S&P Global Ratings

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Research Update:

Hemso Fastighets AB 'A-' Ratings Affirmed Following Transition To Corporate Rating Methodology; Outlook Stable

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PRIMARY CREDIT ANALYST

Teresa Stromberg
Stockholm
(46) 8-440-5922
teresa.stromberg
@spglobal.com

SECONDARY CONTACT

Nicole Reinhardt
Frankfurt
+ 49 693 399 9303
nicole.reinhardt
@spglobal.com

ADDITIONAL CONTACT

Industrial Ratings Europe
Corporate_Admin_London
@spglobal.com

Rating Action Overview

- On June 3, 2021, S&P Global Ratings placed Hemsö Fastighets AB on CreditWatch with negative implications on its view that Hemsö's mission is to maximize profits rather than provide a public service, hence falling out of scope for the updated "Methodology For Rating Public And Nonprofit Social Housing Providers" criteria.
- However, we continue to recognize the company's very high cash flow stability and solid EBITDA interest coverage from its assets, despite its elevated debt leverage under our criteria for corporates, and think it would likely benefit from extraordinary support from its main shareholder The Third National Pension Fund (AP3), which owns 85% of the company, in case of financial distress
- We therefore affirmed our 'A-/A-2' issuer credit rating and 'K-1' short-term Nordic regional scale rating on Hemsö, three notches above the 'bbb-' stand-alone credit rating, applying our "Key Credit Factors For The Real Estate Industry."
- We also affirmed our senior unsecured issue rating on the company at 'A-', and removed all ratings from CreditWatch negative.
- The stable outlook reflects our anticipation that Hemsö's portfolio should continue to generate stable and predictable cash flows over the next 12-24 months, with an adjusted debt-to-debt-plus-equity ratio of 61%-62%, and an adjusted EBITDA interest coverage above 4.5x.

Rating Action Rationale

The affirmation reflects our application of the "Key Credit Factors For The Real Estate Industry" in our credit assessment of Hemsö. Our ratings also consider the potential likelihood from any extraordinary support the company would receive from its largest controlling shareholder, AP3. On June 3, we placed Hemsö on CreditWatch negative following our view that the company now viewed its mission as maximizing profits to shareholders rather than providing a public service, thereby falling out of scope for our "Methodology For Rating Public And Nonprofit Social Housing Providers" criteria, which excludes commercially motivated entities. We now assess Hemsö under our corporate rating methodology for real estate holding companies. Our rating assessment also incorporates the potential likelihood of extraordinary support under our "Group Rating Methodology" that Hemsö could receive from AP3.

We expect market fundamentals to remain favorable for Hemsö's properties, with predictable and positive like-for-like (LFL) rental income growth. We believe the company's community service property portfolio enjoys strong demand, thanks to demographic changes such as a growing and aging population, particular in the countries in which it operates. Hemsö is one of the largest owners of social infrastructure properties in Sweden (representing 67% of property value as of June 30, 2021) but also well diversified into Germany (17%) and Finland (16%). Our analysis is also supported by the high creditworthiness of tenants, with the majority (94%) of its rental income stemming from tax-funded tenants and with a high share of direct public tenants (63%), as well as the company's geographically diversified portfolio. The property portfolio is diversified across several property types within social infrastructure, including nursing homes (39% of property value), education (31%), health care (17%), and the justice system (13%), where demand should remain strong and new supply should be moderate in the next few years. The portfolio stood at Swedish krona (SEK) 69.6 billion and comprised 421 properties as of June 30, 2021. Hemsö's portfolio is characterized by a high occupancy rate of around 98% with a long average lease duration of 9.5 years, supporting high cash flow visibility and predictability over the busines cycle. The company has a relatively modern asset base, and about 25% of its portfolio value comes from properties built less than five years ago. We forecast LFL rental income will grow by 1.5%-2.0% in the next 12-24 months, mainly supported by rent indexation because as all of its lease agreements are linked to inflation with a weighted average of 90%. We also understand that the company's cash flow will benefit from new production.

Hemsö has shown resilience during the COVID-19 pandemic, with negligible impact on its operations. Its income remained unaffected, with virtually no rent rebates and tenant bankruptcies and retaining rent collection at prepandemic levels. In the wake of a difficult economy in 2020, the portfolio reported a positive (1%) LFL rental growth while asset value increased 4%-5%, mainly from yield compression and uplift from development projects, primarily in Sweden. We view community service properties as lower risk, especially housing for elderly people, since demand is less sensitive to economic cycles than other real estate segments, such as retail or offices. The company reported a net yield of 4.4% in first-half 2021, compared with 4.5% as of Dec. 31, 2020.

We expect Hemsö to continue expanding its portfolio in the next 12-24 months through acquisitions and project development, in line with its growth strategy within existing markets. The company continued expanding its portfolio in the past 24 months, reaching SEK69 billion as of June 30, 2021, compared with SEK55 billion as of Dec. 31, 2020. This mainly followed acquisitions in Finland and in Germany as well as several development projects mostly in Sweden. As of June 30, 2021, Hemsö had ongoing new construction and refurbishment projects valued at about SEK8.2 billion, mainly related to that of new schools and nursing homes. In line with the company's strategy, we anticipate the majority of those projects will be completed over the next 24 months. While we view exposure to development activities as riskier compared to renting properties, we understand, that Hemsö will maintain its development exposure--both directly and indirectly--at less than 15% of total portfolio value. We expect the company to continue expanding in Finland and Germany. We understand that Hemsö's international expansion is primarily based upon the search for higher-yielding properties allowing for strong cash flows, and we view positively geographical diversification to markets with positive market fundamentals for the company's operating segments. Still, there are political risks related to reimbursement and changes in the regulatory environment in different regions. For instance, operators in Sweden and Finland are mainly funded via public health care spending whereas operators in Germany are primarily funded by government health care insurance and fees from users. In general, we believe private operators could add some additional risk compared with public tenants.

We expect Hemsö's leverage ratios will improve over the coming 12-24 months with our adjusted debt to debt plus equity declining closer to 60%. Our assessment of Hemsö's financial risk profile reflects the company's relatively high leverage metrics with debt to debt plus equity at 66.1% as of June 30, 2021. However, we take into account the company's strategy to reduce leverage and we forecast its ratio to decline to about 61%-62% by year-end 2021. We anticipate that the company's credit metrics will improve in the near term amid the company's growth ambitions, supported by around SEK2 billion of proceeds from asset disposals and SEK1 billion in capital contribution from the shareholders, expected in third-quarter 2021. Nevertheless, we believe the company's ratio of debt to EBITDA will remain relatively high, at around 16x. Hemsö's current financial policy with a maximum loan-to-value ratio of 70% (translating into S&P Global Ratings-adjusted debt to debt plus equity of about 75%) compares negatively with that of most rated peers. We nevertheless understand that Hemsö maintains sufficient headroom under the ratio and historically reported a loan-to-value ratio substantially below its maximum financial policy target (60.1% as of June 30, 2021). We expect that Hemsö's management will remain committed to financial discipline and leverage reduction with a reported loan-to-value ratio of well below 60% over the next 12-24 months. Hemsö's capital structure benefits from a relatively low average cost of debt of only 1.1%, and an average debt maturity of 6.5 years. This is also reflected in the company's solid EBITDA interest coverage of above 4.5x. Our analysis also takes into account the company's fully unsecured funding structure, providing high asset flexibility.

Our stand-alone rating incorporates a one-notch upwards adjustment for our comparable rating analysis, reflecting our expectation of Hemsö's improving leverage metrics in the near-to-medium term. In line with the company's commitment to deleverage, we expect the company to execute its financial target and discipline in the near term and expect its ratio of debt to debt plus equity to decline by the end of 2021 to near 60%. In addition, we view positively solid EBITDA interest coverage of above 4.5x which compares favorable compared with that of peers in the same financial risk category.

We apply three notches uplift to our assessment of the company's 'bbb-' stand-alone credit profile because we consider AP3's holding in Hemsö as strategically important with a high likelihood of group support. Hemsö is 85% owned by AP3, which has the option to acquire the remaining stake of 15%, currently held by Swedish listed real estate company AB Sagax. We assess Hemsö as a strategically important holding and accordingly our ratings on it incorporate a three-notch upward adjustment to our assessment of the company's 'bbb-' stand-alone credit profile based on our group rating methodology. We understand that AP3 considers Hemsö a long-term core investment and is highly unlikely to sell it because of stable, predictable cash flows, showing limited correlation to other holdings in the portfolio, and we expect AP3 would support Hemsö in the case of financial difficulties. More precisely, based on publicly stated capitalization targets for Hemsö, AP3 is committed to inject capital if Hemsö's capitalization falls below a minimum target of 35%, which equals a maximum loan-to-value of 70%. This commitment is further demonstrated by a track record of capital contribution of SEK1 billion annually over the past three years to support Hemsö's growth strategy while maintaining leverage metrics stable. The company also holds a contractual agreement whereby AP3 commits to subscribe to commercial paper of up to SEK5 billion should Hemsö fail to access the capital markets. We further understand that financial covenants in Hemsö's loan agreements indicate that AP3 is committed to remain Hemsö's majority shareholder.

Outlook

The stable outlook reflects our view that Hemsö will continue to generate strong and predictable cash flows, benefiting from its resilient asset segments with a large share of public-sector tenants. We anticipate the company to continue to expand its portfolio in line with its growth strategy, while at the same time exhibiting financial discipline. We expect LFL rental income will increase 1.5%-2.0% in the next 12- 24 months and our adjusted ratio of debt-to-debt plus equity to remain well below 65%. We also forecast an EBITDA interest coverage ratio of above 4.5x and debt to EBITDA to remain close to 16x.

The stable outlook also includes our view that Hemsö will remain strategically important to AP3.

Downside scenario

We could lower the rating if the company were to fail to deleverage, with adjusted debt to debt plus equity to remain at 65% or above. This could occur, for instance, due to lower-than-expected asset revaluation or any debt-funded investments. We could also lower the rating if EBITDA interest coverage falls toward 1.8x or below or if the ratio of debt to annualized EBITDA materially differs from our forecast. A deterioration in the company's liquidity assessment could also affect the rating negatively.

We could also consider lowering the rating on Hemsö if there is a change in AP3's commitment toward their investment in Hemsö, which could lead us to revise our view of Hemsö's support from its main shareholder.

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, implying a debt to debt plus equity sustainably well below 55% and debt to EBITDA falling toward 13.0x or below, with EBITDA interest coverage remaining solidly above 4.0x. This could stem from a stronger-than-anticipated portfolio revaluation or equity-financed acquisitions. That would also assume no change in the shareholder's strategy or commitment toward Hemsö.

Company Description

Hemsö is one of the largest private owner of public service properties in Sweden. It became an independent company in 2009 as a sprung of from Kungsleden, which divested its stake in it to AP3. Hemsö is 85% owned by AP3 and 15% by AB Sagax.

As of June 30, 2021, Hemsö owned 421 properties with a market value of about SEK69.6 billion. The property portfolio is divided into four categories: nursing homes (39%), education (31%), health care (17%), and premises for the legal sector and justice system (13%).

Our Base-Case Scenario

In our base-case scenario, we assume the following:

- LFL rental growth of 1.5%-2.0%, mainly based on our inflation expectations in the company's regions of operations (mainly Sweden, Germany, and Finland).
- A sustained high occupancy rate of 97%-98% in the next 24 months, reflecting strong anticipated demand for Hemsö's properties.
- Capital expenditure (capex) of SEK3.5 billion-SEK4.5 billion per year in 2021 and 2022, including expenditure for development projects. In addition, we forecast portfolio acquisitions of about SEK3 billion and less than SEK1 billion in 2021 and 2022, respectively.
- A 5% positive portfolio revaluation in 2021 with slightly less in 2022, mainly based on the company's first-half 2021 reported revaluation and our expectations of further positive price development.
- Dividend payments of close to SEK1 billion annually, in line with the company's dividend policy and strategy.
- Stable average cost of debt of 1.2%-1.3%.

Based on these assumptions, we arrive at the following credit measures over the next 12-24 months:

- EBITDA to interest coverage of above 4.5x;
- Adjusted debt to debt plus equity at 61%-62%; and
- Debt to EBITDA of close to 16.0x.

Liquidity

Our assessment of Hemsö's liquidity profile as adequate is supported by the company's access to committed bank lines. We forecast that liquidity sources will exceed funding needs by 1.2x over the next 12 months.

Principal liquidity sources as of June 30, 2021, include:

- Unrestricted cash and equivalents of SEK519 million;
- About SEK11.5 billion of committed undrawn revolving credit facilities, maturing in more than 12 months.
- Our forecast of cash funds from operations of about SEK2.1 billion for the next 12 months;
- Committed asset sales of SEK2.0 billion; and
- Committed equity injection of about SEK1.0 billion to be drawn in third-quarter 2021.

Principal liquidity uses over the same period include:

- Short-term debt maturities of about SEK9.0 billion, including commercial paper;
- Committed acquisitions of SEK296 million;

- Committed capex of about SEK2.90 billion; and
- Dividends of about SEK1.06 billion.

Covenants

Hemsö has covenants under its bank debt and credit lines. We understand that the headroom under these covenants is adequate, at more than 10%. We expect the company to maintain sufficient headroom under all financial covenants.

Requirements

Main financial bank covenants for Hemsö include:

- A loan-to-value ratio of 70% (it was 60.1% as of June 30, 2021)
- Interest coverage ratio above 1.5x (5.3x as of June 30)
- Secured debt to total assets below 40% (0% as of that date)

Issue Ratings - Subordination Risk Analysis

Capital structure

As of June 30, 2021, Hemsö's capital structure comprised SEK43.1 billion of reported debt to which the majority is senior unsecured bonds (SEK33.7 billion), SEK4.9 billion of commercial paper, and the rest in loans European and Nordic banks.

Hemsö has bonds outstanding under holding company Hemsö Fastighets AB and financing vehicle Hemsö Treasury Oyj.

Analytical conclusions

We equalize our issue rating on the company's senior unsecured bond with the issuer rating because the share of secured debt is less than 40% of its total assets (0% as of June 30).

Ratings Score Snapshot

Issuer Credit Rating: A-/Stable/A-2

Business risk: Strong

- Country risk: Very low
- Industry risk: Low
- Competitive position: Strong

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb-

- Entity status within group: strategically important (+3 notches from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

************* **Hemso Fastighets AB** *************		
Ratings Affirmed; Outlook Action		
	To	**From**
Hemso Fastighets AB		
Issuer Credit Rating	A-/Stable/A-2	A-/Watch Neg/A-2
Nordic Regional Scale	K-1	K-1/Watch Neg

**************** Hemso Fastighets AB ***************

Ratings Affirmed; Outlook Action		
	To	From
Hemso Fastighets AB		
Hemso Treasury OYJ		
Senior Unsecured	A-	A-/Watch Neg