

Research Update:

SBB 'BBB-' Rating Affirmed And Removed From CreditWatch After Allegations Withdrawn, Disposal Progress; Outlook Stable

June 10, 2020

Rating Action Overview

- Samhallsbyggnadsbolaget i Norden (publ)'s (SBB's) CEO Ilija Batljan is no longer facing an investigation regarding insider dealing and the allegations have been withdrawn.
- In our view, this means the case will have a limited effect on SBB's management and operations including its asset-disposal program and relationships with municipalities,.
- We now anticipate that SBB will be able to continue its disposal plan in 2020, resulting in our adjusted debt-to-debt-plus-equity ratio falling below 60% on a sustainable basis, from 64.6% in first-quarter 2020, over the next six months.
- We are therefore affirming the 'BBB-' long-term issuer credit and issue ratings on the company and its senior unsecured debt and removing them from CreditWatch, where they were placed with negative implications on May 8.
- The stable outlook reflects our view that SBB's properties should benefit from high demand in resilient segments, including community services and regulated residential, thanks to favorable demographic trends and housing shortages in the Nordics.

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Rating Action Rationale

We consider the recent allegations against the CEO of SBB to have a limited effect on the management and operations of the company, including the asset disposal program and relationships with municipalities. This is supported by the disposal transactions that SBB has executed in recent weeks despite challenging market conditions, and the signing of new lease contracts with municipalities, including a recent contract with the Swedish Police Authority to build a 3,500-square-meter (sqm) police station in Sälen. Notably, SBB was not part of the investigation, with allegations directed toward the CEO only. In our view, recent events show limited damage from a reputational perspective given SBB's focus on public tenants, where we understand eligibility requirements may be quite stringent. We still believe SBB is heavily reliant

on founder and CEO Mr. Batljan, who has a key role in managing and running the business. In addition, he still owns 8.9% of the share capital and has 33.8% of the voting rights. However, we understand that SBB aims to have adequate governance standards in place, with a well-established management team, and that the board operates effectively, with five independent members out of seven in total. In our base case, we currently do not anticipate any material disruption stemming from management and governance issues and we will continue to monitor any unforeseen events and update our rating analysis if necessary.

We expect improving credit metrics primarily on the back of asset disposals. Based on first-quarter 2020 figures, our adjusted debt to debt plus equity reached 64.6% as a result of the completion of the Hemfosa acquisition. This corresponds to a reported loan-to-value (LTV) of 50% over the same period, with the difference partially coming from our treatment of the hybrid instrument. We understand that the company is aiming to dispose of at least Swedish krona (SEK) 10 billion in assets this year, mainly to deleverage its capital structure. So far, SBB has secured SEK5.7 billion of property sales in 2020 (most closed post first-quarter 2020) and is currently working on additional transactions to be announced in the short term. We acknowledge that SBB has finalized deals under challenging market conditions, given transaction activity has remained muted and financing difficult to obtain on the back of the COVID-19 pandemic. Properties divested comprised a mix of residential, office, and community service assets including assets related to the withdrawn transaction with Nyfosa. We believe there is strong demand for SBB's stable-yielding assets with long leases, which is indicated by purchasing prices exceeding book value for first-quarter 2020 and the Hemfosa valuation in third-quarter 2019 by mid-single and double-digit percentages respectively. In addition, we notice the COVID-19 pandemic has had a limited effect on the company's operations. Rent collection in May was above 99%, with deferred rents of SEK12 million and rent discount referrals of SEK1 million year-to-date from total rental income of SEK1.3 billion in first-quarter 2020. This demonstrates that cash flows are only marginally affected by external factors or the economic cycle, since they mainly come from public tenants and/or regulated residential properties.

As a result, we anticipate that the company will be able to execute its disposal plans this year.

This will mean a decline in debt to debt plus equity to below 60% (57%-58%) on a sustainable basis within the next six months. Furthermore, we believe that the reduction in overall leverage, combined with the cash flow contribution of recent acquisitions, will likely improve EBITDA interest coverage to well above 2.4x for 2020, from 2.0x for the 12 months ended March 31, 2020, including our adjustments for the hybrid capital. Due to refinancing activities in the beginning of the year, primarily on the euro bond market, the cost of debt improved to 1.5% at the end of the first quarter from 1.8% at year-end 2019. We understand that SBB's management will remain committed to its financial policy and achieving a reported net debt in relation to total assets of well below 50% over the short term.

With the successful closing of the Hemfosa acquisition, SBB improved its market position in niche community services properties, becoming one of the largest listed real estate players in the Nordics. We are revising upward our assessment of SBB's business risk profile to strong from satisfactory because we consider its scale and size have improved, as well as its cash flow stability, in line with other rated peers of the same category such as Dutch residential landlord Vesteda or German residential player Grand City Properties. The Hemfosa acquisition has led to a significantly larger portfolio of about SEK80.2 billion, compared with SBB's SEK30.8 billion on a stand-alone basis in third-quarter 2019. Including the anticipated asset disposals, we expect the company's portfolio to mature at about SEK75 billion at year-end 2020. We consider that the

transaction has improved SBB's scale, scope, and diversity, with the number of assets increasing to 1,342 units as of first-quarter 2020 from 842 as of third-quarter 2019 and the leasable area to 4,180 sqm from 1,795 sqm. It also enhanced the portfolio's geographical footprint, since the combined group has a stronger presence in Sweden (76%), Norway (15%), Finland (8%), and Denmark (1%) as of first-quarter 2020, with 66% of the property portfolio located in larger Nordic cities such as Stockholm, Gothenburg, Malmö, Helsinki, and Oslo. We continue to assess the fundamentals of the community services property market as very favorable. This stems from the robust demographic dynamics, with an expanding population, higher share of elderly people, limited new supply of social infrastructure properties, and high credit quality of tenants. Overall, the combined group will benefit from a high occupancy rate above 95% and long leases averaging seven years, given turnover at renewal is very limited in this asset class.

The current rating includes a one-notch downward adjustment for our comparable analysis.

This reflects the company's relatively weak positioning within our financial risk profile as well as its smaller absolute cash flow base compared with other rated investment-grade peers. Compared with 'BBB'-rated peers, SBB's leverage remains at the weaker end of the significant category, notably with our forecast of above 55% debt to debt plus equity for 2020 and 2021. In addition, SBB has gone through a series of transformative acquisitions in the past few years, significantly extending its portfolio primarily through properties for public use, yet it has a limited cash flow and earnings base. Consequently, the track record in terms of operational performance and portfolio cash flow potential is limited. We also view the business risk position at the weaker end of strong, given the scale, scope, and diversity of the portfolio remains more limited than other real estate companies we rate in the same category in the Nordics, such as Akelius Residential Properties (€11.8 billion), Balder (SEK149.0 billion), or Heimstaden (SEK131.0 billion) as of first-quarter 2020. SBB will still face some geographic concentration risk as all its activities are in the Nordics, while peers such as Akelius and Heimstaden are diversified internationally.

Environmental, social, and governance (ESG) credit factors relevant to the rating action:

- Strategy, execution, and monitoring
- Governance factors

Outlook

The stable outlook reflects our anticipation that SBB's portfolio should benefit from high demand in its resilient asset segments, supporting cash flow generation. We expect like-for-like rental income will increase by approximately 1.5%-2.0% in the next 12-to-24 months. Over the next six months, we expect SBB to continue its asset-disposal program and exhibit financial discipline, with the debt-to-debt-plus-equity ratio declining to below 60% (including our adjustments for the hybrid capital) on a sustainable basis. We also project SBB's EBITDA interest coverage will increase to well above 2.4x.

Downside scenario

We could lower the rating if the company fails to reach its leverage targets, translating into S&P Global Ratings-adjusted debt to debt plus equity remaining above 60%. This could occur due to slower-than-anticipated asset disposals or materially weaker operating performance. We could also take a negative rating action if EBITDA interest coverage did not improve to more than 2.0x or

if the ratio of debt to annualized EBITDA materially differs from our current forecast.

In addition, we would view negatively further unforeseen events that affect the company's operating performance or harm its overall credit risk profile.

Upside scenario

We could raise the rating if SBB's financial policy became commensurate with higher-rated peers in the 'BBB' category. This would result in debt to debt plus equity staying firmly well below 55%, EBITDA interest coverage strengthening to 3x or higher, and debt to EBITDA declining toward 13x or below, with the company maintaining a sizable portfolio of resilient asset classes in favorable locations.

An upgrade would also be contingent on SBB successfully integrating recent acquisitions with anticipated synergies and establishing an operational track record with a maturing portfolio, resulting in a good visibility and predictability of cash flows.

Company Description

SBB is one of the largest listed real estate companies in the Nordics with a portfolio value of SEK80.2 billion (€7.6 billion as of March 2020). SBB invests mainly in commercial service properties (77% of total portfolio value) and Swedish regulated residential properties (17%). In addition, the company owns other properties, mainly commercial assets, with identified development potential (6% of portfolio value), on which it seeks to obtain building rights to be sold afterward. The portfolio is located in the Nordic region with 76% in Sweden. The company recently entered into two new markets: Finland (in 2018) and Denmark (in 2019).

Our Base-Case Scenario

Assumptions

In our base case we assume:

- Annual like-for-like rental income growth of 1.5%-2.0% for SBB's properties.
- A slight improvement in EBITDA margin to 58%-59% for the next 12-24 months following synergies from the acquisition.
- About 3% like-for-like overall portfolio revaluation for 2020 and 1% revaluation for 2021, supported by sound demand and limited supply features in SBB's markets.
- Annual capital expenditure (capex) of SEK650 million-SEK850 million in the next 12 months, including development projects (mix of joint ventures, turnkey, and direct development) as well as capitalized maintenance, mainly invested in its Swedish property portfolio, in line with the company's strategy.
- Material asset disposals in the next six months and more modest acquisition plans. We assume disposals of about SEK10 billion for 2020, and about SEK2 billion for 2021.
- Average cost of debt to remain stable 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 of about 3x, compared with 2.0x for the 12 months ended March 30, 2020.
- Adjusted debt to debt plus equity of 57%-58% in 2020, with marginal further improvement in 2021 compared with 64.6% at first-quarter 2020.
- Debt to EBITDA of about 15x, including the full year effect of 2019 acquisitions.

Liquidity

We assess SBB's liquidity as adequate, based on our estimate that the company's liquidity sources will likely cover uses by more than 1.2x in the 12 months starting March 31, 2020. SBB's high cash balances and recent SEK2.0 billion increase in the revolving credit facility (RCF) to SEK9.1 billion enhance the company's liquidity position.

We currently assess that available sources should comfortably cover uses of liquidity. However, our liquidity assessment is currently limited at adequate, mainly given SBB's standing in the credit markets in still challenging conditions.

Principal liquidity sources include:

- SEK4.6 billion in available unrestricted cash including cash at the Hemfosa level.
- The SEK7.1 RCF with a maturity of more than 12 months.
- Our estimate of funds from operations of about SEK1.7 billion.
- Committed asset sales of SEK4.3 billion.
- SBB recently increased the RCF by another SEK2 billion.

Principal liquidity uses include:

- SEK6.3 billion of contractual debt amortization payments, of which we understand SEK3.3 billion has already been repaid.
- Dividends of about SEK940 million.
- Capex of SEK815 million, 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 first-quarter 2020, SBB's capital structure consisted mainly of senior unsecured bonds (SEK32.8 billion), traditional bank loans (about SEK15.2 billion), commercial paper (SEK4.3 billion) and hybrid bonds (SEK10.3 billion). At March 31, 2020, the proportion of interest-bearing liabilities with fixed interest was 95% with an average debt maturity of 4.3 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 17% as of first-quarter 2019). We believe the ratio will remain below our threshold of 40%.

The subordinated hybrid notes are rated 'BB', two notches below the issuer credit rating, as per our approach for hybrid capital.

Ratings Score Snapshot

Issuer Credit Rating: BBB-/Stable/A-3

Business risk: Strong

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

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers

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

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Swedish Real Estate Company SBB Assigned An 'A-3' Short-Term Issuer Credit Rating, May 22, 2020
- Swedish Property Company Samhallsbyggnadsbolaget i Norden 'BBB-' Rating On CreditWatch Negative After Governance Concern, May 8, 2020

Ratings List

Ratings Affirmed; Outlook Action

| | To | From |
|---|-----------------|--------------------|
| Samhallsbyggnadsbolaget i Norden AB (publ) | | |
| Issuer Credit Rating | BBB-/Stable/A-3 | BBB-/Watch Neg/A-3 |
| Senior Unsecured | BBB- | BBB-/Watch Neg |
| Subordinated | BB | BB/Watch Neg |
| Commercial Paper | A-3 | A-3/Watch Neg |

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