FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Hemsö Fastighets AB to 'AA-'; Outlook Stable

Fri 22 Mar, 2024 - 7:50 AM ET

Fitch Ratings - Frankfurt am Main - 22 Mar 2024: Fitch Ratings has upgraded Hemsö Fastighets AB's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'AA-' from 'A+', with Stable Outlooks. We have removed the ratings from Under Criteria Observation (UCO). A full list of rating actions is detailed below.

The upgrade reflects the application of a new rating approach, following the updating of our rating criteria. Under this approach, we now give greater weight to extraordinary support from the company's majority owner, AP3, a Swedish state pension fund (Hemsö is 85% owned by AP3 and the remaining 15% by Sagax). Fitch looks through AP3 to Sweden as sponsor. We also apply a new indicative guidance table for Standalone Credit Profiles (SCP).

We assess the extraordinary support from AP3 with 'Strong Expectations', applying the updated government-related entities (GRE) criteria. We assess the SCP at 'bbb+', seven notches below Sweden's rating (AAA/Stable), under our updated "Public Policy Revenue-Supported Entities Rating Criteria". This combination results in a bottom-up +4 rating approach, leading to 'AA-' IDRs.

KEY RATING DRIVERS

Support Score Assessment 'Strong expectations'

We assess support from AP3 for Hemsö with 'Strong Expectations' (score of 20 points out of a maximum 60) under our new GRE criteria. The support score is a combination of our assessment of the responsibility to support and incentive to support.

Responsibility to Support

Decision Making and Oversight 'Strong'

Hemsö is closely controlled and monitored by its owner. This is reflected in AP3 appointing Hemsö's board and setting and approving its long-term business strategy.

Hemsö reports at least quarterly to AP3 and is in frequent exchange with its owner.

AP3 states that social infrastructure, Hemsö's core business, is well suited for its owner and Hemsö is a core and profitable shareholding of AP3 providing dividends.

Precedents of Support 'Strong'

Hemsö benefits from a high level of support from AP3. This is reflected in ongoing capital injections towards Hemsö, most recently in 2023, when the owners granted another SEK2 billion of equity injection (7% of Hemsö's equity in 2023) and capital injections totaled SEK5 billion in 2019-2023 (18% of Hemsö's equity). Ongoing support is also based on a multi-year committed credit facility of SEK6 billion, under which AP3 is committed to buy up to SEK6 billion of commercial paper (CP) out of Hemsö's SEK12 billion CP programme.

Fitch views these as tangible signs of support ensuring Hemsö's business activities and strengthening its liquidity profile.

Incentives to Support

Preservation of Government Policy Role 'Strong'

Hemsö operates in an important and growing market, driven by Sweden's growing population and the government's obligation to provide sufficient social infrastructure. In Fitch's view, a default of Hemsö would be politically very sensitive and create a large loss for AP3, while Hemsö's activities could be gradually taken over by other private or public operators.

We therefore assume its default would cause the loss of valuable assets, as its liquidation could hand over assets to creditors. A rescue would therefore have a meaningful net benefit over the medium to long term, as Hemso is the core provider for social infrastructure in Sweden.

Contagion Risk 'N/A'

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 established a SEK6 billion EMTN programme and a SEK12 billion CP programme. Its commercial law status and non-policy-role mean Hemsö's links to the public sector are based on AP3's ownership.

However, we do not consider Hemsö high profile for its government, and its default would not necessarily increase the cost of financing for the government or other GREs. It would also not be seen as whole-system failure in Fitch's view.

Standalone Credit Profile

Hemsö's 'bbb+' SCP reflects the combination of a 'Stronger' risk profile and a financial profile assessed at the better end of the 'bb' category, with a forecast leverage ratio averaging 12.9x in 2024-2028 in our rating case (2023: 13.9x).

Risk Profile: 'Stronger'

Fitch assesses Hemsö's risk profile at 'Stronger', reflecting the combination of assessments below.

Revenue Risk: 'Stronger'

There is a very high demand for social infrastructure in Sweden. The country's ongoing population growth and its rising life expectancy mean we expect the demand for social infrastructure and nursing homes and schools in particular, together accounting for 74% of Hemsö's properties, to remain high. Sweden's expected population growth for 2017-2029 is 10% and the share of people aged over 80 will increase by 58%.

This is similar for Hemsö's business activities in Finland and Germany, contributing to 35% of Hemsö's portfolio. Ongoing high demand is further reflected in a large amount of outdated buildings, which need to be renovated or newly set up.

Fitch views the pricing characteristics of Hemsö's properties as 'Midrange', as we assume Hemsö will have sufficient negotiating power to adjust rents to cover at least inflationary increases. Based on the past 10 years of performance, property income has consistently covered property costs by more than 3x, and almost 4x in 2023.

To ensure stable inflation-adjusted income, Hemsö aims to expand its long-term lease agreements. The average lease was 9.5 years at end-2023 and lease agreements for new construction are between 15 and 25 years. The agreements include annual rent adjustments to reflect increases in the consumer price index.

Expenditure Risk: 'Stronger'

In our view, Hemsö's operating costs are well identified and not affected by significant volatility. They have increased consecutively in the past 10 years, but growth remained below that of its property income. Hemsö has contractual agreements ensuring revenue adjustments for increasing cost items, like inflation.

Property costs are mainly derived from operating costs related to heating, electricity, maintenance, property tax and leasehold fees. We assume this risk is mitigated by Hemsö's expertise and prudent management, and its improving building standards.

We view Hemsö's mechanisms for investment planning and funding as strong. Its long-term expertise means Hemsö has well-established procedures for project development and is a well acknowledged capital market participant. Hemsö is further not committed to business growth and could act opportunistically in terms of new projects if required.

Liabilities and Liquidity Risk: 'Stronger'

Fitch sees limited risk in Hemsö's debt. Hemsö has well-established funding programmes, reflected in its SEK6 billion EMTN and SEK12 billion CP Programme. The debt amortisation profile is smooth except for repayment peaks in 2026 and 2028, when more than 10% of direct debt is due. Hemsö's maturing debt over Fitch's rating-case horizon is always covered by the entity's liquidity and committed credit lines, significantly limiting its refinancing risk.

We view Hemsö's liquidity position to be sound, reflected in its available unrestricted cash (2023: SEK1.6 billion) and its committed lines of credit, together totalling SEK13.6 billion at end-2023. In addition to its owner's obligation to buy up to SEK6 billion of Hemsö's CP programme upon request, we assume AP3 will provide further liquidity to Hemsö if needed.

Financial Profile 'Midrange'

We assess Hemsö's financial profile at the better end of the 'bb' category. Our rating case expects Hemsö's leverage to average 12.9x in 2024-2028 and end at 11.9x in 2028 (2023: 13.9x), the debt service coverage to be 0.6x (2023: 0.4x) and the gross interest coverage at 3.3x (2023: 3.1x)

In Fitch's rating-case scenario, Hemsö's EBITDA is expected to reach SEK4,685 million in 2028, from SEK3,610 million in 2023. However, its EBITDA margin would remain on average close to its 2023 level (73%) in the next five years, as higher rents compensate rising maintenance and staff costs. Much of the EBITDA evolution will depend on the realisation of investments, as the EBITDA would increase significantly if Hemsö stopped debt-funded investments.

We expect Hemsö's net adjusted debt to increase to about SEK55.8 billion by 2028 from SEK50.2 billion in 2023, as the current business plan foresees SEK13.8 billion of investments over 2024-2028, far below the total capex spent in 2019-2023, of SEK32 billion.

Additional Risk Factors Considerations

No other asymmetric risk affects Hemsö's ratings. Fitch considers the company's management and governance practices to be in line with the sector's standards, characterised by high involvement from the state, and the management shares strategic decisions with AP3. The legal and regulatory framework in Sweden is highly regulated and external controls that are performed frequently do not pose a material challenge for Hemsö. The information quality is on par with industry standards.

No single factor leads to equalisation for Hemsö.

Derivation Summary

Fitch views Hemsö as a GRE of Sweden (AAA/Stable) and applies a bottom-up +4 rating approach. This reflects 'Strong Expectations' of support from Sweden and a SCP of 'bbb+', seven notches below the sovereign rating. The SCP's assessment of 'bbb+' reflects the combination of a 'Stronger' risk profile and a financial profile assessed in the 'bb' category under our rating-case scenario, with a leverage averaging at 12.9x in 2024-2028 (2023: 13.9x).

Short-Term Ratings

The Short-Term IDR of 'F1+' is consistent with a Long-Term IDR of 'AA-'.

National Ratings

Not applicable

Debt Ratings

The senior unsecured rating of 'AA-' provided for Hemsö Treasury OYJ is based on the explicit guarantee provided by Hemsö Fastighets AB to its SPV.

Issuer Profile

Hemsö Fastighets AB is one of Sweden's largest providers of social infrastructure, including nursing homes and educational, health care and judicial properties. It operates in Sweden (65% of its property portfolio), Finland (17%) and Germany (18%).

KEY ASSUMPTIONS

Fitch derives the SCP from its rating-case scenario over 2024-2028 based on the following assumptions:

- 4.8% annual increase in operating revenue, driven by a price effect on rents and project finalisation

- 3.1% annual increase in operating expenses, driven by inflation and an increasing number of properties

- Net capex on average at close to SEK2,682 million, in line with Hemsö's investment plan

- Cost of debt of 2.4%, considering interest rate increases

Our scenario factors in a limited additional stress of 10bp towards operating revenue and 20bp towards Hemsö's operating expenses, as Hemsö's financial figures are not subject to large fluctuations and the base-case already incorporates a reasonable amount of stress.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

A downgrade of Sweden's (AAA/Stable) would lead to a rating action on Hemsö's ratings, all else remaining equal.

Hemsö's ratings would also be downgraded, it its SCP would be lowered to 'bbb'. This would be triggered by a deterioration of the leverage to above 15x.

A downgrade could also result from a weaker assessment of responsibility-to-support or incentive-to-support factors under the GRE criteria.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

An upgrade of Hemsö's IDRs could result from a stronger assessment of responsibility-to-support or incentive-to-support factors under the GRE criteria.

ESG Considerations

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

The ratings of Hemsö are credit-linked to the ratings of Sweden.

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.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Hemso Fastighets AB	LT IDR	AA- Rating Outlook Stable	Upgrade	A+ Rating Outlook Stable
	ST IDR	F1+	Affirmed	F1+
	LC LT IDR	AA- Rating Outlook Stable	Upgrade	A+ Rating Outlook Stable
	LC ST IDR	F1+	Affirmed	F1+
Hemso Treasury OYJ				
senior unsecured	LT	AA-	Upgrade	A+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 12 Jan 2024)

Public Policy Revenue-Supported Entities Rating Criteria (pub. 12 Jan 2024) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Hemso Fastighets AB	EU Issued, UK Endorsed
Hemso Treasury OYJ	EU Issued, UK Endorsed

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch's website.

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