

Research Update:

# Swedish Property Company SBB 'BBB-' Rating Affirmed Following Independent Audit; Outlook Remains Positive

April 14, 2022

## Rating Action Overview

- Following the publication of several short-seller reports by Viceroy Research on Samhällsbyggnadsbolaget (SBB), the company has responded to the allegations and its independent auditors have performed an extensive review of all the issues raised.
- We understand the auditors found no material deficiencies or irregularities. That said, we will continue to monitor any developments or issues that could harm SBB's standing in the credit financial markets.
- We anticipate that SBB will continue to generate stable cash flow thanks to high demand for its resilient asset portfolio. We expect the company to expand the business at a moderate pace and in line with its financial policy.
- We affirmed our 'BBB-' issuer credit rating on SBB. We also affirmed our 'BBB-' issue rating on the senior unsecured debt and our 'BB' issue rating on the subordinated hybrid instruments.
- The outlook remains positive, reflecting our view that we could raise the ratings on SBB within 12 months if its S&P Global Ratings-adjusted debt to debt plus equity drops well below 55% on a sustainable basis and its interest cover ratio and debt to EBITDA improve in line with our base-case expectations.

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## Rating Action Rationale

**Following the publication of SBB's annual report, the external audit by Ernst & Young has revealed no material deficiencies or irregularities on governance aspects, related-party transactions, and valuations.** SBB released its annual report on April 6, 2022. We understand that the auditor, represented by Ernst & Young, has performed an extensive audit for the 2021 year-end report. This audit involved additional and senior resources, reviewing major transactions over the past two years and performing a shadow valuation on a large part of the portfolio. We understand the review revealed no deficiencies in governance structure, related party dealings,

valuations, and third-party transactions. Furthermore, we understand that SBB's portfolio has been assessed by five third-party appraisers (Savills, Newsec, Cushman & Wakefield, JLL, and Collier), and that EY has confirmed the external valuers' independency from SBB.

**Although we consider that some aspects of SBB's corporate governance structure do not follow best practices, we note that most of them are not uncommon for the Nordic markets.**

In our view, the company is heavily reliant on its founder and CEO, Mr. Ilija Batljan, who has a key role in managing and running the business and owns 31.5% of the voting rights and 8.0% of the share capital as of December 2021. We think such corporate structures have a higher risk of conflicts of interest arising between stakeholder groups than other listed companies with highly diversified shareholder structures and independent management teams. We note, however, that this is a common feature in Nordic corporate structures, where executives from the management team are often also significant shareholders, such as Fastighets AB Balder (where CEO Mr. Erik Selin owns 36.4% of share capital and 49.9% of voting rights). We consider that the presence of ordinary shares carrying different share classes and voting rights is not best governance practice because it creates a misalignment between ownership and voting rights, which can also be a source of conflict of interest. That said, we note that SBB is not an outlier in this regard, since it is common among listed corporates in the Nordics to carry different voting rights. Historically, this differentiation was assigned to allow founders to keep control over their companies.

**SBB had a material portfolio revaluation in 2021, primarily due to yield compressions and property management, but our forecasts for future value uplift prospects remain conservative in the wake of rising interest rates.**

SBB's high-value uplift totaled Swedish krona (SEK) 20.6 billion (corresponding to about 20% value growth) in 2021. In our view, this partly stemmed from the material yield compression in the sector for public services properties and residential assets. We note that SBB's yield compressed by 50 basis points (bps) to 3.8% in 2021 from 4.3% in 2020, which is line with what we observe for our other rated peers such as Willhem AB (-40bps), Hemsö Fastighets AB (-50bps), and Heimstaden Bostad AB (-71bps on Swedish operations)].

We think the additional value uplift compared to peers (Willhem reported a 15.6% fair value adjustment growth and Hemsö and Heimstaden reported growth of 12.5% and 9.0%, respectively, for their Swedish operations) is mainly attributed to project development and building rights, as well as gains on disposals and positive rental uplift. On absolute levels, we consider that SBB's valuation of SEK29,425 per square meter for its community service properties is lower than Hemsö's SEK34,147 per square meter because SBB has a lower share of properties located in metropolitan areas and larger cities. In line with other rated real estate peers, SBB engages with third-party appraisers, and we understand these appraisers conduct fair value adjustments every quarter. Our forecasts for 2022 and 2023 are more reserved in terms of value uplift, given the current environment with rising interest rates. That said, we project some future valuation uplift from SBB's project development. As of Dec. 31, the company holds a building right portfolio with 3.2 million square meters of gross floor space area, valued at SEK1,320 per square meter. Progression of new planning decisions and zoning plans will generate some further value creation, in our view. In addition, we anticipate that SBB will continue to refurbish about 600 units per year, in line with its targets. Given below-market leases of SEK1,089 per square meter on average for the residential assets at year-end 2021 and rent of SEK1,868 per square meter for new production (Statistics Sweden 2021), we consider it likely SBB will generate a positive cash flow effect post refurbishment.

**We anticipate that SBB will continue to pursue its growth strategy in the community service properties and regulated residential sector, albeit at a slower pace, and we expect the company will improve its credit metrics over 2022-2023.**

The positive outlook reflects our view that SBB's credit metrics should continue to strengthen over the next 12 months, primarily due to improved cash flow generation from recent acquisitions as well as some further contribution from property management. Adjusted debt to debt plus equity stood at 53.8% on Dec. 31, 2021 versus 52.5% on Dec. 31, 2020, including our adjustments for hybrid bonds, which we treat as 50% debt and 50% equity. We note, however, that the ratio returned above 55% during 2021 as a result of acquisitions during the first half of the year, standing at 56.1% as of June 30, 2021. Interest coverage also improved to 3.0x at year-end 2021 from 2.7x at year-end 2020, thanks to enhanced earnings and a low average cost of debt of 1.1%. We forecast adjusted debt to debt plus equity at 52%-54% over the next 12-24 months, and improved EBITDA interest coverage sustainably above 3x, supported by increasing cash flows from recent acquisitions and an average interest rate of 1.6%-1.7% for the senior debt (excluding hybrids). We also anticipate the company's debt to EBITDA to improve toward 16x-17x on an annualized basis over the same period, albeit constrained to some extent by the recent yield compression. Rating upside hinges on the company maintaining prudent financial discipline such that its ratios continue to improve and stay at stronger levels in the long term.

**We think SBB's liquidity and funding profiles should remain adequate over the next 12 months, but we will closely monitor its upcoming maturities in 2023 and standing in the financial markets because spreads have recently increased.**

The company's debt repayments for the next 12 months total SEK13.3 billion and mainly relate to SEK7.8 billion of commercial paper. We understand the company intends to roll over existing maturities with short-term debt. SBB also has SEK8.2 billion of cash and cash equivalents and SEK12.5 billion available under its committed undrawn backup facility as of Q4 2021. However, the company has material debt maturities of SEK13 billion in 2023 and we will monitor how it addresses these in the coming months given current challenging conditions in the financial markets, since SBB's credit spreads have materially widened over the past couple of months. Any rise in interest rates may also put pressure on refinancing and weaken credit ratios.

**We continue to apply one downward notch to the issuer credit rating given SBB's acquisitive profile, which has resulted in some volatility in the company's credit metrics.**

This reflects the company's limited track record of maintaining improved leverage ratios and managing risks related to its growth strategy compared with other higher-rated real estate peers with more stable portfolios. SBB has expanded significantly in the past few years with a series of transformative acquisitions. However, we note a limited track record of stable operations due to the large amount of acquisitions and disposals over the past few years. In 2021, the level of acquisitions and disposals was very material, which makes it more challenging to track progress and could result in nonrecurring costs.

## Outlook

The positive outlook reflects our view that we could raise the ratings on SBB within the next 12 months if its adjusted debt to debt plus equity remains well below 55% on a sustained basis, and its interest cover ratio and debt to EBITDA improve to sustainably above 3.0x and 15x-16x, respectively, reflecting the company's commitment to its financial policy.

At the same time, we would expect SBB to continue to expand its portfolio in line with its growth

strategy, while also exhibiting financial discipline. An upgrade would be contingent on SBB successfully establishing an operational and financial track record as well as maintaining good access to capital markets, including a recovery in its bond trading.

Our outlook also reflects our expectations of continued favorable market fundamentals for SBB's portfolio, supporting cash flow generation via high demand in its resilient asset segments, community service properties, and midrange residential apartments, where demand will exceed supply trends.

## **Downside scenario**

We could revise the outlook to stable if the company fails to reach its leverage targets of debt to debt plus equity of well below 55% on a sustained basis. This would most likely occur following higher-than-expected debt-financed acquisitions or investments, or if its operating performance is materially weaker than we forecast.

We could also revise the outlook to stable if EBITDA interest coverage does not remain above 3.0x on a sustainable basis or if debt to annualized EBITDA is materially higher than our forecast. In addition, we would view negatively further unforeseen events that affect the company's operating performance or harm its overall credit risk profile. An inability to access financial markets for refinancing needs would also result in a negative rating action.

## **Company Description**

SBB is one of the largest listed real estate companies in the Nordics and has a portfolio value of SEK149.3 billion (€14.9 billion as of December 2021). SBB mainly invests in community service properties (60% of total portfolio value) and Swedish regulated residential properties (35%). The company also owns other properties (5%), mainly commercial assets with identified development potential, for which it seeks to obtain building rights to sell the assets afterward. The portfolio is in the Nordic region, with 75% in Sweden. The company also has operations in Norway (17%), Finland (7%), and Denmark (1%).

## **Our Base-Case Scenario**

### **Assumptions**

In our base case, we assume:

- Annual like-for-like rental income growth of 2%-3% for SBB's properties in the next two years.
- Stable occupancy rate of 97%-98%, reflected in strong anticipated demand.
- An improvement in the EBITDA margin to 65%-68% for the next 12-24 months, primarily reflecting a higher contribution of dividend from its joint venture (JV) and associates, as well as some synergies and lower administration costs.
- Like-for-like overall portfolio revaluation of 2.0%-2.5% for 2022-2023, supported by sound demand and limited supply features in SBB's markets. We also factor in additional uplift from property development.
- Annual capital expenditure (capex) of SEK4.5 billion-SEK5.0 billion in the next 12 months, including development projects (a mix of JVs, turnkey business, direct development, and

capitalized maintenance, in line with the company's strategy.

- Continued portfolio expansion and positive net investments.
- Average costs at about 1.6% excluding the outstanding hybrid instrument.

## **Key metrics**

Based on these assumptions, we arrive at the following credit measures over the next 12-18 months:

- EBITDA to interest coverage above 3.2x-3.4x from 2022, compared with 3.0x as of Dec. 31, 2021;
- Adjusted debt to debt plus equity remaining at 52%-54% in 2022, with marginal further improvement in 2023; and
- Debt to EBITDA of 17x-19x, including the full-year effect of recent acquisitions.

## **Liquidity**

We assess SBB's liquidity as adequate. We anticipate that liquidity sources will likely cover liquidity uses by more than 1.2x for the 12 months from Dec. 31, 2021. SBB's cash balances and SEK12.7 billion revolving credit facility (RCF) enhance the company's liquidity position. We assume SBB will continue to renew its short-term line of credits, as it has done in the past. We exclude disposals and acquisitions from our analysis because they are not committed.

We note that the credit spreads of SBB's bonds have materially widened in the past few months and we will monitor SBB's access to financial markets for refinancing purposes.

We expect principal liquidity sources for the 12 months from Dec. 31, 2021 will include:

- SEK9.5 billion in available unrestricted cash;
- The SEK12.7 billion RCF with a maturity of more than 12 months; and
- Funds from operations of SEK3.5 billion-SEK4.0 billion.

We expect principal liquidity uses over the same period will include:

- SEK13.3 billion of contractual debt amortization payments, of which we understand SEK7.8 billion refers to commercial paper;
- Dividends of about SEK2.6 billion; and
- Capex of SEK4.5 billion-SEK5.0 billion, although we understand most of it is not committed.

## **Covenants**

We understand that SBB needs to comply with covenants for its existing bond issuances and credit lines. We estimate that the headroom under these covenants is adequate, at more than 10%.

## Issue Ratings - Subordination Risk Analysis

### Capital structure

As of Q4 2021, SBB's capital structure comprised interest-bearing liability amounting to SEK87.995 billion in the form of traditional bank loans (about SEK23.7 billion), senior unsecured bonds (SEK53.1 billion), commercial paper (SEK11.2 billion), and hybrid bonds (SEK17.3 billion). At Dec. 31, 2021, the proportion of interest-bearing liabilities with fixed interest was 74%, with an average debt maturity of 4.1 years.

### Analytical conclusions

We rate SBB's senior unsecured bonds in line with the 'BBB-' issuer credit rating given the limited portion of secured debt (secured debt to total assets was 12% as of Q4 2021). We think the ratio will remain below our threshold of 40%. We rate the subordinated hybrid notes 'BB', two notches below the issuer credit rating, as per our approach for hybrid capital.

## Ratings Score Snapshot

### Ratings Score Snapshot -- Samhallsbyggnadsbolaget i Norden AB (publ)

Issuer Credit Rating	BBB-/Positive/A-3
Business risk:	Strong
Country risk	Very Low
Industry risk	Low
Competitive position	Strong
Financial risk:	Significant
Cash flow/leverage	Significant
Anchor	bbb
<b>Modifiers:</b>	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Fair
Comparable rating analysis	Negative (-1 notch)
Stand-alone credit profile:	bbb-

### ESG credit indicators: E-2, S-2, G-3

## Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

## Related Research

- Samhallsbyggnadsbolaget i Norden's 2021 Results Show Sustained Credit Metrics Amid High Asset Rotation, Feb. 28, 2022
- Samhallsbyggnadsbolaget i Norden AB Outlook Revised To Positive; 'BBB-' Ratings Affirmed, March 1, 2021

## Ratings List

### Ratings Affirmed

#### Samhallsbyggnadsbolaget i Norden AB (publ)

Issuer Credit Rating	BBB-/Positive/A-3
Senior Unsecured	BBB-
Subordinated	BB
Commercial Paper	A-3

#### SBB Treasury OYJ

Senior Unsecured	BBB-
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