong, averaging 4.9x in 2020-2022.

Liquidity

We consider Hemsö's liquidity adequate, based on the company's strong internal cash flow generation and ample committed facilities, offsetting debt repayments and expected high spending on investments and acquisitions. Furthermore, despite the turbulence in financial markets, we expect Hemsö's access to external financing to remain satisfactory. Also, the company has sufficient liquidity sources to cover bond refinancing in 2020 if the financial markets were to dry up.

We estimate that Hemsö's sources of liquidity of about SEK17 billion will cover uses of about SEK14.1 billion by approximately 1.22x for the coming 12 months.

Our estimate of the company's liquidity sources include:

- About SEK3.1 billion in cash, including a capital injection from the owner
- Pre-interest cash flow from operations of about SEK2.3 billion
- Expected proceeds from asset sales of about SEK 50 million
- SEK11.5 billion of undrawn contractually committed facilities expiring beyond 12 months, including a SEK5 billion agreement from the 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 SEK3.4 billion
- Expected acquisitions of about SEK1.3 billion
- Dividends of SEK860 million
- Debt service (including interest costs) of about SEK8.4 billion, of which about SEK5.1 billion relates to commercial paper

Outlook

The stable outlook reflects our view that Hemsö will continue to generate strong and predictable cash flows, benefiting from its low risk business profile with a large share of public-sector tenants. Although we see potential risks related to the spread of COVID-19 and the company's continued expansion, we expect that Hemsö will continue to generate strong cash flows to mitigate the pressure on its financial performance. Furthermore, we expect management will remain conservative, adhering to its strategic target of generating more than 50% of rental income directly from public-sector tenants while also managing the international expansion prudently.

Upside scenario

We could raise the ratings if we observe stricter financial policies, leading to a structurally improved liquidity position and more conservative debt metrics. Alternatively, rating upside could emerge if Hemsö's enterprise risk profile strengthened materially, for example from a significant structural increase in direct rents from public-sector tenants, as well as a steady financial risk position and contained international expansion.

Downside scenario

We could lower the rating if Hemsö became more exposed to cyclicality and stiffer market competition, potentially materializing if the proportion of private-sector tenants approached 50% of rental revenue. In addition, rating pressure could intensify if the company's financial performance deteriorated significantly, leading to higher debt levels above 20x EBITDA and a potentially weaker liquidity position.

Key Statistics

Table 1

Hemsö Fastighets AB--Financial Statistics

	--Fiscal year end Dec. 31--				
(Mil. SEK)	2018	2019	2020bc	2021bc	2022bc
Revenues	2,618	3,046	3,299	3,553	3,830
EBITDA	1,803	2,141	2,331	2,553	2,819
Operating income	1,803	2,141	2,331	2,553	2,819
Net income from continuing operations	3,085	3,111	2,561	2,719	2,922
Interest expense	422	481	490	519	565
Funds from operations (FFO)	1,803	2,141	1,840	2,035	2,254
Capital expenditures	2,660	2,724	3,380	2,931	2,800
Total assets	47,406	57,945	63,449	66,861	71,819
Debt	29,728	35,542	37,683	38,625	40,977
Equity	13,199	16,714	19,465	21,278	23,194
EBITDA margin (%)	68.9	70.3	70.7	71.9	73.6
EBITDA interest coverage (x)	4.3	4.5	4.8	4.9	5.0
Operating cash flow/debt (%)	4.8	4.9	4.9	5.3	5.5
Debt/EBITDA (x)	16.5	16.6	16.2	15.1	14.5
Debt/debt and equity (%)	69.3	68.0	65.9	64.5	63.9

Note: 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	Score
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	2
Liquidity	4
Financial policies	3

Table 2

Hemso Fastighets AB--Ratings Score Snapshot (cont.)

Key rating factors	Score
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: 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- S&P Global Ratings Definitions, Sept. 18, 2019

Ratings List

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

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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.