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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

- Hemsö Fastighets AB's large public-sector tenants base provides predictable revenues, balancing risks from its planned expansion, international presence, and higher share of private-sector corporate tenants than its rated peers.
- We expect Hemsö will maintain strong financial performance and a resilient balance sheet through 2020, while containing financing risks by lengthening the debt maturity profile and adding multilateral sources to its funding mix.
- 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 flows and debt-service metrics, mitigating risks associated with the company's expansion over the next 24 months.

Rating Action

On Dec. 19, 2017, 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

We affirmed our ratings because we expect Hemsö will continue to display robust financial performance on the back of strong profitability from projects coming on stream in the coming 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 foresee Hemsö's debt sustainability metrics (debt to EBITDA and EBITDA interest coverage) remaining stable through 2020. We also expect 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: grouped under 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 (42% of revenues) and is actively expanding internationally. We reflect this higher risk exposure through a negative adjustment in the long-term rating on Hemsö.

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, demand for Hemsö's services is strong. As a result, the majority (58%) of its rental income stems from public-service-related properties with long leases. Hemsö's revenues therefore also display modest cyclicality, and the high credit quality of its public-sector tenants supports its overall business profile. However, we note that among the tenants are also large private public services providers, especially in elderly care and education. In particular, we observe a material undersupply of elderly care services, which, combined with Swedish municipalities' legal obligation to supply these services, results in a high probability that the public sector would assume those operations in the event of a falloff of private operators.

Hemsö is one of the largest providers of public service properties in Sweden, whose economic fundamentals also support a high demand for public services. 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.

While default risk of individual private operators exists, we consider reletting risk low, since the municipality would likely step in to ensure provision of legally mandated public services. In addition, divestments and new lettings in 2017 have helped reduce the vacancy rate, which is now a very low 1.2%. Moreover, Hemsö has worked actively to increase the average lease duration to 8.8 years at the end of the third quarter of 2017, from 8.0 years in third-quarter 2016, which supports the predictability of its cash flows and further strengthens its business fundamentals.

Nevertheless, Hemsö's appetite for international expansion continues and non-domestic exposures (Germany and Finland) accounted for 21% of property value as of third-quarter 2017, up from 16% in June 2016. Hemsö's international presence, originally due to a legacy portfolio in German elderly care, has been increasing of late, 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, an increasing proportion of its international rental income comes directly from public entities. We also note that management is continuously gaining experience in its new market segments of education and research in Germany and Finland. 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.

We consider Hemsö's financial performance to be strong, as demonstrated by a five-year average EBITDA-to-revenue ratio of 67%. We foresee that higher-yielding German and Finnish properties coming on stream will help strengthen profit margins. We expect EBITDA to revenues will exceed 70% by 2019.

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 SEK2.2 billion per year, thereby contributing to its rapidly expanding balance sheet. In addition, acquisitions are set to remain a key component of Hemsö's expansion strategy, and we therefore expect some investments and acquisitions will be financed through divestments and further refinement of existing property.

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 in 2017, and so far 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 fairly stable values of Hemsö's social infrastructure properties will support the resilience of Hemsö's balance sheet throughout our base case. Since we project strong profitability, we foresee Hemsö's debt to debt plus equity reducing to 71.5% in 2019 from 72% in 2017, despite a notable nominal increase in debt of SEK4.7 billion.

Despite rising investments, we expect Hemsö's debt will stay relatively stable at around 16x EBITDA in 2017-2020 as a result of strengthening EBITDA margins. Moreover, EBITDA to interest coverage is currently very strong at 4.7x 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 2019.

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.

In our base case over the next 12 months, we estimate sources of cash of about SEK13.9 billion will cover uses of about SEK11.6 billion by about 1.2x.

Liquidity sources include:

- Around SEK650 million in cash;
- Pre-interest cash flow from operations of around SEK1.3 billion;
- Expected proceeds from asset sales of about SEK600 million; and
- SEK11.3 billion of undrawn contractually committed facilities expiring beyond 12 months, including a SEK4 billion agreement from Hemsö's owner to refinance commercial paper and our expectation that Hemsö will add multilateral lenders to its funding mix.

Uses include:

- Capital expenditures on repairs and new development of about SEK2.35 billion;
- Expected acquisitions of about SEK1.2 billion;
- Dividends of SEK650 million; and
- Debt service (including interest costs) of about SEK7.4 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, we estimate that Hemsö has flexibility to reduce the number of acquisitions, decrease planned capital expenditures, and likely waive dividend payments should funding markets suddenly dry up.

Outlook

The stable outlook reflects our view that Hemsö will 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 associated debt buildup, we anticipate that continued strong performance will sustain the resilience of its financial position. 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 Hemsö's liquidity improved substantially, for example via further lengthening of the debt maturity profile or additional backup liquidity arrangements. In addition, ratings upside could build if we observed a significant structural increase of direct rents from public-sector tenants to 85% of rental income sources, together with a reduced appetite for international expansion, as shown by a clear strategy shift.

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, downward rating pressure would build if the company's financial performance deteriorated significantly, leading to higher debt totaling 20x EBITDA and a potentially weaker liquidity position.

Key Statistics

Hemso Fastighets AB Key Statistics

	—Fiscal year end Dec. 31—				
(Mil. SEK)	**2015**	**2016**	**2017bc**	**2018bc**	**2019bc**
Revenues	2,000.0	2,204.0	2,367.1	2,565.9	2,794.3
EBITDA	1,287.0	1,435.0	1,619.9	1,770.8	1,960.9
Operating income	1,287.0	1,435.0	1,619.9	1,770.8	1,960.9
Net income from continuing operations	1,315.0	2,308.0	2,237.3	1,576.4	1,811.9
Interest Expense	418.0	387.0	344.5	399.0	459.5
Funds from operations (FFO)	869.0	1,048.0	763.3	948.4	1,050.9
Capital expenditures	1,024.0	1,516.0	2,490.0	2,354.0	2,100.0
Total assets	27,102.0	34,953.0	39,194.1	42,825.2	46,041.7
Debt	17,454.0	22,483.0	26,636.8	29,294.1	31,297.5
Equity	6,764.0	8,672.0	10,324.3	11,350.7	12,612.5
EBITDA margin (%)	64.4	65.1	68.4	69.0	70.2
EBITDA interest coverage (x)	3.1	3.7	4.7	4.4	4.2
Operating cash flow/debt (%)	4.5	5.5	2.6	3.1	3.4
Debt/EBITDA (x)	13.6	15.7	16.4	16.5	16.0
Debt/debt and equity (%)	72.1	72.2	72.0	72.2	71.6

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.

Related Criteria And Research

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - August 14, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- Criteria - Governments - General: Methodology For Rating Public And Nonprofit Social Housing Providers - December 17, 2014
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- General Criteria: Principles Of Credit Ratings - February 16, 2011
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Ratings List

	Rating	
	To	From
Hemso Fastighets AB		
Issuer Credit Rating		
Foreign and Local Currency	A-/Stable/A-2	A-/Stable/A-2
Nordic Regional Scale	—/—/K-1	—/—/K-1
Senior Unsecured		
Foreign Currency	A-	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. 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.

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