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Research Update:

Swedish Property Company SBB Affirmed At 'BBB-' On Announced Strategic Deal With Brookfield; Outlook Remains Negative

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Rating Action Overview

- Samhällsbyggnadsbolaget i Norden (SBB) has announced it has sold a 49% stake in a newly formed entity (EduCo), which owns SEK44.9 billion of public education assets, to Brookfield for a cash consideration of about SEK9.2 billion, with additional proceeds of up to SEK1.2 billion should further targets be met.
- We believe the transaction, if it materializes as expected, should have a positive impact on SBB's leverage ratios and liquidity position, since the company will use the cash proceeds to repay debt over the next 12-24 months.
- Yet we are mindful of current challenging conditions in the real estate markets and SBB's elevated leverage as of third-quarter 2022, despite all transactions announced by the company in recent months before this announcement.
- We have affirmed our 'BBB-' ratings on SBB and its senior unsecured debt and our 'BB' rating on the subordinated hybrid instruments.
- The negative outlook indicates that we could lower the ratings within 12 months if SBB fails to achieve its leverage targets, causing our adjusted debt-to-debt-plus equity ratio to remain at 60% or higher or EBITDA interest coverage to fall below 2.4x for a prolonged period.

Rating Action Rationale

The affirmation follows SBB's announcement that it is selling 49% of its wholly owned public education property portfolio (EduCo) to an open-ended core infrastructure fund of Brookfield for SEK9.2 billion in cash. SBB intends to use the proceeds to repay outstanding debt. SBB created EduCo by transferring Swedish krona (SEK) 44.9 billion (about €4.1 billion) of its educational portfolio. We understand that the portfolio will be divested at a slight discount of 2.7% to the book value, measured on the gross price, and SBB has the possibility to obtain additional earnouts should certain financial targets be met. EduCo's financing structure comprises about SEK6.9 billion of outstanding external bank loans attached to the transferred assets and a SEK14.5 billion intercompany bank loan provided by SBB, carrying a fixed rate of 3% with a six-year tenor. SBB will manage EduCo's daily operations, governed by an asset management agreement where Brookfield will pay 1.8% of EduCo's net operating income as a management fee. Although we view the transaction as positive for SBB, with a solid partner such as Brookfield, we believe it may add complexity to SBB's corporate structure. This is because SBB will lose direct ownership over a large part of its education portfolio and its control will be somewhat constrained, although we acknowledge EduCo will be operated and managed by SBB through an asset management agreement. We view the current transaction as in line with SBB's previously stated strategy to strengthen its balance sheet, and it reduces near-term refinancing risks. We understand the proceeds will be used to pay down a bridge loan of €750 million signed in early November, which was used to buy back senior unsecured bonds and hybrid bonds totaling €500.9 million, in cash consideration for a total of €631 million in principal as of Nov. 18, 2022.

We anticipate that the transaction should improve SBB's leverage metrics, though we are mindful of risks to the sustainability of credit metrics under challenging market conditions. Pro forma the transaction, we estimate that S&P Global Ratings-adjusted debt to debt plus equity will likely fall to around 55% on closing, from 59.8% as of Sept. 30, 2022. Yet we continue to see remaining uncertainties related to the sustainability of SBB's credit metrics at this level, given volatility experienced over the last few months, primarily due to high asset rotation. In addition, we consider that potential asset-valuation declines could go beyond our base-case scenario of 5% to 10% in the next 18 months, and the possible adverse impact from other market-related developments, such as financial holdings, foreign exchange losses, and total return swaps, as the company experienced recently. On the other hand, we expect interest coverage to stay close to 3.0x in fourth-quarter 2022 (3.1x as of Sept. 30, 2022, and we project that EBITDA interest coverage will fall to 2.5x-2.6x in 2023-2024 in the context of rising interest rates, narrowing the headroom versus our 2.4x downside trigger. We anticipate that leverage, as measured by the company's debt-to-EBITDA metric, will improve toward 15x-16x on an annualized basis over the same period.

SBB's liquidity situation should strengthen after the transaction, implying limited refinancing risk over the next 12-24 months. We estimate that SBB's cash on the balance sheet should increase to SEK18.4 billion from SEK4.9 billion as of Sept. 30, 2022, including committed disposals of SEK4.3 billion that management expects to close in the fourth quarter and the cash proceeds of SEK9.2 billion as part of the transaction with Brookfield. Adding SEK7.9 billion in committed undrawn revolving credit facilities maturing beyond 12 months, we arrive at total liquidity of around SEK26 billion. Combined with estimated funds from operations of SEK3.4 billion-SEK3.6 billion per year, this should adequately cover upcoming debt maturities of SEK13.7 billion (including commercial paper and a bridge loan) and SEK16.9 billion in 2023 and 2024.

We continue to incorporate a one-notch downward adjustment from the 'bbb' anchor, given SBB's elevated asset rotation, which has resulted in some volatility of its credit metrics in recent months and adds complexity to the overall corporate structure. SBB's negative standing in our comparable ratings analysis 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 over the past few years with a series of transformative acquisitions and, in particular, over the last 12-24 months undertook substantial acquisitions and disposals, which may result in non-recurring costs and make it more challenging to track progress.

Outlook

The negative outlook indicates that there is a one-in-three chance that we would lower the ratings on SBB. Over the next six months, we expect SBB to execute on the transaction with Brookfield with the debt-to-debt-plus-equity ratio improving to around 55% (including our adjustments for the hybrid capital) providing that it closes in line with expectations. In our base-case scenario, we also project that SBB's EBITDA interest coverage will remain above 2.4x, although with limited headroom. We believe that SBB's portfolio should continue to benefit from high demand in its resilient asset segments, supporting cash flow. We conservatively expect like-for-like rental income will increase 4%-5% in the next 12-to-24 months, supported by leasing contracts of public tenants tied to inflation.

Downside scenario

We could take a negative rating action if SBB fails to achieve its leverage targets, causing adjusted debt to debt plus equity to remain at 60% or higher. This could for example occur following materially negative asset valuations of its property portfolio, beyond our current expectations; if the company continues its growth strategy, with debt-financing funding sources; if announced disposals or the transaction with Brookfield do not materialize as expected; or if operating performance is materially weaker than in our forecast. We could also lower the rating if EBITDA interest coverage falls below 2.4x or if debt to annualized EBITDA differs materially from our forecast.

We could also take a negative rating action if we see further constraints on the company's management and governance structure, including unexpected events that weaken SBB's creditworthiness.

Upside scenario

An outlook revision to stable would entail the absence of unexpected negative events. We would also revise the outlook to stable if SBB's EBITDA interest coverage stays well above 2.4x. This would imply that the company has refinanced upcoming maturities via alternative funding sources in line with other similarly rated peers. For a stable outlook, we would also assume that SBB's leverage ratios would stay well below 60%, with timely execution of disposals to address debt well ahead of their maturity dates if capital markets remain challenging. A revision of the outlook to stable would also be contingent upon SBB successfully establishing a track record of visibility and predictability of its credit metrics.

Company Description

SBB is one of the largest listed real estate companies in the Nordics and has a portfolio value of SEK154.5 billion (€15.3 billion as of Sept. 30, 2022). SBB mainly invests in community service properties (60% of the total portfolio value) and Swedish regulated residential properties (35%). In addition, the company owns other properties (5%), mainly commercial assets with identified development potential, for which it seeks to obtain building rights, to be sold afterward. The portfolio is in the Nordic region, with 76% in Sweden. In addition, the company has operations in Norway (16%), Finland (7%), and Denmark (1%).

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 Sept. 30, 2022. SBB's cash balances of SEK4.9 billion, committed disposals of SEK4.3 billion, cash proceeds from Brookfield of SEK9.2 billion, and a SEK7.9 billion revolving credit facility (RCF) enhance the company´s liquidity position. We assume that SBB will continue to renew its short-term credit lines as it has done in the past. We exclude from our analysis disposals and acquisitions, since they are not committed.

Principal liquidity sources include:

- SEK 4.9 billion of available unrestricted cash;
- Committed disposals of SEK4.3 billion;
- Cash proceeds from the Brookfield transaction of SEK9.2 billion;
- The SEK7.9 billion RCF, which matures in more than 12 months; and
- Our estimate of funds from operations of SEK3.4 billion-SEK3.6 billion.

Principal liquidity uses include:

- SEK13.7 billion of contractual debt amortization payments maturing within 12 months, of which we understand SEK2.5 billion refers to commercial paper;
- Dividends of about SEK2.6 billion; and
- Capital expenditure of SEK4.5 billion-SEK5.0 billon, 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 third-quarter 2022, SBB's capital structure comprised interest-bearing liabilities amounting to SEK95.4 billion--comprising traditional bank loans (about SEK35.7 billion), senior unsecured bonds (SEK57.2 billon), and commercial paper (SEK2.5 billion)--as well as SEK17.3 billion of hybrid bonds. As of Sept. 30, 2022, the proportion of interest-bearing liabilities with fixed interest was 80%, with the average maturity at 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 19% as of third-quarter 2022). We believe this 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-/Negative/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
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Fair
Comparable rating analysis	Negative (-1 notch)

ESG credit indicators: E-2, S-2, G-4

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: 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

- Swedish Property Company Samhallsbyggnadsbolaget Outlook Revised To Negative From Stable; 'BBB-/A-3' Ratings Affirmed, July 8, 2022
- Swedish Property Company Samhallsbyggnadsbolaget Outlook Revised To Stable From Positive; 'BBB-/A-3' Ratings Affirmed, June 9, 2022
- Samhällsbyggnadsbolaget 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
- Swedish Property Company SBB Affirmed At 'BBB-' On Proposed Acquisition Of Norwegian Peer Entra; Outlook Stable, Nov. 30, 2020

Ratings List

Ratings Affirmed	
Samhallsbyggnadsbolaget i Norden AB (publ)	
Issuer Credit Rating	BBB-/Negative/A-3
Senior Unsecured	BBB-
Subordinated	BB
Commercial Paper	A-3
SBB Treasury OYJ	
Senior Unsecured	BBB-