Research Update:

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

March 24, 2021

PRIMARY CREDIT ANALYST

Carl Nyrerod
Stockholm
+ 46 84 40 5919
carl.nyrerod
@spglobal.com

SECONDARY CONTACT

Johanna Melinder
Stockholm
+ 46 84 40 5926
johanna.melinder
@spglobal.com

Overview

- Hemsö continues its strategy of building a portfolio of high-quality properties for core tax-financed public service operations in Sweden, Finland, and Germany.
- In third-quarter 2020, Hemsö received another capital injection from its owners to allow for continued expansion while simultaneously strengthening the company's capital structure in line with updated financial policies.
- Furthermore, to date the spread of COVID-19 has had a limited impact on Hemsö's financial position.
- We are affirming our 'A-/A-2' and 'K-1' ratings on Hemsö.
- The stable outlook reflects our view that Hemsö will continue its strong financial performance and contain debt buildup, mitigating risks associated with its expansion over the next 24 months.

Rating Action

On March 24, 2021, 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 Hemsö and our 'A-' long-term issue rating on its rated senior unsecured debt.

At the same time, we affirmed our 'A-' rating on Hemsö Treasury OYJ's senior unsecured debt because we consider this finance vehicle to be a core subsidiary of Hemsö Fastighets AB.

Rationale

The affirmation reflects our view that Hemsö will remain committed to its low-risk strategy and continue reporting robust financial results, partly thanks to new investment projects generating strong profitability. Consequently, we expect the strong cash flows will mitigate debt accumulation in a period of extensive capital expenditure projects, resulting in stable debt metrics in the coming years. The capital injections by the owners will also allow for continued expansion while strengthening the capital structure in line with the company's revised financial policies.

According to our criteria "Principles Of Credit Ratings," published Feb. 16, 2011, on RatingsDirect, we assess Hemsö's enterprise risk and financial risk profiles, the components of its stand-alone credit profile (SACP), 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 (37% of total revenues) and is actively expanding internationally. Hemsö'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.

Hemsö has a strong enterprise risk profile, supported by its low industry risk, solid economic fundamentals, and strong market position. 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. The majority (63%) of its rental income stems directly from public-sector tenants with long leases. Given Hemsö's exposure to the public sector, its revenue displays limited cyclicality, and the high credit quality of its public-sector tenants supports the overall business profile. Consequently, the effects of COVID-19 have had a limited impact on Hemsö's financial position.

We note that large private public-services providers, especially in elderly care and education, are among Hemsö's tenants, adding an element of risk, although the proportion of such tenants is relatively low. Still, since Swedish municipalities are legally obliged to supply these services, we see a high probability that the public sector would take over the operations of a private welfare provider that fails to adequately provide them. Overall, 94% of Hemsö's revenue streams are tax financed, pointing to limited exposure to shifting economic conditions and its effects on demand.

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, Hemsö has actively divested properties not deemed attractive long-term holdings. We view as positive the company'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 since the company started its operations. In 2020, the vacancy rate was 2.1% compared with 1.9% in 2019; we do not view the increase as a structural trend but rather expect vacancy rates to remain relatively stable at around 2% in the coming years. Moreover, Hemsö has worked actively to gradually increase the average lease duration. At year-end 2020, the average lease duration was 9.8 years, broadly unchanged from 9.9 years at year-end 2019.

Hemsö continues to expand in Finland and Germany. Together, these nondomestic exposures accounted for 32% (unchanged from 2019) of the company's property value as of year-end 2020. Hemsö's international expansion stems primarily from the search for higher-yielding properties and the desire to achieve geographic diversification. Hemsö's management is continuously acquiring experience and insight into market segments in Germany and Finland, facilitating further expansion. Overall, we continue to view Hemsö's strategy as aligned with its organizational capabilities and flexible, allowing it to adjust to prevailing market conditions, even though nontraditional activities weigh on 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 received an additional Swedish krona (SEK) 1 billion capital injection from its owners to enable continued expansion while simultaneously maintaining its capital structure. Furthermore, the company has a subscription agreement with Tredje AP-Fonden, specifying that the latter pledges to refinance commercial paper of up to SEK5 billion (about €490 million) if Hemsö were to experience difficulties sourcing financing in the market.

We consider Hemsö's financial performance to be strong, as demonstrated by a five-year average EBITDA-to-revenue ratio of 71%, unchanged from the previous review. We observe that higher-yielding German and Finnish properties, combined with a gradual modernization of the Swedish property portfolio, has resulted in improved profit margins in the long term. Although we see potential risks from the company's expansion and associated debt buildup, we anticipate that continued strong performance will mitigate pressure on its 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, we observe that Hemsö's niche segment of public-service properties has remained attractive. Therefore, we anticipate that the fairly stable values of Hemsö's social infrastructure properties will underpin the balance sheet's resilience throughout our base-case period. Since we project strong profitability, we foresee Hemsö's debt to debt plus equity decreasing to 63% in 2022 from 68% in 2019.

In our view, Hemsö's financial management is competent and adheres to prudent risk policies while maintaining active treasury management. The average cost of debt remains low at 1.2%. As of year-end 2020, the average debt maturity was 6.7 years (7.4 years at year-end 2019) and the average interest maturity 6.2 years (6.4 years at year-end 2019). Currency exposure is limited since Hemsö 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 from 17.0x in 2020 to 16.2x. Moreover, we expect the average EBITDA-to-interest coverage to remain strong, averaging 5.4x in 2021-2023.

Liquidity

We consider Hemsö to have adequate liquidity, based on its strong internal cash flow generation and ample committed facilities, offsetting debt repayments and expected high spending on investments and acquisitions. Furthermore, based on its continued access to turbulent markets in 2020, we expect Hemsö's access to external financing to remain satisfactory. In addition, Hemsö has sufficient liquidity sources to cover refinancing in 2021 even if the financial markets were to dry up. We estimate that, as of year-end 2020, Hemsö's sources of liquidity of about SEK18.9 billion will cover uses of about SEK 16.7 billion by approximately 1.13x for the coming 12 months.

Our estimate of Hemsö's liquidity sources include:

- About SEK1.9 billion in cash, including a capital injection from the owner;
- Preinterest cash flow from operations of about SEK2.6 billion;

- Expected proceeds from asset sales of about 2.0 billion; and
- SEK12.5 billion of undrawn contractually committed facilities expiring beyond 12 months, including a SEK5 billion agreement from Hemsö's owner to refinance commercial paper.

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

- Capital expenditure on repairs and new development of about SEK3.7 billion;
- Expected acquisitions of about SEK2.5 billion;
- Dividends of SEK905 million; and
- Debt service (including interest costs) of about SEK10.0 billion, of which about SEK5.1 billion relates to commercial paper.

Furthermore, although not included in the liquidity calculation above, Hemsö Treasury issued a €500 million bond at the beginning of 2021.

Outlook

The stable outlook reflects our view that Hemsö will continue to generate strong and predictable cash flows, benefitting from its low-risk business profile with a large share of public-sector tenants. We see potential risks related to the company's expansion, including gradual debt buildup. However, we expect that continued strong performance and capital injections from owners, as needed, will mitigate the pressure on Hemsö's financial position and that proactive treasury management will contain refinancing risks. Furthermore, we expect Hemsö's 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 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 we observed a material strengthening of Hemsö's enterprise risk profile, 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 we observed that Hemsö was becoming 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 debt to EBITDA to go beyond 20x and a potentially weaker liquidity position.

Key Statistics

Table 1

Hemsö Fastighets AB Financial Statistics

(Mil. SEK)	2019	2020	2021bc	2022bc	2023bc
Revenue	3,046	3,293	3,537	3,873	4,179
EBITDA	2,141	2,268	2,491	2,768	3,036
Operating income	2,141	2,268	2,491	2,768	3,036
Net income from continuing operations	3,111	3,333	3,064	3,282	3,408
Interest expense	481	569	503	507	513
Funds from operations (FFO)	2,141	2,268	1,988	2,260	2,523
Capital expenditure	2,724	3,255	3,732	3,245	2,292
Total assets	57,945	65,193	70,796	76,940	81,863
Debt	35,542	38,652	40,415	43,570	45,529
Equity	16,714	20,083	23,242	25,495	27,713
EBITDA margin (%)	70.3	68.9	70.4	71.5	72.6
EBITDA interest coverage (x)	4.5	4.0	5.0	5.5	5.9
Operating cash flow/debt (%)	4.9	3.9	4.9	5.2	5.5
Debt/EBITDA (x)	16.6	17.0	16.2	15.7	15.0
Debt/debt and equity (%)	68.0	65.8	63.5	63.1	62.2

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: Group Rating Methodology, July 1, 2019
- 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

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-
Hemso Treasury OYJ	
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.